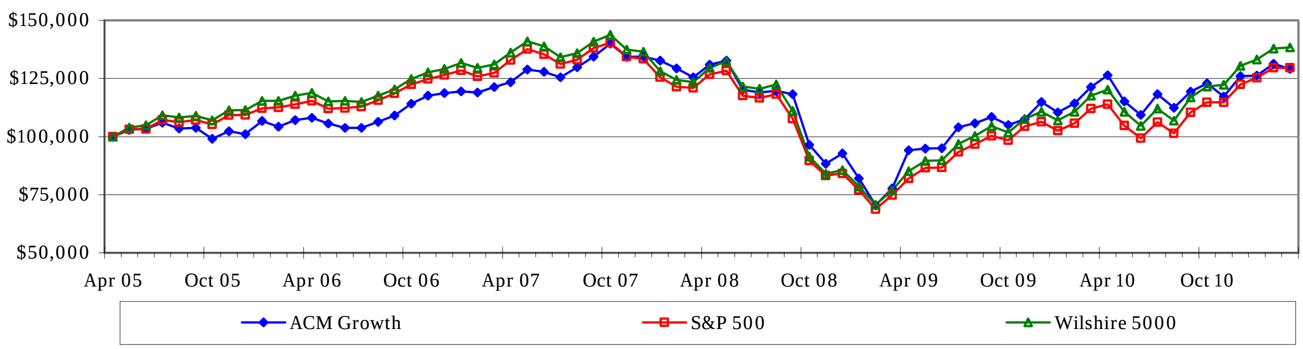
Athena Capital Management

Cumulative Growth Performance

Performance as of 3/31/11	Year to date	1 year	3 years	5 years	Since inception (4/30/05)
ACM Growth	2.46%	6.47%	2.87%	20.55%	29.14%
S&P 500	5.93%	15.65%	7.23%	13.83%	29.64%
Wilshire 5000	6.01%	17.58%	12.10%	17.64%	38.35%

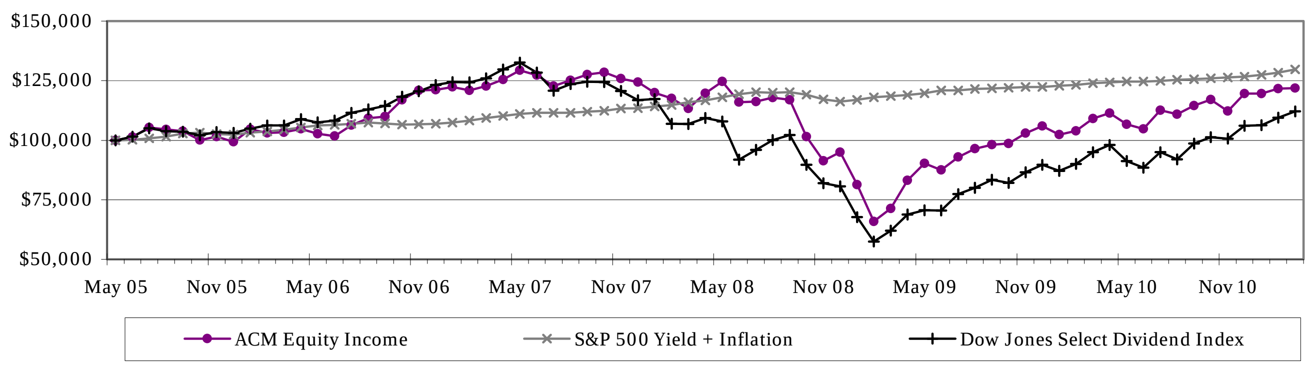
Comparison of the change in value of $100,000 investment in ACM growth versus S&P 500 and Wilshire 5000



Cumulative Equity Income Performance

Performance as of 3/31/11	Year to date	1 year	3 years	5 years	Since inception (5/31/05)
ACM Equity Income	1.93%	11.68%	7.57%	17.91%	21.86%
S&P 500 yield + inflation	2.44%	4.74%	11.96%	24.33%	29.79%
Dow Jones Select Dividend Index	5.68%	18.03%	4.96%	5.55%	12.07%

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 15, 2011

The 1st quarter was the best in 12 years for stock returns as the Federal Reserve continued to pour fuel on the risk-taking fire. Although we achieved very satisfactory returns, our portfolios lagged the market as small, speculative investments continued to out-perform our big, prudent ones.

In this quarter's letter, I discuss: our performance; my view on markets and the economy; what may happen when the Federal Reserve ends its second quantitative easing program; and our investment in rural telecom: Frontier Communications.

Performance this quarter

Growth portfolios out-performed the S&P 500 over the last 5 years, but under-performed over all other time periods. Our investments in large, conservatively financed, highly profitable companies continue to lag the returns of small, highly indebted, marginally profitable firms. Although I don't know when this trend will reverse, I am certain it will. Or, as Horace more articulately put it, "Many shall be restored that now are fallen and many shall fall that now are in honor." (Ars Poetica)

Growth's out-performance this quarter came from **Comcast** and **Pfizer.**

Comcast finally completed its purchase of NBC Universal from General Electric and announced strong earnings and earnings growth. Market participants finally seem to be grasping that cable TV isn't dead, that broadband internet is a very profitable and growing business, and that slowly expanding sales with declining costs creates a very nice earnings growth profile. Although I used its price run-up to trim our out-sized position, I'm confident Comcast is likely to show more earnings and price growth in the future.

Pfizer's big news this quarter, since ousting its CEO in December, was that it was trimming its research and development budget and using the proceeds to buy back stock. Investors seem keen on this strategy, as am I, because research and development spending has not been generating good returns on investment. In the absence of good investment opportunities, repurchasing shares at low prices is the right way to allocate capital. Given Pfizer's prodigious cash flow and dividend yield, this strategy should continue to generate good returns going forward.

Microsoft and **Frontier Communications** were growth's under-performers the quarter.

Microsoft's cardinal sin is that it continues *not* to be Apple or Google. Specifically, Microsoft continues to lose ground in smart phones, tablets, online advertising, search, browsers, operating systems, and application software. What market participants seem to ignore is its solid existing business lines, and its improvement and potential improvement in the very areas most think it is currently weak. Microsoft is not standing still, and the immense profitability of its current businesses is allowing its expansion in Server and Tools, cloud computing, gaming, gesture interface, etc. With a 2.5% dividend, 11% free cash flow yield and 12% growth, I'm happy to live with Microsoft's sins.

Frontier Communications (detailed in the Investment Spotlight below) disappointed investors with lower than expected sales and higher than expected expenses last quarter. Just as investors were overly optimistic with last fall's better than expected announcement, they became overly pessimistic with this quarter's. Although Frontier is dealing with difficult market dynamics that shouldn't be taken lightly, its 15% free cash flow yield and 9% dividend provide ample margin of safety against these challenges.

Equity income portfolios out-performed the S&P 500 Yield Plus Inflation over the last year, but lagged over all other time periods. Our relative performance slowed this quarter as inflation regained traction and our portfolios were too conservatively positioned to benefit from a more speculative market. Over time, I'm confident that our approach will allow us to maintain gains the market loses and grow income faster than inflation. With a 4% yield and franchise businesses with pricing power, I'm quite convinced we'll reach our goals.

For the first time since inception, equity income's out- and under-performers this quarter were the same as Growth's: **Comcast** and **Pfizer** on the upside and **Microsoft** and **Frontier** on the downside. Please see my remarks above on all four.

Market and economic outlook

The S&P 500 climbed 5.9% last quarter, again out-pacing its historical average. It's prudent to ask whether recent gains will be maintained, and with a less than 3% projected return over the next six years, my magic eight-ball says, "Outlook not so good." Our portfolios, being better positioned, are much more likely to maintain gains going forward.

Athena Capital Management

Projected annualized returns over the next 6 years	
S&P 500 (growth benchmark)	-3.0% to 8.9%
S&P-500-yield-plus-inflation (equity income benchmark)	3.3% to 6.3%

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

I'm flat-out surprised at the market's recent resilience. In an environment of surging commodity prices, severe political strain in the Middle East, Japan's worst natural disaster in 300 years, and unsustainable fiscal difficulties in Europe and the U.S., you'd expect risky financial assets to be down and conservative ones to have done relatively better. Not the Teflon Stock Market—bad news simply does not stick!

Despite its non-stick façade, **the market will, in due time, reflect its over-valuation relative to underlying fundamentals.** When that happens, stocks are likely to give back much if not all their recent gains. At that point, investors will go from wishing they were fully invested to regretting—again—their imprudence. By then, of course, it will be too late. I'll be the first to admit I have no clue on the timing of such a correction (though I speculate on a potential cause in my "Summer Thriller?" article below), but I'm certain markets will eventually reflect the facts.

Not being short-sighted enough to chase recent returns, nor speculative enough to guess timing, **I continue to invest our money in companies with high earnings relative to price and good prospects for growth over time.** Though out of favor, this method has worked over the last 140 years, and will likely continue to do so for those patient enough to employ it.

Summer Thriller?

The Federal Reserve is ending its second round of quantitative easing (QE2) this summer. When the first round ended last spring, markets took at beating. As Mark Twain put it, history doesn't repeat but it does rhyme, so be prepared for possible bumps and opportunities to profit.

Quantitative easing describes when a central bank (in our case, the Federal Reserve, headed by Ben Bernanke) **creates money to buy government bonds, thus increasing money supply.** The aim is to jump-start economic growth by spurring bank lending. The first round—QE1—ran from fall 2008 to spring 2010 and totaled $1 trillion. It seems to have worked (like heroine *seems* to help an addict), but when QE1 ended, the economy and markets fared poorly (like an addict's withdrawal). In reaction, the Fed hinted at another round—QE2—in late August, which became official in November with $600 billion c0mmitted through June 2011.

It's not entirely clear what, if anything, will happen when QE2 ends, but it bears watching. QE1's end was followed by the "flash crash" and a 15% decline in the S&P 500. The market's reaction this time will depend on how the underlying economy is doing. Right now, it seems to be recovering, but it's not clear if that's due to QE and fiscal stimulus, or self-perpetuating growth. What *is* clear is that markets have proven *very* sensitive to Fed policy—as seen in the stock market's 28% blast-off since the Fed's hint last August. Put another way, there's been an 86% correlation between changes in the Fed's balance sheet and the direction of the S&P 500 (David Rosenberg, 3/18/11).

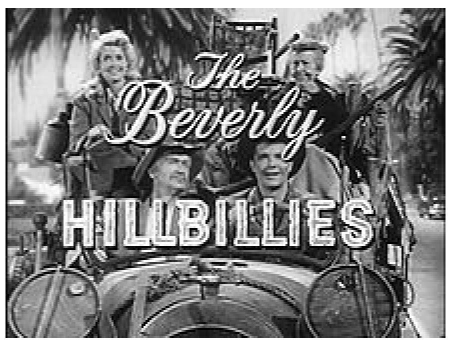
Stock prices will likely be volatile this summer as market participants try to anticipate which way the Fed will go: jumping at hints of another round of quantitative easing, and diving at signs the economy doesn't need help. After ending QE2, the Fed will probably play "wait & see," initially, just as it did after ending QE1. If the economy regains its footing, the Fed will likely stay on the sidelines. In that case, growth will continue, but at a slower pace than over the last eight months. If, however, the economy and markets turn sour, the Fed might implement round three—QE3.

QE3, like QE2, would come with a price tag: higher interest rates and commodity prices. Higher interest rates result as bond buyers demand more yield fearing higher inflation (increasing money supply frequently leads to this). Higher interest rates, in turn, slow economic growth by hurting borrowers at all levels—consumer, business, and government. Oil and agriculture prices surge when markets anticipate that increased money supply will lift such commodities most (as it did with QE2). This too slows economic growth over time as higher input costs permeate the costs of all other goods.

Rapidly rising commodity prices bring an additional high cost—civil unrest. In fact, spiking commodities can easily be blamed for unrest in the Middle East, China and the rest of the 3rd world, where commodities account for 40-60% of the cost of living versus less than 20% in western world and Japan. The more QE the Fed does, the harder emerging markets must work to suppress inflation and civil unrest, risking an economic hard landing that would make the economic results of Japan's earthquake seem tame.

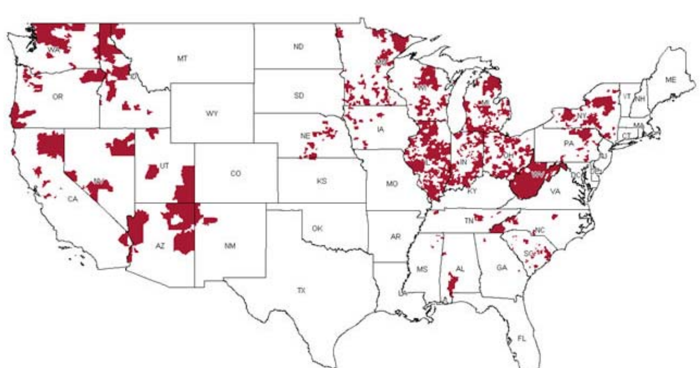
I'm not certain what will happen when QE2 ends in June, but it's easy to see how the market reacted in the past and why it may be jumpy this summer. This turbulence may seem unpleasant at first blush, but with volatility comes opportunity. I won't try to game this transition foolishly, but I will be ready to pounce if markets over-react in either direction. If fortune favors the prepared mind, then we're ready.

Investment Spotlight: Frontier Communications



Frontier Communications isn't the "Final Frontier" of Star Trek fame, but more like Jed Clampett's—backwoods and proud of it! That doesn't make it a bad investment, though, because **even a low-tech, rural phone company can deliver excellent returns if the price is right.**

Frontier, formerly Citizen's Communications, provides wireline services to small and medium cities and rural areas in 27 states across the U.S. (West Virginia is one of their biggest territories—enough said). **With around 6 million customers, it offers voice, data and video services in smaller markets—that is, markets with low competition.** Such areas lack the high density and growth of urban markets, and are thus less desirable to big telecom companies.



It's understandable why: rural wireline markets have been contracting due to population stagnation and alternative services like cable, satellite TV, and wireless telephone and internet. Such declines are especially painful because network costs shrink little when customers leave. **Instead of focusing on high growth and network density like bigger telecoms, rural companies concentrate on retaining customers and slicing costs faster than revenues fall.** That business model is significantly different than the one deployed by large telecoms.

So, why does Frontier intentionally struggle in such a market? Because, **with the right approach, declining markets can be profitably harvested for shareholders.** For example, cigarette smoking has declined steadily in North America and Europe for years, yet tobacco companies on both continents have generated excellent returns for shareholders by carefully managing revenue declines while slashing costs. And, that's precisely what Frontier is doing in its own market.

Its strategy is to buy rural territories from 1) big companies that aren't built for that model, and 2) small companies that aren't successfully adapting to the new reality. Frontier proved this strategy most recently with its Pennsylvania's Commonwealth Telephone acquisition in 2007, turning something narrowly profitable into a cash machine. Frontier is doing it again—on a much bigger scale—with the acquisition of Verizon's rural business (consummated last summer), which *tripled* Frontier's customer base.

The investment question now becomes: how effectively can Frontier repeat the process. Frontier has their work cut out for them: whereas Frontier loses customers at a 3% rate in its legacy territory, the acquired Verizon property has been losing customers at a *12%* rate. Frontier's challenge is real, but it has an excellent record deploying its rural business strategy. I think they'll succeed because, as Morningstar's equity research analyst put it, "Frontier is one of the most efficient carriers we follow."

Business strategy, however, isn't the sole determinant of investment success. **More important is the price paid, and we bought a bargain.** With free cash flow of $1.23 and a $0.75 dividend, we're sitting on a 13.8% free cash yield and 8.4% dividend (our average purchase price was $8.89). Try finding those numbers in a savings account! That's cheap, but with a shrinking business, it's cheap for a reason. What will the market pay for declining earnings? If Frontier's profits decline at 3%, it should be worth $12 a share (6%: $9.50; 9%: $7.70; 12%: $6.50). Our return will depend on how well Frontier cuts costs and retains customers—it's all about execution. In the meantime, an 8% dividend simply crushes the S&P 500's measly 2%.

Frontier Communications may be more backwoods banjo than concert piano, but boring can be beautiful at the right price. With an excellent record of managing rural telecom decline, low purchase price, and significant dividend yield, **Frontier may prove a cash gusher just like Jed Clampett's oil property.**

Until next quarter

Thank you for your business. I remain confident our results will improve over time, even though I can't predict the precise moment that will happen. I look forward to reporting on that progress to you, as I'm sure you do to receiving it.

If you have any questions, comments or feedback for me, please feel free to contact me at any time. I'm always happy to hear from you and help in any way I can.

Respectfully yours,
Mike

Michael Rivers, CFA
Athena Capital Management
370 Waco Court, Colorado Springs, CO 80919
719-761-3148, mike@athenacapital.biz