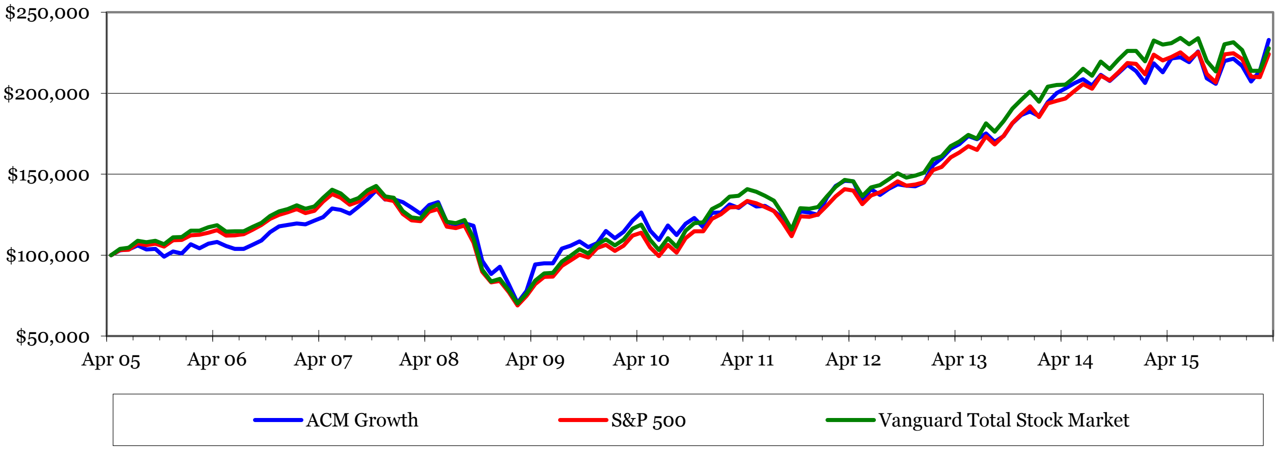
Athena Capital Management

Cumulative Growth Performance

Performance as of 3/31/16	Year to date	3 years	5 years	10 years	Since inception (4/30/05)
ACM Growth	7.41%	40.62%	80.42%	117.50%	133.00%
S&P 500	1.35%	39.82%	72.94%	96.87%	124.20%
Vanguard Total Stock Market	0.45%	36.06%	66.68%	94.47%	127.77%

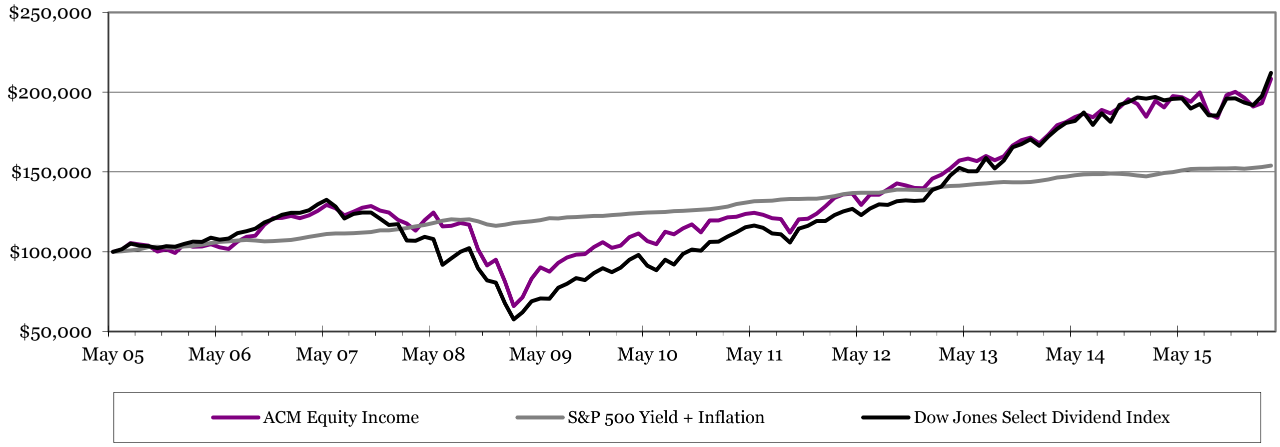
Comparison of the change in value of $100,000 investment in ACM growth
versus S&P 500 and Vanguard Total Stock Market



Cumulative Equity Income Performance

Performance as of 3/31/16	Year to date	3 years	5 years	10 years	Since inception (5/31/05)
ACM Equity Income	6.07%	36.86%	71.00%	101.63%	108.38%
S&P 500 yield + inflation	1.25%	8.97%	18.63%	47.49%	53.97%
Dow Jones Select Dividend Index	9.63%	43.63%	89.29%	99.80%	112.14%

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 14, 2016

After an ugly start to the year, the S&P 500 reversed course and finished the quarter up 1.35%. Our portfolios did much better as we exploited the market's turmoil to benefit from bargain prices. More on that below.

This quarter's letter covers our regular topics, portfolio performance and market and economic outlook, as well as how I'm working to improve our results through better fiancial modeling . I hope you find it informative.

Performance this quarter

Growth portfolios out-performed over all period reported: year to date, 3 years, 5 years, 10 years and since inception. This out-performance was due mostly to individual security selection, but also to some ridiculous price declines created by January's market upheaval. Such happy outcomes won't occur every quarter, but when they do, we are likely to benefit.

Joy Global and **USG Corp** were growth's out-performers this quarter.

Joy Global is the largest manufacturer and servicer focused solely on mining equipment. Joy's stock has plunged over the last two years due to the collapse of commodity prices and the mining industry. We purchased Joy's stock in December 2015 and January 2016 when its price reflected a bankruptcy risk that didn't seem possible given Joy's steady servicing income. Our purchases were quickly rewarded after Joy announced results that made it clear bankruptcy wasn't an issue over the short to intermediate term. We've already taken some profits in Joy because I believe the decline in the mining sector isn't over, yet.

USG is North America's largest producer of wallboard, and a significant manufacturer of other construction products worldwide. USG's price fell over the last six months on concerns about the housing market's lumpy recovery. We were able to buy at some very low prices relative to underlying value, and have already been compensated with a substantial rebound. I expect the housing market's recovery to continue in fits and starts with USG benefiting throughout that process.

Growth saw under-performance from **Wells Fargo** and **M&T Bank** this quarter.

Wells Fargo and M&T Bank are the 3rd and 12th largest U.S. community banks ranked by assets. Both declined this quarter on broad concerns about interest rates and loan defaults (all banks declined, so the concerns were not specific to Wells or M&T). As I've described in previous letters, banks mostly make money on the difference between the rate they lend to borrowers and the rate they pay depositors. With interest rates rock bottom—orchestrated by the Federal Reserve—banks are seeing loan rates decline faster than the rates on deposits (which are essentially at zero and can't go much lower). Bank stocks climbed late last year on hopes that interest rates would trend higher as the Fed increased rates for the first time in nine years, but those hopes were dashed after weak economic data came out, putting further rate increases in doubt. Investors have also become increasingly concerned that the crash in energy prices will lead to rising loan defaults from banks. The combination of low interest rates and threatening loan defaults has led investors to flee from banks stocks, including Wells and M&T. I think these concerns are overblown and investors will see this as banks report growing book value per share and relatively flat earnings even with low interest rates and growing loan defaults.

Equity income portfolios out-performed our long term benchmark over all tracking periods. We have, however, lagged behind our short term benchmark over all periods other than 10 years. With interest rates so low, income investors are chasing yield wherever they can find it, especially in riskier investments. Situations like this always end badly, and I'm guessing this one will, too. That is why we continue to play the long game that allows us to generate good dividend and interest income growth without resorting to short-sighted yield chasing that can lead to principal losses. I believe our prudent yield tortoise will beat the high yield hare at the finish line.

Philip Morris International and **USG Corp** were equity income's out-performers this quarter. Please see my comments on USG above.

Philip Morris International (PMI), the largest seller of cigarettes outside of the U.S. and China, continues to climb on market share gains and unexpectedly small declines in units sold. Added to this, the currency headwinds PMI has been facing—caused by a strong U.S. dollar—seem to be abating. I think PMI will continue exercising its pricing power, building on its market share gains, and deploying its capital prudently, thus generating good returns over time.

Equity income saw under-performance from **Wells Fargo** and **M&T Bank**. Please see my comments above on both.

Market and economic outlook

After much volatility, the S&P 500 returned 1.4% in the 1st quarter of 2016. This puts the index in a position to generate uninspiring average returns of

4.2% for growth and 5.2% for equity income. By being more selective than owning the S&P 500, however, I believe we can achieve better results over the next six years.

Projected annualized returns over the next 6 years	
S&P 500 (growth benchmark)	-4.2% to 12.5%
S&P-500-yield-plus-inflation (equity income benchmark)	2.2% to 8.2%

How do I arrive at these numbers? See my 2Q05 and 3Q14 articles.

The 1st quarter of 2016 started roughly. The stock market was down over 10% into mid-February before recovering into March. Like last summer, most of that decline was caused by fears concerning China's economy and how that affects world markets. In addition, investors are worried that global growth has permanently slowed.

This worry is justified by the facts: the world economy has been growing slower than in the past. Whether you look at developed markets like the U.S., Europe and Japan; or developing economies like China, Mexico and Eastern Europe; or emerging markets like Africa, Southeast Asia and Latin America; most countries are growing slower than 10, 20 or 30 years ago.

The latest government plan to "fix" this problem is negative interest rates, already implemented in Sweden, Denmark, Switzerland and Japan. Because low and zero interest rate policies have uniformly failed to boost growth— because they lead to mal-investment—I see no reason to expect negative interest rates to work any better. As Albert Einstein commented, "the definition of insanity is doing the same thing over and over again and expecting different results."

Despite these negative headwinds, I feel quite positive about our prospects for good returns over the long run. One reason is that I expect our value oriented investment style to come back into favor, and I believe that might have begun in the 1st quarter of 2016. Another is my intensive effort to improve our investment returns by analyzing what has and hasn't worked over the last eleven years, explained more fully in the next section.

To err is human; to improve, Sublime

"We must not say every mistake is a foolish one."
– Cicero

"By seeking and blundering, we learn." – Goethe

"Those who cannot learn from history are doomed to repeat it." – Santayana

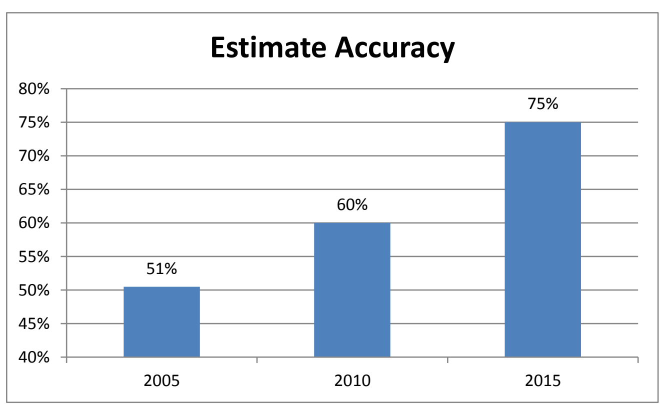
"Mistakes are always forgivable, if one has the courage to admit them." – Bruce Lee

I make mistakes. I know, you didn't hire me to make them, but I err nonetheless. **The important thing is to learn from one's mistakes and improve.** That's the deliberate path I've been on over my 20 years of investing.

More narrowly, my route to improvement is through the financial models I build to pick investments. These models use inputs like sales, profit margins, growth, shares outstanding, dividends, and multiples of earnings to predict returns for each prospective investment over five year periods. If my models are accurate, we can expect to pick good investments and beat the market over time; if not, then we won't. Improving the accuracy of such models on an on-going basis is vital, therefore, to increasing our chances of beating the market and the amount by which we win.

This continual effort has been effective. By examining my five year predictions against actual results, I've gained a concrete understanding of where my models need work. For example, between 2005 and 2010, I recognized I was generally over-estimating profit margins and growth rates. By adjusting those estimates down, I improved our estimate accuracy from 51% to 60% (with an estimate accuracy of 51% I had beaten the market by over 72%—6% annualized—from 1995 to 2004).

From 2010 to 2015, I further improved my estimate accuracy from 60% to 75% by adjusting my valuation models to account for the unique nature of each business and the way it was perceived by investors. The chart below shows my upward path of development over the last 10 years.

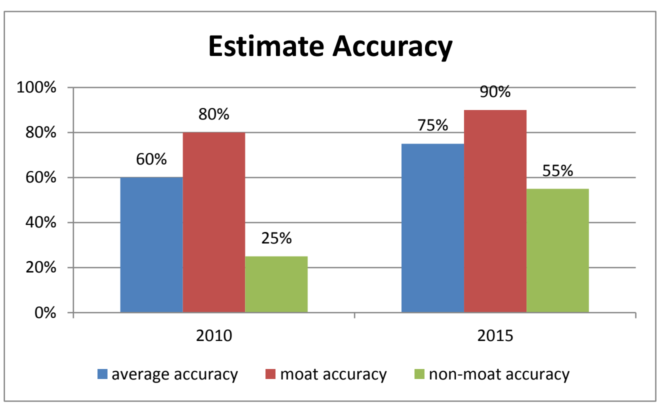


Although going from 51% accuracy to 75% is excellent progress, it hasn't been enough to overcome the headwind of Value losing to Growth over the last decade (see my 4Q15 client letter, Value versus Growth). I consequently resolved to deepen my investment process with the goal of boosting our chances of overcoming our value tilt and increasing the amount we can beat the market over the long haul.

My first step was to re-read Warren Buffet's partnership and shareholder letters four times (repeated re-reading aids deep understanding). Who better to learn from than the best investor of modern times? By studying the master, I hoped to find penetrating insights that would lead to better understanding and predictions of company performance.

Buffett says it took him two decades of buying weak businesses and regretting it to recognize how important it is to buy good businesses. Buffett refers to good businesses as possessing protective moats, which prevent competitors from successfully attacking their profitable castles (see my 3Q13 client letter, Investing: The Fortress Approach). I decided to see if Buffett's "moat" framework was a relevant filter for improving my prediction accuracy.

Indeed it was. **By breaking my estimate accuracy into moated and non-moated businesses, I found that I was much better at forecasting moated businesses.** For instance, my 2010 accuracy of 60% consisted of 80% accuracy for moated businesses and 25% accuracy for non-moated businesses. My 2015 accuracy of 75%, it turns out, consisted of 90% accuracy for moated businesses and 55% accuracy for non-moated businesses. The chart below shows my overall, moated, and non-moated prediction accuracy in 2010 and 2015.



This discovery is profound. By being more selective—only considering moated businesses—my accuracy could improve remarkably over our current 75%, perhaps to as high as 90%! That's what I've been analyzing over the last three years and what I've been implementing to improve our investment results.

Nobody—especially me—likes making mistakes. But, through painstaking analysis**, I've learned from my errors and improved our investment accuracy.** Just as important, I've made this improvement cycle an on-going part of my research and analysis process. This should, I'm convinced, produce results over time.

Until next quarter

If you have any questions or comments about the economy, markets, financial planning, performance, my research process, or specific investments, please don't hesitate to contact me. I look forward to hearing from you.

Indefatigably,
Mike

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