

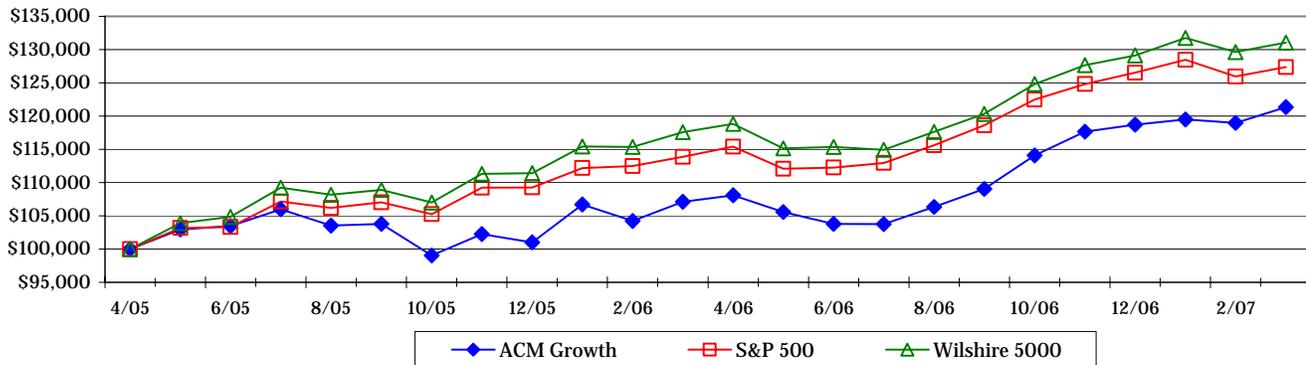


Athena Capital Management

Growth Performance

Performance as of 3/31/07	Year to date	1 year	Since inception (4/30/05)
ACM Growth	2.21%	13.27%	21.34%
S&P 500	0.64%	11.83%	27.36%
Wilshire 5000	1.49%	11.44%	31.05%

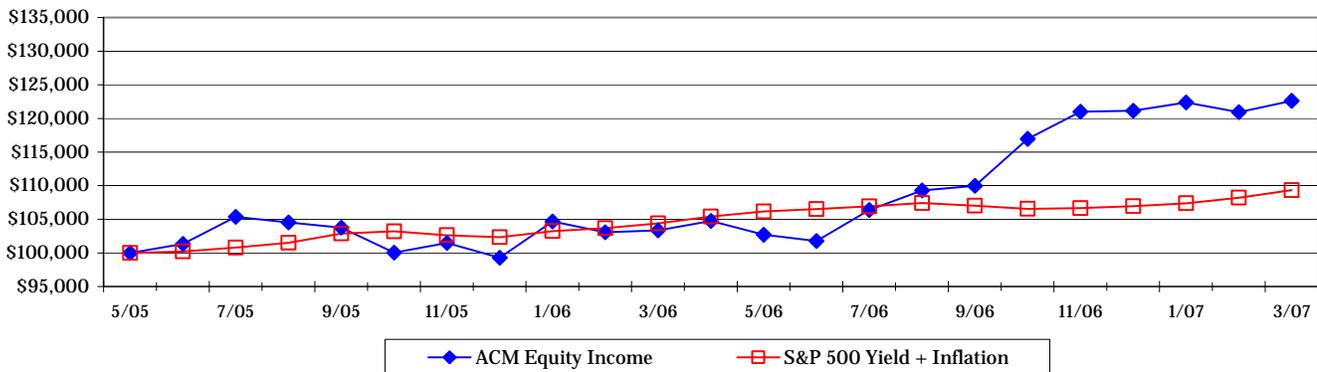
Comparison of the change in value of \$100,000 investment in ACM growth versus S&P 500 and Wilshire 5000



Equity Income Performance

Performance as of 3/31/07	Year to date	1 year	Since inception (5/31/05)
ACM Equity Income	1.22%	18.63%	22.61%
S&P 500 yield + inflation	2.23%	4.74%	9.34%

Comparison of the change in value of \$100,000 investment in ACM equity income versus S&P 500 yield plus inflation



Past performance is no guarantee of future results. As in all equity investing, there is a risk for potential loss. Performance results were calculated after deduction of all management and trading fees. Portfolios were valued daily, trade date accounting was used, accrual accounting was used for dividends. Time-weighted rates of return that adjust for significant cash flows were used. Returns from cash were included. For ACM growth accounts, the S&P 500 was used as benchmark because it was deemed the most readily available and widely known growth composite. It should be noted that ACM growth accounts were more concentrated, sometimes had higher cash investments, included international investments, and were invested in companies with different market capitalizations and characteristics than the S&P 500. Although these differences existed, the accounts shown were invested for growth and not set to achieve any particular market capitalization or exposure. ACM equity income accounts used S&P 500 yield plus inflation because this combination of the most readily available equity yield and growth with inflation was deemed the most relevant benchmark for equity income accounts. These accounts are designed to provide an equity yield for income plus growth to maintain purchasing power over the impact of inflation. Both out- and under-performance of accounts shown were due both to individual security selection and to concentration of investments. Neither market nor economic conditions contributed significantly to account performance. ACM growth and equity income portfolios include all portfolios under management during all periods of management and include portfolio performance as of the first day of management. The accounts depicted used no leverage or derivatives. The S&P 500 and S&P 500 yield plus inflation returns shown do not reflect commissions, trading expenses, or management fees, which would have reduced both benchmarks' results.



Athena Capital Management

April 18, 2007

Athena Capital has been in operation for over two years now! Building this business has been one of the most humbling and gratifying experiences of my life. What an amazing journey!



In this quarter's letter, I will describe how we are doing, what I expect from the stock market going forward, how I assemble portfolios for you, our investment in Weyco Group, why stock is such a common way to invest, and a bit about one of my heroes, Charlie Munger.

How Are We Doing?

As you can see in the graphs on page one, our accounts continue to make excellent progress.

Growth accounts have out-performed the market since 2005, over the past year, over the past 6 months and over the latest quarter, but continue to play catch-up since inception. Based on my analysis of growing underlying values, I remain confident that this catch-up will continue into the future. In contrast, income accounts under-performed this quarter, but continue to be far ahead of our benchmark. Recent portfolio moves should maintain and perhaps grow this out-performance over time.

Growth accounts generated out-performance from **Leucadia National** and **POSCO**. Leucadia (a diversified holding company) simply recovered from the downdraft caused by worries related to its purchase of an iron ore mining concern in Australia. It's up around 39% from our average purchase price. The price of POSCO (a Korean steel manufacturer, 3rd largest in the world) caught up with business value as the market recognized its strong underlying fundamentals. To put icing on the cake, Warren Buffett disclosed he owns a significant piece of the company, too.

Growth accounts' under-performers were **Comcast** and **Microsoft**. Comcast (the largest cable company in the US) pulled back on news that it will spend more money on growth than the market expected. I believe the market is being too short term oriented, here, and that the value created will greatly exceed the additional expense. Microsoft (the largest software maker in the world) declined on news that its new operating system, Vista, will not sell as many copies as quickly as the market expected. Again, I think the market's short term focus loses the long term perspective of how profitable Vista will be over time.

Equity income accounts saw out-performance from **Eastman Chemical** and **Kimco Realty**. Eastman

Chemical (a diversified chemical manufacturer) seems to have jumped after the company announced a plan to buy back more of its stock. Kimco (a real estate investment trust) moved up as fears of higher interest rates, which sent the price down 2 quarters ago, seem to have faded.

Equity income's under-performers were **USA Mobility** and **ConocoPhillips**. USA Mobility (the largest pager company in the US) sank on fears its user decline rate will be worse than the company projects. I think the company is trimming costs rapidly to maintain profitability and that its dividend is well protected. ConocoPhillips seems to have pulled back on concerns about its overseas operations. I think these concerns are overblown and that its domestic operations are well enough positioned to make up for overseas weakness.

6 Year Market Projections

The S&P 500 had a bumpy ride this quarter with one day drops of 3.5% and 2%, but still managed to finish the quarter in positive territory, up 0.64%. My view of market returns has changed little.

Projected annualized returns over the next 6 years	
S&P 500 (growth benchmark)	-6.2% to 8.0%
S&P-500-yield-plus-inflation (equity income benchmark)	3.4% to 6.4%

How did I arrive at these numbers? Visit "Free Articles" at www.athenacapital.biz to see my 7/12/05 article.

The market is facing stiff headwinds from slowing profit growth, high valuations, and difficult year-over-year comparisons. We, however, have the benefit of long term profit growth faster than the market and lower valuations. I won't predict short term performance, but I continue to be optimistic about how our investments will do relative to the market over the long run.

The interest rate picture continues to indicate a slowing economy with long term interest rates still below short term interest rates. On top of this, the housing market is starting to show negative year-over-year price comparisons, and the recent meltdown in subprime lenders is causing a tightening in credit which will further dampen that market. Protectionist measures being forwarded by both the President and Congress present another difficulty, and historic examples of such actions bode poorly for the economy. Such economic concerns may impact the stock market some time over the next few years, but they will not last, and our investments should thrive over time.



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Assembling Portfolios

In last year's letters, I talked about picking investments. Now, I'll extend that discussion to **how I take a list of investments and decide what portion of your portfolio to invest in each.** That's what I mean by assembling portfolios.

In this article, I'll describe the counter-posing forces of diversification and concentration, and why the choice between one and the other determines the results you get. If you've heard these terms and never fully grasped what was meant, I hope this discussion clarifies things for you.

What is portfolio management?

Let's suppose you're the president of Acme Pharmaceuticals. You employ 100 lab technicians and must test a list of 100 drugs for efficacy: one drug may lower cholesterol, another may reduce the impact of hay fever, one may prevent the spread of cancer, another may prevent hair loss, and so on.



How would you put your 100 lab technicians to work, and on which drugs? Would you put all 100 to work on just one drug, 25 to work on each of four drugs, or one technician on each of 100 drugs?

These are the types of questions I ask myself when I pick how much to invest in each company. Like the example above, I have 100% of your portfolio to invest and I can invest it in an unlimited number of ways. My purpose is to provide you with the best returns possible while assuming an appropriate risk level.

Probability and Impact

The difficulty in making this decision is that **some drugs will have a greater probability of working than others, and some drugs will have a greater impact than others.** And, the impact of a drug is completely independent from the probability that it will work. For example, the drug that cures cancer will have a *much* bigger impact than the drug that prevents hair loss. For that reason, you may be willing to put a lot more technicians to work on the cancer drug than the hair loss drug. Also, this would probably be the case

even if the cancer drug were much less likely to work than the hair drug, because the higher *impact* of a cure for cancer may far outweigh the lower *probability* that it works.

If you were absolutely, 100% certain the cancer drug would work, and that it would have the greatest impact, would you put 100% of your technicians on it? I would. You probably aren't 100% certain, though, **because the human body is so complex that you cannot figure out ahead of time which drug will be most effective.** Instead, you must allocate your lab technicians before knowing which drug works.

Just like the human body, the economy is an incredibly complex system. This complexity prevents perfect knowledge of future outcomes. Like with the human body, the best you can do is assign *probabilities* to outcomes, and acknowledge that some outcomes have larger *impacts* than others. For example, a cancer drug may have a 40% probability of success and an impact of saving 1 billion lives while the hair loss drug has an 80% probability of success and an impact of slightly improving the lives of 300 million people. Similarly, one investment may have a 40% probability of beating the market by 10% per year while another investment may have an 80% probability of beating the market by only 1% per year.

Diversification and Concentration

It's within this context of probability and impact that diversification and concentration become important.

Diversification is spreading your bets.

Concentration is focusing your bets. For instance, if you put 100 technicians to work on 100 drugs, then you're spreading your bets as far and evenly as possible—you're seeking diversification. In contrast, if you put all 100 technicians to work on only one drug, then you're focusing all your resources on one option—you're pursuing concentration.

By diversifying your options, you are preventing both very good and very bad outcomes. With 100 technicians working on 100 drugs, you're more likely to find at least some drugs that work. The problem is time: just one technician working on one drug may take a *very* long time to produce results. Diversifying over many options reduces your chance of failure, but at the price of dramatically reducing the impact of good outcomes.

By concentrating your options, you're allowing both very good and very bad outcomes. For instance, putting all 100 technicians to work on the cancer drug will either yield a huge success, or an utter



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failure. Total concentration allows you to focus on the best option, but with big risk.

In a field with uncertain outcomes, like investing, the best choice is some mix between diversification and concentration. Complete diversification (stocks, bonds, real estate, commodities, small cap, large cap, foreign, domestic, etc.) provides average results. If your investment manager can't beat average, then full diversification at lowest cost is the way to go. To beat average, however, you need some degree of concentration. But, concentration is a double-edged sword—you may end up below rather than above average! Concentration is a necessary, but not sufficient, condition for beating the market.

Unfortunately, in financial markets, individuals and professionals rarely beat average. I've seen statistics showing roughly 80-90% of professionals and individuals get less than average returns. This implies that many investors try to beat average by concentrating, but much fewer than half succeed because of trading costs and management fees. But, this also means that 10-20% of investors beat average, and the rewards are large enough to keep people trying.

My job as an investment manager is to find an optimal balance between diversification and concentration. I work to identify investments with high probabilities of achieving high impact returns, and then concentrate on those investments. I also increase the probability of good outcomes by doing in-depth research, thus reducing uncertainty. In next quarter's letter, I'll provide more detail on this process and why I think it works best.

Investment Spotlight: Weyco Group

Weyco Group is a men's shoe company. Specifically, it designs and markets moderately priced and better-grade men's branded footwear for casual, fashion and dress lifestyles. Its key brands include: Florsheim, Nunn Bush, Brass Boot, and Stacy Adams.



Weyco's products are sold to shoe specialty stores (like Zappos.com), **department stores** (like Macy's) **and clothing retailers** (like Men's Warehouse). The company also has a retail division

(Florsheim Shoe Shop) which consists of 34 company-owned stores in the United States, four in Europe, and an Internet business (www.florsheim.com). Further, Weyco has licensing agreements with overseas retailers and third party manufacturers who use Weyco's brands to sell apparel and accessories (like belts, wallets, socks).

Each of Weyco's shoe brands has a unique history. Milton Florsheim and his father, Sigmund, first designed and manufactured dress shoes in Chicago in 1892. William Stacy and Henry Adams founded Stacy Adams in 1875, and their shoes were especially popular during the roaring 1920's and the jazz era. Nunn Bush started in 1912 with the goal of providing shoes of style and unique comfort. Brass Boot began in 1968, delivering European design, comfort and construction.

Weyco Group was founded in 1906 as the Weyenberg Shoe Manufacturing Company. Almost 100 years later, Thomas and John Florsheim (Milton's grand and great-grand sons) were running Weyco, and not Florsheim, because Milton had sold the family brand in 1952 and they'd gone to work for Weyco instead. Amazingly enough, Thomas and John were able to return the Florsheim brand to the family by buying it for Weyco in 2002.

The men's dress shoe business has good economics. Although somewhat cyclical, it generates good returns on capital over economic cycles. Because Weyco doesn't chase fads and makes men's (rather than women's) shoes, its business tends to be relatively stable. Management owns over 16% of the business, so their interests are aligned with shareholders. I like this investment because management is competent and invested, the business is stable and generates good returns, and its small size leads to little coverage by Wall Street, so price is frequently quite reasonable.

**Why Is...
...stock such a common way to invest?**

The British East India Company became the first joint stock company in 1600. It was formed to pool the capital of entrepreneurs who were successfully trading with India by sea. Those who contributed capital to the venture were issued tradable shares of stock to represent their ownership in the venture.





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The only problem with this form of ownership was that investors were not protected from the company's losses. A joint stock company was nothing more than a very large partnership. In a partnership, each member is liable for the losses as well as gains of the company *personally*. That means that if the company goes bankrupt, creditors can pursue each shareholder's personal wealth to pay the debts of the corporation.

The ingenious British got around this problem with the Limited Liability Act of 1855. Although limited liability companies and partnerships existed before this time, this Act combined the joint stock concept with limited liability. This allowed businesses to raise capital by issuing shares of stock *and* shielded investors' personal assets from creditors.

What you think of as stock today is equity ownership with limited liability. Equity means ownership, as opposed to a loan. Equity owners have a right to the residual income of a company, which means they get the profit after all other expenses.

Not surprisingly, people were much more likely to contribute money to business ventures when they could buy partial ownership *and* they were protected by limited liability. Purchasing shares of stock allows people to put their money into several companies, thus spreading their risk. Stock became popular because of these characteristics, and is currently the largest method for businesses to raise capital from the public.

Admirable business people: Charlie Munger (1924 – present)

Charlie Munger is best known as Vice Chairman of Berkshire Hathaway and Warren Buffett's sidekick. What isn't generally known is that Munger is also an extraordinary individual and businessman in his own right.

Munger was born in 1924 in Omaha, Nebraska, to a prominent lawyer. After a brief stint as a math major at the University of Michigan and service as a weather forecaster in the Army Air Corp during World War II, Munger went to Harvard to get a law degree. He graduated magna cum laude in 1948.

Munger settled in Los Angeles and joined the firm of Wright & Garrett at \$275 a week. While there, he worked diligently for his clients, saved much of his income, and invested on the side. Munger, due to his legal profession, was exposed to opportunities to invest

directly in both industrial and real estate ventures. This taught him much about judging people and businesses.

One of Munger's early business ventures almost flopped. He helped the owner of Transformer Engineers buy out the venture capitalists who'd funded the company. Unfortunately, the buy out was done with debt and the business had numerous operational problems. Munger says, "It was a lot of struggle, a lot of nerve pain. We damned near lost everything."

Munger had better luck with real estate. He turned a shopping center in Alhambra, California into 442 one-story, own-your-own condos. He'd discovered by then that landscaping was a key to success. He says, "Lush landscaping. That's what sells. You spend money on trees, and you get it back triple. Stinting on landscaping is building malpractice."

Munger met Warren Buffett in 1959 in Omaha. Pretty soon, they were discussing investing ideas over the phone on a regular basis. Buffett tried to convince Munger to give up law and pursue investing full time. In 1962, Munger started a new law firm, Munger, Tolles (which exists to this day), and an investment partnership, Wheeler, Munger & Company.

In 1965, Munger stepped down as an active member of his law firm and spent most of his time investing. His investment partnership had a very rough ride during the mid 70's, dropping over 50% in value, but from 1962 to 1975 provided partners with 24.3% annualized returns versus 6.4% for the Dow Jones Industrial Average.

During this time, both Munger and Buffett were acquiring positions in many of the same companies. This eventually created a complex corporate structure that led Munger to close his investment partnership and become Buffett's Vice Chairman at Berkshire Hathaway. Together, Munger and Buffett grew Berkshire Hathaway into one of the greatest business success stories in modern times.



Munger is an amazing combination of independent thinker, intelligence, hard work, moral rightness and business savvy. He reads more broadly than Buffett and is more involved in social



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causes. He's a very outspoken critic of intellectual laziness, corporate malfeasance, over-compartmentalization in academia, and unscrupulous professionals. His record seems to speak for itself, but in the shadow of Buffett, few realize what an amazing mind and business talent he possesses.

To find out more about Charlie, you can read his biography, "Damned Right," by Janet Lowe, or you can read a book full of his wit and wisdom called Poor Charlie's Almanack, edited by Peter Kaufman.

Until next quarter

I've got the greatest job in the world, and the only thing that could make it better would be the realization of significant market out-performance, and finding a few more good clients. Market out-performance is my primary focus and I'm working hard at it, but I could use your help in finding more good clients. If you know anyone who could benefit from my unique approach to investing, please put them in contact with me right away!

Thank you for your business, and I look forward to hearing from you over the next quarter.

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