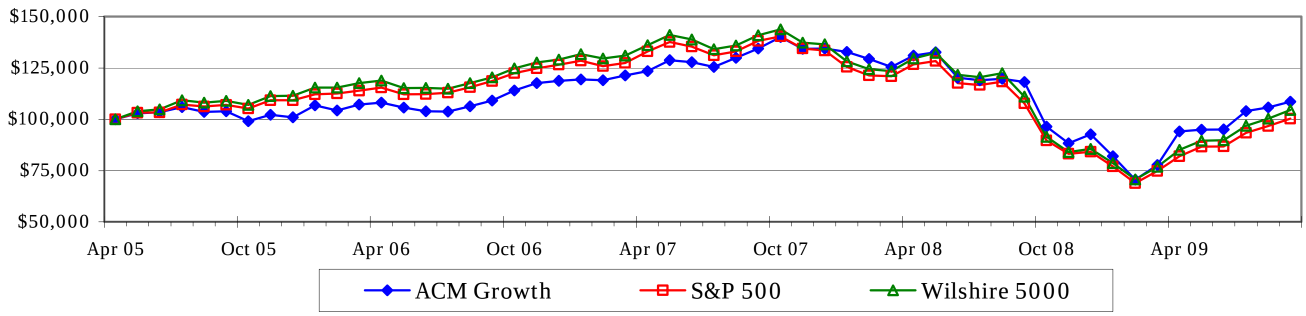
Athena Capital Management

Cumulative Growth Performance

Performance as of 9/30/09	Year to date	2 years	3 years	4 years	Since inception (4/30/05)
ACM Growth	16.99%	-19.30%	-0.52%	4.51%	8.48%
S&P 500	19.27%	-27.36%	-15.42%	-6.30%	0.31%
Wilshire 5000	22.14%	-25.82%	-13.15%	-4.06%	4.50%

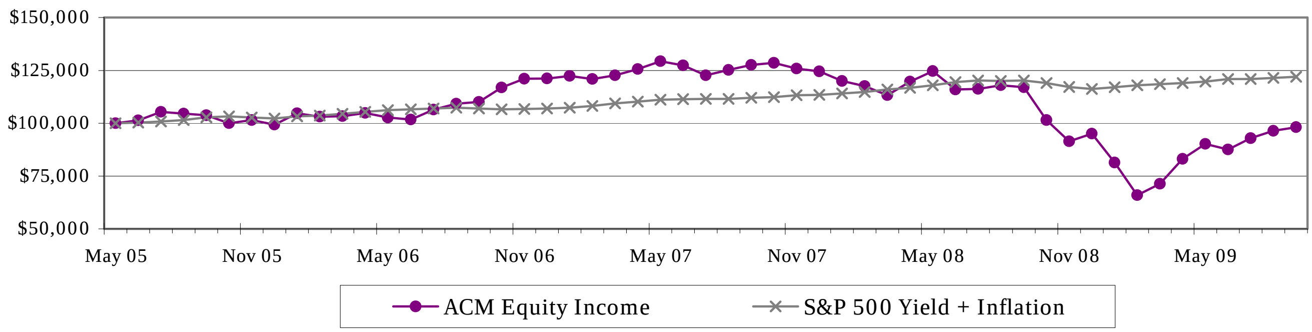
Comparison of the change in value of $100,000 investment in ACM growth versus S&P 500 and Wilshire 5000



Cumulative Equity Income Performance

Performance as of 9/30/09	Year to date	2 years	3 years	4 years	Since inception (5/31/05)
ACM Equity Income	3.29%	-23.10%	-10.80%	-5.43%	-1.89%
S&P 500 yield + inflation	4.95%	8.94%	14.05%	18.62%	22.04%

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 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.

October 15, 2009

The market and our portfolios provided excellent performance this quarter. The S&P 500 is up 34% since March 31st—which is nice—but the easy gains are behind us and future economic growth may not allow this trend to continue without setbacks.

In this quarter's letter, I will discuss our performance, my view on markets and the economy, why China is moving markets, and our investment in Dell.

Performance this quarter

Growth portfolios under-performed year to date and over the last year, but out-performed over 2, 3 and 4 years and since inception. We had an excellent July that was followed by less spectacular, but positive, returns in August and September. Under-performance year to date was due partly to our cash position and partly to company specific results. Like last quarter, I used the market's climb as an opportunity to sell companies where price got ahead of value and buy where price underestimated value. I'm confident these minor changes, as well as our cash position, will allow us to benefit from opportunities, gain higher long-term returns, and lower portfolio risk and volatility.

Growth out-performance this quarter came from **Fairfax Financial** and **POSCO.**

Fairfax, one of our under-performers last quarter, climbed over 48% after posting excellent results. Fairfax is a diversified insurance company with a strong investing division. It posted both good underwriting margins from its insurance businesses and excellent investing results. Fairfax has wisely been raising capital recently, which I expect will foster continued strong growth in the future.

POSCO, a Korean steel manufacturer, rose over 26% this quarter mostly due to increasing world demand for steel. As the global economy recovers, steel demand has recovered, too, and this manifests itself in rising steel prices, especially from Asia. Not surprisingly, POSCO is uniquely positioned to benefit from high steel demand in Asia, and this benefit will likely last for years.

Wellpoint and **Sears Holdings** generated under-performance this quarter for growth accounts.

Wellpoint, a health insurance company, is best known for the Blue Cross Blue Shield insurance it offers in 14 states. It, like many companies in the healthcare industry, seems to trade more based on political winds in Washington than due to fundamental factors like revenues and expenses. Wellpoint was down just slightly this quarter, but I expect it will perform well as the healthcare debate is resolved and the clouds of uncertainty drift away. It is uncertainty, more than anything else, that's causing the market to discount Wellpoint's earnings so highly.

Sears, one of our out-performers last quarter, sunk after reporting earnings in August. Apparently, market participants had been expecting much stronger sales of appliances and household goods than was seen in Sears' second quarter. I think Sears will recover as the housing market does, and that will likely take time. In the interim, Sears has the resources and operational efficiency to weather this economic storm and emerge more nimble and trim on the other side.

Equity income portfolios ratcheted up 12% this quarter, beating our benchmark by over 11%. Despite this strong performance and an outstanding second quarter, we are still lagging longer term benchmarks. As before, I used the market's climb as an opening to sell companies that had soared and buy stronger investments that have yet to benefit from the market's rally. Now, our portfolio's cash yield is 7.7% higher than last quarter, the portfolio is better hedged against market volatility, and our growth profile is stronger. It will take time to catch up and surpass our benchmark, but I continue to be optimistic we'll get there over time.

Equity income out-performance came from two portfolio holdings that were entirely sold this quarter, **Kimco Realty** and **Eastman Chemical**.

Kimco Realty, a commercial real estate company specializing in strip malls, climbed over 58% as investors realized not all commercial real estate companies would go bankrupt. Kimco has always been a pioneer in its field and will continue to be a strong player, but I decided to reduce our exposure to commercial real estate in general and to more indebted companies in particular. Although I decided to cash out our earnings, I would be happy to buy it again at lower prices.

Eastman Chemical, an industrial and specialty chemicals manufacturer, rose over 31% during the quarter as its continued profitability and extended debt maturities were more widely understood by the market. Eastman is an efficient and diversified operator that I'd love to own at lower prices, but I decided to take our profits because more lucrative opportunities were available.

Equity income's under-performers were **Kraft Foods** and **Altria**.

Kraft, a worldwide maker of cheese, coffee, cookies, chocolate, and more, was up this quarter, just not as much as the rest of the market. In particular, Kraft's price was knocked down a notch when it offered to buy Cadbury, a confectionery maker. There are no guarantees the deal will go through, and even if it does, it doesn't eliminate the tremendous value inherent in Kraft's brands. In my opinion, Kraft will either rally quickly if the deal doesn't go through or slowly if it does.

Altria, the parent company of Phillip Morris USA (the owner of Marlboro cigarettes, Copenhagen smokeless tobacco, St. Michelle Winery), was up for the quarter, but, like Kraft, not as much as the market. Altria is continuously under scrutiny for legal and regulatory reasons that seem overblown. Because of my conviction in its investment merit, I purchased more shares in the company. In the long run, I think it will be profitably managed and create growing wealth for shareholders.

Market and economic outlook

The S&P 500 climbed 15.1% this quarter, but is still down 27% over the last two years. Though below its October 2007 peak, it's already become over-valued. I'm projecting returns of only 6% annualized over the next 6 years. With such modest returns in mind, it's important to be invested in options different from the S&P 500, which is why, I hope, you're invested with me.

Projected annualized returns over the next 6 years	
S&P 500 (growth benchmark)	0.1% to 12.3%
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 Great Recession of 2008 – 2009 has probably ended. Manufacturing and service sectors are growing, new unemployment claims are declining, housing prices have climbed a bit, and credit markets have rebounded. The worst recession since the Great Depression likely ended in July.

Unfortunately, this doesn't give the all-clear signal for another raging, 20 year bull market. The U.S. economy has swapped too much private debt for too much government debt. Unemployment is still very high and this looks like another jobless recovery (like the early 1990's and 2000's). Consumer credit is severely restricted and Americans needs to save more for retirement. These structural difficulties may lead to slow growth or even a double-dip (W-shaped) recession.

This may seem unusual, but it's not. **The economy and stock market tend to move in long, irregular cycles.** Economic and market cycles of 10 - 20 years seem to come and go. The market peaked in 1929, cycled up and down for 20 years, and then climbed strongly for 17. The market peaked around 1966, cycled up and down for 16 years, and then soared higher for 18. In my opinion, the market peaked in 2000 and we're in for several more years of cycling up and down.

If we're in a flat cycle, why not invest in bonds? Two reasons: 1) bonds don't beat stocks over the long run, and 2) bonds get killed during inflation. Just because bonds *have* done well doesn't mean they *will* do well. Stocks beat bonds over the long run because they benefit from long term economic growth whereas bonds just pay contracted interest. In addition, if unexpected inflation occurs (it's my opinion it will), then bond returns will be atrocious. Stocks better protect against the ravages of inflation.

Over the long run, **the best thing to do is pick a portfolio of equities that can out-perform the market over time.** If you can beat the market—even by a few percentage points a year—it makes a huge difference to your long term wealth. Because no one can time the market and because missing run-ups like that of the last 6 months eliminates the benefits of investing in stocks, you have to stay invested and ride the bumps. Believe me, I've studied market history for every way to make better returns, and the best way to build wealth is to invest in better than average stocks over the long run.

China is moving markets

An old quote, attributed to Prince Metternich of Austria, was that "when Paris sneezes, all Europe catches cold." The quote referred to the French Revolution's (1830) impact on the rest of Europe. Over the last several decades, the quote changed to "when America sneezes, the world catches cold," reflecting the U.S.'s huge impact on world economic growth. Today, the word "China" could easily replace "America," **for no country is impacting global economic growth like China.**

One major reason is China's population: 1.3 billion people—1/5 of the world. That's not enough, by itself, to impact world growth, but what is enough is China's size and growth rate: 3rd largest economy in the world growing 10% a year (versus U.S. growth of 2 - 4%). **When a country of 1.3 billion people doubles their economy every 7 years, it has a *big* impact on world growth.** Just think of a simple thing like beer. Suppose farming exists to grow enough hops for a given world beer demand, then imagine what happens when 1.3 billion people go from having 1 to 2 to 4 beers a week. It places a *tremendous* strain on existing hops production. Now, think of that same impact on copper, oil, aluminum, wheat, fertilizer, etc. China's affect on world incremental demand is huge because so many Chinese are demanding a bit more of everything each year.

Another reason for China's impact has to do with savings. **I've seen estimates that Chinese saving rates are anywhere from 20% - 50%.** That means that for every dollar a Chinese worker makes, he or she is saving 20 - 50 cents. Compare that to the American savings rate of 0% over the past several years and an historical rate of around 8%. A high savings rate creates a large capital base, which is what's needed to generate production and growth. During tough economic times, like now, savings can be put to work immediately to spur growth, whereas non- or low-saving countries must borrow to foster growth. China can spur growth like no other economy *because* they have the savings to grow.

A third reason for China's outsized impact is their command and control government. Leaving aside whether command and control is good or bad, it cannot be denied that such an economic structure allows China to put money into the economy ***overnight***. In the U.S., our legislative and executive branches must spend months wrangling over spending bills and how to allocate them. This process means that only now—over a year after the crisis hit—is government largesse finally going into action. **China, on the other hand, almost instantly put the same amount of spending to work, over $700 billion, in an economy 1/3 America's size.** You can imagine the impact! Even though China depends tremendously on exports, its economy never shrank and has already re-achieved pre-crisis growth.

China's government has also been very successful at spurring consumer demand. It's offering a 13% rebate to rural Chinese who purchase a computer, refrigerator, TV, or other qualifying appliance. China also cut the sales tax for purchasing a car in half. Passenger car sales in August 2009 were 858,300 versus 451,300 a year ago (Waldmeir, Financial Times, 9/8/2009). **When you can spur 90% growth in car sales, you *will* impact world markets.** Such incentives spur incremental demand for raw materials the world over, which in turn drives broader markets (especially when demand everywhere else is low).

China has also been on a commodity buying spree since prices tanked late last year. Not only are Chinese banks, through government fiat, lending money to businesses to buy copper and iron ore in large quantities, but the Chinese are also buying commodity properties around the world. China recently made an exclusive deal to purchase oil from a Canadian oil sands company in Alberta. They also bought partial ownership of Fortescue, a company mining the Pilbara iron ore range in western Australia (Leucadia, one of our investments, is major investor in Fortescue). Since last spring, such demand from China has caused global commodity prices to rebound strongly.

In addition to commodities, China has been heavily buying securities around the world, especially U.S. Treasuries. Because the U.S. dollar is the world's reserve currency and U.S. interest rates influence all global rates, Chinese buying has lifted the value of the dollar and kept world interest rates low. **China moves world markets because they are buying such a large portion of the world's reserve currency through U.S. Treasuries**. In coming years, China's purchase decisions will continue to greatly impact world currencies and interest rates (let's hope they keep purchasing, otherwise the U.S. dollar could tank and U.S. interest rates could soar).

Growth from China has become a defining factor as the developed economies of the world (like the U.S., Europe and Japan) struggle to arrest decline and restore growth. **This influence has made news out of China, good or bad, critical to the developing recovery we face.** Because global economies depend on China like at no time in recent memory, the question now becomes: will China sneeze, and if it does, how much of a cold will the rest of the world get?

Investment Spotlight: Dell

When it comes to Dell, the name on the door matters. Michael Dell quit college to start a computer business from his Texas dorm room. Although he briefly let someone else run the show for a couple of years, he eagerly stepped back in when results faltered—he very much wants to bring the company back to its former glory. He's aligned his interests with shareholders by only paying himself one fifth what he pays other executives and by owning 12% of the $30 billion company. He's highly competitive and very smart, and wants to see his baby thrive and grow.

Dell manufactures computers—it's a commodity business with little to differentiate products (the vast majority of computers come with an Intel processor and Microsoft software). In such a game, lowest cost wins. Dell is low cost because it builds most of its computers to order and ships them directly to customers. The cost advantage is that Dell gets paid before they build the product and long before they pay suppliers, so they pay little or nothing to finance inventory. Dell also has a culture maniacally focused on wringing costs from manufacturing. Competitors try to do this as well as Dell, but nobody does.

Dell is the 2nd largest computer manufacturer in the world, having recently lost market share to Hewlett Packard (now #1), Acer and Lenovo. At first, Dell lost share because it only sold direct when new consumers shifted to buying computers at retail stores. Dell lost additional share because it focused mainly on desktop computers when consumer tastes shifted first to notebook and then to netbook computers. More significantly, Dell lost market dominance with businesses and government users that previously just wanted computer hardware as they started requiring expert services to set up end-to-end systems.

Dell's missteps have been awkward, but it recognized the situation and adapted quickly. When Dell realized it was losing share in the retail channel, it quickly set up relationships with Wal-Mart and Best Buy (two *very* large retailers). When notebook and netbook sales took off, Dell quickly generated competing products. When Dell lost share from lack of business services, they rapidly created and acquired business service capabilities. Dell can and has adapted to changing market conditions, and faster than anyone thought they could. This adaptation hasn't generated great profits yet, but the contest is far from over and Dell still possesses huge market share to compete and win.

Shares of Dell look cheap. To start, it has $5 per share of liquid assets, so at a $10 per share price (our average purchase price), we only paid $5 per share. Over the last year, during the greatest economic downturn since the Great Depression, Dell reported free cash flow per share of $0.97, so we only paid 5 times earnings—a 19% earnings yield—based on *depressed* earnings. Normalized earnings look more like 2 times earnings—a 47% earnings yield. That provides a ***big*** margin of safety.

Topping it off, like icing on a cake, Dell is likely to strongly grow earnings. Underlying computer demand is conservatively forecast to grow at 10-15% per year for years to come. This is partly based on the fact that households are more likely to buy one computer *per person* than one computer *per home* (my wife and I have 3), and partly on the burgeoning demand from Chindia (China & India: 2.4 billion people), and the rest of the world. Even if Dell loses market share to HP, Acer, Lenovo, Apple, or whomever, their earnings are likely to grow strongly for *years*. When you can buy a company with potential growth of 10-15% at an earnings yield of 19% to 47%, I'd say that's an investment value.

Until next quarter

I stated two quarters ago, you don't want to be on the sidelines when the market takes off. It *has* taken off, and is up over *60%* since the bottom in March. We're not back to the market peak of October 2007, but we're doing a lot better than those who panicked and sold in November 2008 or March 2009. It's a scary ride down and up, but you have to stay invested to get the benefit.

Thank you for your patience and for choosing me to be your investment advisor. I love my job, and I'll love it even more when the long-term benefits of my approach are as obvious to you as they are to me. It's great having such supportive clients whose wealth I get to build over the long run.

I'm still looking for new clients and I could use your help. If you know someone who can benefit from my investment services, please give me their contact information and I'll be happy to contact them. If you're happy with what I do, please refer me to others.

If you get the opportunity, please visit my newly refurbished website: www.athenacapital.biz. In it, I cleaned up the look, better articulated my value proposition, and emphasized the value of working with a Chartered Financial Analyst. Let me know what you think. With your help, I know I'll make it better.

To see my thoughts between client letters, visit my blog: www.mikerivers.blogspot.com. I write an entry once a week about investing, markets or the economy. Seeing my latest thoughts may provide calming reassurance, insightful commentary, or simply interesting facts and figures.

As usual, feel free to call or write with any questions you have. I love to hear from clients and would be happy to provide any support or advice you're looking for.

Respectfully yours,

Mike

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