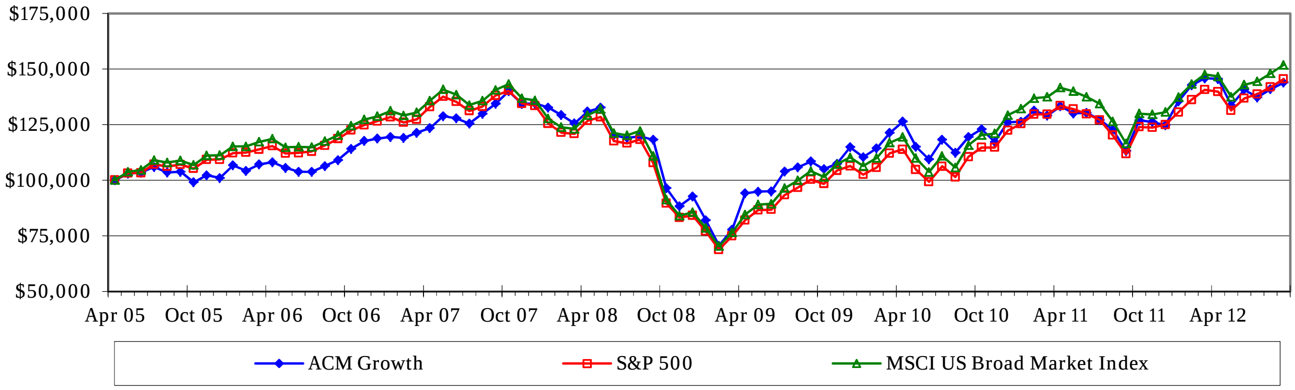
ATHENA CAPITAL MANAGEMENT

Cumulative Growth Performance

Performance as of 9/30/12	Year to date	3 years	5 years	7 years	Since inception (4/30/05)
ACM Growth	15.29%	32.62%	7.02%	38.60%	43.87%
S&P 500	16.44%	45.07%	5.37%	35.93%	45.52%
MSCI US Broad Market Index	16.21%	45.84%	7.99%	39.47%	51.86%

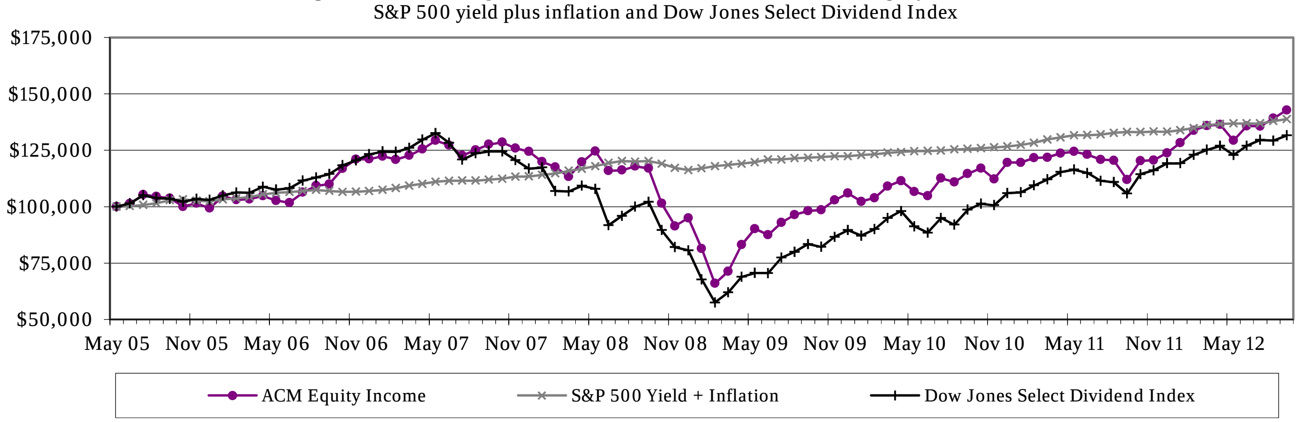
Comparison of the change in value of $100,000 investment in ACM growth versus S&P 500 and MSCI US Broad Market Index



Cumulative Equity Income Performance

Performance as of 9/30/12	Year to date	3 years	5 years	7 years	Since inception (5/31/05)
ACM Equity Income	15.33%	45.56%	11.95%	37.69%	42.84%
S&P 500 yield + inflation	4.23%	14.06%	23.94%	34.96%	38.85%
Dow Jones Select Dividend Index	10.41%	57.81%	5.70%	27.17%	31.63%

Comparison of the change in value of $100,000 investment in ACM equity income versus S&P 500 yield plus inflation and Dow Jones Select Dividend Index



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 16, 2012

The S&P 500 has gained a quite respectable 16% thus far in 2012, due more to an accommodating Federal Reserve than underlying economic strength. Our portfolios—being less speculatively constructed—fared well, but not as well as the overall market.

This letter will cover our investing results; my view on markets and the economy; and why, when it comes to investing, you should fear optimism and celebrate pessimism.

Performance this quarter

Growth portfolios out-performed the S&P 500 over 5 and 7 year periods, but under-performed year to date, over 3 years, and since inception. What's one to make of such conflicting data? Not much, I'm afraid. We have not meaningfully out- or under-performed the market since inception despite holding securities that have differed consistently and *significantly* from our benchmarks. Since 2005, markets have been buffeted by housing in 2006, subprime in 2007, financials in 2008/9, and annual crises in Europe each of the last three years. In reaction, investors have herded into and out of stocks, bonds, commodities, and cash with little discrimination about individual holdings. In time, investors will realize that owning a basket of Toyotas *and* Yugos will produce worse results than owning a basket of *just* Toyotas. We don't have to know exactly when that will happen to know it's better to own Toyotas.

Growth's out-performers this quarter were **Comcast** and **Frontier Communications.**

Comcast, the country's largest cable company, climbed after NBC's Olympic coverage was less of a disaster than many feared (Comcast owns 51% of NBC). Comcast's broadband internet, cable content, and amusement parks are the real story, and all three are generating growing cash flows over time without requiring lots of new capital. Comcast isn't fully priced, yet, but it's moving in the right direction.

Frontier, a rural telecom company, climbed 26% over the quarter as dire scenarios about its imminent demise faded from view. Granted, Frontier has a lot of work to do slowing customer declines and competing with cable and wireless providers, but the underlying business is generating a lot of cash. More importantly, Frontier is making slow, steady progress with broadband to customers and businesses, and its long term value depends more on building those two businesses than anything else.

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

Dell and Hewlett-Packard have become poster-children for the "irrelevant" consumer PC business. What most seem to ignore is that Dell and HP make *almost all* of their money selling computer equipment to enterprises—*not* consumers. Without a doubt, they face stiff competition from Apple and Lenovo in PCs and tablets, and from IBM, Oracle, EMC and Cisco on the enterprise side, but with a 25% earnings yield (annual free cash flow to the price we paid) and strong competitive positions in multiple, vital markets, I think the rumors of their deaths have been greatly exaggerated.

Equity income portfolios out-performed our long-term benchmark over every period but 5 years. Our portfolios benefited from strong equity performance over the quarter that allowed us to beat our long term benchmark since inception. With a dividend yield of 3.6% (80% more than the S&P 500's dividend yield) growing faster than inflation, and bonds to limit short term market volatility, we seem well positioned going forward.

Equity income saw out-performance from **Frontier Communications** and **Pfizer**. Please see my comments above on Frontier.

Pfizer's good returns over the quarter seem more due to bad things *not* happening than good things happening. Pfizer didn't have any large drugs roll off patent, nor did they experience big disappointments in drug research, development, or approval. Just imagine what could happen to Pfizer's stock price if good news did arrive.

Dell and **Winthrop Realty** were equity income's under-performers this quarter. Please see my comments above on Dell.

Winthrop, a commercial Real Estate Investment Trust, continues to raise money from capital markets to buy commercial real estate on the cheap. Short-term investors don't like this because they don't want their share interest diluted unless they can see a return over the next six to nine months. For long term investors like us, Winthrop is doing the right thing, and I believe our patience will be rewarded.

Market and economic outlook

The S&P 500 gained 6.35% this quarter, again reducing my six year projected market returns. Those expecting double digit returns from here are likely to be disappointed, but equities still represent the best house in a bad neighborhood when compared with bonds, cash, commodities, or real estate.

Projected annualized returns over the next 6 years	
S&P 500 (growth benchmark)	-3.4% to 8.4%
S&P-500-yield-plus-inflation (equity income benchmark)	3.6% to 6.6%

How do I arrive at these numbers? Visit "Athena Capital Articles" at www.athenacapital.biz to see my 2Q2005 article.

The world economy is *clearly* slowing. Europe's recession has gone from bad to worse as southern economies like Greece, Portugal, Spain and Italy are even pulling down Germany. China's slowing has accelerated, too, as its economy restructures from debt financed production to consumer led spending. The U.S. economy has, so far, avoided outright contraction, but has been trending slower each quarter (there are a few very smart people who think we've already entered a new recession).

Bonds are usually the best investment when economies are slowing. But, bonds are unusually expensive now and face a day of reckoning with higher inflation. Contrary to popular belief, bonds can be just as risky as stocks, and low yields along with central bank money-printing are the danger signs—just what we're seeing now. Bonds' popularity over the last decade has rendered them more risky than most recognize, particularly the sovereign bonds of developed countries (U.S., northern Europe, Japan).

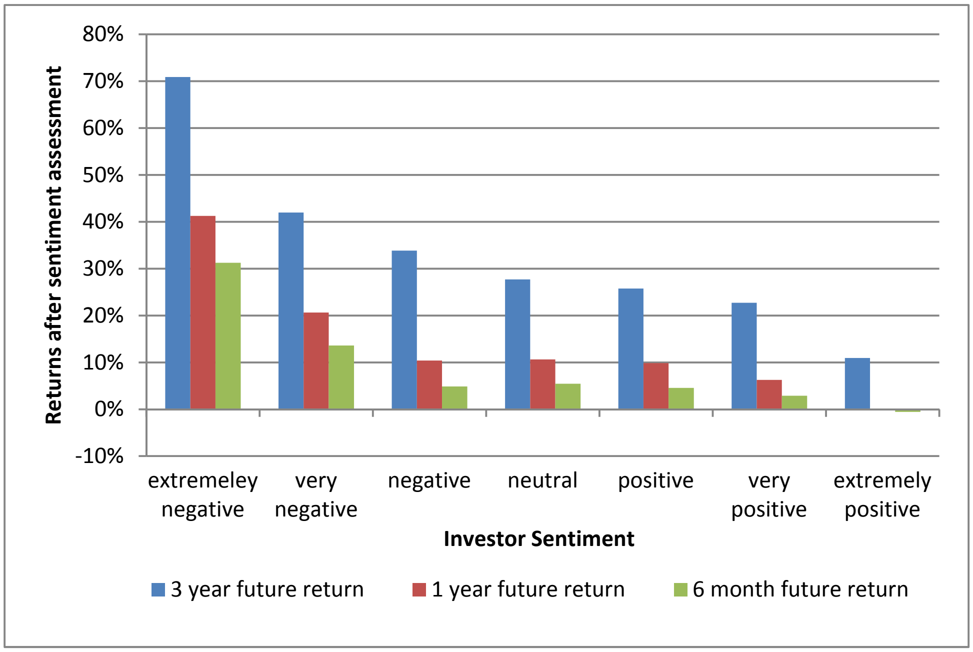
The place to look for good *future* returns is where things *aren't* popular. Right now, that's emerging markets, Europe, and U.S. equities. Investors have been selling all three (as can be seen in mutual fund flows), so that's where you'll find solid investments likely to provide the best future returns. Unpopular securities tend to continue their trend down *initially*—as we've been experiencing—but then prove their worth in time. In the next section, I'll make that case in more detail.

Fear optimism, celebrate pessimism

When it comes to investing, the conventional wisdom from Wall Street to Main Street is: buy "when the coast is clear" and sell "when things look scary." As I'll show, following this dictum leads to lousy results, because **the worst returns are generated when everything looks peachy, and the best returns are earned when things look bleak**.

> *"Be fearful when others are greedy and greedy when others are fearful" – Warren Buffett*

Look at the chart below. The American Association of Individual Investors polls its members once a week to see if they are positive, neutral or negative about the stock market. As the chart shows, **when individual investors are most positive (far right), future returns are lowest, and when they are most negative (far left), future returns are highest**. So much for selling on fear and buying when the coast is clear.



What's true of the market as a whole is just as true of sectors within the market. For instance, investors became extremely enthusiastic about:

- Technology in 2000
- Housing and finance in 2006
- China in 2007
- Commodities in 2008...

...right before each sector plunged.

In contrast, investors became overly negative about:

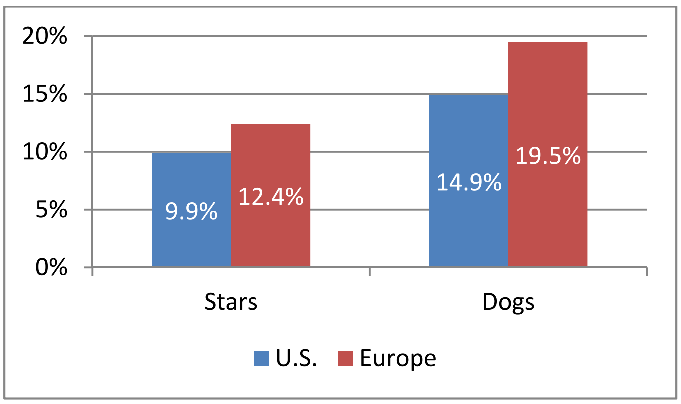
- Emerging markets in 1998
- Energy and materials in 2000
- Technology in 2002
- Financials in 2009...

...right before each produced huge, multi-year returns.

The most-loathed sectors end up soaring and the most-loved sectors end up tanking. With investing, avoid what everyone loves, and love what everyone avoids.

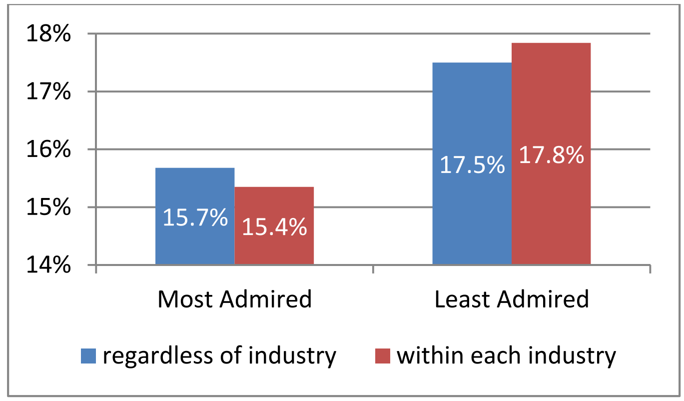
What's true of the market and sectors is equally true for individual stocks: **the stocks most admired for strength generally make lousy investments, and the stocks most despised for weakness usually turn out to be excellent investments**.

Research by Scott, Stumpp and Xu (referenced in Montier, *Value Investing*) showed that **"Dogs"**—stocks with low historic growth and low forecast growth—**tend to greatly out-perform "Stars"**—stocks with high past growth and high expected growth. The out-performance was 5% per annum in the U.S., and 7% in Europe!



How can that be? Stars' future growth almost always disappoints relative to high expectations, and the too-high price paid for seemingly great prospects result in low returns. In contrast, Dogs' future growth frequently exceeds dour expectations, and the too-low price paid for assumed weak prospects generates high returns.

As further evidence, research by Statman, Fisher and Anginer (also from Montier's *Value Investing*) used *Fortune* magazine's annual survey of the most admired companies to demonstrate how investors tend to overpay for excellent reputations**. The stocks of the least admired companies out-performed the most admired companies** by 1.8% a year over four years. After putting each company within its industry, the difference rose to 2.4% per annum! It's not that the highly admired companies do poorly as businesses, but that investors pay a too-high price for esteem and a too-low price for low regard.



Conventional investing advice is flawed: you shouldn't invest when things seem safe and run for the hills when they seem scary. Quite the opposite, you should:

- **fear market optimism**
- **avoid out-performing sectors**
- **shun highly admired companies**

Instead:

- **celebrate stock market pessimism**
- **embrace the sectors everyone has given up on**
- **gladly invest in companies everyone openly avoids**

> *"You pay a very high price in the stock market for a cheery consensus" – Warren Buffett*

I'll readily admit, I'm not the life of a party when people ask me about investing—I'm pessimistic when everyone is optimistic and own companies no one wants to touch. But, if that's the price for generating above average returns, I'll settle for greater wealth over cocktail-party esteem.

UNTIL NEXT QUARTER

Long term out-performance is almost always preceded by temporary under-performance. This is frustrating at first—like a weight-loss program that doesn't yield immediate results—even though it works in the long run. Sticking with the program is the toughest part, but the results do come and then the effort seems well worth it.

On the research front, I've been doing some particularly in-depth industry analysis. Specifically, I'm examining industry dynamics and competitive advantages to better understand what makes one company succeed while others fail. The peril in buying cheap companies—like I do—is that some are cheap for good reason, and I'm learning how to better determine one from the other ahead of time. Eternal vigilance isn't just the price of liberty; it's also the path to improving investment returns.

As usual, **if you have any questions, comments or feedback, let me know.** I always enjoy hearing from you.

Respectfully,
Mike

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