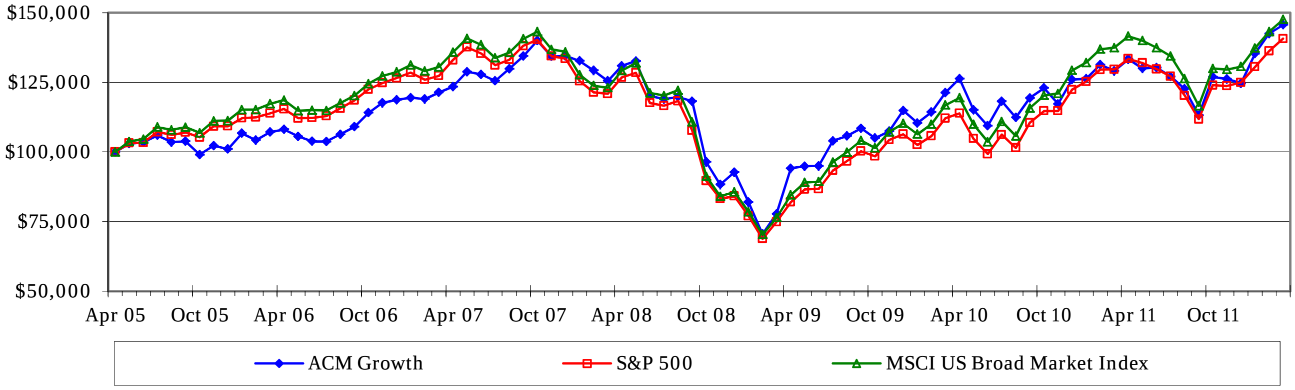
# Athena Capital Management

## Cumulative Growth Performance

| Performance as of 3/31/12 | Year to date | 1 year | 3 years | 5 years | Since inception (4/30/05) |
|---|---|---|---|---|---|
| ACM Growth | 16.88% | 12.78% | 87.34% | 20.01% | 45.65% |
| S&P 500 | 12.59% | 8.54% | 87.99% | 10.48% | 40.71% |
| MSCI US Broad Market Index | 12.95% | 7.35% | 93.07% | 13.07% | 47.60% |

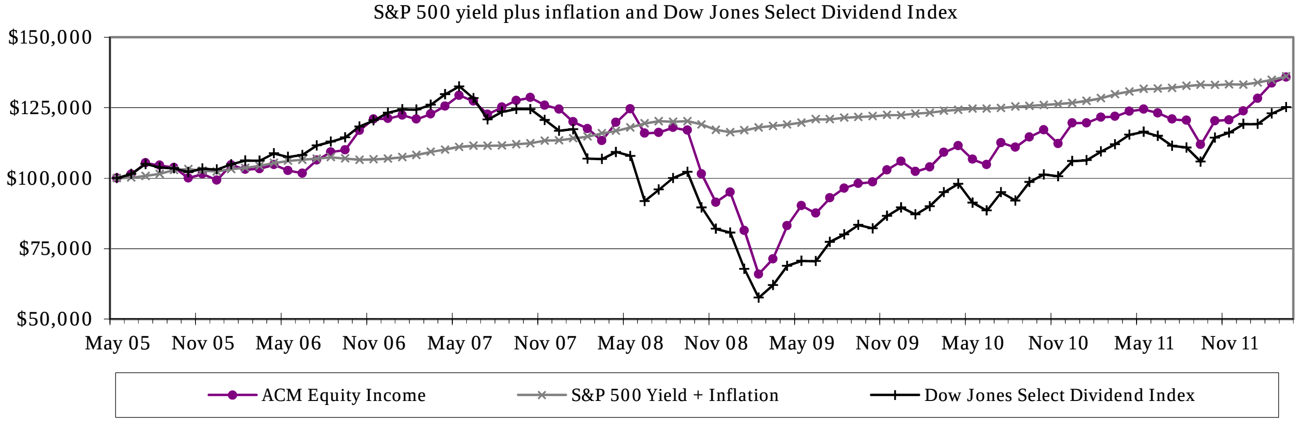
Comparison of the change in value of $100,000 investment in ACM growth versus S&P 500 and MSCI US Broad Market Index




## Cumulative Equity Income Performance

| Performance as of 3/31/12 | Year to date | 1 year | 3 years | 5 years | Since inception (5/31/05) |
|---|---|---|---|---|---|
| ACM Equity Income | 9.76% | 11.51% | 90.49% | 10.73% | 35.88% |
| S&P 500 yield + inflation | 2.18% | 4.88% | 14.84% | 24.49% | 36.12% |
| Dow Jones Select Dividend Index | 5.06% | 11.76% | 101.90% | -0.62% | 25.25% |

Comparison of the change in value of $100,000 investment in ACM equity income versus S&P 500 yield plus inflation and Dow Jones Select Dividend Index




**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 13, 2012

2012 started with a *bang* as the stock market generated its best 1st quarter in 14 years. Happily, we did even better—besting all our benchmarks over the last 3 months.

In this quarter's letter, I'll discuss our investing performance; my view on markets and the economy; my take on why cycles and psychology make investing so difficult; and an investment spotlight pulled from the wreckage of the housing crash: USG Corp.

## Performance this quarter

**Growth portfolios out-performed over every period but one: the 3 year period** (where we lost by just a hair). The high correlations described in last quarter's letter, which persisted for three years, disappeared last January and—no surprise—our returns ended up much better than the market's. As I said at the time, such periods always end, and underlying values rise to the top. Even better, this process still has some way to run before our holdings reach fair value.

Growth's out-performers this quarter were **USG Corp** and **Microsoft.**

USG—profiled in detail below—is a building materials company serving both commercial and residential real estate markets. During the quarter, USG's stock price soared 69% as additional signs showed that building construction may finally be recovering. It's hard to say if real estate has permanently turned the corner, but construction will certainly rebound someday, and USG's stock price will benefit disproportionately.

Microsoft, the largest software company in the world, witnessed a 24% stock rise as investors became more excited about Windows 8 and its potential in tablet and phone markets. In my opinion, Microsoft's stock is cheap even without success in those areas, so *any* degree of success in those markets would be an extra layer of icing on the cake. It'll be fun to see what happens.

**Frontier Communications** and **Fairfax Financial** were growth's under-performers this quarter.

Frontier, the rural telecom company, saw its stock price decline on suspicion, and then confirmation, of a dividend cut. Its reduced dividend doesn't signify instant doom, but breathing room to repay debt and invest in needed network enhancements. Frontier is suffering more from competitive dynamics than anything else, and additional funding will allow Frontier to compete more successfully. The jury isn't out, yet, but I believe Frontier will rebound, and its still-high dividend yield of 10% makes waiting a satisfying proposition.

Fairfax Financial, an insurance holding company, declined on reporting that 2011 was a tough year for catastrophe insurance—the worst since 2005 with hurricane Katrina. Fairfax's results were better than the industry's, though, and due to its solid finances, it's in a better position than competitors to write insurance at high premiums (50% higher in places like Japan and Thailand). Patience seems to always pay off with Fairfax; I believe this time is no exception.

**Equity income portfolios out-performed their long term benchmark over all periods less than 5 years.** It's been a long slog since May 2008, but we've finally gotten within a hair's breadth of beating our target, and now it's time to surpass and grow our lead. I'm certain the path will include inevitable setbacks along the way, but with a 3.5% yield and a balanced portfolio of growth and income investments that grow faster than inflation, I'm confident our long term results will be quite satisfactory.

Equity income, like growth, saw out-performance this quarter from **Microsoft** and **USG Corp**, and under-performance from **Frontier Communications** and **Fairfax Financial**. For more, see my comments above.

## Market and economic outlook

**The S&P 500 climbed 12.6% this quarter, the best since 1998.** This puts long term return prospects back where they were in 1996, 2003 and 2008. In other words, market returns might do well in the short term, but aren't super-attractive over the long run. Like in '96, '03, and '08, the best option is to invest in low-priced securities, which is where we sit.

| Projected annualized returns over the next 6 years | |
|---|---|
| S&P 500<br>(growth benchmark) | -3.6% to 8.2% |
| S&P-500-yield-plus-inflation<br>(equity income benchmark) | 3.5% to 6.5% |

How do I arrive at these numbers? Visit "Athena Capital Articles" at www.athenacapital.biz to see my 2Q2005 article.

**Europe is probably in recession and China's growth is slowing, but the U.S. economy hasn't, yet, succumbed to the downtrend.** The U.S.'s flexible labor markets, innovative workforce, superior capital allocation, and recovering real estate sector have kept growth expanding, but could still be pulled down by foreign economies. But, even if the U.S. succumbs, its long term prospects are better than most expect. There will, no doubt, be surprising bumps (Iran?) and harrowing moments (bond crash?) along the way, but the long term trend-line is still up. Those positioned for perpetual doom and gloom will miss the upside.

**Stock, bond and commodity markets seem to be on hold for now.** Although U.S. stocks have done well, foreign markets have mostly stagnated or declined. Bond markets have done okay as periodic flights to safety boost prices, but yields are so low that long term results look terrible—bonds will prove a lousy place to seek safety. Commodities have held up well, but require increasing economic demand relative to supply to continue thriving, and that's not likely (witness booming U.S. oil production and record low natural gas prices). Like with bonds, commodities' short term outlook appears good, but the long term will be poor indeed.

**Producing assets look like the best bet right now, and over the long run.** Bonds, CDs and cash are denominated in inflationary currency, and that's no place to invest with huge government debt and obligations. Commodities are likely to maintain value under most scenarios, but maintaining is not the same as *growing* value. Only producing assets—businesses, farms, real estate—generate returns and outpace inflation. Growth from such investments will be lumpy, to be sure, but it's the only sustainable growth available. The difficult trick for investors is to stick with them despite feelings in your gut that beg you to do otherwise, which is the subject of my next section.

## Cycles and Psychology

*"Investing is simple, but not easy" – Warren Buffett*

The concept behind investing is pretty straightforward: buy low and sell high. Doing that well, however, is quite difficult: **fewer than 20% of individual or professional investors beat average market returns.** Why is that?

I believe there are two important reasons: one has to do with cycles, and the other relates to human psychology.

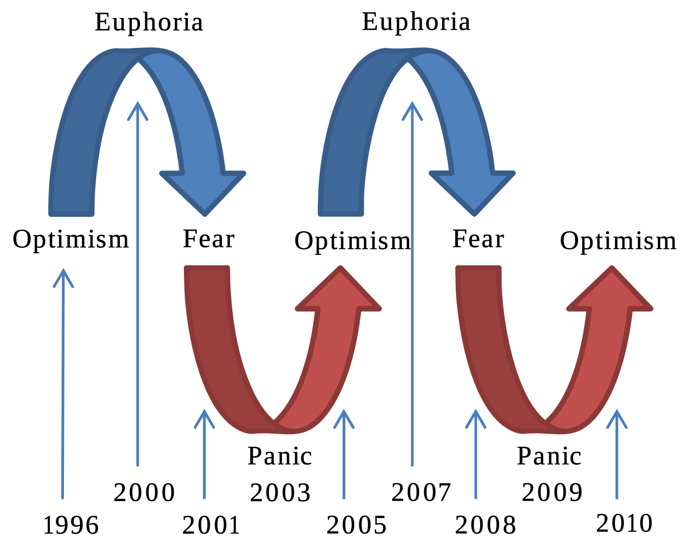
**Cycles are periods—of indeterminate length and magnitude—where things are above or below average.** Think of average rainfall as an example. Sometimes you get five years of "unusually" wet weather, and then three years of "unusual" dryness. Neither is really unusual—it's quite normal for wet and dry periods to occur. But, because we tend to think in terms of averages, the cycles above and below seem out of the ordinary to us.

So it is with business cycles. **Sometimes business is better than average, and sometimes less so.** This is due to government policy (manipulated interest rates, tax policy changes), the uptake of new technology (Internet boom, smart phones), fads and fashions (Crocs, housing mania), competitive dynamics (Wal-Mart, Amazon.com), and so on.

Because business cycles have so many inputs, including the independent choices of millions of people, they last shorter and longer periods (duration), and go higher and lower than anyone can predict (magnitude). This makes investing difficult for those who try to get in and out of markets: How long will the business boom last? How high will it go? It's clear, if business grows strongly for a long time, people invest more; if business slows or tanks, people invest less. **Business cycles tend to last three to ten years, but their duration and magnitude are unpredictable.**

Layered on top of business cycles are market cycles. Think of *business* cycles as due to fundamentals like sales and profits, and *market* cycles as investors' collective reaction to underlying fundamentals. Market cycles are waves riding on top of business cycle waves.

**Market cycles, quite plainly, are due to crowd psychology.** Just as herds of cattle tend to mosey or stampede together, so do investors. They tend to go from optimism (1996 & 2005), to euphoria (2000 & 2007), to fear (2001 & 2008), to panic (2003 & 2009), and then back to optimism (2005 & 2010) in a never-ending cycle.




Just like the business cycle, market cycles make investing difficult because no one knows how long or high they will go. In fact, market cycles are much more erratic than business cycles, which makes sense considering that market cycles are caused by crowd psychology *reacting* to an underlying cycle of variable duration and magnitude—it's a reactionary wave on top of an unpredictable wave! Talk about complexity.

Market cycles can be seen as three concurrent cycles of different lengths: long term cycles of 15 to 20 years (generational), medium cycles of three to ten years (related to the business cycle), and short term cycles that can last weeks or months (due to people guessing when business cycles may begin and end). Like with business cycles, **we understand *that* market cycles occur, but the exact duration and height or depth of each cycle are unknowable.**

The second issue making investing difficult, other than cycles, is our all-too-human trouble in dealing with our psychology. In addition to being confused by variable cycles, **we humans exhibit psychological biases that make successful investing quite a struggle.**

Our emotional brains tend to react like we're still on the African savannah where humans first evolved. When we sense fear, like the stock market falling, we react as if a lion were chasing us. **Although that emotional reaction worked in dealing with predators, it doesn't work well with investing.**

Our fight or flight mechanism is but one example of psychological bias. We exhibit others as well:

- loss aversion: being more scared of losing $1,000 than gaining $2,000
- anchoring: using purchase price instead of underlying value to make sell decisions ("I paid $40 for XYZ Corp., so I want it to get back to that price before I sell")
- extrapolation bias: assuming average historic growth of 10% can be assumed from *this* point forward

Unfortunately, those aren't the only psychological problems investors face, but it gives you a flavor for the problem (for more, see my 1Q08 client letter).

**The combination of variable cycles and human psychology goes a long way in describing the reason so many investors do poorly**. Cycles and psychology lead most to sell in fear and panic, and then buy in optimism and euphoria—the opposite of what's needed to get above average returns (which is why only 20% beat the market).

Happily, there are ways to cope with these problems. The solutions are simple to describe, but take tremendous discipline to implement.

In the case of business cycles: they aren't predictable, so don't shoot yourself in the foot trying to predict or react to them. Instead, **average out underlying fundamentals over a full business cycle** (from peak to peak or trough to trough). This prevents judging investments by their best or worst years, then buying or selling based on skewed data.

To navigate market cycles: don't predict or react to these either, but instead ride through them like a ship cutting through the waves. Just as you can avoid seasickness by focusing on the horizon, **you can avoid market cycle sickness by focusing on the long-term.** Don't be overly influenced by one, three or even five year returns, but concentrate instead on 10, 15 or 20 year metrics. Most investors lack the patience (or stomach) for such a view, and their results suffer accordingly.

In dealing with individual psychology: don't take action based on how you feel. Emotions indicate *how* you feel, not *what* to do. Step away from scary news stories, take a break to gain perspective, think about historic examples where good results were attained, and give yourself time to make important decisions. **Make investment decisions when you feel calm, collected and rational**, and you'll avoid the psychological pitfalls so many fall into.

Why is investing simple but not easy? Because cycles and psychology make buying low and selling high frustratingly difficult. For better results, **average out business cycles, think long term to deal with market cycles, and keep emotions out of investment decision-making.** Doing so makes outstanding results possible. It's not easy, but it's worth it; or, as Spinoza more eloquently put it:

*"All things excellent are as difficult as they are rare" – Baruch Spinoza (1632-1677)*

## Investment Spotlight: USG Corp.

**Everyone knows the housing market is a disaster**. Not only are home prices down over 33% nationwide, but new housing starts have crashed 69% and existing home sales have tumbled 35%. Why would someone sane go digging through *that* wasteland looking for investments? Because housing won't stay down forever, and such negative perceptions result in the best bargains. Sifting through the home construction wreckage, I found a best-of-breed building materials company selling dirt-cheap.

But, first, I must answer the question: **will the housing market *ever* recover? Indeed, it will.** The logic behind my answer is that when over-supplied homes are absorbed, new building growth will resume at its normal pace.

**Historically, new housing growth has averaged 1.6 million a year**: 1.2 million new households and 400,000 demolitions. This number crashed from an above-normal peak of 2 million in 1996 to 600,000 last year as people doubled up and rented apartments. But, as pent-up demand recovers back to 1.6 million, the result will be an additional demand for one million homes a year.

**Opposite this demand is a large supply of housing inventory that must first be absorbed**. This includes an official, listed inventory of around 2 million, and a "shadow" inventory of unlisted homes that could be as large as 3 million (foreclosures, bank-owned, abandoned, owners waiting for a price rebound). So, there's an excess inventory of around 2 to 5 million homes.

Here's the resulting math:

- 1 million per year extra demand
- 2 to 5 million excess inventory
- Therefore, 2 to 5 years until full recovery

*Voila!*

The above analysis is based on somewhat imprecise figures, but the underlying logic is inevitable—**a growing population will need more homes as excess supply is absorbed and old homes fall apart**. Jobs *will* recover over time, and people *will* grow tired of doubling up or renting. The question isn't really whether housing will recover, but how soon.


**Note, too, that real estate is inherently local.** This means demand for new home construction will take-off just as unevenly as it rolled-over six years ago. The recovery will begin in markets with tight supply—like Virginia and Maryland—and spread to markets with loose supply—like Florida and Nevada. Consequently, housing-related companies will rebound *long* before a full housing recovery occurs, and the key is to own them *before* the rally. I think USG is just such a company.

**USG (United States Gypsum) consists of three business segments where it's at the top in each**:

- #1 wallboard manufacturer in North America
- #1 in ceiling grid and #2 in ceiling tiles worldwide
- #1 building products distributor in the U.S.

If you've heard of Sheetrock and thought it was synonymous with wallboard, you're not alone. USG's Sheetrock is to wallboard what Kleenex is to tissues: a brand that stands for the category. Such an association comes with significant upside: USG's products garner premium pricing because of their reputation for quality, dependability and innovation.

You may think "innovation" and "wallboard" don't belong in the same sentence, but **USG has managed to develop wallboard that's 30% lighter than previous versions**. If you've dealt with wallboard, you know how unpleasantly heavy it is. Contractors across the continent are eagerly lining up to buy USG's new UltraLight products. The competition is struggling to catch up.

USG's products participate in three end-markets:

1. **New residential construction**
2. **New commercial construction**
3. **Residential and commercial repair and remodel**

Repair and remodel tends to be much more stable than new construction, and that's a big reason why USG survived the most horrid building materials crash since the Great Depression.

How bad was the downturn? Wallboard manufacturing volumes declined from 38.6 billion square feet in 2006 to 16.7 last year, a 57% drop. Along with unit volume crashing, so did pricing, by 43%. With revenue equal to volume times price, **the wallboard industry saw sales crash 75%—*ouch*!** It's not hard to imagine that USG went from making good money to losing it.

**USG responded aggressively to the downturn by cutting wallboard capacity 35%**. The wallboard industry reacted, too, cutting manufacturing facilities by a staggering 52%. These bold actions made USG and the industry more efficient because highest-cost factories and mines were closed first. The cuts were painful, but will allow wallboard production to recover at more profitable levels when home building rebounds.

How will USG, specifically, recover? USG currently has $3 billion in annual sales, upon which it is losing money. As construction volumes return to normal, USG's sales should easily expand to $4 to $5 billion a year, upon which USG should make $1.50 to $2 per share. **Relative to our average purchase price of $8.43,**

**that's a potential 18% to 24% earnings yield!** That result won't happen overnight, but such upside seems well worth a two to five year wait.

USG is *the* market share and brand leader in manufacturing and distributing the walls and ceilings that surround us all. Though its end-market was grossly over-built, and has since ridden through the valley of death, equilibrium will be restored, and USG will benefit disproportionately. **Home construction may seem like a wreck now, but will greatly reward patient investors who can wait to profit handsomely**.

## Until next quarter

**Finally, a quarter of demonstrable out-performance!** Although short-term under-performance is the frequent cost of long-run out-performance, it's no fun to ask for patience *ad nauseam*. So, thank you for sticking around to reap some of the benefits.

**Rest assured, too, that I haven't been twiddling my thumbs waiting for things to get better.** On the contrary, I've been digging deep into my research and portfolio management processes to fix flaws, generate enhancements, and broaden capabilities. I'm working hard to continuously improve as an investor, so stay tuned.

For updates on my investment thoughts between letters, feel free to visit my blog: www.mikerivers.blogspot.com. With 311 posts and well over 11,000 views, it has generated a respectable readership. If you stop by, let me know what you think.

As usual, **if you have any questions, comments or feedback, let me know.** I always enjoy hearing from you.

Respectfully,
Mike

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