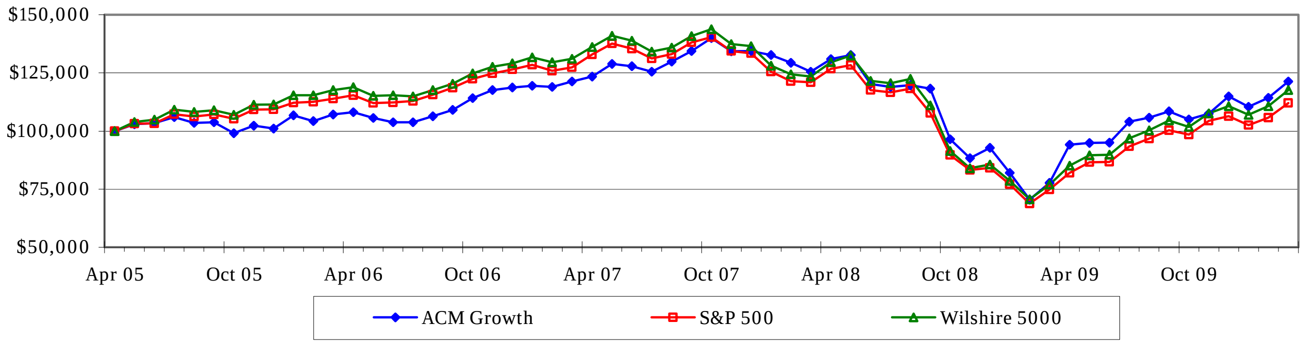
Athena Capital Management

Cumulative Growth Performance

Performance as of 3/31/10	Year to date	2 years	3 years	4 years	Since inception (4/30/05)
ACM Growth	5.60%	-3.38%	-0.06%	13.23%	21.30%
S&P 500	5.39%	-7.27%	-11.98%	-1.57%	12.10%
Wilshire 5000	6.27%	-4.66%	-10.21%	0.06%	17.67%

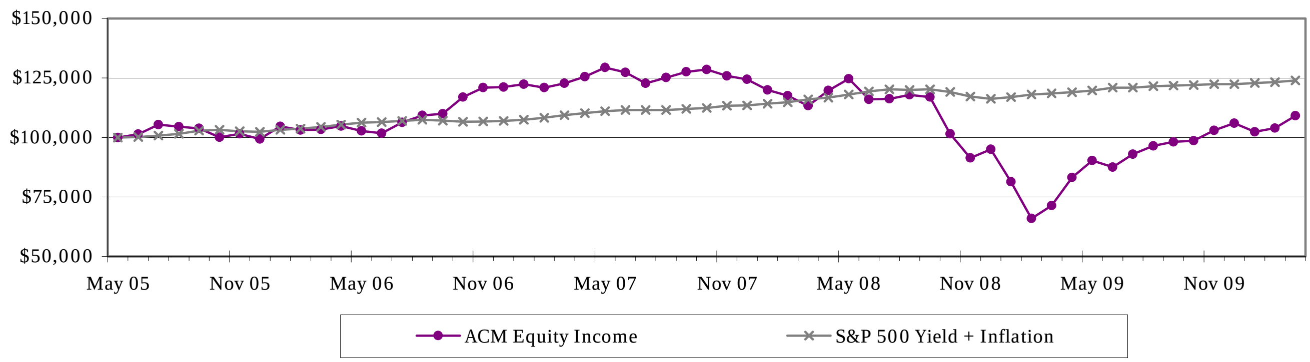
Comparison of the change in value of $100,000 investment in ACM growth versus S&P 500 and Wilshire 5000



Cumulative Equity Income Performance

Performance as of 3/31/10	Year to date	2 years	3 years	4 years	Since inception (5/31/05)
ACM Equity Income	2.95%	-3.68%	-11.08%	5.57%	9.11%
S&P 500 yield + inflation	1.27%	6.89%	13.34%	18.71%	23.92%

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 relative to benchmarks. 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 14, 2010

What a difference a year makes! Looking at our year ago letter, I asked you to hold on through the market's unpleasant roller coaster ride. In fact, I said it was "an epic opportunity to invest." That wasn't idle chatter: growth portfolios are up 56% and equity income portfolios are up 53%. Thank you for having confidence in me. I hope I've lived up to it.

In this quarter's letter, I'll cover our performance; my view on markets and the economy; why cash, bonds and emerging markets aren't the best places to invest right now—and what is; and our investment in an unloved pharmaceutical company: Pfizer.

Performance this quarter

Growth portfolios out-performed for the quarter, and over the last 1-, 2-, 3-, 4-year and since inception periods. Our portfolios grew strongly as investors turned their attention away from the "dash to trash" and back to quality companies with established franchises. Looking forward, I think we'll continue to benefit from this trend change (see Fighting The Last War below for more).

Growth's out-performance this quarter came most notably from **Sears** (again) and **Comcast.**

Sears had another outstanding quarter, up 29.9%. How can a mediocre retailer keep racking up such excellent share price performance? Because investors expect so little, but get so much. Sears generated tons of cash and surprised many with its internet sales efforts. Further, it's looking for new channels to sell its brands, like DieHard batteries that can now be bought outside Sears. Expect more innovation and upside surprises from this underdog.

Comcast climbed 11.7% this quarter as investors finally began recognizing its competitive position and cash generation. After spending decades building its cable network, Comcast is finally reaping the benefits as revenues grow and costs decline. This story is far from over because Comcast is just beginning to tap the business market and its costs have much farther to fall. I believe the Comcast story is still widely misunderstood on Wall Street, which means we'll benefit as they come to see it my way.

Microsoft and **POSCO** were growth's under-performers this quarter. As you may recall, both were out-performers last quarter, and a good bit of their small pullback came from less patient shareholders selling after the run-up.

Microsoft continues to be neglected because of the hype surrounding Apple and Google. I believe there's room for all three businesses to thrive, but that Microsoft's earnings power is the only one being grossly under-rated. Investors seem to be missing its upcoming Office release, the success of Windows 7, the upcoming commercial upgrade cycle, Bing's market share gains, its new mobile operating system, and its new gaming addition, Project Natal.

POSCO's price declined this quarter, along with most Asian markets, as fears of a China slowdown spread. If the world economy slows, POSCO's competitive position will allow it to grab market share; if the world economy doesn't slow, POSCO will benefit from rising steel prices. Either way, I think we'll win in the long run.

Equity income portfolios out-performed our benchmark over the last quarter and year, but are still playing catch up over longer periods. Our progress through the quarter was excellent, and this allowed me to hedge our portfolios' market exposure. The benefit should be a glide-path to intercept and pass our benchmark, but with less volatility than a portfolio fully invested in the stock market. Over time, this will generate smoother growth and higher yields.

Equity income out-performance this quarter came from **Comcast** and **Phillip Morris International** (see above for my Comcast discussion).

Phillip Morris was one of our laggards last quarter, but up 9.4% this quarter (including dividend). Concerns about tax increases in Japan started to fade, and investors were able to more clearly focus on its long term growth prospects and underlying cash generation. In my opinion, we can look forward to years of low double digit growth and generous dividend increases.

Equity income's under-performers were **Pfizer** and **Verizon**.

I discuss Pfizer in much more detail below in the Investment Spotlight section, but I can briefly say its price suffered as its developmental drug portfolio continues to disappoint. If such setbacks continue, we'll be repaid with dividends and share repurchases as the business downsizes. If not, Pfizer's price will surely rally when it reports successes. I like our odds.

Verizon's sin this quarter was not selling Apple's iPhone or iPad, disappointing investors who were gambling on such an announcement. Couple that with the cloud of

Vodaphone's 45% ownership of Verizon Wireless, and you have a recipe for short term under-performance. Verizon, however, will resolve its situation with Vodaphone as early as this summer, removing one cloud, and will resume generating cash from its wireline operations as it reduces capital expenditure this year, removing another. I don't believe we'll have to wait long to see the weather improve.

Market and economic outlook

The S&P 500 climbed 5.4% this quarter, a large margin over its 1.5% long term growth rate. It's nice to see high growth, but a faster than trend increases stretch valuations, thus leading to lower returns going forward. With that, I expect 6 year annualized market returns of a low 4.2%. Wanting higher returns makes it more important than ever to be valuation focused. Our portfolios are.

Projected annualized returns over the next 6 years	
S&P 500 (growth benchmark)	-1.9% to 10.2%
S&P-500-yield-plus-inflation (equity income benchmark)	3.5% to 6.5%

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

The U.S. economy grew at a more than 5% rate in the 4th quarter of 2009, and probably grew at a faster than 3% rate in the quarter just ended. Manufacturing, in particular, has been rebounding strongly. One sign is railroad traffic that has re-achieved levels last seen in late summer 2008. Another is the statistic slowest to recover from downturns: employment, which just moved into positive territory for the first time since fall 2008. There are good reasons to believe we're out of the woods.

Unless, of course, we're not. The housing market that seemed to be recovering late last year is rolling back over in terms of sales volumes and prices. Banks and government programs are working to keep delinquent borrowers in their homes, but most workouts are failing within 9 months. Forebodingly, the mortgage market faces two more waves of adjustable rate mortgage resets, one in 2010 and one in 2011, that might set things back.

The governments of the world, especially China and the U.S., are trying to remove the massive stimulus injected during the crisis. It remains to be seen how smoothly that project goes. In exchanging public debt for private debt, sovereign countries have become the latest credit scare. Whether it's Greece and California, or the U.K. and Japan, governments are over-indebted and struggling to meet their obligations. Rapid growth would fix these problems, but that happy outcome is far from certain.

The U.S. economy, however, is in better shape than most. Our flexible labor force is redeploying to more productive uses faster than in Europe or Japan. Our shareholder focused management teams have cut capacity, liquidated inventories, paid down debt, and built up cash to successfully compete in world markets. Our population growth is a strength that Europe and Japan (and soon China), will wish they possessed to alleviate growing government obligations. The world is under-estimating U.S. potential, and not for the first time.

Our portfolios were constructed with these issues in mind. We have less emphasis on finance and housing, and more on technology and manufacturing. We own steady businesses in healthcare and telecommunications, as well as rapidly growing foreign firms. Our businesses have superior economics and management teams, and sell at very low prices. In the next section, I'll discuss my reasons for this positioning and why the best defense is a good offense.

Fighting the last war

Generals frequently apply the lessons of the last war to their current one hoping to avoid the mistakes of predecessors. But, conditions change and wrong lessons are learned, thus generals suffer at the hands of unkind historians.

Many investors are fighting the last war, too, by investing in what worked last decade: Bonds and Cash, and Emerging Markets. After watching all three out-perform U.S. stocks, especially during the emotionally trying experiences of the last two bear markets, investors charged headlong into what worked last time. By misreading today's situation and last decade's lessons, however, today's investing "generals" are likely to be easy targets for tomorrow's historians.

Military History 101: French generals scarred by World War I wanted to defend themselves against German aggression, and so erected the Maginot Line. The Germans, however, used blitzkrieg to simply bypass those defenses and conquered France.

Similarly, investors burned by stocks over the last 10 years recognized that Bonds and Cash were, in hindsight, excellent investments, and hence joined the defensive brigade. **But, history's broader lesson is that such investments do well when governments are soundly financed and deflation occurs—not the case at present.** Governments have huge spending obligations, low tax revenues, and high debt burdens. They're printing money in overdrive hoping to avoid default and jump-start their economies, consequently creating future inflation. When they succeed, Bonds will suffer as interest rates increase and Cash will devalue, perhaps dramatically. Better investing options are likely to blitzkrieg past such seemingly defensive investments.

Military History 102: Successfully deployed since 750 B.C. and climactically used to defeat the Persians at the Battle of Marathon in 490 B.C., the phalanx was considered an *indisputably* superior military formation by ancient Greece's generals. After being crushed by Rome's legions, in maniple formation, at the Battles of Cynoscephalae and Pydna in 197 and 168 B.C., however, the phalanx proved yet another accepted convention out-maneuvered by a more flexible approach.

Likewise, aggressive investors enticed by a decade of Emerging Market out-performance have become increasingly convinced that good returns will *always* be found there. However, its popularity has caused prices to soar beyond historical norms. **What was cheap 10 years ago is no longer low-priced enough to regenerate past out-performance.** Added to this, most emerging economies depend heavily on growth from developed economies (Europe, Japan United States), which face significant problems due to demographics and high debt burdens. Expensive and structurally dependent, Emerging Markets may find themselves out-maneuvered by more flexible options.

If committing to yesterday's winners is fighting the last war, how are we to avoid the historian's critical pen? First, by not learning the wrong lessons—by **not over-simplistically investing in what worked over the last 10 years.** Following the Investing Herd is almost always a strategy for poor returns.

Next, we must understand *why* prior victors succeeded. 10 years ago, the Investing Herd hated Cash, Bonds and Emerging Markets. Why? Because all three performed poorly over the prior 10 years! Investors thus dumped them *en masse* to purchase what was doing well at the time—technology, media and telecom. That selling depressed prices, making Bonds, Cash and Emerging Markets cheap relative to fundamentals and ready to out-perform. As you've heard from me before, **cheap, unloved investments do very well over the long term.**

What's cheapest and most out-of-favor now? **The sector that's done poorest over the last 10 years: global, large businesses.** With weak investing returns, big companies have been discarded in the shift to Emerging Markets, Cash and Bonds. This depressed prices dramatically relative to fundamentals, which are much stronger than perceived. Large businesses have spent the last decade learning to compete and expand internationally. Just when most effective, they've become least popular.

Finally, we should consider whether current conditions differ from the past. They do. As mentioned earlier, we can expect higher inflation, slower growth, and more governmental financial troubles. **Large businesses out-perform in such circumstances.** With low debt and strong franchises, they're better credit risks than governments. They have pricing power, allowing them to mitigate inflation's threat. And, they prosper during slower growth because they possess the scale and scope to lower costs when smaller companies can't.

To avoid fighting the last war, I've positioned our portfolios with significant stakes in large businesses. **Their unpopularity has led to one of the largest valuation disparities in history** (the true driver of long term returns). In my opinion, they can handle today's unique circumstances better than other alternatives. We may not achieve instant victory, but I'm quite confident our strategy will win this long term investing "war."

Investment Spotlight: Pfizer

You'd think the developer of such well-known drugs as Lipitor, Zyrtec, Zoloft, Viagra and Zithromax could get its stock price to rise, but Pfizer fell from $48 to under $20 over the last 10 years. **The world's largest drug maker (by sales) is unloved by the market even while increasing free cash flow 15% a year over that period.** How did an upstanding company like Pfizer, a Dow Jones Industrial Average component, fall from its state of grace, and what are its prospects in the future?

Pfizer was founded in 1849 as a fine chemicals business by German cousins Charles Pfizer and Charles Erhart. Its first product, santonin (yes, the funny names go back that far), was an antiparasitic. Pfizer's first big hit came with citric acid, used in the burgeoning growth industry of the 1880's: soda beverages like Coca-Cola, Pepsi-Cola & Dr. Pepper. After additional successes with vitamins C, B_2, B_{12} and A, Pfizer's second blockbuster was penicillin during World War II. It wasn't until the 1950's, though, that Pfizer became the research-based pharmaceutical we think of today. Although that research focus worked well for five decades, it's starting to show its age. To understand why, it helps to understand a drug's path from idea to marketable product.

Only 1 in 1000 candidate drugs make it from the laboratory to clinical trials, and of those only 1 in 5 are approved by the Federal Drug Administration (FDA) and marketed. It costs $1 – 2 billion to navigate that 1 in 5000 process. Candidate drugs are awarded exclusive, 20 year patents, but the clock starts ticking as soon as the candidate is discovered in the lab (before testing and approval). In other words, it takes 10 – 15 years to get through study and testing, so a pharmaceutical company is lucky to have 5 – 10 years selling developmentally costly drugs. That's a narrow window to earn back the time and money of research and development. Even after a drug is successfully tested, it takes another $½ – $1 billion to successfully market and sell the drug to doctors and patients. As a last insult, drug development and marketing costs have sky-rocketed while successful development has declined precipitously. This makes Pfizer a bit of a good news, bad news story.

The bad news begins with patent expirations. 25% of Pfizer's revenues come from a single drug: Lipitor, which goes off patent this year. **Pfizer faces several additional patent expirations over the next couple of years, too, and that makes investors understandably nervous.** On top of that, Pfizer has failed to successfully produce new drugs to replace its blockbusters. It's like Honda knowing it can't sell Civics in a couple of years and not having a replacement.

Instead, new drugs are increasingly coming from biotech competitors. The old chemicals-based (versus biologics-based) business model that Pfizer has had so much success with is in decline. Adding insult to injury, generic drug competitors have been successfully challenging patents before the 20 year exclusivity period is complete. Pfizer is facing competition from above by biotechs and below by generics.

That's a lot of bad news, so what's the good news? **Pfizer still makes a LOT of money selling its current stable of drugs.** Even with its patent expiration "cliff," Pfizer will continue to generate very high amounts of cash in the future. Also, Pfizer is expanding internationally, where it now gets close to 60% of its revenues and most of its growth. Such markets, especially emerging economies, have years of rapid growth ahead. Further, Pfizer has taken a page from its generic drug competitors and gone into competition with biotech companies challenging patents and marketing its own generic biologics. This could turn into a blockbuster business in its own right. Finally, Pfizer still has a 500 candidate pipeline of drugs in six areas: oncology, pain, inflammation, Alzheimer's disease, psychoses and diabetes. It seems unlikely all 500 candidates will fail.

Granted, Pfizer faces daunting difficulties and has yet to prove it can exploit its opportunities; but, its stock is priced for extinction. **If you put Pfizer's business into run-off, simply selling its current drugs until they lose patent and then shut the business down over time, you'd earn back the price we paid.** That means we're getting any potential drug successes, a generic biologics business, and rapid international growth for free. At the price we paid, we're getting a 10.7% free cash flow yield, a 3.5% dividend while we wait (about the same as a 10 year Treasury bond, but with much better inflation protection), and potential growth opportunities. Pfizer isn't a sure thing, but the odds seem nicely stacked in our favor.

Until next quarter

The past year has been extremely gratifying. Clients who contributed additional capital in late 2008 and early 2009 are sitting on large gains. Part of that was due to market dynamics and my research, but the larger part was due to brave clients following my advice and putting money to work when the opportunities were ripest. Thank you for that vote of confidence.

I wish I could say the future looks as advantageous now as it did a year ago. **Though our long term return prospects are excellent, the short term looks a bit sketchy.** There are some foreboding clouds on the horizon, both geopolitical and macro-economic. The market rise is likely to continue longer than I expect (I'm almost *always* too early), but a repeat of the last year is almost out of the question.

Not everyone has weathered the last year as well as we have. If you know someone looking for better investment options, please put them in contact with me. In particular, **I'm looking for more folks like you:** patient, long term focused individuals and families looking for a better than average long term returns and someone they can trust. I promise to take good care of them.

As usual, visit my blog to see my thinking between letters: www.mikerivers.blogspot.com. I continue receiving positive feedback that it's both thought provoking and entertaining. If you enjoy it, send your friends and family there, too.

Please feel free to contact me with your questions or comments. I always love to hear from you.

Respectfully yours,

Mike

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