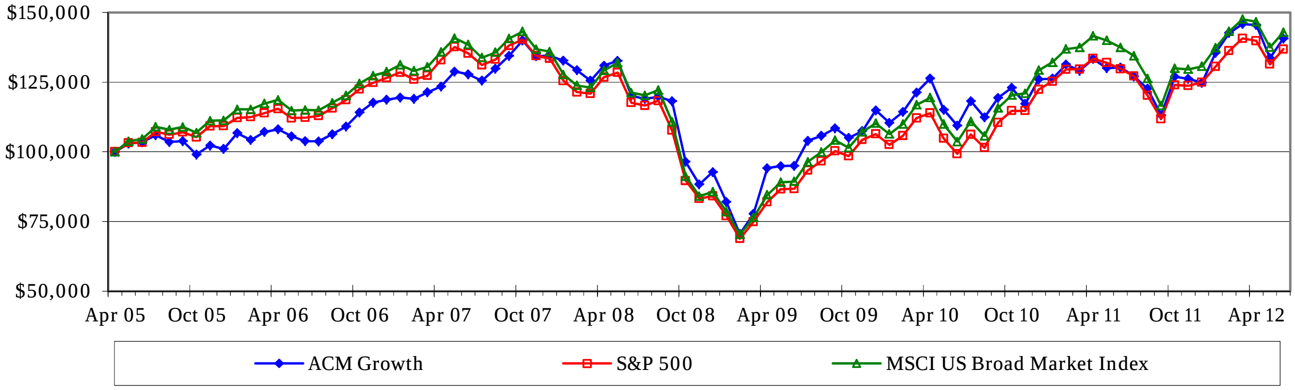
Athena Capital Management

Cumulative Growth Performance

Performance as of 6/30/12	Year to date	1 year	3 years	5 years	Since inception (4/30/05)
ACM Growth	12.72%	7.93%	48.10%	10.02%	40.66%
S&P 500	9.48%	5.45%	57.69%	1.09%	36.83%
MSCI US Broad Market Index	9.38%	3.96%	59.89%	3.21%	42.94%

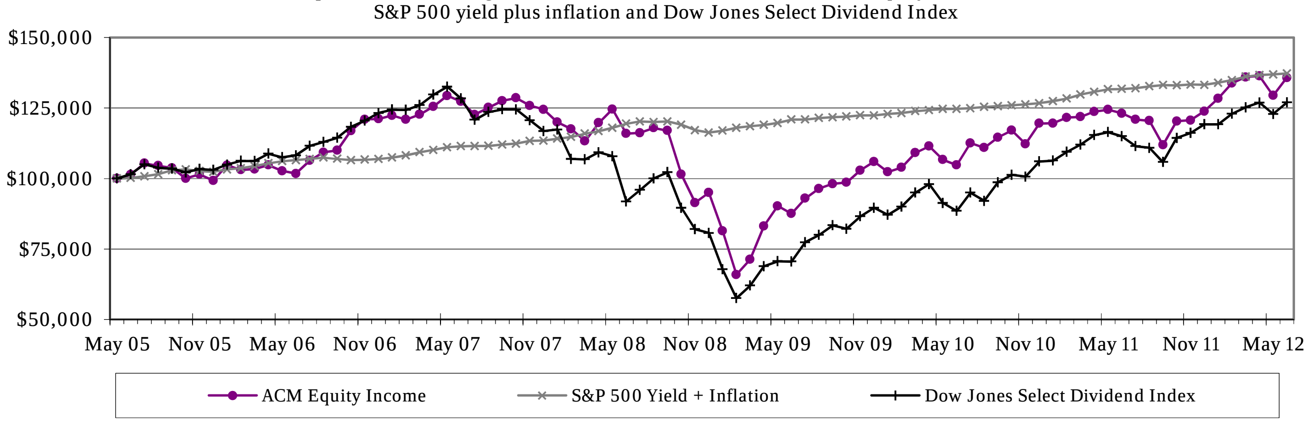
Comparison of the change in value of $100,000 investment in ACM growth
versus S&P 500 and MSCI US Broad Market Index



Cumulative Equity Income Performance

Performance as of 6/30/12	Year to date	1 year	3 years	5 years	Since inception (5/31/05)
ACM Equity Income	9.65%	10.30%	55.18%	6.69%	35.80%
S&P 500 yield + inflation	2.78%	3.94%	13.23%	22.85%	36.93%
Dow Jones Select Dividend Index	6.53%	10.50%	80.05%	-1.05%	27.01%

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

July 17, 2012

The *bang* that started 2012 turned into a whimper in the second quarter as the stock market dropped and then slightly recovered. So far, we're still ahead of our benchmarks for 2012.

This quarter, I describe our investing performance; my view on markets and the economy; my recommendation for how much I think you should save for retirement; and an investment spotlight on value versus growth investing.

Performance this quarter

Again, growth portfolios out-performed over every period but one: the 3 year period. Though the value approach continues to lag *far* behind growth over the last seven years, we are still slightly beating the S&P 500 due to better security selection. When value's historic out-performance re-asserts itself in the future (more on this below), I believe our performance will look even better.

Growth's out-performers this quarter included **USG Corp** and **Comcast.**

USG, a building materials company, had another strong quarter due to a recovering housing market and wallboard pricing improvements. I expect those dynamics to continue as residential real estate continues its lumpy rebound, and USG's UltraLight wallboard continues to demand premium pricing.

Comcast, the country's largest cable company, continues to perform well in broadband internet penetration and business services growth. Added to this, its NBC Universal purchase looks to have more upside than many predicted. I believe these benefits will continue going forward, although at a less vigorous pace.

Dell and **Ryanair** were growth's under-performers this quarter.

Dell, the world's 3rd largest computer company, saw its stock pummeled as investors were disappointed with quarterly sales and earnings. Much of the setback can be attributed to 1) a rebound at Hewlett Packard (channel partners who left two quarters ago returned when HP decided to stay in the personal computer business), and 2) a global slowdown in the information technology sector. Neither of these issues is permanent, and Dell is doing very well in its transformation from a strictly computer business to an enterprise solutions and services company.

Ryanair, Europe's leading discount airline, tumbled on concerns about Europe's political and economic situation, *not* because of anything wrong with its business model. Although we should expect more volatility from Europe, I don't think this will impact the long term value of Ryanair's growing and profitable business model, which is proving quite resilient.

Like last quarter, equity income portfolios out-performed their long term benchmark over all periods less than 5 years. Our combination of dividend paying stocks and diversified bond positions continues to provide a growing stream of income. Expect lumpy performance over time, but with an overall dividend yield that grows slightly faster than inflation.

Equity income saw out-performance from **USG** and **Verizon**. Please see my comments above on USG.

Verizon did well this quarter as investors more fully endorsed its wireless franchise, and grasped potential improvement in its wireline business. Though I expect these trends to continue, Verizon's stock price is beginning to fully reflect underlying fundamentals.

Dell and **Frontier Communications** were equity income's under-performers this quarter. Please see my comments above on Dell.

Frontier, a rural telecom company, continues to digest its large acquisition of two years ago while also facing challenging competition from cable. The good news is that with acquisition efforts mostly complete, Frontier can focus more fully on competitors. I expect Frontier's redoubled efforts to bear fruit soon. Meanwhile, its 10% dividend yield will help the time pass pleasingly.

Market and economic outlook

The S&P 500 fell -2.76% this quarter, causing my six year projections to improve slightly. The prospects won't cause excitement, but that's okay—we're invested in securities that are likely to do much better. Additionally, we can benefit from the market's fluctuations over time, whereas our benchmarks cannot.

Projected annualized returns over the next 6 years	
S&P 500 (growth benchmark)	-2.7% to 9.2%
S&P-500-yield-plus-inflation (equity income benchmark)	3.6% to 6.6%

How do I arrive at these numbers? Visit "Athena Capital Articles" at www.athenacapital.biz to see my 2Q2005 article.

The European economy is contracting, China's growth has slowed, and even the U.S.'s manufacturing sector recently shrank. It was too much to hope that the U.S. economy could completely dodge a global economic slowdown, but it remains to be seen how much our economy slows. It's my advice to be mentally prepared for downside, and happily surprised if it doesn't occur.

Bonds, stocks and commodities are partially reflecting this slowdown. Bond yields have shrunk to levels offering little investment merit (return-less risk, instead of riskless return), stocks have pulled back but don't yet fully reflect a recession, and commodities have taken quite a tumble. I still see stocks as the best combination of inflation protection and long term growth vehicle. We're invested accordingly.

Regardless of what happens economically, markets are likely to be volatile going forward. I wish there were a more pleasant way to ride through such periods, but trying to time the market is almost guaranteed to destroy more wealth than build it (which is why we're not trying). Better times will arrive right when things look most difficult, and that's why you must be invested to benefit (almost no one has the stomach to double down when things look dreadful). This is why a long term focus is so valuable in reaching your goals.

How much will you need to retire?

> *"Let our advance worrying become advance thinking and planning" – Winston Churchill*

Planning for retirement is so daunting that most fail to do it. The effort requires a dizzying array of inputs based on an unknowable future. But, failing to plan is planning to fail, so avoiding the project is even worse. After all, who wants to spend their "golden years" worrying about making ends meet?

What makes retirement planning so difficult?
Let's start with inputs and unknowns:

- Current savings
- Savings from now until retirement
- Taxes in retirement
- Desire/required annual retirement spending
- Retired withdrawal rate
- Tax status of savings
- Returns before and during retirement
- Inflation in retirement
- How long you (and your spouse) will live
- And so on…

Just as the key to real estate is location, location, location, the keys to retirement planning are assumptions, assumptions, assumptions. **Valid assumptions lead to success; invalid assumptions lead to failure.**

For example, most retirement advisors assume you need only 80% of your annual work income in retirement. But, that leaves no margin of error for things like sky-rocketing health costs, higher than expected taxes and inflation, higher vacation expenses, lower than expected returns, and a heap of other contingencies.

Also, many retirement planners use average returns to calculate retirement outcomes, but averages give you only a 50% chance of reaching your goals. Once again, this allows no margin of error. For instance, stocks have returned 10% on average over time, but 0% from 2000 to now (this wrecked the retirement of many retiring around 2000). Also, bonds have returned 5% historically, but is that a valid assumption with current yields of a mere 2% and the *extremely likely* prospect of growing inflation? Not at all.

A good retirement plan can't be based on optimistic or invalid assumptions. Importantly, it should provide you with a higher than 50% chance of reaching your goals. Therefore, the plan needs a ***big*** margin of safety—capable of handling lots of contingencies and an unknown future.

At the same time, the plan must be simple enough to implement without access to a super-computer and complex algorithms. An overly intricate plan can be worse than no plan at all. Precision isn't possible because inputs and unknowns vary so much; but a robust, easily understood aim-point is necessary to reach a happy and successful retirement.

My simple, yet powerful, rule-of-thumb is what I call the Rule of 30. **Basically, you want to save 30 times the amount you'll need annually in retirement,** (from which you can withdraw 1/30th of your starting amount each year). For example, if you want $100,000 a year in annual income, then you need to save $3,000,000.

As you may have noticed, **my Rule of 30 leans heavily on a given withdrawal rate, and that's**

because it's *the* most important assumption—if you pull too much money out of savings each year, you *will* run out of money too soon. My Rule of 30 assumes a 1/30th withdrawal rate (1/30 = 3.33%). I chose this rate because it has a large margin of safety—it has proven to be almost guaranteed to succeed.

In contrast, historical testing shows that a 5% withdrawal rate works *under many circumstances*, but provides too little margin of safety (do you really want to find out 5% was too much as an 85 year old who just withdrew the last dollar?). Further, a 4% withdrawal rate works a *large majority* of the time, but tough economic conditions or unexpected contingencies can upset that plan. **A 1/30th rate, however, can handle almost anything you throw at it, whether lower returns, higher taxes, longer life-spans, higher inflation, etc.** It's not bullet-proof (nothing is), but it can handle almost any economic or market contingency (like 1929, 1966, 2000, for example).

Please note: my Rule of 30 uses annual retirement income as a *net* (not gross) input, which means you multiply 30 times your annual income needs *apart from* pensions and social security. For example, if you'll need $100,000 a year in retirement and you'll receive $30,000 a year from social security, then you'll want $2.1 million to retire ($70,000 x 30 = $2,100,000).

A word of warning: be careful in applying this adjustment! Very few pensions are sufficiently funded (because almost all assume unrealistic rates of return), and social security is grossly under-funded. If you're over 50, you can probably expect to receive most if not all of your social security benefits. If you're under 50, however, expect less than full benefits—perhaps much less (50% may be a good rule-of-thumb, but for my personal retirement plan I assume I'll receive nothing).

If you want your golden years to be golden, consider using my Rule of 30 to plan for retirement. It's not fool-proof, but it's simple and almost guaranteed to provide you with effective guidance for reaching and enjoying your retirement (it's the plan I use).

> *"A good plan today is better than a perfect plan tomorrow." – General George S. Patton*

If you need help doing this kind of retirement planning, please feel free to contact me. Though I'm not a Certified Financial Planner, I do can definitely help you work through the retirement planning process. Just let me know.

Investment Spotlight: Value versus Growth

Value beats growth investing *most* of the time, but not *each and every* time. The periods when value lags can be frustrating to ride out, but as I hope to demonstrate, value's long run out-performance is significant, and well worth capturing.

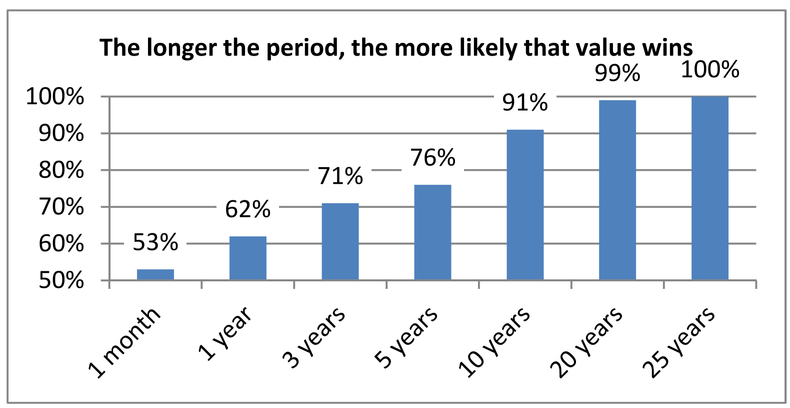
Value beats growth because people tend to over-pay for good prospects and under-pay for a poor outlook. Over time, the high price paid for apparent promise results in under-performance, and the low price paid for seemingly low potential generates out-performance. As long as human nature leads people to buy with their gut instead of their head, value will out-perform.

Two finance professors from the University of Chicago, Fama and French, demonstrated this clearly with their seminal 1992 paper (*Journal of Finance*). Their data covering 1926 to today (updated monthly since 1992) shows value has out-performed growth by 3.2% a year.

3.2% may not seem like much, but over time it adds up to a lot. Such out-performance results in:

- 20% more money over 6 years
- 50% more money over 13 years
- 100% more money over 22 years

Think of it as twice the standard of living in retirement and you'll understand why I think that's worth capturing.



As I said above, **what makes earning that upside tough is that value doesn't out-perform growth over *every* period** (even though it has over the long run). As you can see in the graph below, the longer the investment period, the higher the likelihood that value beats growth.

Looking at this data, many people ask the logical question: why not invest in value when it "works" and growth when it "works"? The reason is **that it's impossible to know which will do best beforehand.** It's like forecasting the weather—you know it rained in hindsight, but you never know with certainty whether it *will* rain tomorrow at noon.

Looking at our performance over the last 7 years, value is demonstrating why it's a hard discipline to follow. Whereas value has historically out-performed growth by 3.2% a year, it has *under*-performed by -1.2% annually over the last 7 years**. In other words, we've been facing a 4.4% headwind over the last 7 years**, making what's usually a fruitful pursuit look much less rewarding.

Despite this bracing 4.4% headwind, we've managed to narrowly beat the market over the last 7 years. The reason is that security selection provided us with a means to overcome the headwind. Looking at our rolling 3 and 5 year returns versus the Russell 3000 Value Index, we've been out-performing value by around 3.5% on average. Put differently**, we've done well as value investors, even though we haven't posted significant out-performance versus the market.**

Rest assured, just as night follows day, our headwind will turn into a tailwind—as history and human psychology shows it *always* has. When that happens, and I have the utmost confidence the time is coming, our performance will likely be much more rewarding.

Value doesn't win over every period (even 7 years!), and that makes value investing a tough approach to sustain. But, it has always won over the long run and the margin of winning makes it well worth the effort.

Until next quarter

We're making steady progress—slowly but surely. Despite the high bar I've set for myself—I aim to beat the market by 3% annualized over time—I have to remind myself periodically that 80% of individual and professional investors don't even match, much less beat, the market. Just because I want to be in the top 5% doesn't mean I should be unreasonably displeased with *only* being in the top 20%.

The top 20% isn't my target, though, so **I've spent a lot of time analyzing my investment process over the last 7 years, and I'm finding ways to improve.** For example, I could have—in hindsight—purchased at lower valuations, sold at higher ones, and selected higher quality companies. This on-going analysis and improvement will benefit our results going forward.

As usual, **if you have any questions, comments or feedback, let me know.** I always enjoy hearing from you.

Respectfully,
Mike

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