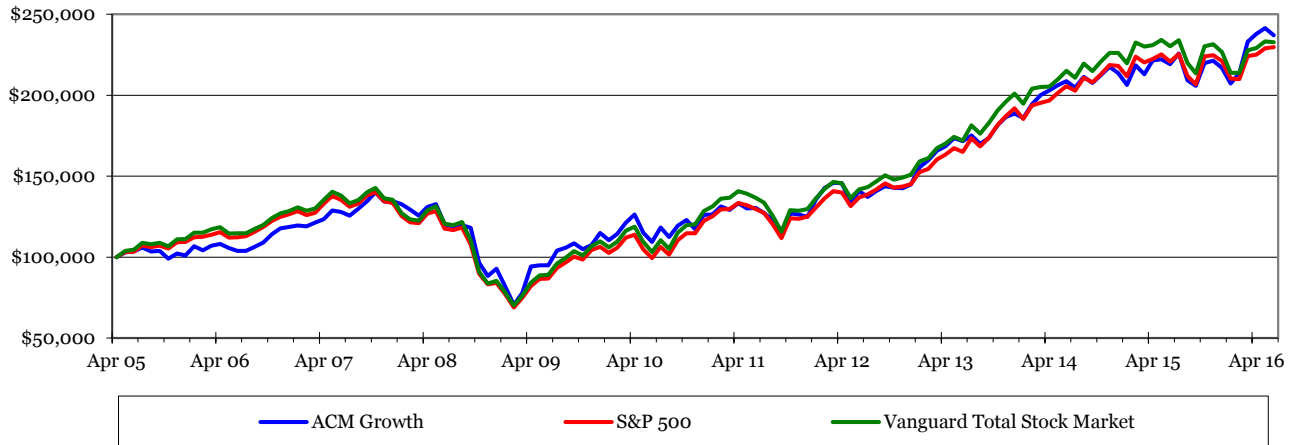


# ATHENA CAPITAL MANAGEMENT

## Cumulative Growth Performance

Performance as of 6/30/16	Year to date	3 years	5 years	10 years	Since inception (4/30/05)
ACM Growth	9.27%	38.20%	81.92%	128.39%	137.09%
S&P 500	3.84%	39.20%	77.03%	104.64%	129.71%
Vanguard Total Stock Market	2.70%	35.39%	70.43%	102.84%	132.86%

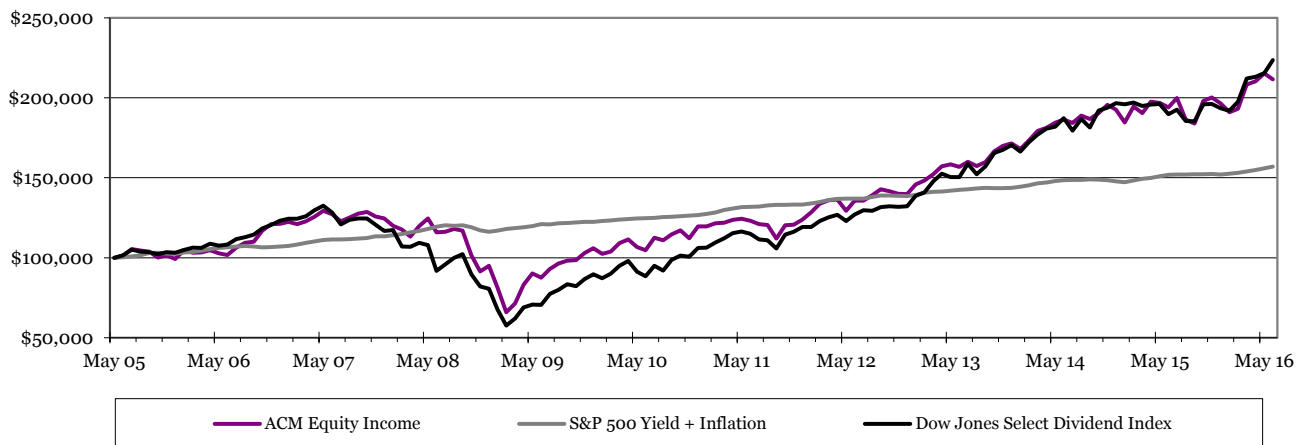
Comparison of the change in value of \$100,000 investment in ACM growth versus S&P 500 and Vanguard Total Stock Market



## Cumulative Equity Income Performance

Performance as of 6/30/16	Year to date	3 years	5 years	10 years	Since inception (5/31/05)
ACM Equity Income	7.64%	34.83%	71.78%	107.85%	111.50%
S&P 500 yield + inflation	3.24%	10.19%	19.17%	47.41%	57.00%
Dow Jones Select Dividend Index	15.54%	48.62%	94.52%	106.60%	123.59%

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. 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.

# ATHENA CAPITAL MANAGEMENT

July 15, 2016

Despite quarter-end volatility caused by Britain voting to leave the European Union (E.U.), the S&P returned 2.5% for the second quarter of 2016. We did slightly worse than the market because our portfolios reacted more negatively to the news from Britain, but I expect that impact will be short lived.



In this quarter's letter, I cover our portfolio performance, my market and economic outlook, and why I think you should mentally prepare for a recession now, when one isn't imminent.

## PERFORMANCE THIS QUARTER

### **Growth portfolios out-performed over all periods reported except the three year period.**

We under-performed this quarter mostly because of our portfolio's reaction to the news that Britain voted to leave the E.U. (Brexit). Up until the vote, we had been beating the market most of quarter, but then our portfolios responded more negatively to the news than the broader market. I think this is a short term phenomenon and that investors will refocus on the fundamentals over time.

**Joy Global** and **USG Corp** were, like last quarter, growth's out-performers.

Joy Global is the largest manufacturer and servicer focused solely on mining equipment. Joy's stock continued to climb this quarter as concerns about its insolvency six months ago have turned into euphoria that the coal and mining sectors will fully recover. I don't expect such a rapid recovery, but I do think Joy will benefit as its coal and mining customers gradually recuperate.

USG is North America's largest producer of wallboard and a significant manufacturer of other construction products worldwide. USG rose over the quarter due to growing optimism that the housing market will fully recover. Although I expect home building to continue mending, this will no doubt occur with fits and starts along the way. USG is well positioned to benefit because of its reputable products and management's careful cost controls.

Growth saw under-performance from **Liberty Global** and **Microsoft** this quarter.

Liberty Global, the largest cable telecom company in Europe, declined this quarter both on fears about Brexit and because Liberty spun off its Latin American operations. I believe fears over Brexit will have little lasting impact on Liberty's cable operations in either

the E.U. or Britain, although currency issues and trade protectionism will keep investors wary for a time. Liberty's spin out of its Latin American operations is a long term positive but had a temporary impact on our portfolios because of when and how the transaction occurred at quarter end. I think Liberty Global has an excellent future ahead of it as cable possesses economic advantages over legacy telecom that will pay dividends for years to come.

Microsoft, the world's largest software provider, dipped this quarter on disappointing earnings results. Microsoft has been performing a balancing act between growing its new cloud businesses while also protecting its legacy Windows and Business sectors. Investors sold Microsoft off on lower than expected cloud growth despite good performance from legacy software. I believe this slower cloud growth is temporary, though, because Microsoft is adjusting well to a rapidly growing market and has successfully maintained its competitive position.

### **Equity income portfolios out-performed our long term benchmark over all tracking periods.**

We continue, however, to lag our short term benchmark, the Dow Jones Select Dividend Index, as investors continue to chase yield. Although it's understandable why investors are seeking yield with bond rates so low, this is leading to short term, risk-seeking behavior that probably won't end well. It's not enough for a security to produce yield, it must also be able to sustain that yield over market cycles and grow faster than inflation over time. I think our portfolios are constructed to do this, whereas the Dow Jones Select Dividend Index looks overly focused on current yield and under-focused on sustainability and growth.

**Philip Morris International** and **USG Corp** were, like last quarter, equity income's out-performers. Please see my comments on USG above.

Philip Morris International (PMI), the largest seller of cigarettes outside of the U.S. and China, continued to climb this quarter on smaller currency headwinds, success in its reduced risk products, and on-going market share gains. These three contributors seem likely to remain in place over the short to intermediate term, so I'm still optimistic about PMI's prospects going forward.

Equity income saw under-performance from **Liberty Global** and **Wells Fargo**. Please see my comments above Liberty Global.

Wells Fargo, the U.S.'s third largest bank, suffered this quarter due to persistent concerns about low interest rates and slower growth prospects. Added to this, Brexit news led investors to sell off all banks, even ones, like Wells, with little business overseas. I think

# ATHENA CAPITAL MANAGEMENT

these concerns are short term in nature and will abate in time. Wells Fargo's broad portfolio of services and low cost platform give it advantages that I believe we'll benefit from as short term worries fade.

## MARKET AND ECONOMIC OUTLOOK

**The S&P 500 climbed steadily this quarter, returning 2.5%.** This puts the market on track to deliver 4.1% returns for growth and 5.2% returns for equity income over the coming six years. I continue to seek higher returns from segments of the market that seem to offer better prospects.

Projected annualized returns over the next 6 years	
S&P 500 (growth benchmark)	-4.3% to 12.4%
S&P-500-yield-plus-inflation (equity income benchmark)	2.2% to 8.2%

How do I arrive at these numbers? See my [2Q05](#) and [3Q14](#) articles.

**The U.S. economy is growing faster than other developed economies as most of the rest of the world stagnates.** The U.S. is the fastest growing developed economy in the world with around 2% growth versus 0.6% in Japan and 1.7% in Europe, but far below its historic 3-4% growth. In the developing world, India and Indonesia are growing well, but Latin America, Russia, and Sub-Saharan Africa are either contracting or growing very slowly. China's growth is over 6%, but this rate has been steadily declining every year since 2010.

**Both positive and negative, government policies are driving economic growth more so than in decades.** In India and Argentina, new regimes are improving their economies with more prudent government spending and stable monetary policies. In Russia, Brazil and Venezuela, in contrast, government interference in the economy has led to steep contractions and dramatically declining currencies. Similar patterns can be seen throughout the rest of the world.

**Even if specific economies are doing well or poor, this doesn't mean that investment returns there will be high or low as a result.** Contrary to what many believe, there is almost zero correlation between the economic growth of a country and its stock market returns. How can that be so? The price of securities relative to fundamentals trumps less influential changes in economic growth rates. For example, Russia's stock market is up 18.9% year to date and Brazil's is up 45.9% even though both economies have been severely contracting.

**Instead of focusing on such big picture themes, it's better to focus on buying good businesses with excellent managers at reasonable prices.** I know you read this from me almost every letter, but a focus on specific company fundamentals and valuation almost always matters more than macro-economic worries and political squabbling. I don't ignore such issues, because politics can dominate for short periods, but I do spend 99% of my time on specific businesses instead of economics. Just listen to greats like Warren Buffett and Peter Lynch, and you'll hear the same thing: time spent trying to predict the economy or feeling gloomy about macro-economics is time wasted.

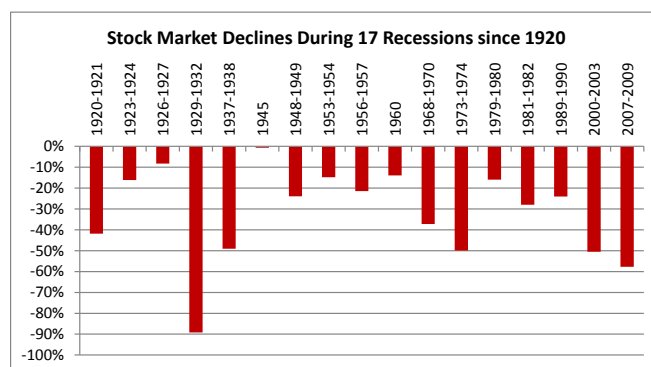
## PREPARE FOR THE INEVITABLE

*"Forewarned, forearmed; to be prepared is half the victory." – Cervantes*

**Whether anyone likes it or not, recessions happen.** The economy seems to go through up and down cycles not much different from nature's periodic ebbs and flows. Ever-changing government policies exaggerate these cycles, contrary to what most think, creating huge booms and busts out of what would otherwise be milder waves. Geopolitical events, too, like war, migration, famine, epidemics, etc. amplify and can even reverse prior trends.

As you probably know, **when recessions occur, the stock market declines—sometimes a lot.** There have been 17 recessions over the last 100 years. On average, the resultant stock market decline has been 32%, but variation around that average has been wide. The worst drop was the Great Depression, down 89%, and the mildest was 1945 with a 1% decline.

**The severity of a recessionary stock market drop depends on the context.** Declines are worse following economic booms and when stock prices are high relative to underlying fundamentals. For example, in the worst 7 declines, the market went down 54% on average; whereas in the 10 milder declines, the market sank a less scary 17%. The following chart illustrates historic stock market declines during recessions.



# ATHENA CAPITAL MANAGEMENT

**When will the next recession come and how bad will it be?** I don't know, and neither does anyone else (if someone says they do, check for your wallet). The economy has been in a rough patch since 2000, which might indicate a milder decline next recession. On the other hand, stock valuations are high relative to fundamentals, so the next downturn might be unpleasant. We just don't and can't know.

Given that recessions happen and they commonly lead to big market declines, **many try to predict such downturns and avoid them.** If only that were possible! The record of people doing so successfully is essentially zero. Not only do you need to get the timing right getting out of the market, but then you also need to get the timing right getting back in. Being right one time is miraculous, being right twice is impossible (if someone says they can, watch their nose grow).

**The reality is that market timers get out after the market has tanked, and back in long after the market has recovered.** The most damaging decision investors can make—more than high fees, investment selection, asset allocation, etc.—is trying to get in and out of the market to avoid recessionary declines. If you ever feel tempted to time the market, invert Nike's famous motto—*Just DON'T Do It!*

**The smarter decision, instead, is to prepare mentally for recessions and market downdrafts.** Benjamin Graham (Warren Buffett's mentor) once said that if you can't stand to watch your money temporarily go down by 50%, you shouldn't invest. And, don't think bonds, cash or gold are immune, because each of those have lost 50% of their value at times, too (although cash and bonds suffer this fate more rarely than stocks). If you want to invest and grow your wealth, just accept now the unavoidability of recessions and the certainty that you *will* watch your portfolio temporarily decline in value.

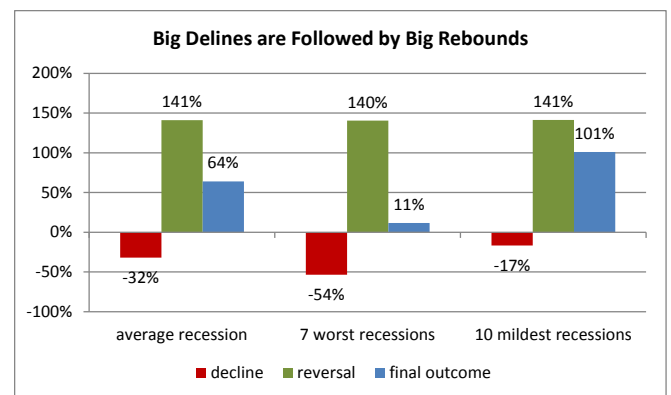
Preparing yourself now for this inevitability is crucial, otherwise you might panic and try to time the market. It may sound overly simple, but **just accepting declines as a part of investing in the relatively tranquil present will allow you to more successfully navigate an inevitably volatile future.** The emotional impact of big declines are such that you can't wait until they occur to decide to become calm and accept them.

In addition to psychological readiness, **you should also embrace the fact that downturns are huge investment opportunities.** Great returns, after all, are built on pessimism, despondency, panic and low prices, not optimism, enthusiasm, euphoria and high prices.

**Start by recognizing that large declines have almost always been followed by big recoveries.**

A 40% decline in the stock market means a 67% reversal to get back to break even, and a 50% decline is followed by a 100% growth to recover. From there, the market almost always goes higher, still.

As evidence, **in the 17 recessions of the last 100 years, 32% average declines were followed by 141% gains, leaving investors 64% better off.** In the 7 worst recessions, average 54% declines were followed by 140% increases that left investors up 11%. In those cases, the rebounds didn't blow past the drops, but in the 10 milder declines, they did: 17% average declines were followed by 141% increases that left investors 101% better off. As one commentator put it, it's not *timing* the market, it's *time in* the market.



Perhaps more importantly, **panicked markets always lead some companies to fall worse than others, thus providing excellent opportunities to sell shallow decliners and buy deep droppers.** Many excellent long term investing records have been built on just these types of scenarios. You only make hay when the sun is shining, and it shines brightest during recessionary downturns.

**You don't have to like recessions or stock market declines to accept their inevitability.** You can get ready now by mentally preparing for unavoidable market downdrafts. Try to remember that big downturns are followed by huge recoveries, and that they create optimal circumstances for generating superior long term returns.

*"Chance favors the prepared mind."* – Louis Pasteur

## UNTIL NEXT QUARTER

As usual, if you have any questions or comments about this letter, investing, financial planning, or anything else, please don't hesitate to contact me. I always enjoy hearing from you.

# ATHENA CAPITAL MANAGEMENT

Doggedly,  
Mike

Michael Rivers, CFA  
Athena Capital Management  
370 Waco Court, Colorado Springs, CO 80919  
719-761-3148, [mike@athenacapital.biz](mailto:mike@athenacapital.biz)