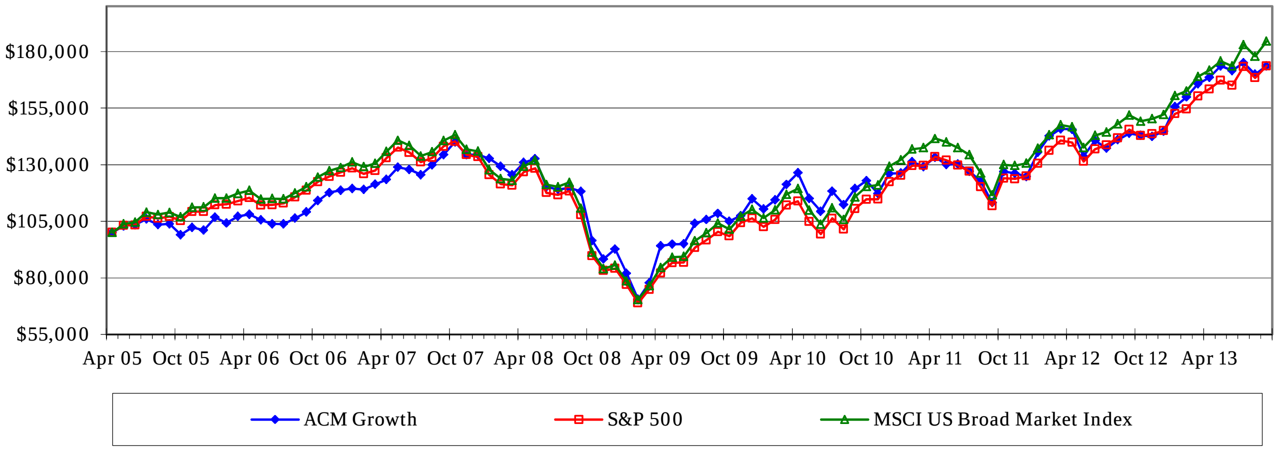
ATHENA CAPITAL MANAGEMENT

Cumulative Growth Performance

Performance as of 9/30/13	Year to date	3 years	5 years	7 years	Since inception (4/30/05)
ACM Growth	19.91%	45.42%	46.91%	59.22%	73.63%
S&P 500	19.79%	57.17%	61.18%	46.43%	73.67%
MSCI US Broad Market Index	21.31%	59.49%	66.54%	53.54%	84.58%

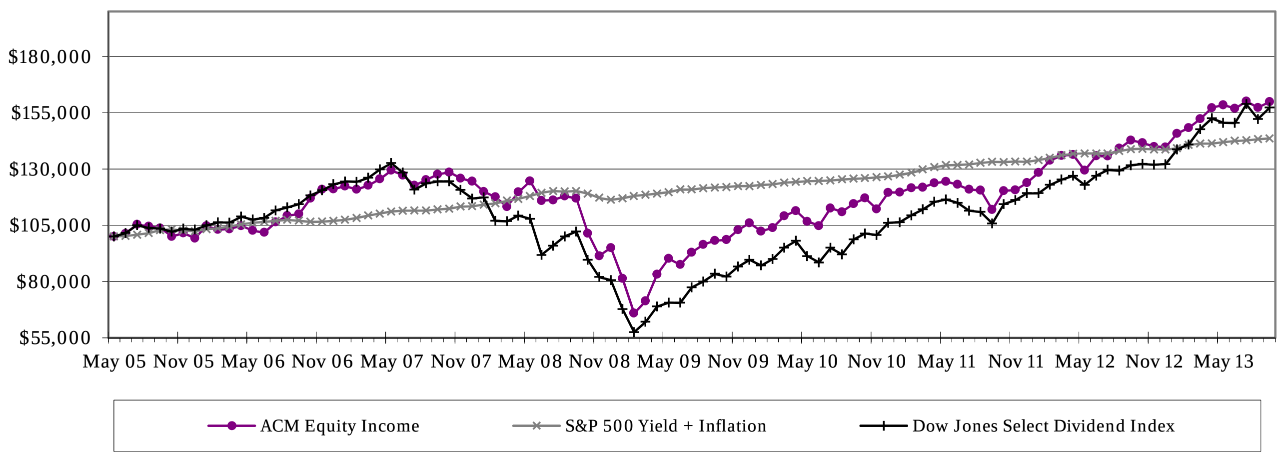
Comparison of the change in value of $100,000 investment in ACM growth
versus S&P 500 and MSCI US Broad Market Index



Cumulative Equity Income Performance

Performance as of 9/30/13	Year to date	3 years	5 years	7 years	Since inception (5/31/05)
ACM Equity Income	14.37%	39.50%	36.62%	45.30%	59.82%
S&P 500 yield + inflation	3.55%	14.26%	19.40%	34.16%	43.56%
Dow Jones Select Dividend Index	19.00%	59.36%	53.88%	37.39%	57.24%

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, 2013

The stock market posted another very strong quarter, up 5.2%—and is now up 19.8% year to date. Perhaps the fiscal cliff that caused so much consternation last December wasn't so bad after all. As will happen from time to time, our portfolios lagged after three quarters of solid out-performance.

In this quarter's letter, I'll review our growth and equity income portfolio performance, provide my usual comments on markets and the economy, and then describe the fortress approach to investing.

Performance this quarter

Growth portfolios lagged the S&P 500 over 3 and 5 years and since inception, but still won year to date and over 7 years. I truly hate to lose to the market over any period, but must admit that it's a part of the business. Returns are lumpy and out-performance comes in fits and starts. I remain steadfast, however, that our portfolios *will* out-perform by a meaningful amount over the long haul, and that my improving research process will grow our advantage (see my section below, Investing: the Fortress Approach).

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

POSCO, a Korean steel manufacturer, bounced back from recent lows on signs that Asia's lagging economies may be growing again. Whether lasting growth is under way is open to question, but POSCO's position as a low cost producer of high-value steel in the region isn't. As long as it maintains that lead through research and development and efficiency improvements—and it is—POSCO will generate strong profits through the economic cycle.

Comcast, which includes both the largest U.S. cable company and NBCUniversal, continues to post strong numbers. Not only is broadband cable for consumers and businesses growing strongly, but NBCUniversal had an excellent summer of cable and broadcast viewership, film sales (its highest ever), and amusement park attendance. Comcast is firing on all cylinders. Even better, I expect these strong results to continue.

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

Hewlett-Packard (HP), the world's largest information technology company by sales, reported solid earnings this quarter, but with a disappointing projection for next year. Instead of achieving their goal of growth in 2014, they believe they won't get there until 2015. HP's operational turn-around is progressing steadily, even if it takes a bit longer to reach milestones. I believe its price will reflect such progress in the fullness of time.

Microsoft, like HP, suffered this quarter from a weak information technology market, but also from self-inflicted wounds: its efforts to grow in the phone and tablet markets continue to disappoint. As in the past, investors are ignoring Microsoft's huge profits and market share gains on the enterprise side of the business, particularly in data centers and the cloud. Although Microsoft faces stiff headwinds in new, fast growing segments, its strong performance in bigger, more profitable segments have yet to be fully reflected in its stock price.

Equity income portfolios continue to out-perform our long-term benchmark over all periods. Our stocks continue to grow rapidly (as does the Dow Jones Select Dividend Index), but our bond holdings took a hit over the quarter. Rising interest rates like we experienced this quarter are bad for bonds (see my comments below under Market and Economic Outlook), and that slowed us down a bit. Despite that, I continue to believe our mix of stocks and bonds will provide steady, but not rip-roaring, growth and income over time.

Equity income saw out-performance from **Mercury General** and **Comcast**. Please see my comments above on Comcast.

Mercury General, an agent-based auto insurer operating in 13 states, generated strong returns this quarter on the back of higher interest rates. Although higher rates led to declines in Mercury's bond portfolio, they also provide the opportunity for higher investment income going forward. Mercury's well-underwritten auto policies and conservative investment portfolio are benefiting from this unfolding situation. I took the market's recognition of this situation as an opportunity to trim our position.

Hewlett-Packard and **Microsoft** were equity income's under-performers this quarter. Please see my comments above on both.

Market and economic outlook

The S&P 500 gained 5.2% this quarter, driving down my projections for future returns yet again. Above trend returns now mean lower returns in the future—a mathematical identity. I hope this information not only helps you adjust your investing expectations down a bit, but also fosters a desire to find better returns than the market will most likely provide. That's my job, and I'm on it.

Projected annualized returns over the next 6 years	
S&P 500 (growth benchmark)	-4.0% to 7.8%
S&P-500-yield-plus-inflation (equity income benchmark)	3.5% to 6.5%

How do I arrive at these numbers? See my 2Q2005 article.

The economies of the world seem to be picking up steam. The U.S. is benefiting from a cautiously growing housing market and a slow but steadily improving employment picture. The European economy, though still quite sluggish, may finally be recovering from its half-decade malaise. China and Japan are moving again—perhaps temporarily—because of government stimulus programs.

You may have noted my less than enthusiastic tone in describing world growth. This economic environment is one that only Alfred E. Newman could love: "What, me worry?" I suppose it's better than the alternative, but it doesn't bring images of rapidly accelerating growth or 20% compounding returns. But, the combination of not-so-bad/not-so-good has prevented security prices from becoming outrageously high or pessimistically low, and relative stability feels good considering the circumstances.

The only asset class that *has* suffered, recently, has been long bonds. As I've repeated in this space before, when interest rates get very low, they have only one direction to go: up, and that means declining bond prices. My back-of-the-envelope calculations show the 10 year Treasury bond lost 11% in price as bond yields went from 1.7% to 3.0% between May and September, and the 30 year Treasury bond lost 22% going from 2.4% to 3.7% (peak to trough). At very low interest rates, long bonds provide return-less risk instead of risk-less return.

In the meantime, commodities have provided no return over the last 9 years. They've been up 83%, down 57%, and back up 27% to reach break-even. Over the long run, commodity prices tend to decline as producers become more efficient at bringing "things" out of the ground, water and air. When prices spike, as they can for years, it becomes very profitable to bring more supply to market, which brings prices back down again. That is why commodities are not great long-term investments.

In contrast, stocks and real estate have done well, (2-4% better than bonds, 6-8% better than commodities) **in the face of historically tough headwinds**. Despite their ups and downs over the last decade—quite dramatic from 2007-2010—stocks and real estate have generated price growth above inflation and regular income. That's why they do better than bonds and commodities over the long haul.

Future equity returns may not dazzle, but they offer the best option for growth *and* income. It's easy to wish we had owned what went up most recently, but driving by looking through the rear-view mirror is certain to cause an accident. We must drive by looking through the windshield, and that is where strong businesses, ones that profit and grow through thick and thin, provide the best returns. As I'll touch on in the following section, all my investment research is focused in this area.

Investing: the fortress approach

Imagine a hostile army approaches, and you stand between two fortresses. Do you run to the hastily constructed wooden structure out in the middle of a flat, open plain; or to the one on top of a steep hill, surrounded by a wide moat, in a fortification with thick, high concrete walls?

The answer is obvious, yet provides a nice analogy for picking investments: **some businesses are simply much easier to defend against competition than others**. Like a strong fortress, they have characteristics that make them difficult to attack. Such businesses make better investments because they generate *sustainable* earnings over time. Nothing crushes sales and ruins profit margins more thoroughly than fierce competition ravaging a weak business.

I've found five kinds of businesses that seem to best resist attack (with a *lot* of help from Warren Buffett and Bruce Greenwald). I'll describe each in the order of their strength, starting with the best.

The ultimate business fortress is a *consumer franchise*. Warren Buffett describes it as: "a pervasive favorable reputation with consumers based upon countless pleasant experiences they have had with product and personnel." A great example is Coca Cola (like its rival Pepsi). It tastes good consistently, its caffeine lifts you up, and the company promotes feel-good advertising and events (Olympics, concerts, World Cup) that link their product with happy times. Such a fortress can and has been attacked, but it withstands like no other. Philip Morris International (non-U.S. tobacco) is a consumer franchise we own.

Next, a *government franchise* possesses licenses that exclude competition. Such businesses would be "natural monopolies" even without government licenses because of their unique characteristics. Burlington Northern Santa Fe (BNSF) is a good example of this. It owns railroad rights-of-way that would be extremely difficult to replicate. In fact, government rules and regulations pretty much prevent other railroads from competing along its routes. BNSF also has access to key locations like the port of Los Angeles, Wyoming's Powder River Basin coal, and North Dakota shale oil fields that others find extremely difficult to acquire. A government franchise we own is Comcast cable.

Another great stronghold is an *enduring position as the low cost producer*. Because such businesses have structurally lower costs, rivals find it difficult or impossible to compete on price. GEICO, the auto insurer, courts low risk drivers, goes direct instead of using agents, and is so frugal that only tight-wads enjoy working there. These characteristics give it the lowest costs in the business, and they maintain that position by driving costs lower each year. Ryanair (Europe's low cost airline) is our holding along these lines.

A business with *local dominance* doesn't win with sheer size, but by being strongest in a limited geographic area. Believe it or not, Wal-Mart experienced its most explosive growth this way. It is frequently credited with superior merchandising, logistics and hard bargaining with suppliers, but its secret sauce was building out from Bentonville, Arkansas and concentrating on limited geographies at each point in time. In this way, its five local stores were competing with competitor's two, and thus had huge advantages in marketing, logistics, inventory, etc. in those locations. Our Wells Fargo holding built itself the same way.

Finally, a fort with *niche product dominance* rules a narrow segment. Large companies can't reap sufficient benefit from small niches, and small competitors can't replicate the dominant company's scale and reputation. McLane isn't the largest trucking company, but they dominate the supply of convenience stores: they are larger than the next 17 competitors. No large trucker wants the hassle of such a specialized niche, and no small distributor has built enough scale to compete effectively. USG is an example of a dominant niche company we own.

Even a great business is unlikely to dominate permanently. No fortress—literal or figurative—has maintained superiority forever. **But, a good business can sustainably resist attack for a long time, allowing shareholders to reap high, sustainable profits**. By focusing on such businesses, instead of those with weak protection, the odds of happy endings goes up dramatically.

Until next quarter

Please contact me if you have any questions, comments or feedback. A client reached out to me this quarter asking for help with their retirement and college funding plan. We had a lengthy discussion utilizing some of my in-house analytical tools that helped create a new, more specific approach going forward. Perhaps I can help you in the same way.

Respectfully,
Mike

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