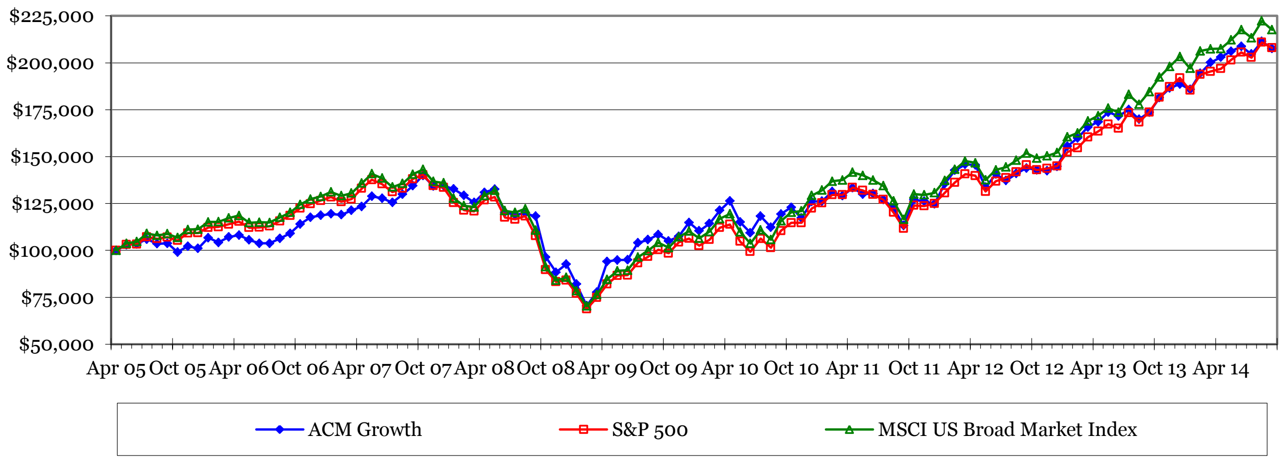
Athena Capital Management

Cumulative Growth Performance

Performance as of 9/30/14	Year to date	3 years	5 years	7 years	Since inception (4/30/05)
ACM Growth	10.08%	83.44%	91.44%	54.48%	107.67%
S&P 500	8.35%	86.05%	107.31%	50.58%	107.95%
MSCI US Broad Market Index	7.02%	86.69%	108.95%	54.72%	117.58%

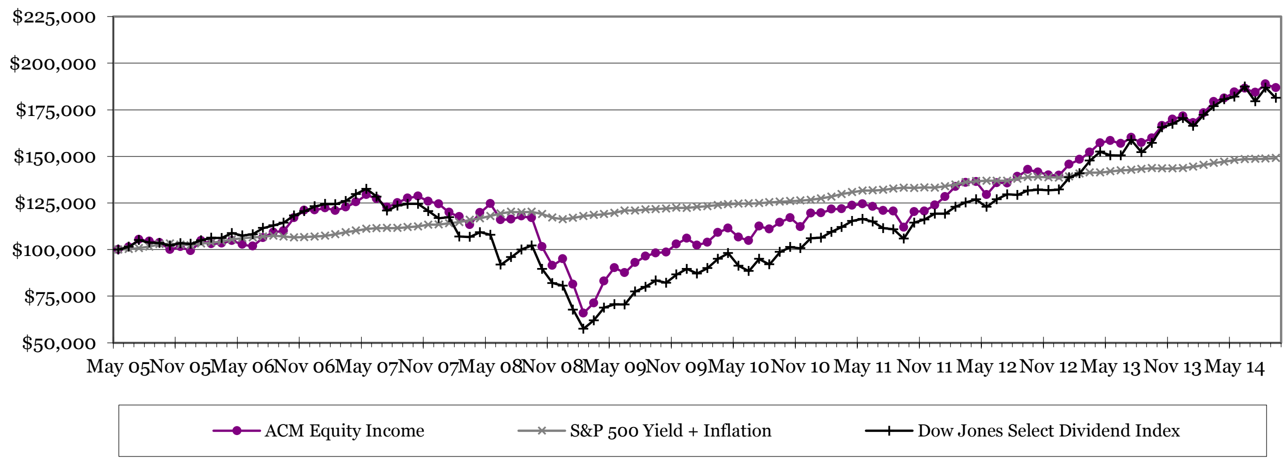
Comparison of the change in value of $100,000 investment in ACM growth versus S&P 500 and MSCI US Broad Market Index



Cumulative Equity Income Performance

Performance as of 9/30/14	Year to date	3 years	5 years	7 years	Since inception (5/31/05)
ACM Equity Income	8.85%	66.89%	90.32%	46.38%	86.77%
S&P 500 yield + inflation	3.71%	11.96%	22.46%	33.07%	49.08%
Dow Jones Select Dividend Index	6.35%	71.42%	117.44%	45.63%	81.36%

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.

Athena Capital Management

October 22, 2014

The market was up just 1.1% this quarter, but has provided a not-too-shabby 8.4% return so far in 2014. Both growth and equity income accounts lagged the market this quarter, but continue to beat their benchmarks by meaningful amounts year to date.

In this quarter's letter, I will review our growth and equity income performance, provide my usual commentary on markets and the economy, and finish with an evaluation of the six year market return projections I provide each quarter. I hope you enjoy and get something out of it.

Performance this quarter

Growth portfolios beat the S&P 500 year to date and over seven years, but came up short over all other periods. Beating the market requires investing differently than the market, and over some periods that leads to under-performance. This requires some intestinal fortitude at times, but that is the price paid for returns received. As I'll highlight below, I don't see anything fundamentally wrong with our individual holdings, so I expect returns will move toward that underlying reality over time.

Growth's out-performers this quarter were **Microsoft** and **IBM**.

It took investors some time (I first started buying shares of Microsoft in the early winter of 2005), but they are finally catching on that Microsoft is dominant in very profitable enterprise markets. That edge is increasing as they grow market share in server and database software. Most investors focus too much on Microsoft's consumer business—a minority of revenues and less than 30% of profits. But, the real story for Microsoft has always been about enterprise software, and there they are winning.

IBM, one of the largest information technology businesses in the world, did well this quarter as it sold its commodity-like server business to Lenovo. IBM has a long history of shifting from low-profit commodity markets to high-profit specialized markets, and they continue that transformation today. The shift to cloud computing is clearly a challenge for Big Blue, but they seem to have the right culture and approach to succeed. I don't expect IBM's progress to be smooth, but I do expect it to be profitable.

Markel and **Deere** were growth's under-performers this quarter.

Markel, a specialty insurance company, pulled back this quarter on the threat of higher interest rates hitting its bond and stock portfolio. But, Markel's stock portfolio did well this quarter, and its bond portfolio is mostly short term, so less vulnerable to higher interest rates. I'm surprised by investors' short-sighted impression of Markel, but I don't expect it to last long.

John Deere, the largest farm equipment company in the world, had a rough quarter due to a bumper crop for corn, wheat and soybeans. Counterintuitively, huge production on farms means lower commodity prices and lower profits for farmers, and farm profits are what buy new farm equipment. Deere is hitting the end of a long boom for farming, which may not rebound soon, but the economics of the business are compelling and its valuation is tempting for long term investors.

Equity income portfolios continue to out-perform our long-term benchmark over all periods. As I hinted last quarter, the opportunity might arise to sell some of our bond holdings and buy cheaper income paying stocks, and that is part of what happened this quarter. Also, the threat of higher interest rates caused many low-growth, high dividend stocks–like utilities—to do poorly, and that helped us do better than the Dow Jones Select Dividend Index. Although I'm certain there will be bumps along the road, we seem well positioned to continue producing a growing stream of income over time.

Equity income saw out-performance from **Microsoft** and **IBM**, the same companies that did well for growth accounts (please see above for more information).

Fairfax Financial and **Deere** were equity income's under-performers this quarter. Please see my comments above on Deere.

Fairfax, a specialty insurance company based out of Canada, faced the same headwind as Markel: the threat of higher interest rates. Fairfax is well positioned to handle higher interest rates with a hedged equity portfolio and, like Markel, safe short term bonds. I don't expect Fairfax's swoon to last long because nothing fundamental at the company has deteriorated. Investors, I think, will soon recognize that, too.

Market and economic outlook

As mentioned above, the S&P 500 returned 1.1% this quarter and 8.4% year to date. This quarter's slightly below-trend performance increased my 6 year projections (see the section below for more on how I've improved my forecasts), but not enough to inspire true enthusiasm. That's okay, because I believe parts of the market will provide better than average returns, and that is where we are invested.

Projected annualized returns over the next 6 years	
S&P 500 (growth benchmark)	-4.3% to 12.4%
S&P-500-yield-plus-inflation (equity income benchmark)	2.0% to 8.0%

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

The global economy continues to steam ahead. Despite China's slowing growth/credit problems/Hong Kong unrest, military conflicts in the Ukraine, Syria and Iraq, another potential recession in Europe, and Brazil's floundering economy and politics, global growth keeps motoring along.

In my opinion, most of the credit for global growth goes to the high productivity of the U.S. private sector. While politicians debate what should be done to promote growth, the information technology (IT) industry produced growth by revolutionizing wireless communications and cloud computing, bringing new products and services to the world at lower cost. While academics theorize about what leads to job growth, the petroleum and chemical industries have dramatically increased production, lowered input costs for innumerable products, and created a hiring boom.

Just look at the farm industry, **which has become so productive that farmers may not make money for the next two years.** Why? Because they've produced so much corn, wheat, soybeans, etc. that crop prices have collapsed. Agriculture has been revolutionized over the last decade with information technology, wireless soil monitoring systems, high efficiency center-pivot and drip irrigation, and the most productive farm equipment in the world. This new technology has been invented, produced, and sent to the rest of the world. The IT, petrochemical and agricultural industries demonstrate why the U.S. private sector is improving the world economy: it has been innovatively increasing productivity in countless lines of business.

That doesn't mean things can't go wrong. Even the strongest running back can be taken down by enough linemen. Right now, our running back is carrying a posse of lineman, but still making forward progress. That seems sustainable until the next crisis comes along, which could be war, credit collapse, currency devaluation, political brazenness, or simply the ebb and flow of our organic economy. No one can predict accurately when or how that will come along, so there's no use in attempting such a feat.

That's why I'm focused on business fundamentals, and not the Fed, politicians or other prognosticators. Let others focus on short term crystal-ball-gazing or whether now is the time to buy Bitcoin. Instead, I'm analyzing companies with sustainable competitive advantages that are bringing plenty to the world in new forms and are doing it profitably. Looking there, you find good long-term opportunities to invest.

NINE YEARS OF MARKET PREDICTIONS

After opening for business 9¼ years ago, I decided to provide you with quarterly market returns projected over the coming six years. My goal was not only to give you specific numbers to use for financial planning, but also to psychologically prepare you for better or worse results than were generally anticipated. I've been keeping track of how my projections have panned out (six year projections starting 9¼ years ago provides us with 3¼ completed years, or 13 quarters to examine).

In my first client letter (2nd quarter 2005), I spelled out my method for calculating projected returns. For growth accounts, I combine expected earnings growth, dividend yield, and valuation change—how excited investors are about stocks—and add them together:

Expected growth return =
(1) earnings growth +
(2) dividend yield +
(3) valuation change

In 12 out of 13 growth predictions, actual six year returns fell within my expected range, showing 92% accuracy. Not bad. For each component:

(1) Earnings growth averaged 3.7% versus my 6% prediction, with a range of 0.9% to 8.9%. The lower average makes sense considering the huge economic collapse in 2008-2009.
(2) Dividend yield has averaged 1.9% versus my 1.9% expectation, with a range of 1.8% to 2.3%.
(3) Valuation change averaged -1.6% per year versus my prediction of -14% to 0.1%, with a low of -5.9% and a high of 0.8%. Here, it looks like I was overly pessimistic in my predictions.

During the one period I was off on growth returns, I under-estimated earnings growth. Specifically, the high end of my projection was 8.5% and the actual ended up 9.8%. Though not precise, I think the guidance was still effective.

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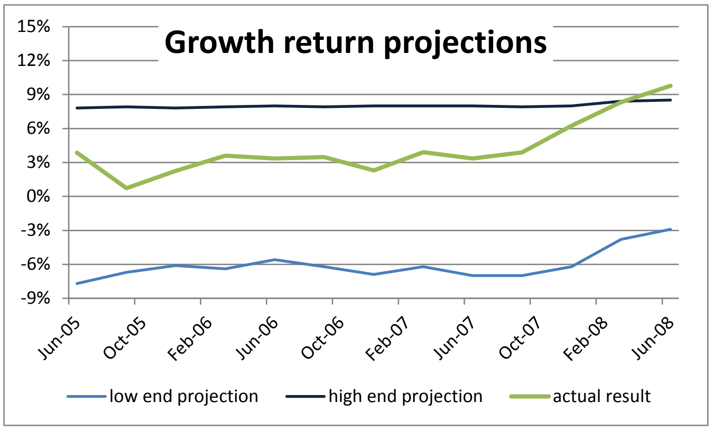


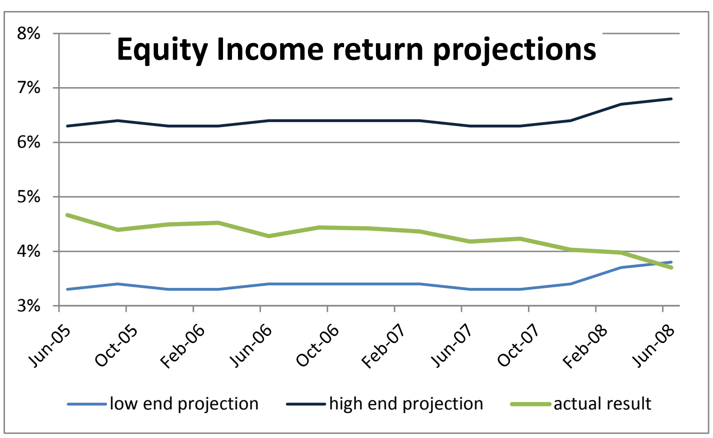
For equity income, my projection is generated by adding together dividend yield and inflation expectation.

Expected equity income return =
(1) dividend yield +
(2) inflation expectation

With equity income, I was also right 12 out of 13 times, for 92% accuracy.

(1) Dividend yield averaged 1.9% versus my 1.9% estimate with a range of 1.8% to 2.3%.
(2) Inflation averaged 2.1% versus my prediction of 1.5% to 4.5%, with a range of 1.4% to 2.5%. I was relatively accurate, but inflation trended lower than I expected.

The single period I was wrong with equity income, I over-estimated the low end of inflation by 0.1%. Though under, I don't think it was off by enough to lead you too far astray.



Most models have assumptions that prove flawed over time. Once such flaws are discovered, **the model should be updated to make it more accurate.** What have I learned that can be improved going forward?

For growth projections, I now use a broader range to reflect the fact that earnings growth fluctuates so far from average. Instead of using a 6% point-estimate, I've moved to a range of 4% to 8%. Also, I now use a higher end-point for valuation. Market valuations have crept from 10 times earnings to 20 times earnings over the last 65 years as investors have become more comfortable with equity investing. I have, therefore, moved from a low-end valuation of 10 times earnings to 12 times earnings and moved my high-end valuation from 20 times earnings to 25 times earnings.

For equity income, the improvement is even easier. Instead of using 1.5% to 4.5% to estimate future inflation, I now use a range of 0% to 6% to account for the broader swings we are likely to experience.

Though not 100% precise, my six year projections have been accurate enough to keep you psychologically prepared for future returns, and give you specific numbers for financial planning. **With improvements, I expect my future six year return projections will become even more accurate, thus providing even better guidance.** I hope you find this helpful.

Until next quarter

As usual, if you have any questions or comments for me, I'd love to hear from you. Until next quarter, I'll keep my nose to the grindstone ferreting out investment opportunities.

Resolutely,
Mike

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