

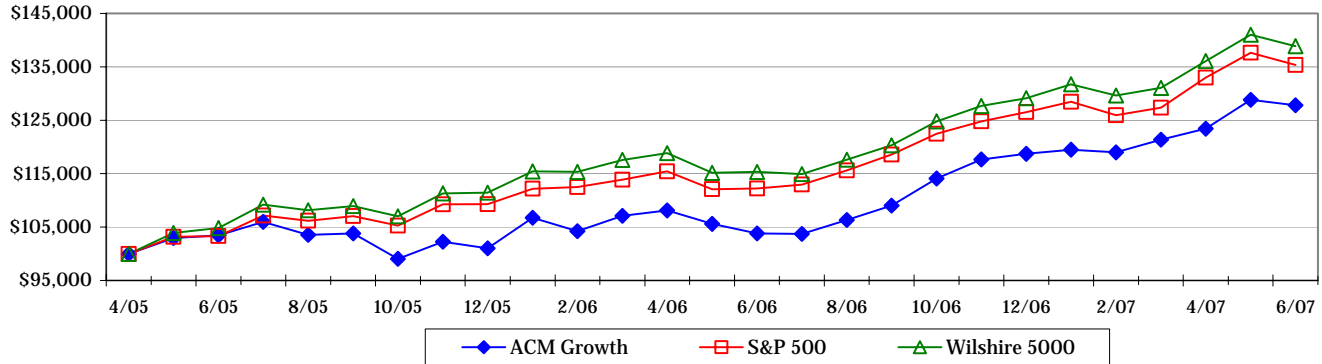


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Growth Performance

Performance as of 6/30/07	Year to date	1 year	2 years	Since inception (4/30/05)
ACM Growth	7.67%	23.13%	23.55%	27.82%
S&P 500	6.96%	20.59%	31.00%	35.36%
Wilshire 5000	7.56%	20.41%	32.48%	38.89%

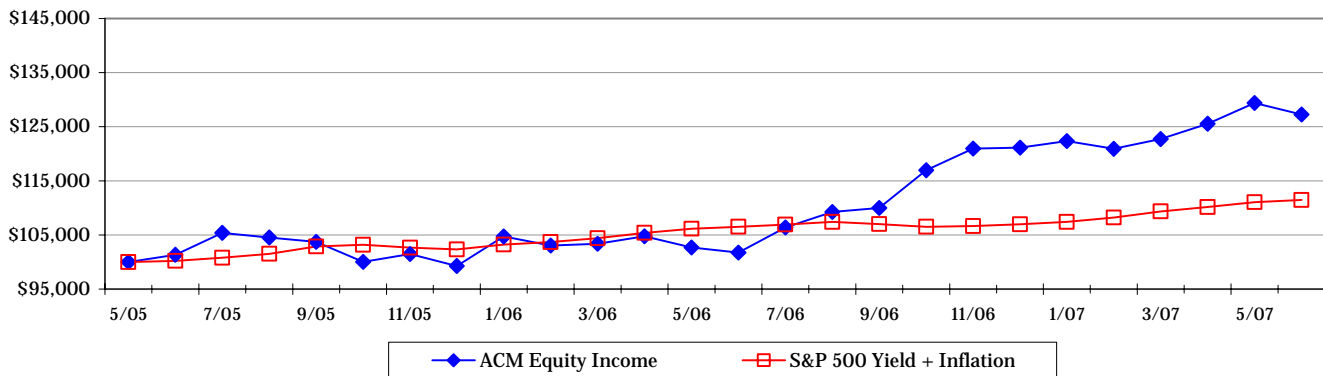
Comparison of the change in value of \$100,000 investment in ACM growth versus S&P 500 and Wilshire 5000



Equity Income Performance

Performance as of 6/30/07	Year to date	1 year	2 years	Since inception (5/31/05)
ACM Equity Income	5.08%	25.09%	25.60%	27.28%
S&P 500 yield + inflation	4.21%	4.65%	11.23%	11.46%

Comparison of the change in value of \$100,000 investment in ACM equity income versus S&P 500 yield plus inflation



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. 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.



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July 18, 2007

Summer-time, summer-time, sum-sum-summer-time! It's been a hot one already, but it's good to thaw out from an unusually cold and snowy winter. To top it off, I'm going to become a dad sometime in August! A summer to remember.



In this quarter's letter, I'll cover how our investments are doing, what I expect from the market and economy, how I measure and use the concept of impact to assemble your portfolio, our investment in Fairfax Financial, the Dow Jones Industrial Average, and James J. Hill. I hope you find it informative and entertaining.

How Are We Doing?

The pictures and tables on page one show our accounts continue to make good progress. In growth accounts, we out-performed the market year to date and over the last year, but under-performed over the last two years and since inception. Our accounts are performing as I expected, and our underlying businesses continue to outpace the market's trendline growth rate. Equity income accounts have out-performed in all periods so far. We won't beat the benchmark every quarter, but I continue to be optimistic about our future results. Equity income provides a 4% payout and should continue to grow faster than inflation over the long term.

Growth accounts generated out-performance, like last quarter, from **Leucadia National** and **POSCO**. Leucadia (a diversified holding company) continued to rally as the market seemed to completely forget its aversion to Leucadia's iron ore investment in Australia. It's up 66% from our average purchase price. POSCO (a Korean steel manufacturer, 3rd largest in the world) soared as the market continued to embrace the idea of Asia as a long term growth story. POSCO is up 135% from our average purchase price!

Growth accounts' under-performers were **Fairfax Financial** and **Newmont Mining**. Fairfax (an insurance holding company) pulled back a bit after rallying 133% from July 3, 2006 to March 30, 2007. I believe part of this pullback is concern about the upcoming hurricane season. Although Fairfax's earnings would decline if major hurricane damage occurred, I continue to believe it's an attractive investment over the next five years. Newmont (the 2nd largest gold miner in the world) declined with the price of gold. I believe Newmont provides an excellent hedge against inflation and the company will be successful at cutting its costs over the long run.

Equity income accounts saw out-performance from **Royal Dutch Shell** and **USA Mobility**. Royal Dutch Shell (one of the world's largest oil companies) rallied as the company continued to buy back its own stock. USA Mobility (the largest pager company in the US) simply recovered from its swoon last quarter. Although little relevant news came out, the market decided to revalue the company 34% higher.

Equity income's under-performers were **Kimco Realty** and **iStar Financial**. Both Kimco (a Real Estate Investment Trust) and iStar (a real estate financing company) dropped as interest rates spiked. I had already trimmed Kimco due to valuation, and iStar's drop was minimal. Regardless of what interest rates do over the short term, both of these companies possess enviable franchises that will grow dividend payouts over the long term, which is our key concern going forward.

6 Year Market Projections

The S&P 500 had another bumpy quarter, but finished up 6.3%. My view of market returns continues to deteriorate as the market rallies. 6% trendline growth, a 1.8% dividend yield, and high multiples on normalized earnings make for an unexciting combination. In contrast, I continue to expect our portfolios to outperform the market over the long term.

Projected annualized returns over the next 6 years	
S&P 500 (growth benchmark)	-7.0% to 8.0%
S&P-500-yield-plus-inflation (equity income benchmark)	3.3% to 6.3%

How did I arrive at these numbers? Visit "Free Articles" at www.athenacapital.biz to see my 7/12/05 article.

Interest rates made a big move last quarter with long rates moving significantly higher and short rates sinking slightly. Market participants are expecting accelerating inflation and an accelerating economy. This is good news in terms of economic growth, but may be bad news for the housing market.

The market for lending to homeowners experienced additional turmoil last quarter. This turmoil, along with new government legislation restricting mortgage loans and higher interest rates, will continue to hamper the housing market. I don't suspect we'll see high economic growth in the U.S. until the housing market's troubles have been purged, and this may take a couple of years.



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Assembling Portfolios, Part II

Last quarter, I used Acme Pharmaceuticals as an analogy to describe impact, probability, diversification and concentration. This quarter, I'll more thoroughly describe the concept of impact, and, more importantly to you, how I use it to shoot for above average returns in your account.

What if...

Suppose you're skipping along in a forest one day, and **you find a magical crystal ball lying next to the path**. On it, you see etched in black, "just say the name of a public company, and I'll show you its *exact* price in five years."

Of course, the first thing you'd do is look around for the candid camera crew. The last thing you need is to be caught on film talking to a crystal ball. But, when you don't see anyone filming, **you whisper "Microsoft," and "\$61.56" appears on the shiny surface of the ball.**



Assuming you believed the crystal ball, **what would you do with such information?** Would you run out and buy Microsoft because you uttered its name at a crystal ball?

Probably not. What you might do is go home to your computer, bring up a financial website, and **check the current price of Microsoft**. Suppose you saw it was selling for \$30.48 and paying a 1.3% dividend. Is that a good purchase price? Should you buy?

What you might do is divide \$61.56 into \$30.48 and **see that you'd double your money over 5 years!** Plus, you'd receive a 1.3% dividend while you waited. Not bad.

Sorry, no magical crystal ball

I hate to spoil it for you, but **I don't have a magical crystal ball that tells me stock prices in five years**. But, I have the next best thing: a clear understanding of which inputs affect future prices and returns.

You see, **future returns can be broken down into four components that can be analyzed and**

estimated. Those four components are: earnings, growth, multiple and dividend.

Earnings represent how much money a company makes. Growth projects how fast earnings will increase. Multiple estimates how much others in the stock market are likely to pay for future earnings. And dividend shows how much of earnings a company pays out to shareholders each year.

It's not as good as a magical crystal ball, but **thorough analysis provides a powerful tool in making investment choices**.

Analytical crystal ball

Using my analytical crystal ball, I estimate the future price of every company I can understand. Just like with the magical crystal ball, I can use those **future price estimates to figure out what returns could be earned by investing in each company**.

That's what I mean by *impact*. **Impact is the return that could be earned by investing in a particular company**. The way I like to look at it is in terms of annualized return over the next five years. For example, if Microsoft's price doubles over the next five years and it pays a 1.3% dividend over those years, then Microsoft would generate a 16.36% annualized return over the next five years. With that information, I can compare the return on Microsoft to other investment options and pick the one with the highest return, or impact, potential.

But, you may be asking, **how does my analytical crystal ball tell me that Microsoft will sell for \$61.56?** (If you don't like math, you can skip this paragraph.) First, I think Microsoft will earn around \$1.94 per share over the next year on a normalized basis. Second, I think Microsoft can grow those earnings at around 12% per year over the next five years, leading to \$3.42 in earnings per share five years from now. Third, I think the market will be willing to pay 18 times those earnings, giving me a five year price estimate of \$61.56. Fourth, Microsoft pays a 1.3% annual dividend.

After doing in-depth research on each business's economics, management and valuation, my analytical crystal ball allows me to rank our investment options and choose the companies that look most attractive. And, most importantly to you, **if your account is full of companies that look attractive, then your portfolio's result should be quite satisfactory, too**.

Too good to be true? You betcha! My crystal ball is only one part of the equation. It identifies my estimate of the



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impact an investment will have on your portfolio. The next part of the equation is probability, the likelihood that my projected impact will be realized. Just like the pharmaceutical company I discussed last quarter, I must assess which companies have the greatest probability of achieving their estimated impact. But, **I'll save a full discussion of probability for next quarter's letter.**

Investment Spotlight: Fairfax Financial

Fairfax Financial is a financial services holding company. It owns several insurance operations and an investment management practice. The insurance side includes Canadian, U.S. and Asian insurance, reinsurance (insuring other insurers), runoff insurance (settling future claims on insurance that has been discontinued) and insurance services and technology.



To succeed, Fairfax must both successfully underwrite insurance and get good returns on premiums collected. And, that's exactly what it does. Although Fairfax's underwriting side has had a rough five years, their prior record and recent efforts illustrate they can underwrite profitably. On the investing side, they have an outstanding record of getting good returns on the premiums they collect.

Fairfax is headed by the indefatigable Prem Watsa, who founded Fairfax's investing arm, Hamblin Watsa, in 1984, and then started piecing the insurance side together in 1985. Watsa owns over 10% of the company and other insiders own an additional 12%, so management's interests are aligned with shareholders.

Fairfax's guiding principles include such heart-warming concepts as: **being soundly financed, providing complete disclosure, being honest and having integrity.** The unusual thing is that Fairfax actually means it!

Fairfax is a business with **good economics run by smart managers whose interests are aligned with shareholders.** As you probably know by now, those qualities and the right price are what I look for in an investment.

Why Is...

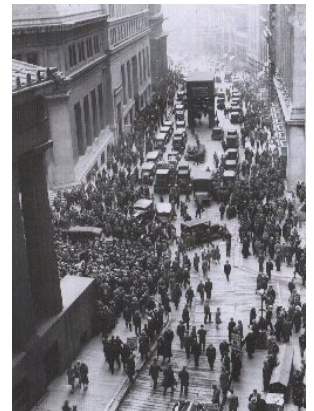
...the Dow Jones Industrial Average such a frequently quoted index?

The Dow Jones Industrial Average (DJIA) was first published in May 1896 by Charles Dow in the newspaper he co-founded, The Wall Street Journal. Dow had created the Dow Jones Transportation Average in 1884, but wanted an index to track the performance of the new and growing segment of the market, industrial companies. The DJIA originally consisted of only 12 companies, including General Electric, the only component still there today. Both indexes still exist.

In 1916, the number of stocks in the DJIA increased from 12 to 20, and then to 30 in 1928, its present number of components. The DJIA currently includes such major companies as Microsoft, Intel, American Express, Caterpillar, Coca-Cola, General Motors, Hewlett Packard, Johnson & Johnson, Citigroup, Pfizer, Wal-Mart, and Walt Disney.

During the market's rise over the last century, the DJIA has been the bellwether most people watched in tracking the market. The DJIA was closely followed and frequently quoted on the way up during 20's, 50's, 60's, 80's and 90's, and on the way down during the 30's, 70's, and early 2000's.

Because it consists of only 30 companies, somewhat arbitrarily selected by Dow Jones & Company, **it has been frequently criticized as being too narrow to adequately track the entire stock market.** Many market followers have noted that larger indexes, like the S&P 500 (which tracks 500 of the largest U.S. companies) or Wilshire 5000 (which tracks 5000 readily traded U.S. companies) better represent the U.S. stock market as a whole.



Regardless of this, the DJIA continues to be the most frequently cited and most well known index. In my opinion, this reflects its **long history and frequent quotation by the popular press over the last 111 years.**



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Admirable business people: James J. Hill (1838 – 1916)

James J. Hill was born in what is now Ontario, Canada. Although he received only 9 years of formal schooling, by that time he was already adept at algebra, geometry, land surveying and English. At age 14, when his father died, Hill left school to care for his family.

After learning bookkeeping as a clerk in Canada, he moved to St. Paul, Minnesota at the age of 18. **In his first several jobs, he learned how to handle freight transfers between steamboats and railroads.** During this time, he learned “how to extract favorable rates from shippers, how to beat back their attempts to inflate rates artificially, how to purchase commodities cheaply and undercut competitors, how to deliver efficiently, and how to cultivate and maintain loyalties of customers by voluntarily anticipating and looking after their every wish.” (Malone)

Hill eventually set himself up running a steamboat business while also cornering the local coal market. Wherever he worked, he made a business’s reputation for efficiency because he “worked incredibly hard, sometimes laboring late into the night, falling asleep at the desk, then getting up for a swim in the river and a cup of black coffee, then going back to work.” (Malone)

As a result of the Panic of 1873 **Hill, at age 35, was able to buy the nearly bankrupt St. Paul and Pacific railroad.** Hill turned this little railroad into the Great Northern Railroad, the *only transcontinental railroad built without subsidies from the federal government.*



Hill played a significant part in building the states of North Dakota and

Montana. His railroad created new towns to which immigrant farmers could move. Hill helped these farmers by teaching them how best to farm and utilize livestock. His railroad also brought them the lumber, livestock and seed they needed to succeed. Farmers and townspeople there prospered because they could easily send fresh produce east and west to markets eager to purchase goods. This would not have been possible without Hill’s railroad.

Hill was known as an extremely hard worker. **Hill said the secret of success was, “Work, hard work,**

intelligent work, and then more work.” Using attention to detail, perpetual cost cutting, persistence and hard work, Hill built a transcontinental railroad across the northern United States when others said it couldn’t be done.

If you want to learn more about James J. Hill, I highly recommend *James J. Hill: Empire Builder of the Northwest* by Michael P. Malone.

Until next quarter

Thank you for choosing to do business with me. I appreciate your confidence and look forward to providing you with excellent investment returns.

Welcome also to the newest members of the Athena Capital family. The second quarter was a particularly gratifying month for growing the business and I’m happy to bring more of you on to what I consider the best path to investing success.

As usual, if you know anyone who could benefit from my unique approach to investing, I’d be happy to welcome more new clients to the Athena Capital family. Provide them with my contact information or pass their information to me so I can contact them.

Until next quarter, enjoy your summer and I look forward to communicating with each of you over the coming months.

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