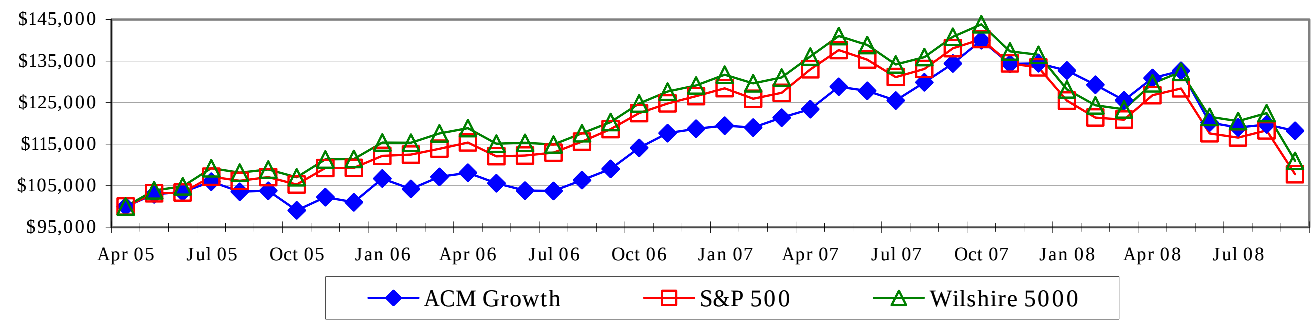
Athena Capital Management

Growth Performance

Performance as of 9/30/08	Year to date	1 year	2 years	3 years	Since inception (4/30/05)
ACM Growth	-12.11%	-12.08%	8.38%	13.86%	18.19%
S&P 500	-19.29%	-21.98%	-9.15%	0.65%	7.75%
Wilshire 5000	-18.70%	-21.20%	-7.74%	1.92%	11.01%

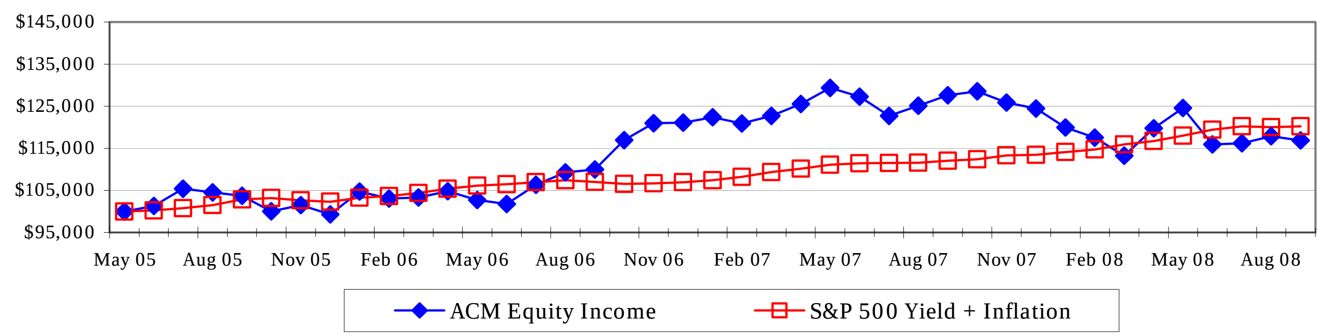
Comparison of the change in value of $100,000 investment in ACM growth versus S&P 500 and Wilshire 5000



Equity Income Performance

Performance as of 9/30/08	Year to date	1 year	2 years	3 years	Since inception (5/31/05)
ACM Equity Income	-6.09%	-8.38%	6.28%	12.68%	16.90%
S&P 500 yield + inflation	5.99%	7.32%	12.35%	16.86%	20.01%

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.

October 15, 2008

As I've warned for years, vulnerabilities in the housing market and economy could greatly disappoint investor expectations. Despite this warning coming to pass, our portfolios are performing very well, and I'm becoming increasingly optimistic about future returns.

In this letter, I will discuss our investments, my market and economic outlook, why I'm so optimistic while everyone else is worried, and our investment in Sears.

Performance this quarter

Growth portfolios significantly out-performed our benchmarks this quarter. In fact, we are beating the market over every time period measured. Unfortunately, our recent out-performance has been a matter of doing less poorly than the market rather than scoring positive returns. As the saying goes, "you can't eat relative performance." Experience has shown, however, that when the market does recover, our higher starting point will prove very advantageous for absolute, long term returns. After all, that's what matters.

Growth accounts received out-performance from **Fairfax Financial** and **Sears Holdings** this quarter.

Fairfax is a Canadian insurance company with diverse insurance and investing operations. Fairfax long ago predicted current market turmoil, and bought insurance in the form of credit default swaps that have since made the company a fortune. For unknown reasons, the market finally realized the gravity of this situation and reversed Fairfax's decline by rallying over 50% from September 3rd to quarter end.

Sears is one of North America's largest retailers. Although Sears had another dismal operational quarter, the market seemed to catch on that a profitable retail operation out-performing peers and backed by formidable assets just might be worth something in the long run. While the S&P 500 dropped 4% from July 15th to quarter end, Sears Holdings surged 33%. (See my later article for more information on why I like Sears.)

Growth's under-performers this quarter included **Ryanair Holdings** and **Canadian Natural**.

Ryanair is Europe's largest discount airline serving travelers within the European Community. Ryanair's stock suffered as investors increasingly fear how a tough recession could impact European travel. Ryanair has the lowest costs in the world and is conservatively financed, so I'm quite confident it will survive the current downturn and emerge an even more successful competitor when Europe's economy recovers.

Canadian Natural is an oil and gas exploration and production company with operations in Canada, the North Sea and Africa. Canadian Natural's stock has declined with the price of oil and gas on fears that an economic slump will significantly hurt end demand. Although lower oil prices will hurt in the short term, I believe that Canadian Natural will prosper due to its efficient operations and unique oil sands project.

Equity income portfolios performed well this quarter despite the tough environment for stocks. Although we continue to under-perform our benchmark for the time being, we finished the quarter with a positive return and a portfolio yield of around 5% while the S&P 500 declined 8.4% and yields only 2.5%. Maintaining principal value and a solid yield in this environment is quite satisfactory.

Equity income accounts saw out-performance from **Wells Fargo** and **Berkshire Hathaway** this quarter**.**

Wells Fargo is the fourth largest bank in the U.S. I added it after watching and waiting—literally—for years. It's one of the strongest banks in the world and should benefit greatly over the long run from current turmoil. The market seemed to agree with me shortly after we bought, sending its shares up over 65%.

Berkshire Hathaway is a diversified holding company run by Warren Buffett. Berkshire is benefiting from its battleship-strong balance sheet and *$40 billion* cash hoard by making great deals during this distressful time. The market seemed to realize this, too, sending its shares up 10%.

Equity income's under-performers this quarter were **iStar Financial** and **Royal Dutch Shell**.

iStar Financial is a commercial real estate investment trust. It continues to be plagued by worries that its real estate loans may go south and that it may have difficulty borrowing money. These concerns are not idle and iStar will continue to struggle until the economy and credit markets recover.

Royal Dutch Shell is one of the world's five largest integrated petroleum companies. Its price declined along with oil and gas prices this quarter over concerns about the slowing global economy. Although oil and gas prices may decline further, the world economy will recover and worldwide demand for oil will provide Royal Dutch Shell with strong profits for years to come.

Market and economic outlook

The S&P 500 was basically flat in July and August, then dove 9% in September. This decline, along with long term earnings growth, is finally putting the S&P 500 on track to achieve positive returns over the next 6 years (as shown my table below). Although a higher probability of positive future returns is good, we are still looking at most likely returns of only 5%. Not surprisingly, I continue to expect *our* investment returns to outpace that projection over the long run.

Projected annualized returns over the next 6 years	
S&P 500 (growth benchmark)	-0.9% to 11.3%
S&P-500-yield-plus-inflation (equity income benchmark)	4.1% to 7.1%

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

The U.S. and global economy are finally reflecting the concerns I've voiced for years. Retail sales are slumping, unemployment is climbing, housing markets are down significantly, and factory activity is in decline. Although it's been a long time in coming, the overhang of bad debt and an artificial housing boom are finally dragging world economies down into a full-blown recession.

Added to this, credit markets, the lifeblood of our modern economy, have seized up. It's become very difficult for both businesses and individuals to borrow money, and this is leading to huge declines in spending. When businesses can't borrow to expand, buy inventory and pay employees, and consumers can't borrow to purchase cars and homes, end demand for almost everything suffers.

The U.S. government is intervening even more significantly than during the Great Depression. After organizing and backing the Bear Stearns sell-off, it has since taken Fannie Mae and Freddie Mac into conservatorship, seized the assets of AIG (the world's largest insurance company), seized the operations of Washington Mutual and forced the sale of Wachovia. It's now implementing a plan to purchase illiquid securities in an attempt to get credit markets flowing again.

Despite all this gloom and doom, I remain very optimistic about future returns. Whether or not government intervention works, the U.S. economy is the most dynamic and resilient in the world. Although things are tough now—and will probably get tougher in coming quarters—the U.S. economy will recover and strong growth will resume.

It's always darkest before dawn. I can't predict precisely when things will get better, but they will. It's important to remember that waiting for a recovery is waiting until it's too late. The stock market tends to rebound months before the economy does. Because economic data comes out so slowly, no one will know for sure a recovery is occurring until long after the stock market booms. The best thing to do is focus on the long term and think about the strength of our underlying businesses.

Why I'm so confident

With the market's recent wild volatility and poor performance, many feel worried about current and future investing results. In contrast, I'm feeling increasingly confident about our future returns as the market declines. This raises a good question: **why am I so confident when everyone else is feeling more and more anxious?**

History is one reason. Stock prices tend to swing far above and below the stable trend of underlying fundamentals. These wild swings in prices, when looked at over the course of history, provide a good guide of what to expect for future returns. When prices increase far above fundamentals, returns tend to be low until prices move back to trend; when prices decline far below trend, returns tend to be high until prices move back to trend. **Because market returns have been low recently, I'm confident long term returns will be higher going forward.**

Another reason I'm confident: we aren't invested in the market's average stock—quite the opposite. I spend a lot of time uncovering above-average companies with better economics, higher-quality management and lower prices than the market. Superior businesses tend to do even better during market turmoil because they have the ability to grow when weaker companies must trim back. **This down cycle out-performance increases our businesses' underlying value, thus further boosting my confidence in our future returns.**

Finally, segments of the market tend to go in and out of favor over time. Over the last couple of years, "momentum" has been in favor. Momentum investing buys stocks that have gone up—under the theory that things that have gone up continue going up. Momentum stands in opposition to value investing, which buys stocks that have gone down to benefit from the expectation they will go back up again. **Although**

momentum has out-performed value lately, that won't last.

Why? Because whenever momentum out-performs value for a period of time, that trend ends abruptly with value investing retaking the out-performance baton. The last time momentum out-performed value for several years was in the late 1990's, and we all know how that ended. Because the momentum segment has out-performed the value segment over the last couple of years**, I expect value to soon take back the out-performance baton, giving yet another reason to feel confident.**

It doesn't seem normal to feel confident when everyone else is worried, but the facts seem to clearly support my confidence. When I look at the history of stock market cycles, the superiority and value of our particular holdings, and the recent out-performance of momentum over value investing, I can't help but feel very confident about our future prospects. Be forewarned, these returns may not be visible right away because short term market swings are always unpredictable. But, over the long run, I think you'll look back and see why I was feeling confident when most were feeling grim.

Investment Spotlight: Sears Holdings

Sometimes people ask me what I'm investing in, and I happily tell them, "Sears." Their reactions run the gamut from "Are you out of your mind!" to "I never shop at Sears" to "I hope you're good at something else." I don't blame them for that reaction—Sears doesn't seem to be firing on all cylinders. But, underlying its crumbling façade lies what may be one of the best investment opportunities available.

Sears Holdings includes 3 businesses: Kmart, Sears Domestic and Sears Canada. Sears also owns well known brands like Kenmore appliances, Craftsman tools, DieHard car batteries and Lands End clothes. As an investment, I like to look at Sears three ways: worst, most likely and best case scenarios.

The worst case scenario for Sears is a giant going-out-of-business sale. In that case, Sears sells off its inventory and real estate, pays its debts, and then distributes leftover cash to shareholders. This scares the heck out of most people, but what if I told you that Sears would probably fetch $150 to $300 a share in liquidation? Not bad with a purchase price of around $93 a share! How's that possible? Because Sears was once a must-have store for *every* mall, so it signed sweetheart 99 year leases at very low rents. That real estate, even in a depressed retail market like today, would fetch enough to pay off all debts and leave a lot of cash for shareholders.

The most likely scenario is that Sears limps along as a poor to mediocre retailer. This may not inspire great confidence, but keep in mind that Sears normally generates $14 per share in earnings. That's a 15% earnings yield to purchase price! It may seem like Sears is going downhill fast or that the recession will never end, but I think a lousy retailer capable of generating a 15% earnings yield in normal economic conditions provides a salivating margin of safety.

With seemingly rosy worst and most likely scenarios, what could I have in store for the best case? Sears' chairman of the board is none other than Eddie Lampert, whom I wrote about in my 4Q07 client letter. This is the guy who generated 30% annualized returns for his investors from 1988 to 2007 (which would have turned $100,000 into $14.6 million). **The best case scenario is that Eddie gets Kmart and Sears making money, and then redeploys that money into better returning opportunities** (I don't believe pouring money into Kmart and Sears in hopes of beating Wal-Mart, Target, Best Buy and Home Depot is a wise move). In this case, Sears would become an asset allocation machine managed by one of the best investors alive today. That could mean wonderful returns for many, many years to come. (As a teaser, keep in mind that's how Berkshire Hathaway started.)

As I hinted in the paragraph above, management at Sears is very good. Sears' board of directors includes eight members, all professional investors and retail executives with excellent track records of success. **Eddie Lampert's hedge fund and Sears' management and directors own over *55%* of the company!** It's unusual to find a board and management team with excellent qualifications—it's *very* unusual to find them with that much ownership. Management wants Sears to succeed and their money is enthusiastically invested beside ours.

Is Sears a sure-fire investment? No, there is no such thing. But, my analysis indicates that **Sears is dramatically under-valued based on a probabilistic assessment of the worst, most likely and best case scenarios.** Things could go dramatically wrong and Sears could turn out to be worth much less than my analysis indicates, but I believe the odds are against it.

Why do I happily tell people I'm invested in Sears? Not just to see the startled look that inevitably appears on their face. **I own Sears because it appears very under-valued, we get to align ourselves with an excellent management team, and there's a hidden upside** that could turn Sears into an outstanding long term investment.

Until next quarter

Thank you for continuing to do business with me and welcome aboard new clients. Thank you for putting your trust in me and keeping it there despite these difficult times. I'm working hard to earn your trust, and I think you'll like the results.

Athena grew new assets under management by over *70%* over the last 12 months. This growth is great because it allows me to focus even more time on research and portfolio management, which will further improve results over the long run.

I stopped almost all marketing last October when I realized all my clients were coming from referrals and current contacts. Remarkably, I received my best growth ever. With that in mind**, I'd welcome any referrals you believe would benefit from my investment approach.** I believe this is a great time to invest, so bringing them on board soon could significantly reward them.

Please note, I'm raising my minimum account size for *new* clients from $20,000 to $100,000 shortly after New Year. So, if you know anyone below that minimum who might be interested, send them my way as soon as possible. **It's *truly* a great time to invest!**

Until next quarter, feel free to call or write me with any questions you may have. Also, feel free to visit my blog, www.mikerivers.blogspot.com, to see my latest views on the market and economy, especially if you become concerned about current events. I look forward to hearing from you over the quarter.

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