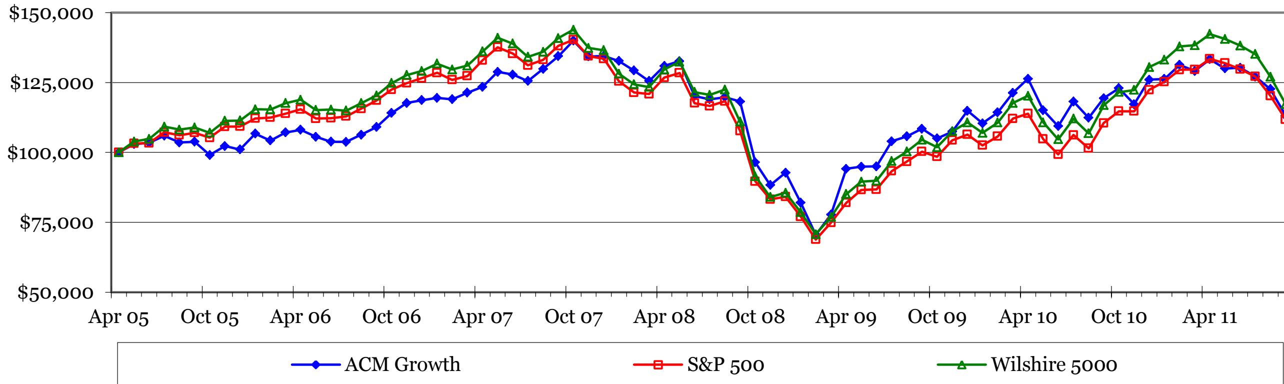
Athena Capital Management

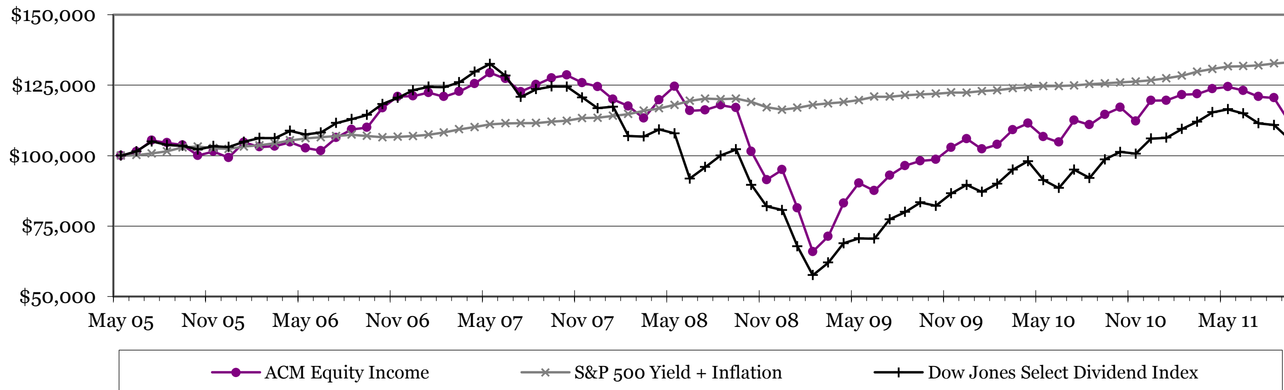
Cumulative Growth Performance

Performance as of 9/30/11	Year to date	1 year	3 years	5 years	Since inception (4/30/05)
ACM Growth	-10.18%	-5.19%	-4.22%	3.81%	13.21%
S&P 500	-8.67%	1.15%	3.73%	-5.76%	11.77%
Wilshire 5000	-10.14%	0.32%	5.64%	-2.54%	17.27%



Cumulative Equity Income Performance

Performance as of 9/30/11	Year to date	1 year	3 years	5 years	Since inception (5/31/05)
ACM Equity Income	-6.39%	-2.32%	-4.33%	1.74%	11.91%
S&P 500 yield + inflation	5.09%	5.98%	10.75%	24.43%	33.15%
Dow Jones Select Dividend Index	-0.23%	7.22%	3.54%	-7.55%	5.80%



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.

© Copyright 2011 Athena Capital Management Corp. All rights reserved. Permission is hereby granted to electronically link, forward, or store this document in its entirety or to quote passages as long as source is attributed to "Michael Rivers, CFA, Athena Capital Management." Nothing in this letter should be considered investment, financial, tax, or legal advice. The opinions, estimates and projections contained herein are subject to change without notice. Information throughout this letter has been obtained from sources believed to be accurate and reliable, but such accuracy cannot be guaranteed.

Athena Capital Management

October 19, 2011

Markets were down in the 3rd quarter—after swinging wildly from one day to the next—mostly over news of fiscal and economic troubles in Europe and the U.S. Pleasantly, our portfolios held up slightly better than the market.

This quarter's letter will cover: our investing performance; my view on markets and the economy; some excellent guidance from Benjamin Graham—the Dean of Wall Street; and an update on one of my highest conviction holdings: Dell.

Performance this quarter

Growth portfolios have out-performed all periods that began before 12/31/07 and under-performed every period since that date. What happened? Investors have been herding in a strangely coordinated way: instead of carefully considering the investment merits of individual securities, they've been buying or selling bonds/stocks/commodities/gold as groups (for the mathematically-minded: correlations between S&P500 stocks usually average 30%; recently, they've been 90%!). Some commentators call this the "risk on/risk off" trade. Not to worry, this phenomenon appears frequently in market history and always ends as abruptly as it begins. When that happens, I expect our portfolios will perform better relative to the market.

Growth's out-performers this quarter were **Verizon** and **Fairfax Financial.**

Despite a contentious strike by wireline workers and stiff competition in its wireless business, Verizon's stock price held up well this quarter. I believe investors are starting to grasp the steady nature of Verizon's cash flows and the cost cuts it's likely to make going forward. Verizon's strong performance gave us the chance to trim our position and seek higher returns elsewhere.

Fairfax, an insurance holding company, held up well over the quarter for what I think were two reasons: 1) recent insurance claims due to tornados, earthquakes and hurricanes are likely to lead to higher insurance premiums—benefiting Fairfax; and 2) Fairfax mostly hedged its investing portfolio to protect against just the type of market swoon we've experienced recently. I expect prudent moves by Fairfax will continue benefiting shareholders going forward.

Comcast and **Dell** were growth's under-performers this quarter.

Comcast fell as investors worry that consumers will "cut the cord" by switching from cable TV to Internet TV. I'm significantly less concerned than others for two reasons: 1) cable TV declines are tiny and due almost entirely to *temporary* economic conditions (low employment and housing starts); and 2) even if customers do "cut the cord," they'll need a broadband Internet connection from the cord they supposedly cut (broadband Internet generates double the profit margin for Comcast). Comcast's businesses are still viable, and believe investors will see this clearly in time.

Dell (covered in more detail in the Investment Spotlight, below) declined over the quarter when Hewlett Packard announced it may abandon the personal computer business. Since that event, HP's CEO was fired and Dell announced a $5 billion share repurchase. HP's ambiguity is great for Dell's business (customers prefer a company committed to its products), and Dell's repurchase will increase our economic value by 25% (all else equal).

Equity income portfolios continue to under-perform the S&P 500 Yield Plus Inflation over all periods. After playing steady catch-up for the last two-and-a-half years, our portfolios pulled back along with the rest of the stock market. Though unpleasant, this retreat will give us an opportunity to position the portfolio for stronger growth going forward. With a 4.3% yield and principal value intact, we're much better positioned than 10- and 30-year government bonds yielding less than 2% and 3%, respectively.

Equity income's out-performers this quarter were the **Corporate Bond ETF** (Exchange Traded Fund) and **Mortgage Bond ETF.**

Bond ETFs trade like equity securities, but are composed of portfolios of bond securities. The Corporate Bond ETF consists of 662 investment grade corporate bonds; The Mortgage Bond ETF includes 187 Mortgage Backed Securities. I purchased these bond ETFs because I believe they represent better value than government bonds—higher yields and better supported principal values. These securities gained in value over the quarter when stocks declined: investors seek safety in bonds as markets swoon. If stock markets continue to decline, I expect to sell these securities and purchase higher-yielding equities that possess better inflation protection attributes.

Frontier Communications and **Pfizer** were equity income's under-performers this quarter.

Frontier, a rural wireline telecommunications company, saw its price decline as investors continue to fret over

© Copyright 2011 Athena Capital Management Corp. All rights reserved. Permission is hereby granted to electronically link, forward, or store this document in its entirety or to quote passages as long as source is attributed to "Michael Rivers, CFA, Athena Capital Management." Nothing in this letter should be considered investment, financial, tax, or legal advice. The opinions, estimates and projections contained herein are subject to change without notice. Information throughout this letter has been obtained from sources believed to be accurate and reliable, but such accuracy cannot be guaranteed.

Athena Capital Management

Frontier's acquisition of Verizon's rural wireline business. The large acquisition resulted in several challenges, including technical integration and a declining customer base, but I think Frontier is successfully working through both issues and can easily pay its dividend while further improvement occurs.

Pfizer declined as many investors were disappointed that rumors about the company being broken into big pieces didn't pan out. Although such a strategy might benefit short-term traders, it would not benefit long-term investors like us. Pfizer is correctly recognizing which businesses it should keep or sell, and we'll benefit from their far-sightedness in time.

Market and economic outlook

The S&P 500 fell 13.9% last quarter. Such falls may seem like a downer, but they mean higher returns going forward—as reflected in my estimates below. Forward projections aren't yet enough to generate out-right excitement (3rd quarter 2009 estimates were 5.6% to 18.5%), but they are an improvement. This is a good time to make new investment commitments.

Projected annualized returns over the next 6 years	
S&P 500 (growth benchmark)	0.5% to 12.9%
S&P-500-yield-plus-inflation (equity income benchmark)	3.8% to 6.8%

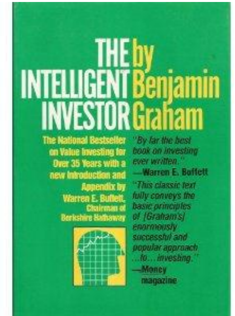
How do I arrive at these numbers? Visit "Free Articles" at www.athenacapital.biz to see my 7/12/05 excerpt.

With all the data in, it's clear the world economy went from slow growth to deceleration late last spring. It showed up first in the emerging markets, especially China, and then spread into the developed economies of the U.S., Europe and Japan. What first seemed like a temporary reaction to the earthquake in Japan turned out to be more pervasive and persistent.

Making matters worse, both U.S. and European governments decided to play kick the can instead of facing fiscal problems. There's nothing markets hate more than uncertainty, and inconsistent messages and actions from elected officials is increasing uncertainty daily. We'll get past this one way or the other: with real leadership soon, or with real leadership following a crisis. It's easy to judge which path markets would prefer, it's harder to guess which we'll take.

This means markets are likely to continue violently bouncing up and down. Although such swings feel nerve-wracking, they bring tremendous opportunity for prepared investors. My best returns have always followed crisis markets where it seemed the world would end. It never does, but the returns from such conditions are truly phenomenal. If you find that hard to imagine, please observe the greater than 80% returns from 2002 to 2007 and 2009 to 2011. Or, better still, review the advice below from someone who successfully invested through the Great Depression.

The Intelligent Investor



Warren Buffett describes Benjamin Graham's book, *The Intelligent Investor*, as "**By far the best book on investing ever written**." I couldn't agree more. With that in mind, I've plucked some of my favorite excerpts from the book to share with you. For investors, these are words to live by.

On investing methodology:

> "To enjoy a reasonable chance for continued better than average results, the investor must follow policies which are (1) inherently sound and promising, and (2) are not popular in Wall Street."

> "…any approach to moneymaking in the stock market which can be easily described and followed by a lot of people is by its terms too simple and too easy to last."

> "You are neither right nor wrong because the crowd disagrees with you. You are right because your data and reasoning are right."

> "…in the world of securities, courage becomes a supreme virtue *after* adequate knowledge and a tested judgment are at hand."

On stock market fluctuations:

> "…the stock market often goes far wrong, and sometimes an alert and courageous investor can take advantage of its patent errors."

> "…the investor may as well resign himself in advance to the probability rather than the mere possibility that most of his holdings will advance, say, 50% or more from their low point and decline the equivalent one-third or more from their high point at various periods in the next five years."

© Copyright 2011 Athena Capital Management Corp. All rights reserved. Permission is hereby granted to electronically link, forward, or store this document in its entirety or to quote passages as long as source is attributed to "Michael Rivers, CFA, Athena Capital Management." Nothing in this letter should be considered investment, financial, tax, or legal advice. The opinions, estimates and projections contained herein are subject to change without notice. Information throughout this letter has been obtained from sources believed to be accurate and reliable, but such accuracy cannot be guaranteed.

On Wall Street:

"Wall Street's view of the longer future is notoriously fallible…"

"As in all other activities that emphasize price movements first and underlying values second, the work of many intelligent minds constantly engaged in this field tends to be self-neutralizing and self-defeating over the years."

On investment return expectations:

"To achieve *satisfactory* investment results is easier than most people realize; to achieve *superior* results is harder than it looks."

"The rate of return sought should be dependent… on the amount of intelligent effort the investor is willing and able to bring to bear on his task."

On the psychology of investing:

"…even the intelligent investor is likely to need considerable will power to keep from following the crowd."

"It is easy to tell you not to speculate; the hard thing will be for you to follow this advice."

"…indeed, the investor's chief problem—and even his worst enemy—is likely to be himself."

"An elementary requirement for the intelligent investor is an ability to resist the blandishments of salesmen offering new common-stock issues during bull markets."

On buying under-valued securities:

"Buying a neglected and therefore undervalued issue for profit generally proves a protracted and patience-trying experience. …The principle is sound, its successful application is not impossible, but it is distinctly not an easy art to master."

"…two major sources of undervaluation: (1) currently disappointing results and (2) protracted neglect or unpopularity."

"It is our argument that a sufficiently low price can turn a security of mediocre quality into a sound investment opportunity…."

On paying too much for securities:

"…common stocks with good records and apparently good prospects sell at correspondingly high prices."

"High valuations entail high risks. …It often proves much more difficult to continue to grow at a high rate after volume and profits have already expanded to big totals."

"…most of the fair-weather investments, acquired at fair-weather prices, are destined to suffer disturbing price declines when the horizon clouds over—and often sooner than that."

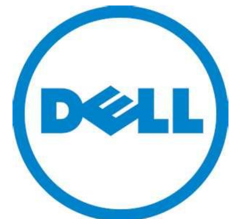
On buying securities with a margin of safety:

"…the function of the margin of safety is, in essence, that of rendering unnecessary an accurate estimate of the future. If the margin is a large one, then it is enough to assume that future earnings will not fall far below those of the past in order for an investor to feel sufficiently protected against the vicissitudes of time."

"…a true margin of safety is one that can be demonstrated by figures, by persuasive reasoning, and by reference to a body of actual experience."

In turbulent markets, like we've experienced recently, it's comforting to refer to first principles. Graham's writing is the best in the business—it's where today's investing gurus turn in volatile markets. I hope you find it helpful, too.

Investment Spotlight: Dell update



As you may or may not have noticed, I don't buy and sell investments frequently. This lowers expenses and allows us to leverage the multiple years of research that go into each idea. The downside, if you could call it that, is that low turnover yields fewer new ideas for investment spotlights, **so I decided to update you on my investment thesis—and soaring enthusiasm—for Dell** (first covered in my 3rd quarter 2009 letter).

Since I wrote about Dell two years ago:

- sales climbed 23%, operating income is up 71%, and net income soared 89%
- on a per share basis, those metrics climbed 34%, 84% and 105% respectively
- cash per share on the balance sheet rose 42%

© Copyright 2011 Athena Capital Management Corp. All rights reserved. Permission is hereby granted to electronically link, forward, or store this document in its entirety or to quote passages as long as source is attributed to "Michael Rivers, CFA, Athena Capital Management." Nothing in this letter should be considered investment, financial, tax, or legal advice. The opinions, estimates and projections contained herein are subject to change without notice. Information throughout this letter has been obtained from sources believed to be accurate and reliable, but such accuracy cannot be guaranteed.

Athena Capital Management

- free cash flow per share rocketed a stunning 147% (cash free to distribute to shareholders or expand the business)
- and, the stock price...***dropped*** 10%

Obviously, **Wall Street isn't interpreting the numbers the same way I am.** (For that matter, are they even looking?)

Dell's improving results partly reflect a recovering economy, but also hard work transforming its product mix and service offerings. Realizing that competition from Asia was commoditizing the computer manufacturing business, **Dell decided to remake itself from a "box" maker into a services and solutions provider**.

To get there, Dell first out-sourced product manufacturing to Asia and Eastern Europe, and then acquired the information technology service company, Perot Systems. Next, Dell made a slew of small, mostly private acquisitions to increase its expertise in data center a) storage (pictured right), b) management, c) networking and d) security. **Now, Dell owns high-value intellectual property targeted at fast growing markets**.

On the demand side of the equation, **Dell continues to focus on high volume purchases from commercial and public institutions more than one-off sales to consumers**. In fact, less than 20% of Dell's revenues and less than 10% of profits come from consumers. This targeting benefits Dell because consumers have been more deeply impacted by the recent economic malaise, and consumer products face tough competition from heavy hitters like Apple and new product categories like tablets.

Dell's institutional focus also benefits from the huge move toward cloud computing (centralized and networked, rather than distributed, computer processing and storage). This trend is allowing Dell to generate excellent growth from its server, storage, networking (pictured right), and data center management offerings. Though cloud computing has traditionally been HP, IBM and Oracle's turf, Dell is gaining entry due to the market's rapid growth, and because mid-sized businesses (Dell's historic strength) are leading the charge even more aggressively than large enterprises.

Dell's strategy has also targeted fast-growing emerging markets. Dell is the largest computer company in India, a market of 1.3 billion people, and its sales to emerging markets are growing at around 20% a year—rapidly approaching one-third of sales. Not surprisingly, there is much more room to grow.

Michael Dell's reaction to the company's stock price weakness over the last two years has been to purchase $150 million at $14.37 per share last March and $100 million $13.57 per share last December. These weren't stock option give-aways or bonus compensation, but **Dell opening his own wallet and buying with conviction**. With an average price of $12.85 in our accounts, I think we're well positioned along-side him.

I must admit, I don't understand other investors' reaction to Dell. They seem more worried about top line sales than bottom line profits, and overly concerned about Dell's negligible consumer business switching to tablets. With $3.70 in net cash per share on its books, $1.74 of earnings per share and $2.29 of free cash flow per share over the last 12 months, Dell looks like a bargain at $14.14 (at quarter end). It may take time, but in the long run, I'm confident the market will see things my way.

Until next quarter

Thanks again for your business. We may be facing yet another shaky market, but our portfolios are well-structured to weather the storm and benefit disproportionately when markets recover. Stressful markets may be no fun on the nerves, but they're outstanding for growing portfolios.

If you get a chance, **please stop by to see my recently updated website, www.athenacapital.biz**, and let me know what you think.

As usual, **if you have any questions, comments or feedback for me, please contact me at your convenience.** I always enjoy hearing from you.

Respectfully,
Mike

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

© Copyright 2011 Athena Capital Management Corp. All rights reserved. Permission is hereby granted to electronically link, forward, or store this document in its entirety or to quote passages as long as source is attributed to "Michael Rivers, CFA, Athena Capital Management." Nothing in this letter should be considered investment, financial, tax, or legal advice. The opinions, estimates and projections contained herein are subject to change without notice. Information throughout this letter has been obtained from sources believed to be accurate and reliable, but such accuracy cannot be guaranteed.