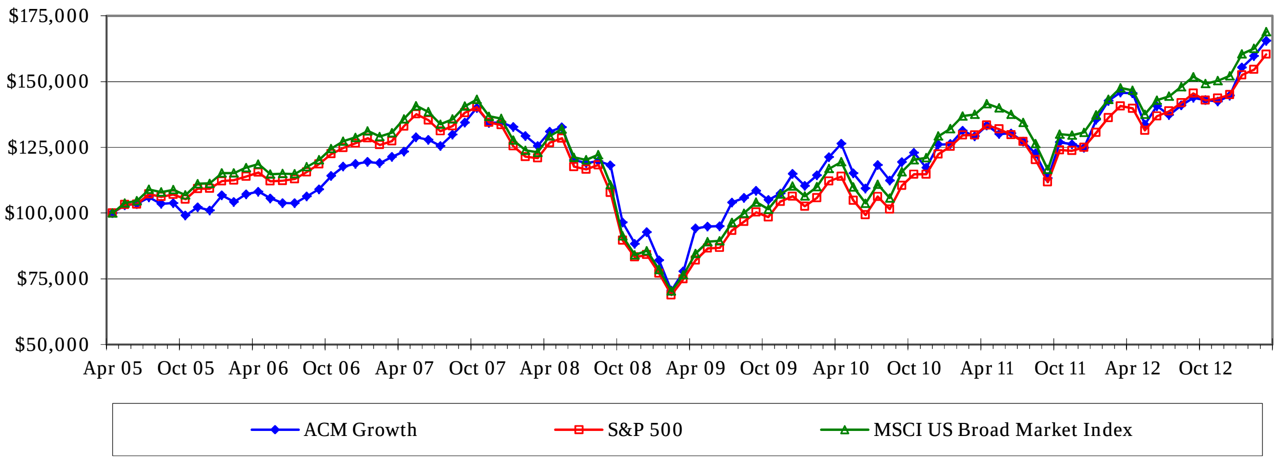
ATHENA CAPITAL MANAGEMENT

Cumulative Growth Performance

Performance as of 3/31/13	Year to date	3 years	5 years	7 years	Since inception (4/30/05)
ACM Growth	14.43%	36.46%	31.85%	54.52%	65.53%
S&P 500	10.60%	43.04%	32.64%	40.80%	60.35%
MSCI US Broad Market Index	11.02%	44.52%	37.25%	44.02%	68.94%

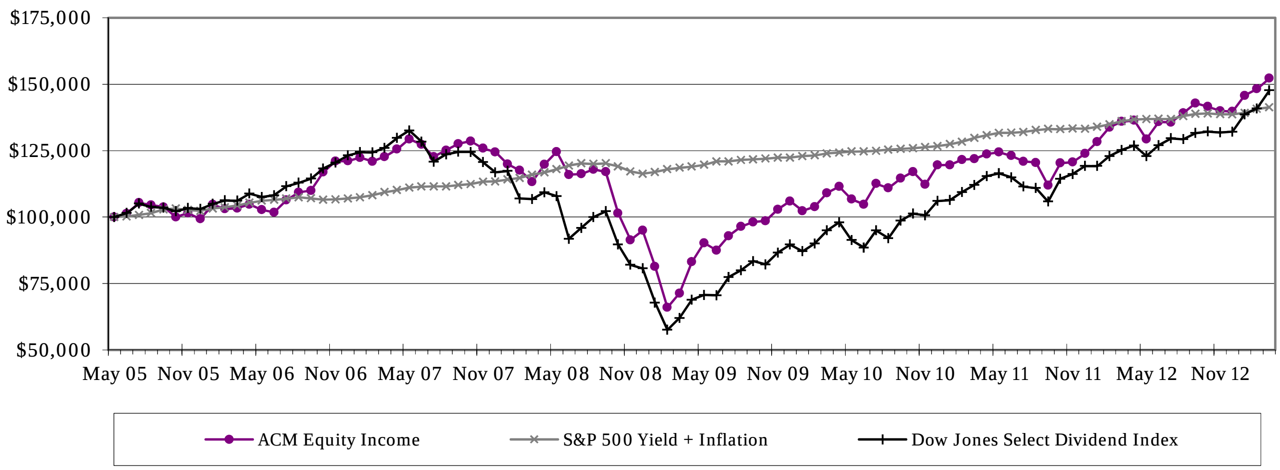
Comparison of the change in value of $100,000 investment in ACM growth
versus S&P 500 and MSCI US Broad Market Index



Cumulative Equity Income Performance

Performance as of 3/31/13	Year to date	3 years	5 years	7 years	Since inception (5/31/05)
ACM Equity Income	8.96%	39.52%	34.38%	47.30%	52.23%
S&P 500 yield + inflation	1.91%	14.02%	21.88%	35.35%	41.29%
Dow Jones Select Dividend Index	11.78%	55.55%	38.32%	39.11%	47.70%

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 16, 2013

2013 started nicely, with the S&P 500 up 10.6% in the first quarter alone. Growth portfolios did even better, climbing 14.4%. Equity income portfolios performed well, too, beating their long term benchmark by over 7%.

In this letter, I will review our investing results, discuss my view on markets and the economy, and highlight the lessons I've learned over 17 years of investing.

Performance this quarter

Growth portfolios out-performed the S&P 500 year-to-date, over 7 years, and since inception, but under-performed over 3 and 5 year periods. We did well mostly because securities so out of favor last year did well early this year—especially personal computer (PC) companies. The market is fickle, though, so I'm not counting on this trend-reversal continuing for long. In the meantime, our quality companies look well positioned to generate good, but not outstanding, returns over the next several years.

Growth's out-performers this quarter were **Hewlett-Packard** and **Dell**.

Hewlett-Packard (HP) and Dell are both information technology companies that sell hardware, software and services to everyone from large enterprises to consumers. Both companies have suffered as the PC market has stagnated, but the market's opinion on HP and Dell changed this quarter when Michael Dell made an offer to take his own company private, and investors began to realize that HP and Dell are *much* more than PC companies. I don't know the outcome of Dell's offer, or if either of either turn-around will succeed, but the underlying cash flows for both are strong, and the potential for fundamental improvement is large.

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

POSCO is a Korean steel producer, the third largest in the world. I think POSCO's price was down this quarter because North Korea has been acting a little crazier than usual, and because of the current over-capacity in steel production (mostly China). There is little POSCO can do about its neighbor to the north, or over-capacity relative to demand, but it can maintain its impressive lead in making high quality steel with the best profit margins—by far—in the industry. At some point, supply and demand dynamics will work themselves out, and POSCO will likely return to making much higher profits.

Frontier, a rural telecom provider, continues to suffer from a combination of high debt, a declining end market, and fierce competition. Investors clearly don't like those characteristics, but I think they are missing Frontier's improving customer metrics and growing network speeds (allowing it to better compete). The bottom line is that Frontier's high and stable cash flows provide a 20% earnings yield and a 10% dividend. This won't cure all ills, but it's a great place to start.

Equity income portfolios out-performed our long-term benchmark over all periods this quarter. Dividend paying equities became particularly popular as investors flock to anything generating more income than bonds. This trend is likely to endure. I'm embracing quality businesses with growing dividends rather than high, no-growth dividends. This path is likely safer and more lucrative.

Equity income saw out-performance from **Hewlett-Packard** and **Pfizer**. Please see my comments above on HP.

Pfizer is the world's largest pharmaceutical company. This quarter, Pfizer successfully sold its nutritional business to Nestle and spun off 20% of its animal health business, Zoetis. The combination of these cash bonuses and a growing pipeline of potential new drugs has investors excited. The real trick is generating profitable new drugs, which could restore Pfizer to growth and lead to even more excitement. It's too early to count chickens, but the number of eggs is quite encouraging.

Frontier Communications and **POSCO** were equity income's under-performers this quarter. Please see my comments above on Frontier and POSCO.

Market and economic outlook

The S&P 500 gained 10.6% this quarter. That pleasant gain is ahead of the underlying earnings trend, which means my six year expectation declined. Given that, future returns don't look overly enticing, making investment selection even more important in successfully growing our portfolios.

Projected annualized returns over the next 6 years	
S&P 500 (growth benchmark)	-3.2% to 8.7%
S&P-500-yield-plus-inflation (equity income benchmark)	3.6% to 6.6%

How do I arrive at these numbers? See my 2Q2005 article.

Happily, the U.S. economy grew faster in 2012 than 2011. The same cannot be said for Europe (decline) or China (growth slowed). Japan was the only other major economy to improve growth year over year.

So much for the rear-view mirror, what about the future? U.S. growth looks increasingly positive, but with threats from government blunders. The Eurozone seems set for improvement, too, but faces the same bureaucratic peril as America. China is also likely to expand growth, especially during its once-every-10-year power change that spurs large spending (a.k.a. political favors).

But, economic growth does not necessarily lead to stock market returns. Surprising to most, the correlation between economic growth and stock market returns is statistically zero. Valuation and per share profitability drive stock returns, not economic growth. I addressed valuation above with my six-year projection. For per share profitability, the negatives are higher interest rates and growing regulation, and the positives are higher consumer spending, a rebounding housing market, and surging productivity.

This negative/positive balance could be good for stocks and real estate even as it's bad for bonds and commodities. That is why I favor productive assets, like equities and income producing properties, over dollar denominated instruments (cash, notes, bonds, CDs, etc.) and "things" (oil, gold, land, coins, art, etc.). Productive assets aren't immune to temporary, unpleasant downdrafts, but their multi-year returns look *much* better than alternatives.

Lessons learned: The Good, The Bad, and The Ugly

We've done well over the last eight years—beating a large majority of investors simply by keeping pace with the market. I'll be the first to admit, though, that I'm *not* satisfied with this outcome. We can do better.

In any endeavor, improvement comes from rigorously examining what has worked, what hasn't, and then changing accordingly. I've embraced such continuous-improvement from the beginning—conducting post mortems on every investment. My goal: to discover whether I was lucky or unlucky, and if my investment process was sound or not. This on-going effort is almost certain to improve our results going forward.

I'd like to share some highlights of what I've learned so far:

- The Good – what's worked well
- The Bad – what's led to mediocre returns
- The Ugly – what's pulled our results down most

The Good

1. The worst of times are the best times to buy.

Our best returns came from bombed out economies, markets, industries and companies. As Warren Buffett says, "...be fearful when others are greedy and greedy when others are fearful." Psychologically, this is *very* hard to do, but the profits are well worth a bit of temporary discomfort.

2. Focus your research and concentrate your investments.

Our highest returns followed from in-depth research on specific companies and industries (competitors, management, suppliers, customers, substitutes, etc.). It can take *years* to really understand a business and its industry, so you have to focus your efforts in limited areas (not enough hours in the day). If you've done that kind of work and really understand what a company is worth, and then it goes on sale, you should invest an enthusiastic amount of money.

3. Look for great company economics.

A company's economics are difficult to determine with precision, but it's what drives long term investment results more than anything else. We've done best when economics were excellent (even if we had to pay a higher price for them). Success is more about *sustainability* than *level* of profitability.

The Bad

1. Low valuation usually isn't enough protection against weak company economics.

When a company or industry falls apart—and they do quite often—it's very difficult to pay a low enough price to do well. This issue mirrors my point above about great company economics. You can do *well* with low valuation by itself, but for *great* results you need to own companies with excellent economics.

2. The quality of management is less important than company economics.

As Warren Buffett put it, "when a management team with a reputation for brilliance tackles a business with a reputation for bad economics, it is the reputation of the business that remains intact." I've bought several brilliant managers only to find that the best jockeys can't win if they are riding old, broken-down nags.

3. High insider ownership isn't always a good sign.

Insiders may buy convincingly into their own inflated self-image, but such ownership is not an accurate signal of commitment or excellence. Insiders can also take a company private when its stock price temporarily tanks, taking advantage of long term shareholders. Finally, high ownership can indicate a founder who doesn't realize the industry and competitive landscape has changed forever—a clear danger for investors.

The Ugly

1. Don't try to time the market.

I'm better at valuing companies than I am at guessing what the market or economy will do over the short term (just like everyone else). Sitting in cash or buying volatility in attempts to smooth results or wait for better opportunities has been *the* biggest drain on our relative performance. Don't worry: I will *never* try this again.

2. Diversification is di-worse-ification.

I know that criticizing diversification is an affront to the sacred cow of the finance profession, but my attempts to smooth returns with broader diversification have generated unsatisfactory results. In every case, it led to a *marginally* smoother ride and *much* worse returns—not a desirable outcome! Buying my 20th or 30th best idea has never worked as well as buying more of my top 10 ideas.

3. Selling companies with weak economics at too-low valuations is quite foolish.

It's best *not* to buy companies with weak economics. But when you realize you have—and it's usually only obvious in hindsight—don't sell too cheaply to "clear the decks." Companies with weak economics usually crash harder than companies with good economics. If they survive—and most do—they rebound *much* more strongly than vigorous companies. So, if thorough research indicates a weak company won't go to zero: be patient, wait for the rebound, and then sell.

I'm convinced that learning from mistakes is *the* key to improving results. Of course, I'd prefer never to make any mistakes—who wouldn't! Barring that miracle, the next best thing is to learn diligently, improve, and then reap the benefits. I hope this brief review shows I'm doing just that.

Until next quarter

If you have any questions, comments or feedback for me, please feel free to contact me any time. I always enjoy hearing from you.

Respectfully,
Mike

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