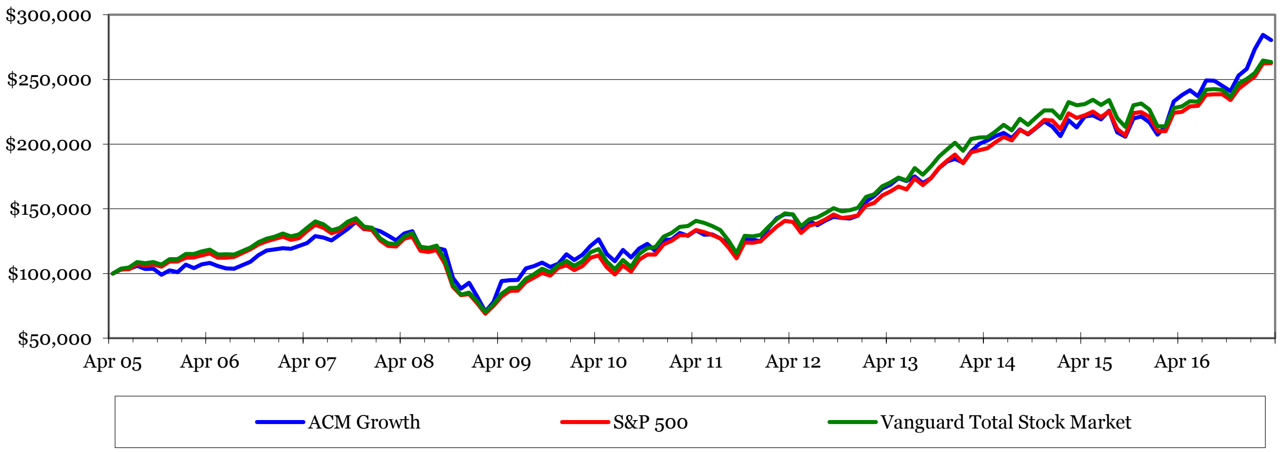
Athena Capital Management

Cumulative Growth Performance

Performance as of 3/31/17	Year to date	3 years	5 years	10 years	Since inception (4/30/05)
ACM Growth	8.64%	40.16%	92.33%	131.14%	180.53%
S&P 500	6.07%	34.45%	86.71%	106.27%	162.71%
Vanguard Total Stock Market	5.31%	28.51%	79.95%	102.58%	163.62%

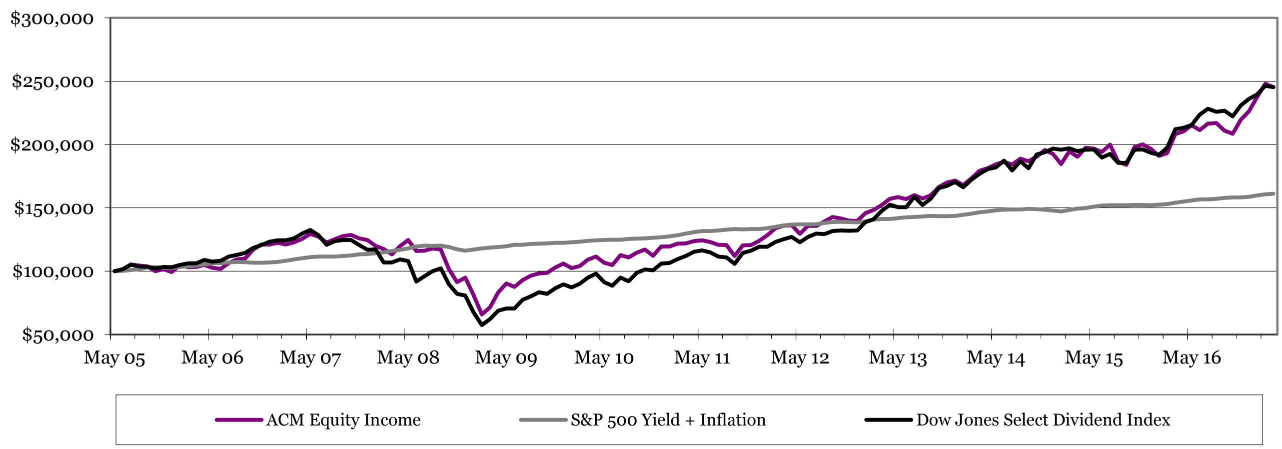
Comparison of the change in value of $100,000 investment in ACM growth
versus S&P 500 and Vanguard Total Stock Market



Cumulative Equity Income Performance

Performance as of 3/31/17	Year to date	3 years	5 years	10 years	Since inception (5/31/05)
ACM Equity Income	8.40%	36.75%	80.39%	99.85%	145.24%
S&P 500 yield + inflation	1.49%	9.93%	18.30%	47.28%	61.03%
Dow Jones Select Dividend Index	3.92%	38.64%	95.86%	94.64%	145.30%

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 and short positions, 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, sometimes short positions, 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. The returns provided are a combination of client accounts and might not represent individual accounts accurately. The firm puts clients into securities that are on a continuum of the two strategies based on their individual level of risk tolerance.

April 14, 2017

The S&P 500 returned 6.1% in the first quarter of 2017, but we did even better: 8.6% for growth and 8.4% for equity income. Individual security selection drove our performance this quarter even as value under-performed growth. This is an excellent outcome considering the headwind from our usual value tilt.

This quarter's letter covers our portfolio performance, my view on markets and the economy, and a section on passive versus active investing. I hope you get something out of it.

Performance this quarter

Growth portfolios, again, out-performed over all periods reported. Unlike last quarter and last year, value investing was a headwind instead of a tailwind, which means our results were due entirely to specific security selection. This is a good situation to be in, and why I've devoted so much time over the last seven years to improving our research process. Just think how things will look when/if value regains its winning ways!

Philip Morris International and **Liberty Global** were growth's out-performers this quarter.

Philip Morris International (PMI), the world's largest tobacco company outside of the U.S. and China, jumped 23% this quarter. One reason is PMI sells its products internationally but reports its financials in U.S. dollars, and the dollar's climb against other currencies finally slowed, revealing at last PMI's excellent underlying sales and profit growth. Another reason: PMI's rapid growth in reduced risk products (vapor instead of combustible), which has lit the imagination of investors who can now envision a tobacco company selling healthy alternatives to combustible cigarettes. Both trends have years to run, so I remain optimistic.

Liberty Global, Europe's largest cable company, climbed 18% on optimism about its underlying operations and reduced concerns about Brexit. Liberty successfully grew its operations in the U.K., Germany and Eastern Europe by extending high capacity cable to homes that haven't had options outside the local phone company. These growth plans extend for years into the future. Investors also seem less concerned about the impacts of Brexit, at least for cable companies, and this gave Liberty an additional boost.

Fairfax Financial and **M&T Bank** were growth's under-performers this quarter.

Fairfax Financial, a Canadian specialty insurance company with worldwide operations, declined 6% this quarter. I think investors are concerned that Fairfax is no longer hedging its equity investments, and about its large acquisition of Allied World Assurance. Investors seem to be ignoring Fairfax's better track record of investing over hedging, and its long term history of successfully integrating dozens of insurance companies over the last three decades.

M&T Bank, a top 15 U.S. community bank based in the northeast and mid-Atlantic region, dropped 1% as investors realized the Federal Reserve may not raise interest rates as aggressively as assumed late last year. This doesn't concern me much because M&T controls its own destiny as it transforms its recent acquisition, Hudson City Bank, from a thrift to a commercial bank. This will lower loan risk and result in better returns on equity, thus mitigating the impacts of interest rates changes.

Equity income portfolios out-performed our long term benchmark over all reporting periods, and beat the Dow Jones Dividend Select Index both year-to-date and over the last ten years. We had an especially good quarter with security selection, which is a pleasant outcome considering value investing's tough quarter. Our portfolio yields a meager 2.2% mostly because our portfolios have gained so much in value. This yield, however, is much more secure than can be found chasing higher yielding alternatives. I think we're well positioned going forward.

Philip Morris International and **Viacom** out-performed for equity income portfolios this quarter. Please see my comments above on Philip Morris.

Viacom, a cable network business that includes Nickelodeon, MTV, Comedy Central and BET channels, climbed 33% this quarter. Most of the credit goes to new CEO Bob Bakish and his plan to focus Viacom on its six major channels and restore Paramount Studios to health with an integrated approach to running the studio. Although Viacom has had a tough couple of years, I believe its franchises are still viable and will generate strong cash flows over time.

Fairfax Financial and **Verizon** under-performed in equity income portfolios this quarter. Please see my comments above on Fairfax.

Verizon, the U.S.'s largest wireless telephone company, fell 9% this quarter on continued missteps by management. Verizon has fallen behind rivals T-Mobile, Sprint and even AT&T in offering unlimited data plans, financing options for new phones, and other innovative offers customers desire. Added to this, its acquisitions of AOL and Yahoo! have distracted management away from its wireless franchise and toward internet video projects that haven't born fruit. Despite all that, Verizon still owns the best wireless network in the country, a strong competitive position, and the lead role in building the next generation of high-speed wireless: 5G.

Market and economic outlook

The S&P 500 returned 6.1% in the first quarter, another above average result. This lowered my six year average projections down to 2.5% for growth and 5% for equity income. With these low expectations, I continue looking for better opportunities and have been diligently finding them.

Projected annualized returns over the next 6 years	
S&P 500 (growth benchmark)	-4.8% to 9.7%
S&P-500-yield-plus-inflation (equity income benchmark)	2.0% to 8.0%

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

U.S. economic growth slowed to a crawl after a brisk third quarter 2016. Some of the blame goes to uncertainty surrounding another election season. Some, too, goes to a slower housing market and weak auto sales. Some goes, no doubt, to the rising U.S. dollar (increasing imports and decreasing exports) as the Federal Reserve is again raising interest rates.

Don't tell investors, though—they don't care. As I've said in previous letters, economic and stock market growth rarely go hand in hand. Mostly, that's because economic growth is backward looking and the stock market forward looking. Right now, investors feel ebullient at the prospect of a pro-business administration cutting taxes, slashing regulation, and spending on infrastructure, so they're gladly pushing stock prices higher.

It wouldn't surprise me, however, to see those high spirits fizzle this summer. In contrast with investor perceptions, factions within Congress and the new administration are in conflict about how—exactly—to cut taxes, roll back regulation and raise money for infrastructure spending. The thin veneer of political unity last fall is slamming into the brick wall of dismal government finances and vote-generating political calculation. As that reality sinks in, I believe investors' mood will sour.

As I've said before, economic trends and investors' frame of mind shouldn't be our primary focus. We should, instead, concentrate on good companies with capable management selling at reasonable prices. And that's where I spend 99% of my time: digging deep to find good values regardless of which way the political and economic winds blow. I'm finding compelling opportunities, and expect to discover more over time.

A Fundamental Choice

Suppose you could—with one choice—guarantee you'd do something better than 80% to 90% of others. That decision would bar you from *ever* being in the top 9% to 19%, but you'd be certain to do better than the vast majority. Would you make that choice? Such an option exists in investing, and it's called Passive (industry jargon for low cost index fund investing).

Arguments for Passive

The empirical proof for Passive is solid: most Active investors lose to the market. Consider the data from Standard & Poor's (S&P):

- 87.5% of all domestic funds lost to the market over the last 10 years
- 94.6% lost over the last 5 years
- 87.4% lost over the last 3 years
- 90.2% lost over the last year

Perhaps you think you could look at the record of money managers over the last three or five years to pick winners? Success at picking a top 25% manager from a past three years to be in the top 25% over next three years: only 15.8%. Over five years: 20.1% (also S&P data).

If that doesn't convince you, consider the theoretical argument. When you add together the investment results of all investors (everyone's losses are someone else's gains and vice versa), the result is the average market return. Subtract fees and you're below average. **People picking stocks in aggregate *can't* beat average because they *are* the market after fees.** Therefore, those paying higher fees—Active—will as a group lose to those paying lower fees—Passive.

Passive—as an investing discipline—advises low cost index funds, and rejecting Active as an option. That locks in average returns minus a very small fee instead of after a much larger fee, allowing you to beat 80% to 90% of Active investors.

Not surprisingly, investors have digested that proof and flooded out of Active and into Passive. According to Morningstar, approximately $985 billion flowed out of Active U.S. stock mutual funds and exchange traded funds (ETFs) over the last 11 years. The inflows into Passive funds over the same period: $925 billion. Investors have voted with their money.

Arguments against Passive

Why, then, would anyone *ever* invest Active versus Passive? 1) Some people recoil at the idea of accepting below average. They don't want their upside limited and feel confident they can pick winning managers. 2) Not everyone can stomach the peaks and troughs of the market with Passive, and anyone not sticking with the market through thick and thin loses Passive's benefits. 3) The more people invest Passive, the less market prices reflect underlying fundamentals, and that can only go so far before poor returns result. In markets, anything can be taken too far, and we might be reaching that point with the flood out of Active and into Passive.

So, what's the alternative to Passive? **Active investing is the notion that *if* you can find a good money manager, you can beat the averages after fees.** Doing better than average isn't just cocktail party fodder, it means not having to save as much, reaching retirement sooner, or ending up with a higher standard of living in retirement.

Arguments for Active

One reason to go Active is that Passive investors can and do panic and sell when the market tanks, or become euphoric and double down at market tops. In contrast, Active investors are more likely to stick with the manager they chose than Passive investors who've hitched their wagon to an impersonal and abstract "market." There's a world of difference between the theoretical return Passive investors *could* get and the actual returns they *do* get in volatile markets (Dalbar and Morningstar gather data on that subject).

Another argument for Active is that savvy investors can successfully pick money managers. This is done by studying track records, understanding investment processes, and judging manager discipline. Research says this is *very* hard to do, but not impossible.

Active investing, too, can add value by tilting toward approaches that work over time. Value, quality, momentum, and volatility are examples of investing tilts with solid track records. Active can also prove beneficial during periods of market disruption when Passive won't, such as market downdrafts or euphoria.

Finally, there is the possibility, with Active, of doing *much* better than the market. As mentioned above, that means a higher standard of living or more time to enjoy it, which is nothing to sniff at.

Arguments against Active

There are, of course, *strong* arguments against Active investing. First, the odds of doing better than Passive are very poor—stunningly so (see S&P's stats above). Everyone likes to think they can outsmart the crowd, but this isn't Lake Woebegone (where everyone is above average) and the reality is that only 10% to 20% actually beat Passive. Why?

It is *very* hard to pick a market-beating money manager. You not only need someone who conducts good research and analysis, but also does it better than *most* of their peers. After all, investing is a competitive endeavor, and winning after fees means you must find someone *much* better than average. Above average intelligence is part of the mix, but more important are a contrarian temperament, independent thinking, a proven investment framework, and the habit of continuous improvement.

Looking at three or five year investing records isn't enough, because every method goes through long phases of in- and out-performance—10 years or more—and investors have a hard time sticking with someone who doesn't win for several years (just ask some of my ex-clients). Short term track records are deceptive, so you must look at *very* long periods of performance (15+ years) to judge a manager's method—its efficacy—and how consistently it's applied.

Now that you know the pros and cons for Passive and Active investing, what's an investor to do? Bet on the top 10% to 20% and forego doing better? Or, take a chance on either under-performing average or striking gold? The choice is up to you. Some choose to do a bit of both, while others go full bore one way or the other.

Considering the odds, it is arrogant to think anyone—much less I—can beat the market. And, yet, I've been doing it for almost 17 years. Look at our returns on the first page of this letter, and you'll see that we're already in the top 5% to 13% over all periods. We're not alone, either: a bevy of other value investors have beaten the market for long periods (Warren Buffett, Walter Schloss, Wally Weitz, Bob Rodriguez, Meryl Witmer, David Dreman, O. Mason Hawkins, Robert Olstein, Seth Klarman, Joel Greenblatt, Bill Ackman, David Einhorn, just to name a few).

Yes, it is *very* hard to beat the market. But, with the right approach, temperament, intellect, work ethic, it can be done. It's not a smooth or consistent ride, but what in life is?

Passive investing has solid empirical and theoretical backing. It's beaten Active ever since it was first conceived and especially over the last decade. Understandably, this has led investors to flood out of Active and into Passive. As with any trend, Passive may have gone too far. Active investing, in contrast, only works *if* you can find a very good manager, and that is *devilishly* hard to do. If you can, though, it means more time in retirement or a higher standard of living. For me, that's worth it.

Until next quarter

If you have any questions or comments about this letter or anything else, please feel free to contact me anytime. It's always great hearing from you.

If you know anyone who needs a good money manager, please send them my information. As you know, referrals are how I grow my business and I'm always looking for new clients.

Unremittingly,
Mike

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