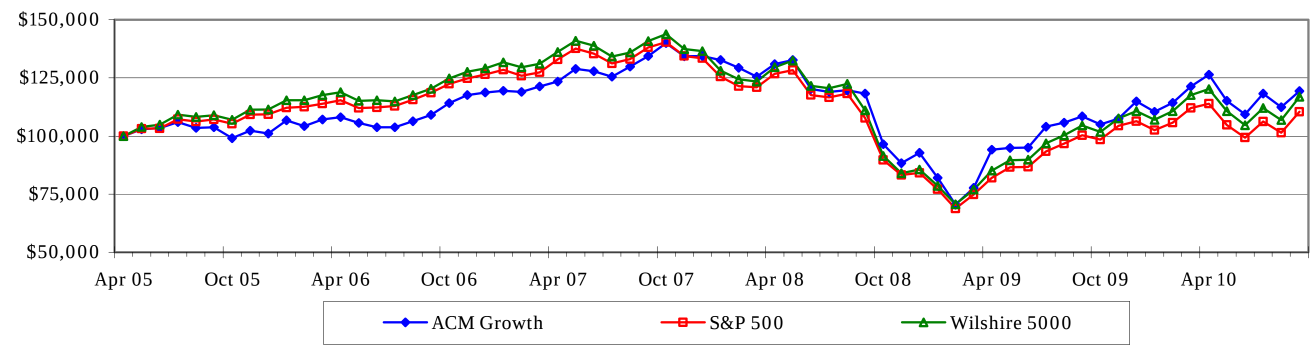
Athena Capital Management

Cumulative Growth Performance

Performance as of 9/30/10	Year to date	1 year	3 years	5 years	Since inception (4/30/05)
ACM Growth	3.94%	10.07%	-11.18%	15.03%	19.40%
S&P 500	3.89%	10.16%	-19.99%	3.22%	10.50%
Wilshire 5000	5.57%	11.86%	-17.02%	7.32%	16.90%

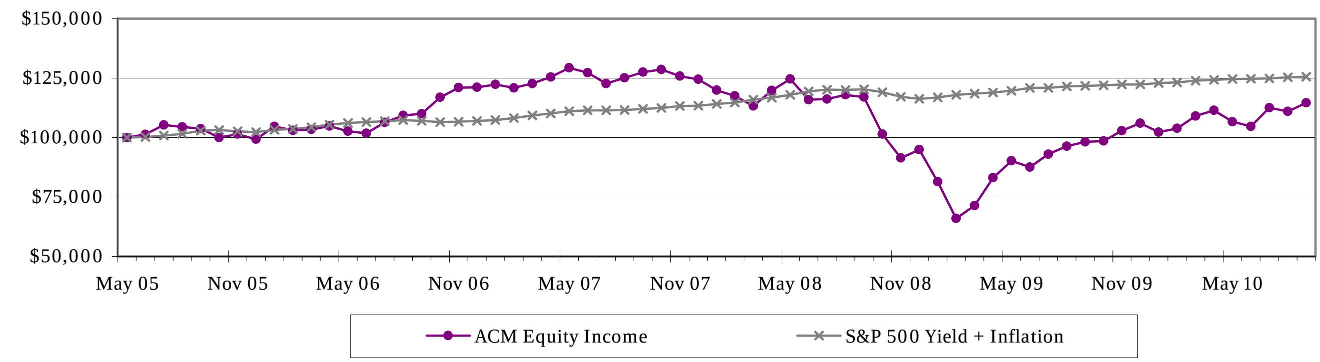
Comparison of the change in value of $100,000 investment in ACM growth versus S&P 500 and Wilshire 5000



Cumulative Equity Income Performance

Performance as of 9/30/10	Year to date	1 year	3 years	5 years	Since inception (5/31/05)
ACM Equity Income	8.11%	16.75%	-10.20%	10.43%	14.57%
S&P 500 yield + inflation	2.86%	3.20%	12.15%	22.12%	25.64%

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.

Athena Capital Management

October 17, 2010

Despite its jarring ups and downs, the 3rd quarter proved rewarding for stock market investors. We participated in the rise, too, but my cautious stance mildly limited our gains. If we can continue to achieve such returns with less risk than the market, I'll be quite happy with long term results.

In this letter, I discuss our performance; my view on markets and the economy; why I think the next five years will be better than the last five; and our investment in a hedge against market downturns: S&P 500 VIX futures.

Performance this quarter

Growth portfolios out-performed year to date, over 3 & 5 years, and since inception, but under-performed over the quarter and 1 year period. The hedge (VIX futures, discussed more fully below) that worked so well in the second quarter as markets declined held back our relative performance this quarter as markets took flight. Although I loath under-performing the market over *any* time period, I think the 42% annualized return we received this quarter (but with significantly less volatility) was more than satisfactory.

Growth's out-performance this quarter came from **POSCO** and **Sears.**

POSCO, a South Korean steel manufacturer, is quite optimistic about Asian demand for steel. When markets agree with that assessment, POSCO's shares soar; but when markets disagree, POSCO's shares tank. As you may have guessed, markets were upbeat about Asian steel demand this quarter. Knowing that markets are not unlikely to change their mind in the future, I reduced our position at a tidy profit.

Sears proves on a quarterly basis just how short term most investors are: this is the *ninth* quarter in a row that Sears has been an out- or under-performer! The underlying value of Sears has not changed that much over the last 2 ¼ years, but the market's over-reaction to quarterly news has. With a good sense of what Sears is worth, I've been happy to sell it when investors are over-eager and buy it when they're despondent. I expect this manic-depressive condition to continue until the housing market recovers, when I expect Sears' price to rise for good.

S&P 500 VIX futures and **Markel** were growth's under-performers during the quarter.

S&P 500 VIX futures declined as the market took off, especially in September. I discuss this security in much more detail below, but suffice it to say I bought the security to protect our portfolio against the market's downside risks. It performed as expected and protected our portfolio during August, but also limited our upside in September. This insurance will prove very valuable if the market declines, or unnecessary if it continues to soar.

Markel is a specialty insurance company with an outstanding long term record and management. Its stock rose *less* than the market over the quarter because its bond portfolio provides little income and its end markets are soft due to overly aggressive competitors. These conditions will reverse in time since insurance markets are inherently cyclical, and when that happens I'm quite confident Markel will prove an excellent long term holding.

Equity income portfolios out-performed over the quarter, year to date and 1 year, but lagged our benchmark over 3 & 5 years and since inception. We continue to gain steadily on our benchmark. The equity income portfolio yielded 3.2% at quarter end (28% better than 10 year government bonds!), and looks likely to grow that yield more quickly than inflation over time. With this profile, it should continue providing satisfactory results.

Equity income out-performance this quarter came from **Verizon** and **Pfizer**.

Verizon owns the largest cell phone business (by subscribers) in the U.S. and one of the largest wireline networks. Investors have been worried that everyone who wants a cell phone already has one, and that wireline networks are dead; this has depressed Verizon's price for several years. In a reversal, investors are beginning to realize that smart phones will allow wireless growth to continue, and that wireline networks are necessary for both wireless *and* wireline broadband. With 6% underlying growth and a 6% dividend yield, Verizon looks like a safe investment to me.

Pfizer, the world's largest pharmaceutical company, has under-performed for years with expiring patents and repeated failures to bring new blockbuster drugs to market. Neither issue has reversed, yet investors seem to be waking up to Pfizer's international growth, large stable of potential drug compounds, and low stock price to underlying value. I agree, and think a 4% dividend with 8% long term growth looks great when compared with 4% government bonds.

Equity income's under-performers were **S&P 500 VIX futures** and **Mercury General** (please see my comments above and below about VIX futures).

Mercury General is a large automotive insurance provider in California and a small one in 12 other states. Mercury, like Markel mentioned above, has been facing the dual headwinds of low bond yields and too competitive insurance markets. With excellent management and prudent investing, I think Mercury will weather this storm. Its 6% dividend yield and potential 6% growth seems to leave us well positioned.

Market and economic outlook

The S&P 500 climbed 11.3% this quarter and is up 3.9% for the year, but with a great deal of volatility. Looking forward, I expect 5.1% annualized returns from the market—better than the last 5 years, but unlikely to dazzle (see article below). I would not be surprised to see continued high volatility going forward.

Projected annualized returns over the next 6 years	
S&P 500 (growth benchmark)	-1.0% to 11.2%
S&P-500-yield-plus-inflation (equity income benchmark)	3.6% to 6.6%

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

Without a doubt, economic growth has slowed since March. Whereas we had over 3% growth in the 1st quarter, the 2nd and 3rd appear to have grown below 2%. The hard question now is whether that less than 2% growth will accelerate, continue or decelerate. If it accelerates, as it has in all post WWII recoveries, the stock market will continue to climb. If not, the market will remain flat or fall.

My crystal ball in forecasting economic growth is about as good as anyone's—that is to say it's as translucent as a bowling ball (revealing *nothing*). Stock market opinion, however, *is* clear, and forecasts a normal post WWII recovery. This can be seen in the price of securities and in analyst estimates. The bond market, in contrast, seems to be forecasting *very* slow growth if not another recession. It should be noted that, historically, the bond market has been right a majority of the time.

Excellent research by Reinhart and Rogoff gives good reason to expect a long, drawn-out recovery. Their studies indicate that financial collapses—like we experienced in 2008—lead to deep and prolonged recoveries that require years of below average growth to re-achieve normal. I tend to agree with their research while acknowledging my inherent fallibility in guessing short term market direction.

Which leads to my current stance in constructing your portfolio: I'm optimistic about long term equity returns (especially the ones we hold), but paranoid about short term market volatility; I'm very concerned about long term inflation, and so avoiding most fixed income investments; I fear geopolitical risks like trade wars and currency disputes, but recognize such quarrels are impossible to predict with precision. In an environment like this, it's smart to own the best investment available: low-priced equities, while being prepared to benefit from market dislocations that seem increasingly likely. I address my optimism about equities in the next section, and my preparations to benefit from potential market dislocations after that.

After years of flat markets, brighter days ahead?

Investing returns over the last 5 years have failed to inspire. The table below shows returns from 9/30/05 to 9/30/10:

	Cumulative return	Annualized return
S&P 500	3.22%	0.64%
Wilshire 5000	7.32%	1.42%
ACM Growth	15.03%	2.84%
S&P 500 yield plus inflation	22.12%	4.08%
ACM Equity Income	10.43%	2.00%

Those aren't the 10%-20% annual returns many came to expect after the 1980 – 2000 bull market. Accordingly, investors are flocking to bonds, alternative investments or anywhere "expected" returns are higher ("expected," here, means looking through the rear-view mirror, not the windshield).

In addition, the stock market has quite literally gone nowhere over the last 10 years. Bonds, on the other hand, have performed nicely, as have gold and emerging markets. Should we follow the crowd and buy fixed income, gold or anything else that has "performed" over the last decade? Not in my opinion.

My reasons are twofold. **First, returns over the last 5 years were as expected.** If you read my first client letter (July 2005), you may recall the poor returns I projected at the time:

	My 5 year projection in 2005	Actual return experienced
S&P 500	-7.7 % to 7.8%	0.64%
S&P 500 yield + inflation	3.3% to 6.3%	4.08%

As you can see, returns experienced fell neatly within my projections. I didn't relish predicting mediocre returns in my first client letter, but I thought it was important to prepare you for likely results.

Why did I expect low returns? In a word: valuation. A study of stock market history made it clear that stock prices relative to underlying earnings would lead to poor returns. The stock market can, like a rubber band, stretch away from fundamentals; but, the greater the stretch, the stronger the pullback to trend. The rubber band snapped down in 2008 and back up in 2009, showing that returns *are* predictable over long periods. Lucky for us, stock prices are currently *much* closer to trend than in 2005, and this is my second reason for not following the crowd.

Forward return projections look much better now than 5 years ago. Below are my expectations over the next 5 and 10 years:

	5 year cumulative return potential	10 year cumulative return potential
S&P 500	25%	84%
S&P 500 yield + inflation	28%	64%

Such returns aren't the thrilling 200% investors would like, but are much better than our experience over the last 5 and 10 years. (If you'd like to know how I generate these forecasts, please contact me and I'll be happy to explain.)

As additional reason for optimism, our accounts could exceed the above projections by continuing to *beat* the market as we have over the last 5 years. If we successfully repeat this feat in the future (no guarantee!), I'd expect the following potential returns:

	5 year cumulative return potential	10 year cumulative return potential
ACM Growth	39%	129%
ACM Equity Income	34%	111%

In my opinion, potentially more than doubling your money over the next decade is good reason to be optimistic about the future.

Let me be clear: the path ahead is likely to be bumpy. The economy faces high and sustained unemployment, potential deflation, and a high probability of protectionism and sovereign debt defaults (which is why I discuss our VXX investment below). This will likely cause great uncertainty and market volatility. But, the more difficult things are in the short term, the better our potential results. **The past and short term future look dim, but the long term future looks bright indeed.**

Investment Spotlight: S&P 500 VIX short-term futures (VXX)

Markets move in long and short term cycles. Understanding how to benefit from such cycles is critical to successful long term investing. When the market peaked in 2000, I could see it was likely to provide negative returns—it has. In 2005, I could see that long term returns were likely to be low—they have been. With that in mind, I've searched for 10 years to find an investment that might allow us to benefit from the market's erratic swings. I found an interesting candidate in 2009.

The VXX is unlike the investments I've described in the past, so it requires a unique explanation. Part I provides a general explanation for those interested in the big picture; Part II provides more detail for those technically oriented or who would like a deeper understanding.

Part I: If you're a little interested

S&P 500 VIX short-term futures, or VXX, is a hedge against market downturns. A hedge is a position established to offset exposure to price fluctuations with the goal of minimizing unwanted risk. Examples of hedges include insurance policies, futures contracts, and bringing an umbrella even though it's not raining. The VXX declines when the market is flat or goes up, and climbs when the market goes down. So, it hedges our risk against market declines and limits our upside if the market takes off. Just like it only makes sense to carry an umbrella if rain is likely, it only makes sense to own VXX if market declines are becoming likely or will be especially painful.

I chose VXX because its downside is quantifiable and its upside offsets risk. When the market climbs, the VXX declines over time; but, when the market tanks, the VXX goes up more than the market goes down. Not only does it hedge the downside, it gives us more bang for the buck. The VXX, like all investments, looks cheap at the right price.

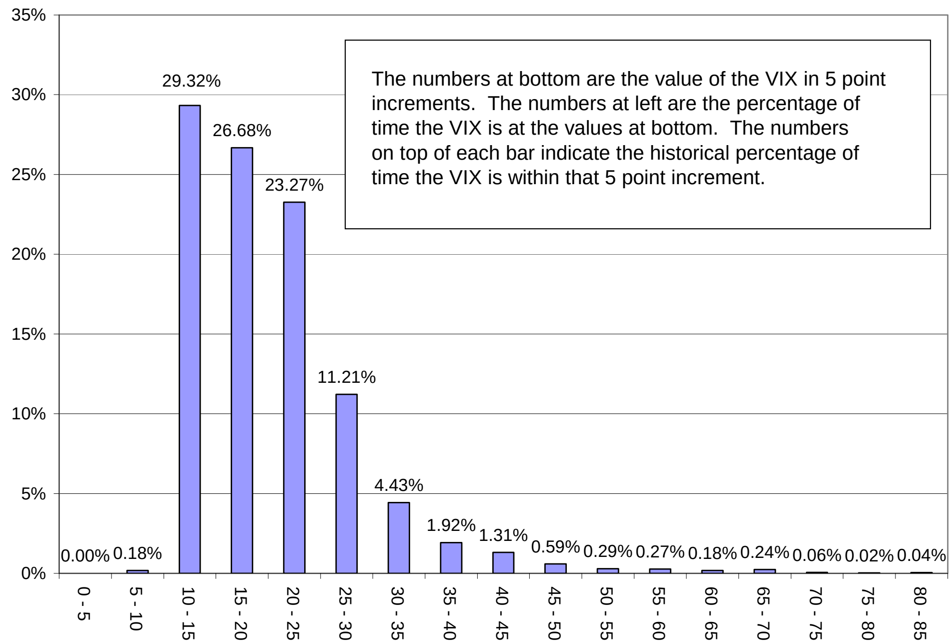
S&P 500 volatility futures are not my normal investment. It's not a company with competitive advantages, great management and sound finances. But, it's an excellent hedge against negative market outcomes, and, if purchased right, can provide good value.

Part II: If you're *really* interested

S&P 500 volatility index (VIX) short-term futures (symbol: VXX) replicates an index that tracks the 1-2 month volatility futures contracts on the S&P 500. Volatility of the S&P 500 is a measure of its dispersion—how much it fluctuates up and down over a given period. On the Chicago Board Options Exchange (CBOE), you can buy and sell futures contracts that attempt to estimate how volatile the S&P 500 index will be in the future. VXX is a security that tracks the total return of 1-2 month futures (hence, short-term) over time. **When market participants think the S&P 500 will be stable or climb over the next 2 months, the VXX goes down in value; when they think the S&P 500 will be volatile or drop, the VXX goes up in value.** Given this detail, why do I think it's a worthwhile investment?

First, as described above, it's an excellent hedge against market downturns: it climbs when the market is highly volatile or declining, and falls when the market is steady or climbing. Put differently, it offsets the price fluctuation risk of the rest of our portfolio. The VXX becomes especially handy when unexpected market dislocations occur, like the so-called "flash crash" of May 6, 2010. Because we owned the VXX that day, we were able to gain from the sale of the VXX (which climbed 35% in one day). **We then had extra cash to buy securities that had declined significantly in price. With such a hedge, we increased long term returns.**

Another reason to invest in VXX is skewed outcomes. In a positively skewed distribution, there is a high likelihood of a low outcome and a low likelihood of a high outcome (see graph below). There is a benefit, though, if the high outcome is much better than the low outcome, even if it's less likely. The S&P 500 volatility index (VIX), which is what the VXX seeks to track, has not gone below 9 since January 1990, but it's been as high as 81. If you bought the VIX at 18, the worst you would have done historically is lose 50% and the best would have been a gain of 350%. With the right probabilities, a potential 350% gain outweighs a potential 50% loss. **If purchased advantageously, the VXX provides a lot of upside and limited downside.**



VXX presents an interesting value proposition, too, at the right price. Unlike the stock of a company, where price fluctuates with respect to underlying fundamentals, the VXX has limited downside and upside over the short term. Historically, the VIX has tended to spend a lot of time at low values and then jump dramatically during market dislocations. That means it might spend 19 days at 15, spike to 30, and then decline back to 15 again. If you buy the VXX at one price, the likelihood of a good outcome is poor; but, if you buy it at the right price, a good outcome becomes more likely. **It's a good value at one price, and a bad value at another.**

Lest you think this investment is too good to be true, let me state plainly that it does have a downside. Because it is an Exchange Traded Note (ETN) that must continuously purchase 2 month futures as older futures expire, its value declines over time. This decline in value is termed negative roll risk and time decay. Just like insurance, it provides a benefit if things go wrong, but at a price. That means VXX provides good short term risk mitigation, but poor long term insurance. The VXX, like all investments, comes with risk.

Despite this, the VXX can provide a margin of safety if purchased well. For starters, it moves counter to the market. At worst, it limits upside if the market takes off; at best, it provides our portfolio with a large cash position right when prices are low. With a profile like that, **it provides protection against bad outcomes and limits the upside in cases where things go from euphoric to even more euphoric.**

Until next quarter

Thank you for your business. It's been a difficult five years to start an investment firm, but I'm happy to say it's succeeding despite stiff headwinds. From what I'll admit was a low base, it's grown at a 36% rate! I have both you and our investment results to thank for that, and I hope you've been happy to come along for the ride.

Though I do little to market Athena Capital, it continues to grow. Much of this business has come through referrals from clients, friends and family, like you. So, **if you know someone in need of investment services, please put them in contact with me.** You can rest assured I will take great care of them.

I continue to get great feedback about my blog, **www.mikerivers.blogspot.com,** which, believe it or not, has attracted readers from all over the world. It may be my witty writing, my insights on markets and the economy, or just sheer boredom on the part of random people surfing the web, but people keep stopping by to see what I have so say. If you'd like to learn more, please visit and subscribe to receive it via email.

If you ever have questions or comments for me, please contact me at your convenience. It's always great to hear from you.

Respectfully yours,
Mike

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