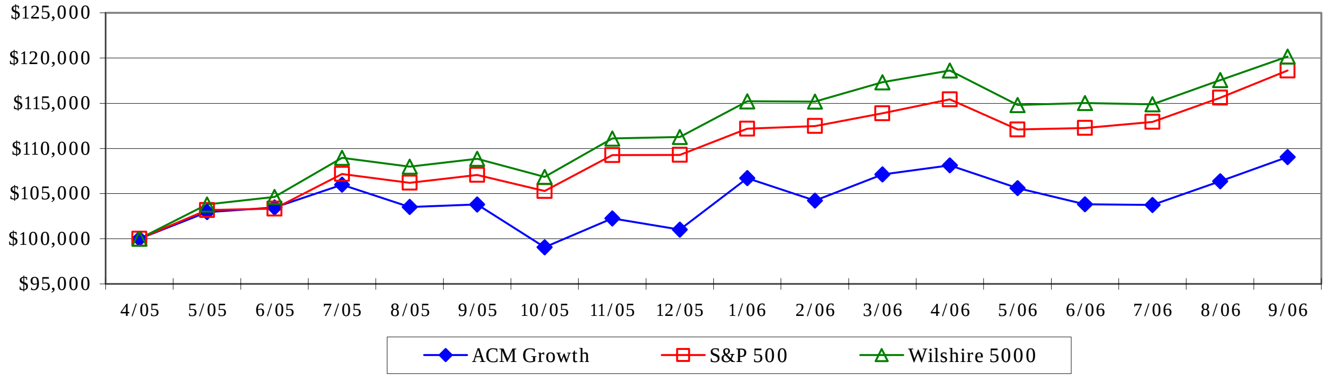
Athena Capital Management

Growth Performance

Performance as of 9/30/06	Year to date	1 Year	Since inception (4/30/05)
ACM Growth	7.95%	5.06%	9.05%
S&P 500	8.53%	10.79%	18.60%
Wilshire 5000	8.00%	10.39%	20.15%

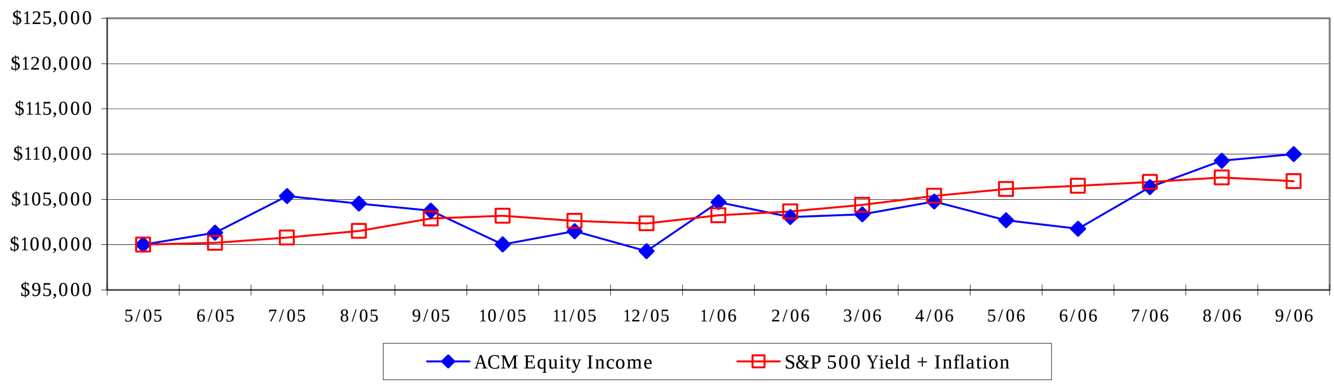
Comparison of the change in value of $100,000 investment in ACM growth versus S&P 500 and Wilshire 5000



Equity Income Performance

Performance as of 9/30/06	Year to date	1 Year	Since inception (5/31/05)
ACM Equity Income	10.79%	6.02%	9.99%
S&P 500 yield + inflation	4.56%	4.01%	7.01%

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.

Athena Capital Management

October 18, 2006

Greetings fellow investors! I hope you are enjoying fall as much as I am.

In this letter, I'll cover: how we are doing, my 6 year projections, how to identify good investments, a bit about Berkshire Hathaway, ticker tape parades, and Sam Walton. I hope you enjoy it.

How Are We Doing?

As you can see on the first page, growth accounts started to play catch-up this quarter and income accounts excelled. I wouldn't put too much stock (pun intended) on our short term results, though. As I've said *many* times, we'll have to wait for the 3 – 5 year numbers to get a clear view of our progress. In the meantime, I've invested our money in companies that continue to produce greater increases in business value than the market.

Growth accounts received out-performance from **Fairfax Financial** and **Markel Corp** this quarter**.** Both Fairfax and Markel are insurance companies that benefited from higher insurance pricing and a weak hurricane season.

In one of our growth holdings, **MacDermid,** management decided to buy the company away from shareholders just like Kinder Morgan did. I'm again disappointed that we won't participate in the company's long term growth, but it's not all bad because we received a short term boost in returns due to management's higher buyout price.

Under-performance in growth accounts came from **Newmont Mining** and **Leucadia.** Newmont declined along with gold prices, but I expect this price decline to prove temporary over the long run. Leucadia declined on an announcement that they invested in a large iron ore project in Australia. I believe the market's reaction will prove short-sighted on this one, too.

Equity income accounts out-performed due to price rises at **Fairfax** and **Kimco.** As mentioned above, Fairfax's price climbed with higher insurance rates and low hurricane activity. Kimco, on the other hand, climbed as the interest rate rise of last quarter turned into an interest rate decline this quarter.

Under-performance for income accounts came from **Mercury General** and **ConocoPhillips**. Mercury declined because of temporarily weak quarterly earnings. ConocoPhillips sank on lower oil and natural gas prices. I think the market is focusing too hard on the short term and not enough on the long term business value of both these companies.

6 Year Market Projections

The S&P 500 had a strong quarter and finished up 5.2% (not including dividends) at $1,336. As may be expected, when prices run up faster than fundamentals, this reduces my expectation for future returns from the market:

Projected annualized returns over the next 6 years	
S&P 500 (growth account benchmark)	-6.2% to 7.9%
S&P-500-yield-plus-inflation (equity income account benchmark)	3.4% to 6.4%

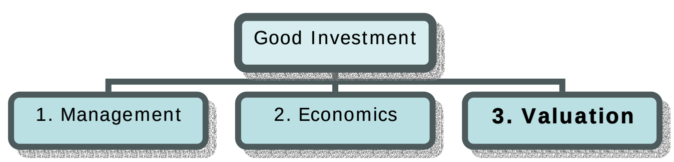
How did I arrive at these numbers? Visit "Free Articles" at www.athenacapital.biz to see my 7/12/05 article.

I would not be surprised to see the market decline going forward to more closely align prices with fundamentals, but predicting such events is near impossible. In contrast, our investments are growing business value faster and selling at prices lower than the market. In other words, the market will fluctuate more than any of us expect, but as long as our money is invested in good companies at cheap prices, we should out-perform over the next 3 – 5 years.

On the economic front, interest rates fluctuated significantly during the quarter and ended with short rates higher than long rates. Such conditions have in the past preceded economic slowdowns (but not necessarily recessions). The housing market continues to show weakness with national median home prices declining from a year ago, inventories of unsold homes at 14 year highs, and meaningful home price declines in those markets where prices became most frothy.

Identifying Good Investments

In part three on good investments, I discuss the *valuation* of a business (using real estate as an illustrative example).



In my last two letters, I evaluated management and economics. To use an analogy, it's like I'm looking at buying an office building, and I've considered the property manager's qualities, and the building's long term profitability.

Now, I'll look at valuation—how much should I pay for the building to get a satisfactory return over time. To do this, I must first highlight the difference between a thing's price, and it's worth or value.

Price does not always equal value

Do you remember Tickle Me Elmo? It was the must-have toy of the Christmas 1996 season. The mania for this toy became so great that one buyer paid $1,500 for a toy with a suggested retail price of $28.99. My point is that *things sometimes sell for more than they're worth.*

Do you remember the Denver housing bust in the 1980's? Home prices dove after the commodity boom of the 70's turned bust in the 80's. A few savvy investors made fortunes buying unwanted real estate on the cheap. In other words, *things sometimes sell for less than they're worth*.

Price and value drift apart when psychology gets the best of people. In general, people tend to be overly optimistic when things go well and overly pessimistic when things go poorly. This pushes prices above value in good times (expensive) and below value in bad times (cheap).

Fortunately, we can benefit when price and value differ. By focusing on what a company is worth *over the long term*, we can exploit opportunities to buy when prices are below value and sell when prices are above value. Recognizing such opportunities, though, requires an ability to calculate business value.

Business value

Calculating what a business is worth is similar to valuing real estate. Just like when an appraiser values your home, there are 3 ways to value a company:

1. Comparable value
2. Replacement cost
3. Adding up cash flows

The comparable value method, logically, looks at comparable selling prices. Using your house as an analogy, if the homes in your neighborhood sell for $90 - $100 per square foot, then your house is likely to fall in that range, too. Similarly, by researching comparable business selling prices, I can independently evaluate a business I'm assessing.

The replacement cost method examines the cost to re-create something from scratch. Imagine rebuilding your house. You would need to buy a plot, lay the foundation, build and finish the house, re-create the landscape, etc. Add up the expenses to rebuild, and you've found replacement cost. Similarly, a business's replacement cost equals all the costs to rebuild a business from scratch (factories, inventory, marketing, etc.). By estimating such rebuilding costs, I can independently compare a business's price to its replacement cost.

Adding up cash flows is the most complex method. Continuing with the housing analogy above, you can value your home by calculating how much money you could make renting it. To do this, you'd figure out a monthly rental rate, subtract the average monthly costs for maintenance—giving you cash flow—then add up cash flows over time. Valuing a business works the same way, by adding up revenues minus expenses over time. Comparing the value of a business's summed cash flows to its price gives me an independent assessment of whether its price is high, low or fair.

In theory, each method may sound precise, but in practice, inexact estimates are required. For instance, it may be difficult to find a sufficiently similar business to derive comparable value—some businesses are unique and no close comparisons can be found. Further, replacement value is based on estimates that may not accurately reflect long term value—like when lumber prices were temporarily high after hurricane Katrina. Also, adding up cash flows require estimates for sales, costs, and growth that can be very difficult to get right—no one has precisely predicted the sales and costs a technology company like Intel. These difficulties make valuation part art and part science.

This art/science dichotomy means valuation works better with a range of values than with a single number. Instead of calculating an absolute value for your home, like $302,456.78, it may be better to use a range, like $275,000 to $325,000. Using a range acknowledges that valuation is based on estimates. With this in mind, I prefer to judge a business's value using a range, too. In fact, I like to buy when price is below that valuation range—with a margin of safety.

Margin of Safety

Margin of safety is the "fudge factor" an engineer uses when designing a bridge. An engineer's design should hold a maximum forecast load plus a "fudge factor," thus intentionally over-building to make sure the bridge will NEVER collapse. The same goes with investing. Instead of buying at fair value, I try to buy *below* value, with a margin of safety, to intentionally under-pay to make sure I get the returns I want.

Buying with a margin of safety protects against an uncertain future. Suppose I think a business is worth $100 per share, and that this value will grow at 10% a year. Suppose, also, that I want a 10% return. If I pay $100 per share and growth turns out to be 8% because an unforeseen competitor enters the market, I won't get my desired return. If, however, I wait to buy the business at $90 per share—with a margin of safety of $10—then I'll still get my desired 10% return even though something unforeseen happened. Buying with a margin of safety allows satisfactory results despite unknowable factors like competition, weather, product recalls, etc.

"With such strict standards for management, economics and value, it's a wonder you ever find investments to buy!" That's right! That's why I spend most of my time doing research and only seldom buying or selling. A business selling above or below value doesn't happen that often. But, when it does, it can really reward owners.

I've talked about the aspects of valuation I look for in a good investment. Now, the last step is to combine what I've discovered about management, economics and valuation together, and make a decision to act or not. And that is what I'll cover in next quarter's final segment on identifying good investments.

Investment Spotlight: Berkshire Hathaway

Berkshire Hathaway is a holding company, which means it "holds" ownership in several subsidiary companies. Its most important businesses are insurance, including auto (GEICO), property and casualty, and reinsurance (insurance for other insurers). Its other businesses include underwear (Fruit of the Loom), flight training (FlightSafety), furniture (Nebraska Furniture Mart), trucking (McLane), shoes (Justin Boots), jewelry (Borsheim's), mobile homes (Clayton), construction products (Acme, Benjamin Moore, Johns Mansville), newspapers (Buffalo News), candy (See's), food (Dairy Queen), energy (MidAmerican)—I'll stop there because the list is quite long.

Berkshire Hathaway was assembled by master investor Warren Buffett over the last 41 years. Buffett purchased a portfolio of companies over four decades by looking for businesses with great managers and excellent economics selling at low prices (guess who I'm trying to emulate).

Buffett doesn't manage these businesses directly. Instead, he buys great companies and lets incumbent managers do their thing. Even though Berkshire is the 13th largest company in America, it has only 17 employees at its central office. Why? Because Buffett stays out of his subsidiaries' way and only needs a few people to run administration at the holding company level.

Berkshire has grown at over 20% a year over the last 41 years. Part of this growth came from smart acquisitions, but most came from subsidiary earnings and investment growth. This outstanding record gave Buffett such titles as "the greatest investor living" and "the Oracle of Omaha." Buffett, surprisingly, has not let this fame go to his head (too much). He's paid a mere fraction of other executives ($100,000 per year), and still lives in the home he bought for around $30,000 back in the 1950's.

Most importantly, Buffett has created a company that emphasizes stewardship, honesty and integrity. Buffett's focus has always been on growing the long term value of his business, thus putting shareholders first (partly because he's its biggest owner). He does business on a handshake when most require an army of lawyers, and he's been an outspoken critic of how other executives squander shareholder value. This culture is unique, and has built tremendous wealth for its owners.

Berkshire is an excellent combination of profitable businesses and outstanding management. I personally seek to imitate Buffett's investing abilities, and think Berkshire is one of the greatest businesses in the world. If you'd like to learn more about Buffett or Berkshire Hathaway, an excellent and very readable book is *Buffett, The Making Of An American Capitalist* by Roger Lowenstein.

Why Is…
…a ticker tape parade called a ticker tape parade?

Ticker tape machines were remotely driven devices used to provide updated stock market quotes. Invented in the 1870's, early versions provided the first mechanical means of conveying stock prices over long distances (using telegraph wires). Previously, stock information was personally delivered via written or verbal messages.

A stock ticker converted something similar to Morse code into a printed strip of paper with a stock's symbol and trade information such as price. The thin strip of paper was referred to as tape, and the ticking sound made by the machine gave it the name ticker tape. Such devices were used until the 1960's when they were replaced by computers. You can still see the modern equivalent of ticker tape when you watch any financial news show with scrolling prices going across the screen.

The first ticker tape parade was held in New York City to celebrate the dedication of the Statue of Liberty. This celebration (on October 29, 1886) used torn up ticker tape as confetti. Ever after, a celebration in New York that included such confetti, even though it was later shredded paper of all sorts, has been referred to as a ticker tape parade. Such celebrations were originally reserved for the end of World Wars, or the Apollo 11 astronauts after they walked on the moon, but lately have been used to celebrate visiting heads of state and sports champions.

Admirable business people: Sam Walton (1918-1992)

Sam Walton grew up in Missouri during the Great Depression. He started work young, selling magazine subscriptions around age 7. He was a natural leader who was highly involved in student government and played four different sports (basketball, football, baseball, swimming). In college, he majored in economics and was a member of ROTC at the University of Missouri.

After college, he started his retailing education as a salesman at JC Penney. This work was interrupted, though, by army service during World War II. After the war, he bought his first store, a Ben Franklin franchise in Arkansas. Here, he learned to buy cheap from wholesalers and pass the savings on to customers. He quickly learned that this led to higher profits because the increased volume made up for the lower profit made on each item. He applied this lesson on a grand scale as he built the Wal-Mart business.

As Walton expanded his five and dime stores, he mastered the ability to learn from other retailers. He was obsessed with finding the best way to run a retail operation, and he wasn't afraid to nose around other stores to find ideas. His wife and kids learned that vacation with dad would inevitably include stops at every retailer on the route to and from a destination. In addition to ideas, Walton eagerly recruited talent from other retailers**.** When he was struggling to create a logistical system to keep his stores stocked, he hired an expert from a competitor to build a robust new inventory tracking system. This soon became one of Wal-Mart's competitive advantages.

Walton was an excellent leader. He'd sought out leadership positions from the time he was young, and he developed a knack for motivating people. Even at 5'9" and 130 lbs, he led his high school football and basketball teams to state championships. He applied his leadership skills at his stores, both in the way he treated people and in his policy of letting them own a piece of Wal-Mart. He encouraged both his managers and associates (his name for employees) to buy stock and participate in the growth of the business. This motivated them and made them rich.

Sam Walton was an extraordinary retailer and businessman. He built his discount stores into the largest retailer in the world, and he did it by passing savings on to customers, grabbing ideas and talent from other retailers, and providing excellent leadership for his associates. To learn more about ole Sam, pick up *Sam Walton, Made in America, My Story* by Sam Walton and John Huey.

Until next quarter

I'd love to get your feedback, and I've created a way for you to do so anonymously. Stop by my website, www.athenacapital.biz, and visit the Contact ACM page. There, you'll find a form to submit feedback on my services, letters, website, or whatever is on you mind. I look forward to hearing from you.

If you know anyone who could benefit from my services or advice, please send them to my website or provide them with my contact information. I'm always looking for more good clients.

Thank you for your business, and I look forward to hearing from you over the next quarter.

Michael Rivers, CFA
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