Athena Capital Management Corp.

July 12, 2005

The stock market as a whole is grossly over-valued. Based on historical precedent and sound reasoning, it would have to drop by 28% today or remain flat for the next six years to become fairly priced.

Does this mean there are no good companies to invest in?

No. I'm finding several great businesses that are likely to provide good returns over the next six years.

Does this mean the stock market will crash? Or remain flat?

No. We can't predict, consistently or precisely, what the stock market will do over any short period. My assessment, though, may mean that you'll want to prepare yourself for a bumpy market over the near term.

Based on history, I expect S&P 500 (growth benchmark) returns over the next six years of -7.7% to +7.8% annually.

Also, I anticipate S&P 500 dividend yields plus inflation (income benchmark) between +3.3% to +6.3% annually over the next six years.

While I can't guarantee future returns, it's my goal to provide better returns than this for you. And, since we don't have to invest in the market as a whole, I think our odds of beating the market are excellent.

Why am I starting my first client letter with such a gloomy view?

Because I promised to act with integrity, even if this means giving you less than great news. I want you to feel prepared for the future -- both psychologically and financially. The best way to do this is by providing you with my clearest thinking on this subject. Below, I'll justify my view with the historical evidence and sound reasoning I referred to above.

How did I get to the above expectations? I did the same thing a good engineer does: I broke the problem down into fundamental components.

First, I broke S&P 500 returns into three components:

- earnings growth
- dividend yield
- valuation change

Next, I examined the historical record of each component in turn, along with inflation, so that I could form reasonable projections.

Last, I recombined the components to form the expectations described above. This approach is detailed below.

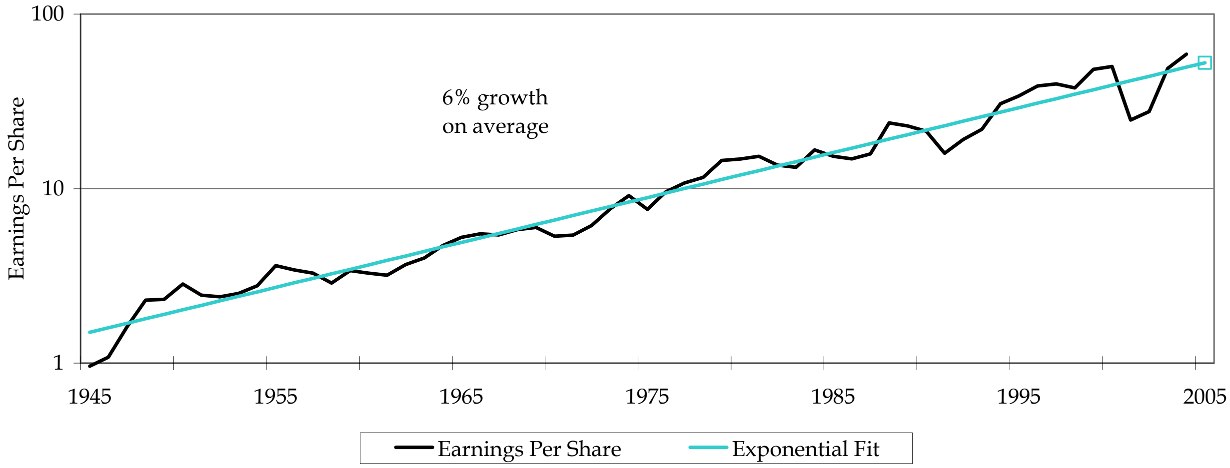
Earnings Growth

By earnings growth, I mean the future growth a company will achieve on a per share basis in percentage terms. If you take a company's revenue, subtract all costs, and then divide that by shares outstanding, you arrive at a company's earnings per share.

This is how much money a company has made, per share of stock offered on an exchange. You can also think of it as how much money a company has made for each shareholder. Earnings growth is the amount that this per share figure grows on an annual basis.

Historically, S&P 500 earnings per share have grown at about 6% per year over the last 60 years. As the graph below depicts, this growth trend has been remarkably stable over time.

S&P 500 Historical Earnings Per Share



Why have the earnings per share of the S&P 500 grown at 6% per year? Because the S&P 500 is a very good indicator for the economy as a whole, which grows at right around 6% a year.

Since S&P 500 earnings growth has been so stable -- and because it's so clearly linked to the growth of the economy as a whole -- it's reasonable to expect S&P 500 earnings growth to continue at this same 6% rate in the future.

So now, we have the first of our three components: 6% annual earnings growth.

Dividend Yield

The second component to examine is dividend yield, which is the amount of dividends paid per share expressed as a percentage of price.

To estimate dividend yield for the S&P 500, you take expected dividends for the upcoming year from the 500 companies making up the S&P 500, and divide that by the price you would have to pay to receive those dividends. With a current price of around $1,225 per share, and an estimated dividend of around $22.18, we wind up with an annual yield of 1.8%. That's all there is to the second component.

Valuation Change

The third component is more abstract and difficult to understand, but represents the most important factor both now and in the future.

Valuation changes because people's enthusiasm, or lack of enthusiasm, to buy a security changes. If people think a security is the best investing option around, they're willing to pay a higher price for it, which pushes valuation higher. If people don't want to own a security, they sell it, and that pushes valuation lower.

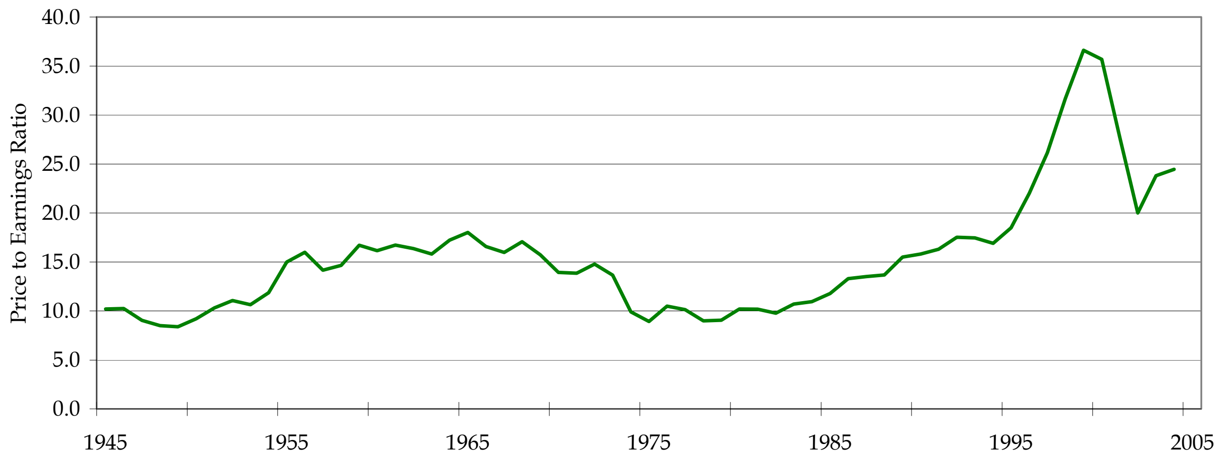
The securities industry uses something called the PE (price-to-earnings) ratio to measure valuations. We derive the PE ratio by dividing the price in the open market by the earnings per share of the security in question.

The higher the PE ratio, the more people are willing to pay for a security. The lower the PE ratio, the less they're willing to pay. As this willingness to pay higher or lower PEs changes, so does the return received for those who own the security.

How do returns change as valuations change?

If people become more enthusiastic and are willing to pay higher prices, then current owners get higher returns and future buyers get lower returns. Or, if people become less enthusiastic and are willing to pay less, then current holders get lower returns and future purchasers get higher returns.

S&P 500 Historical, Normalized Price to Earnings Ratio



Historically, annual S&P 500 PE ratios have fluctuated from as high as 36 (1999) to as low as 8 (1949, see graph above).

When S&P 500 PEs are high, people are excited about owning stocks and willing to pay a high price for that privilege. When S&P 500 PEs are low, people think equity investing is a terrible idea and will pay only a low price to buy equities. Over the last 60 years, S&P 500 PEs have averaged around 15, and historically at least, they have **always** returned to average after being driven above or below.

Unfortunately, PEs returning to historical norm from current levels would make investing in the S&P 500 distinctly unappealing. For example, if PEs took six years to return to historical average, the change from a current level of 22 to 15 would produce -6.2% annual returns due solely to valuation change.

More dramatically, if PEs moved to the bottom of that historical range (from 22 to 8) over the next six years, returns from valuation change would be -15.5% annually. Since a PE ratio at 22 represents a historical high that has never been maintained for long, the best-case scenario is no valuation change or a 0.0% return due to this component.

We now have our three components to calculate the growth benchmark projection, but we also need to look at inflation to get our income benchmark projection.

Inflation

Inflation is tricky to forecast because it depends on governmental policy. However, we can use the historical record as a reasonable guide to the future. In the last 60 years, inflation has fluctuated from as high as over 14% to below 0%. More than half of this time, though, it has been between 1.5% and 4.5%, so I think this is a reasonable range to use for the future. Although this forecast is not precise, it works well for stocks because the companies underlying stocks can usually adjust their revenues and costs so their earnings and dividends keep pace with inflation.

Recombining the parts to come up with forecast ranges

I reach my forecast for six year returns on the S&P 500 by simply adding together the first three components described above:

- 6.0% earnings growth + 1.8% dividend yield + 0.0% valuation change = 7.8% annual returns
- 6.0% earnings growth + 1.8% dividend yield + -15.5% valuation change = -7.7% annual returns

I achieve my forecast for six year yields on the S&P 500 plus inflation by adding together dividend yield and inflation:

- 1.8% dividend yield + 1.5% inflation = 3.3% annual returns
- 1.8% dividend yield + 4.5% inflation = 6.3% annual returns

That's how I determined my projections above -- by breaking down future returns into their components, examining the historical record to make reasonable projections into the future, and then recombining the components to reach future projections.

Let me end with two final thoughts.

First, the stock market returning to average or below would represent a great time to invest, with excellent returns going forward. Although a flat stock market or a potential drop is not pleasant to live through, it represents a once or twice in a lifetime opportunity to lock in excellent future returns.

Second, I'd like to reiterate that, because we don't need to invest in benchmarks, our future returns aren't bound to the forecasts above.

I look forward to doing my best to uncover the finest investment opportunities available, thus striving to prevent my projections from being an issue for you.

Michael Rivers
Portfolio Manager
Athena Capital Management Corp.
mike@athenacapital.biz
www.athenacapital.biz