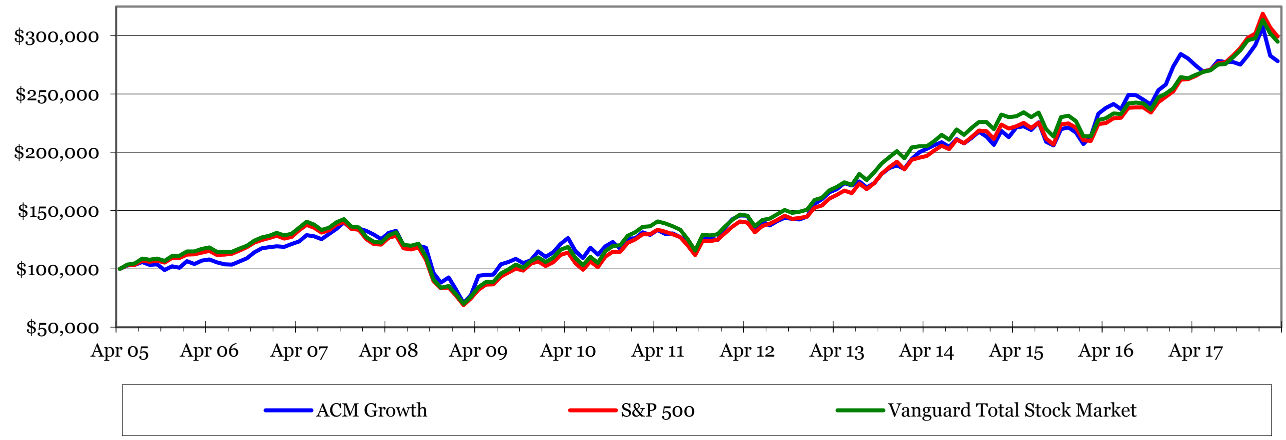
Athena Capital Management

Cumulative Growth Performance

Performance as of 3/31/18	Year to date	3 years	5 years	10 years	Since inception (4/30/05)
ACM Growth	-4.74%	30.58%	67.89%	121.59%	178.19%
S&P 500	-0.76%	35.95%	86.75%	147.70%	199.46%
Vanguard Total Stock Market	-1.00%	28.14%	76.11%	140.50%	194.83%

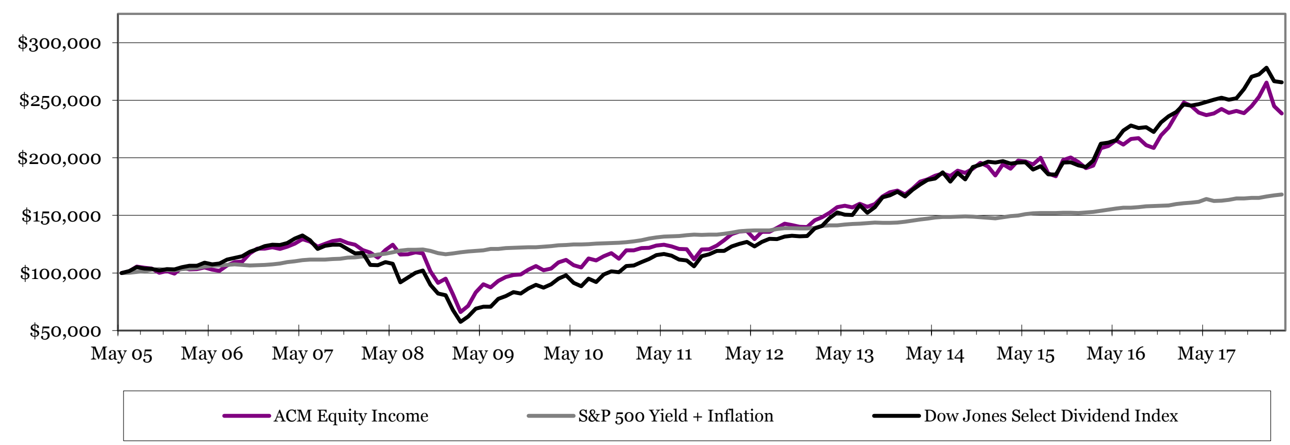
Comparison of the change in value of $100,000 investment in ACM growth
versus S&P 500 and Vanguard Total Stock Market



Cumulative Equity Income Performance

Performance as of 3/31/18	Year to date	3 years	5 years	10 years	Since inception (5/31/05)
ACM Equity Income	-5.72%	25.22%	56.62%	110.51%	138.47%
S&P 500 yield + inflation	1.71%	12.50%	18.97%	45.00%	68.09%
Dow Jones Select Dividend Index	-2.54%	36.28%	79.79%	148.69%	165.55%

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 11, 2018

First quarter 2018 was rough, with lots of volatility and the S&P 500 down -0.8%. We were down even further: -4.7%. What happened? The market felt the pain of higher interest rates and a potential trade war, and our particular holdings fared poorly due to company specific news (more on that below).

If our past year's performance makes you think I should be sitting in the corner with a dunce cap on my head, please consider the data below. It shows underlying earnings growth expected from the S&P 500 and our growth and equity income portfolios as well as the price being paid for those underlying characteristics.

	Expected growth	Price paid per unit of earnings & growth
S&P 500	2.0% - 10.0%	24.0x
Athena Growth	2.5% - 11.0%	13.3x
Athena Equity Income	1.7% - 11.1%	13.6x

The table shows that investors are willing to pay almost *twice* as much for the S&P 500 as our holdings even though they are likely to get slightly worse growth per dollar of investment. Why would they do that? I think investors are both over-estimating the robustness of the S&P 500 and under-estimating the strength of our holdings. This inconsistency can't last, but it will likely make me look dumb for longer than I'd prefer. The price of long term out-performance is frequently short term under-performance, and we've felt that keenly over the last four of quarters.

This letter covers our quarterly performance, what's going on in the economy and markets, and a review of how Microsoft went from hero to zero and back again. Microsoft's story is relevant in that many of our current holdings resemble its situation several years ago and provides an interesting example for what might happen going forward.

Performance this quarter

Growth portfolios, again, under-performed the S&P 500 over all reported periods. We own large positions in cable companies and a bank that did poorly this quarter. Those share price declines were, ironically, contradicted by good underlying business performance in sales, profit margins, returns on equity and earnings per share. Sometimes news-specific issues hit a concentrated portfolio like ours, but that's likely short-lived. Soon enough, investors will refocus on underlying fundamentals, after which I expect better outcomes for us.

M&T Bank and **USG Corp.** out-performed for growth accounts this quarter.

M&T Bank, a large northeast bank centered in Buffalo, climbed 8% on higher interest rates and continued excellent execution. As interest rates rise, banks tend to make more money as their loan rates adjust more quickly than the interest they pay on deposits, and M&T benefited from that. Added to this, M&T has been successfully transitioning a recent acquisition, Hudson City, from a home lending focus to commercial banking, which is more profitable and lower risk. I expect M&T to continue executing well and to potentially make additional smart acquisitions over time.

USG Corp., the largest wallboard manufacturer in the U.S., climbed 5% this quarter on news it might get purchased by Knauf (a German building materials company). Warren Buffett owns 31% of USG and offered to sell his stake to Knauf, which already owns 25% of USG, as long as Knauf can buy the rest of USG for at least $42 a share. USG's board is pushing for a higher price, which is wise considering its strong position, but also means the deal might not go through. Regardless of what happens, I agree with Buffett that USG is worth at least $42 a share as opposed to the $33 a share it was trading at before the potential deal was announced.

Comcast and **Liberty Latin America** under-performed in growth accounts this quarter.

Comcast, the largest cable company in the U.S. and owner of NBCUniversal, fell 15% this quarter on news that Comcast is interested in buying Europe's Sky satellite TV business and worries about cord cutting. Investors continue to fret over lost cable video customers while ignoring much more profitable broadband and business customers that keep growing and becoming a larger part of the business. More understandably, investors are concerned that Comcast might overpay for Sky in an attempt to position itself as a global entertainment company. Although I sympathize with investor worries, I think they've over-reacted. Comcast's current management has an excellent track record of capital allocation and business execution over several decades, which gives me confidence they won't make a mess of things.

Liberty Latin America, a significant telecom provider in Chile, Puerto Rico, Panama and several Caribbean islands, fell 4% this quarter due to difficulties with its Puerto Rican business and competitive dynamics in several of its markets. Hurricanes Irma and Maria devastated Puerto Rico, both its infrastructure and economy, and the cost of recovery will be expensive and time consuming. Not surprisingly, Liberty's competitors have used this as an opportunity to compete on price both in Puerto Rico and other impacted markets. I think Liberty has superior infrastructure and better management, though, so the effects are likely temporary. In my opinion, Liberty has the highest growth potential of any of our investments, so the long range view looks outstanding even as the short term feels challenging.

Equity income portfolios beat our long term benchmark over all periods except year to date, and continue to lag the Dow Jones Dividend Select Index. Equity income portfolios suffered the same sting as growth portfolios: company specific news in cable and our largest bank position. You never know when the news flow will turn positive, so I focus instead on underlying fundamentals, which look quite strong. You can expect our principal value to fluctuate along with the market, which will probably remain unpleasantly volatile, but our income payout should grow steadily along with or faster than inflation.

M&T Bank and **Markel** were equity income's out-performers this quarter. Please see my comments above on M&T Bank.

Markel, a specialty insurance company we've owned since 2005, climbed 3% on good results and high expectations. Markel weathered the hurricane season well due to its conservative underwriting and excellent investing operation, including a fast growing private market segment. I expect Markel to continue its outstanding record of underwriting and investing, and for its true upside to be felt only once insurance markets harden with better pricing and constrained capacity (which tends to happen after large catastrophes). This might not happen soon, but I think it's inexorable.

Comcast and **Wells Fargo** were equity income's under-performers this quarter. Please see my comments above on Comcast.

Wells Fargo, the largest community bank in the U.S., exists under a black cloud of Federal Reserve sanctions and on-going negative headlines, thus causing its price to fall 14% this quarter. Despite scandals of fake accounts and improper practices, Wells Fargo's weak oversight has little impacted customers or its underlying deposit and lending franchises. I doubt its dark clouds will pass soon, and consider new negative headlines almost certain; but, its stock price over-reflects the downside, making it, I believe, a strong long term investment.

MARKET AND ECONOMIC OUTLOOK

The S&P 500 lost 0.9% so far in 2018. This below trend result means my six year average estimates increased mildly to 2.6% for our growth benchmark and 5% for our equity income benchmark. As usual, I think we can do better and have invested accordingly.

Projected annualized returns over the next 6 years	
S&P 500 (growth benchmark)	-4.7% to 9.8%
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.

Welcome back volatility! If anyone thought markets had reached a new era of steady increases to be enjoyed forevermore, the first quarter was a harsh wake-up call. January saw the S&P 500 climb 7.5% only to fall 11.8% in early February, then rebound 10.6% and fall 7.7% in March. After several years of unusual market calm, volatility came back with a vengeance and seems to be sticking around.

One reason is the concern I highlighted last quarter: the threat of higher interest rates. Expected inflation increases and the need for large government debt issuances led to higher rates early last quarter. Markets tend to anticipate such changes ahead of time, so when investors saw their fears coming to pass, they tried to adjust their portfolios in the same way all at the same time, causing dramatic price swings. Such is the nature of markets.

Going forward, economic and market growth will likely reflect further changes in government policy. Lower corporate taxes and less regulation are good for economic growth, but immigration restrictions and trade tariffs are very bad. Which of these two opposing forces is winning at the moment will almost certainly decide immediate market direction. Foreign economies will be less impacted by our policy shifts, but cannot remain unscathed. Considering that U.S. stocks are much more expensive than global equities at present, I'm finding better opportunities abroad.

That's the reason you've seen us buying businesses overseas of late. For example, we own the largest cable company in Europe and an up and coming telecom business in the Caribbean and Latin America. Worldwide, we hold the largest tobacco company outside China and a rapidly expanding Canada-based insurance company. Many of our companies, like IBM, Deere and Microsoft, are U.S. domiciled, but generate more revenues internationally than within the U.S. That doesn't mean we're *only* foreign owners— two of our largest holdings, Comcast and Wells Fargo, are almost exclusively U.S. focused. But, I'm finding more value outside our borders, so our portfolios increasingly reflect that judgment.

Unfortunately, our foreign tilt won't lead to quick and easy profits. If it were simple, everyone would do it, right? Quite the opposite, momentum is squarely on the side of U.S.-centered companies for now, and we've been feeling the consequences for several quarters. That dynamic will shift as investors become more selective and price conscious about what they own. I don't know precisely when this shift will occur (no one else does either), but I don't doubt its inevitability.

MICROSOFT: FROM HERO TO ZERO... AND BACK AGAIN

Microsoft's stock price peaked in December 1999 just under $60 a share, then fell 75% over nine years to a low just under $15. From these ashes it rose phoenix-like to a new high over $97—up over 500%. **What caused Microsoft's fall from grace? Why did we buy big when it was down? Why did it rebound so strongly?** In this section, I aim to answer those questions.

To start, turn back the calendar to the late 1990's when Microsoft was a stock market darling. **It dominated operating systems with Windows and application software with Office** (Word, Excel, PowerPoint, Outlook). It held over 90% market share and generated stunningly high profitability. Microsoft was so successful it was charged with antitrust violations and put under government surveillance for over a decade.

As the 2000's progressed, however, Microsoft was seen as losing its edge. Growth was occurring in new areas beyond Microsoft's grasp: iTunes and iPods in music, Google in search, Amazon in shopping, Facebook in social networking, Netflix in video. In smartphones and tablets, Microsoft dramatically lost to Apple's iOS and Google's Android. Google's web browser—Chrome—overtook Microsoft's once dominant Explorer, and Google's lightweight operating system was making inroads with Chromebooks.

In applications, too, Microsoft's supremacy was under assault. Apple was succeeding not just with iTunes and iOS, but also with its own office suite: Pages, Numbers, Keynote and Mail. In addition to search, Android, YouTube and maps, Google was also making progress with its office applications: Docs, Sheets, Slides and the wildly successful Gmail. Menacingly, new third party apps were launched almost daily through Apple's App Store and Google Play.

Windows and Office weren't the only things seemingly troubled. Microsoft was lagging Sony's PlayStation and Nintendo's Wii with its Xbox gaming system, losing badly with Bing in search, and failing dramatically with its Zune music player. Investors were coming to view Microsoft as unable to compete.

But, were things really so dire? After a deep dive, my research indicated otherwise.

First, investors were missing Microsoft's continued dominance and defense in operating systems. Yes, smartphones and tablets were growing much faster than PCs, but PCs were still mainstays for creating if not consuming content, especially in the workplace. And there, Microsoft still ruled with over 90% market share.

Another knock against Microsoft was its weak operating system launches: Vista and Windows 8. But, Microsoft had a long history of alternating good and bad operating system releases: Windows CE—fail, Windows XP—success, Vista—fail, Windows 7—success, Windows 8—fail, Windows 10—success. There was no news there; investors fretted even as Microsoft remained firmly in control.

Second, observers were ignoring Microsoft's continued supremacy in word processing, spreadsheets and presentation software. Office had become *the* standard because it had been used by so many for so long, especially professionals. Such users weren't eager to learn new software, or rip and replace documents, presentations and models they'd built over decades. Consumers just hadn't converged on an alternative to Office, and Microsoft preempted the competition by making Office readily available on iOS and Android. Office was too entrenched to be easily supplanted.

Finally, Wall Street grossly underestimated Microsoft's position in enterprise software, then called Servers & Tools. Here, Microsoft had grown market share and profitability for over a decade, mostly under the radar. Information Technology (IT) professionals were already familiar with Microsoft software, so they were willing and eager to adapt its back office solutions, too. As a result, Microsoft had a strong presence in server operating systems, database software, middleware, directory services, security software, and so forth.

More importantly, Microsoft was growing into a new-fangled area of distributed computing referred to as The Cloud, which was rapidly replacing its alternatives as a cheaper/faster/better option. The Cloud had been pioneered by Amazon Web Services, but Microsoft quickly became the #2 player and was growing even faster. Investors seemed to be ignoring its budding potential there.

To sum up, the difference between investor perception and the underlying reality regarding Microsoft was wide. What mattered even more to Wall Street was the numbers. And there, my figures indicated investors were quantitatively as well as qualitatively misjudging Microsoft. I used a technique called sum of the parts to value Microsoft: break the company into segments, value each piece separately, and then add up the parts to see what the whole is worth.

In operating systems, Microsoft was in the lead but fading, so I valued it like a newspaper company—steady decline but with high profitability. In applications, Microsoft was dominant but growing less quickly, so I valued that piece like a consumer goods company—high profitability but only average growth. In Servers & Tools, Microsoft was growing into a new niche, so I valued that segment like an emerging tech company—rapid growth and expanding profit margins from a small base. Search and gaming I assumed were worth nothing and could be killed if they didn't perform.

Adding up the pieces, Microsoft looked significantly under-valued. Investors were clinging to a narrative that Microsoft was irrelevant and the death of the PC was nigh. After all, the prophetic Steve Jobs had declared the PC era was over, so Microsoft must be toast, right? Not necessarily.

That's why we bought a small position between 2005 and 2008, and then a much bigger position from 2008 to 2011. **The more I studied and learned, the more convinced I became that Microsoft was a solid bet.** By late 2011, it had become our largest holding at over 12% of our portfolios.

Please keep in mind this was a difficult action to take at the time. The general view on Microsoft was that it was irrelevant, a has-been, a goner. As we were buying aggressively, headlines announced the death of the PC and the coming doom for Microsoft investors. This illustrates that our best investments are almost always out-of-favor when we make them, and that you shouldn't take the consensus view as unquestionable truth.

So, what happened to change the story for Microsoft? **First, an activist investor called ValueAct bought a big chunk in 2013 and asked for a seat on the board of directors.** Unlike many activist investors who try to bully management, ValueAct had a reputation for positively engaging with companies—bringing new perspectives on management, market focus, and capital allocation. They saw the value of Servers & Tools as well as the legacy power of Windows and Office, and wanted that recognized. At the time, it was rumored they were considering new management as a path to changing investor perceptions.

Next, Microsoft's management did indeed change. During its period of price decline, the CEO had been Steve Ballmer, who'd taken over from Bill Gates after being his deputy for 20 years. Ballmer had a reputation as a weak technologist, and he'd made several disastrous acquisitions attempting to challenge Google and Apple. He announced his coming retirement in 2013, and Satya Nadella was promoted to CEO in 2014. Nadella was the manager who'd successfully built the Servers & Tools division into a power player in enterprise IT, and was seen as a visionary technologist who clearly grasped where business software was heading.

It should be noted that Microsoft was under-valued long before ValueAct or Nadella, but it took these two changes to rejigger Wall Street's view of Microsoft. The value was there, it just needed catalysts for investors to see things in a new light.

As Microsoft went from:

1) **on their death bed, to**
2) **maybe they'll survive, to**
3) **they're back in action, to**
4) **one part is performing very well, to**
5) **they've regained the lead,**

the stock price took off. It's been a fun ride during which we've trimmed our position as price increasingly reflected underlying value. Today, we still hold a small position as the momentum behind Microsoft's Cloud grows and the company continues performing well. We'll stay put until the price indicates more hope than reality.

Not every company goes from hero to zero and back again. Microsoft rebounded because the underlying truth was better than investors' perceptions. For me, it took a while to fully grasp the situation, but when it became clear investors had dismissed Microsoft and were off the mark, we bought aggressively. **Such opportunities occur rarely—only when a negative perception meets contradictory research and analysis.** When that happens, though, it's a wonderful thing.

UNTIL NEXT QUARTER

If you're feeling discouraged by our recent performance, you're not alone—so am I! Rest assured I have almost all of my net worth invested in the same holdings as you, so: a) I am truly incentivized to see our investments do well, and b) I have with deep deliberation picked what I think will do best in proportion to how well I think they will do and how confident I am in that outcome. This won't result in instant gratification, but I've put everything I've got—my money, mind, time and effort—into generating the best result I can for all of us.

Please contact me if you have any questions or comments about this letter, our performance, the market and economy, financial planning, or anything else that is on your mind. I'm always happy to hear from you and eager to help in any way I can.

With the long term in clear focus,
Mike

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