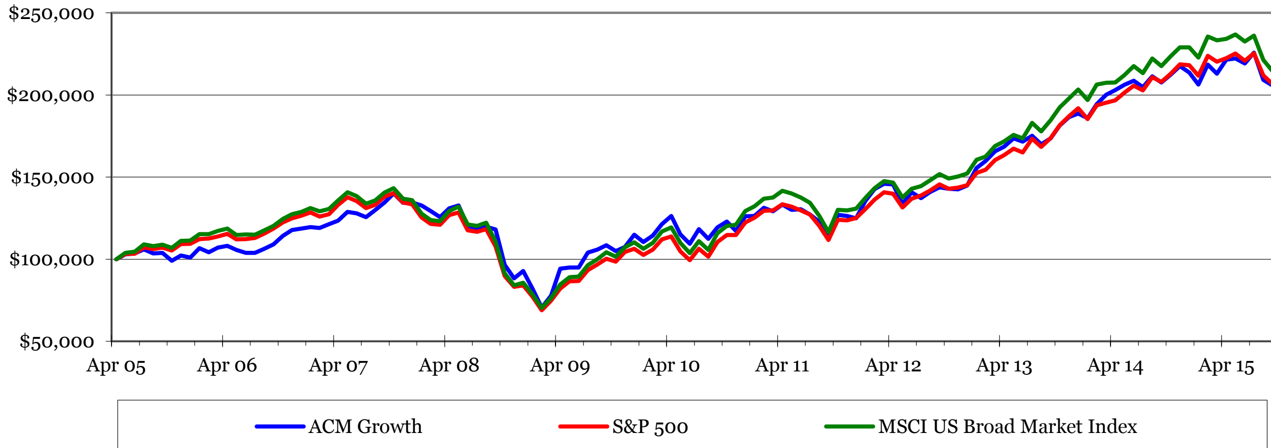
Athena Capital Management

Cumulative Growth Performance

Performance as of 9/30/15	Year to date	3 years	5 years	7 years	Since inception (4/30/05)
ACM Growth	-3.64%	43.07%	72.40%	74.16%	105.84%
S&P 500	-5.28%	42.02%	87.03%	91.81%	106.67%
MSCI US Broad Market Index	-6.31%	41.31%	85.42%	93.63%	114.60%

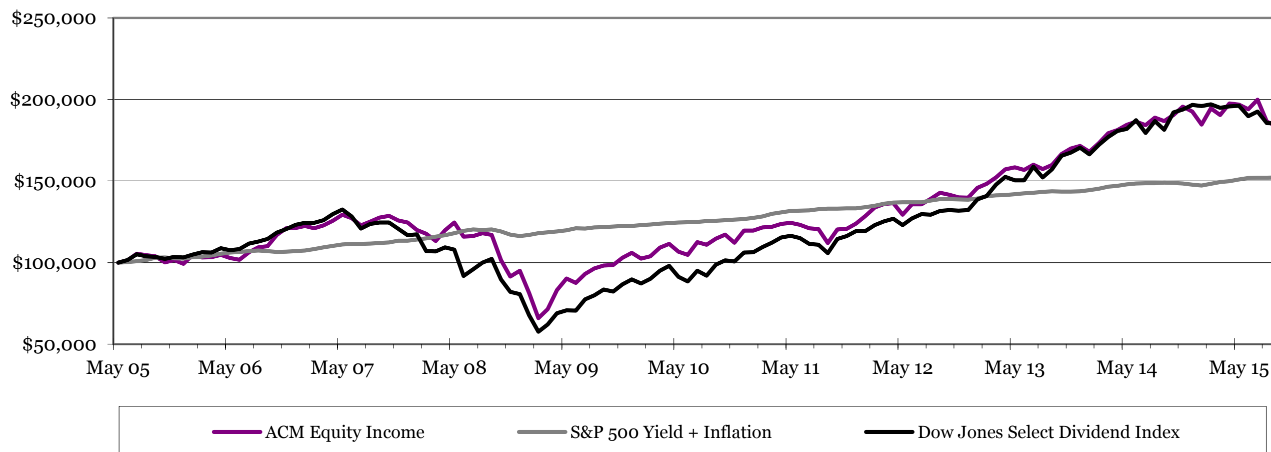
Comparison of the change in value of $100,000 investment in ACM growth versus S&P 500 and MSCI US Broad Market Index



Cumulative Equity Income Performance

Performance as of 9/30/15	Year to date	3 years	5 years	7 years	Since inception (5/31/05)
ACM Equity Income	-4.47%	28.77%	60.55%	57.24%	83.94%
S&P 500 yield + inflation	2.92%	9.57%	21.09%	26.54%	52.14%
Dow Jones Select Dividend Index	-5.75%	40.86%	87.92%	81.46%	85.42%

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.

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Athena Capital Management

October 19, 2015

This quarter, for the first time since 2011, the market dipped more than 10%. The most obvious reasons for the pullback were falling Chinese stocks, tanking commodity prices, and declining business earnings. Despite this backdrop, we did better than the market both this quarter and year to date.

In this quarter's letter, I cover our performance, what I see happening with markets and the economy, and the type of investment that seems to do best for me: understandable, but misunderstood.

Performance this quarter

Growth portfolios out-performed this quarter, year-to-date, and over the last three years, but trailed over longer reporting periods. We did better than average both because our holdings fundamentally out-performed other businesses, and because several of our holdings are considered a calm port in a market storm.

Coca-Cola and **USG** were growth's out-performers this quarter.

Coca-Cola, the largest nonalcoholic beverage company in the world, out-performed partly on better than expected numbers and partly by being a stable business in an unstable market. Coca-Cola's earnings exhibited better pricing power and volume increases than expected, and that led investors to be more optimistic about its near term future. I expect this trend to continue with surges and setbacks along the way.

USG, the largest wallboard company in the U.S., did well because it reported better than expected earnings in July, and we sold much of our position in August. The housing market continues to recover in fits and starts, and USG benefited with higher than expected wallboard sales. In August, USG's out-performance, along with Viacom's price plunge, led me to sell USG to buy Viacom. The timing was more lucky than good, but it frequently works out to sell something loved and buy something hated.

Growth saw under-performance from **John Deere** and **IBM** this quarter.

John Deere, the largest tractor and combine manufacturer in the world, suffered a bad quarter as optimism about crop prices turned to pessimism. As I described in our previous letter, John Deere's stock does well when investors expect poor crop volume, leading to high crop prices and farm income. The optimism that made Deere an out-performer last quarter was based on wetter than expected spring weather. But, that weather turned dry in summer, thus leading to pessimism on crop prices. Such short term considerations matter less than Deere's long term earnings power, and the world's growing need for increased food supplies.

IBM, one of the largest information technology (IT) providers in the world, generated poor returns this quarter after reporting weaker than expected numbers in July. IBM is going through the long term process of transitioning its customers from on-premise IT to a combination of on-premise and cloud-based IT. These transitions never go smoothly, and IBM's stock price suffered this quarter when investors expected steadier earnings growth. I think IBM's transition is succeeding and this will show up in the numbers over time.

Equity income portfolios under-performed this quarter and year-to-date, but out-performed over all other periods. Although we did better than the market this quarter, we were not immune to the market's recent swoon. This is why I tend to focus more on equity income's yield and yield growth instead of principal value: short term price fluctuations don't necessarily impact portfolio yield or that yield's growth. Even with bigger drops in the market—always a possibility—our portfolios are very likely to continue generating robust and growing income over time.

Coca-Cola and **Microsoft** were equity income's out-performers this quarter. Please see my comments above on Coca-Cola.

Microsoft, the largest software company in the world, had another excellent quarter due to continued optimism about its cloud services and sufficient calm about its legacy software. Microsoft, like IBM, is making the transition from legacy, on-premise IT to a combination of on-premise and cloud solutions. The difference is that Microsoft is further along in the transition and investors are feeling increasingly excited about its cloud business while not feeling too dour about Microsoft's slowing legacy software sales.

Equity income saw under-performance from **John Deere** and **Wells Fargo**. Please see my comments above on John Deere.

Wells Fargo, the largest community bank in the U.S., performed poorly this quarter due to concerns about interest rates. Banks make much their money on the spread between deposit and loan interest rates. With rates so low (due to the Federal Reserve), banks are making less money as loan rates decline and deposit rates are stuck near zero. Many expected the Fed would raise rates in September, but that hope faded during the market drop in August, causing bank stocks like Wells Fargo to decline. I think this concern

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overlooks Wells Fargo's excellent deposit and loan growth, which will generate increasing profits even if rates stay low.

MARKET AND ECONOMIC OUTLOOK

The S&P 500 returned -6.4% in the 3rd quarter and -5.3% so far in 2015. These poor returns have increased my average expectations up to a more interesting, but not yet tantalizing, 5.8% for growth and 5.3% for equity income.

Projected annualized returns over the next 6 years	
S&P 500 (growth benchmark)	-2.7% to 14.3%
S&P-500-yield-plus-inflation (equity income benchmark)	2.3% to 8.3%

How do I arrive at these numbers? See my 2Q05 and 3Q14 articles.

The world economy continues to slow. Despite improving growth from the U.S. and India, global growth as a whole is struggling. This can be seen most clearly in the significant decline in commodity prices over the last year. Whether you look at oil, iron ore, copper, coal or farm products, the story is the same: prices are down 15-60%.

Much of that decline can be explained by China's slowdown. Because China accounts for 60% of world concrete demand, 54% of aluminum, 50% of nickel, 48% of copper, 46% of steal, and 49% of coal, it's easy to see how a slower China leads to lower commodity prices and declining world growth.

China's deceleration, however, is both a cause and effect of a global growth slowdown. On the one hand, China's economy is shifting from being mostly manufacturing to more consumer focused, and that requires a massive reallocation of resources. That shift alone could cause slower growth. On the other hand, China is slowing *because* the global economy isn't demanding the same amount of manufactured goods as in the past, which is in turn requiring China to adjust.

Either way, world economic growth is declining, and that's causing higher market volatility. China's massive hiccup in August is but one example of recent market swings, and more is likely to follow from China and elsewhere. At first glance, this may seem like a bad thing. Aren't lower prices and broader price swings bad for investors? I believe just the opposite.

Big price swings are good for savvy investors who keep their heads. High future returns are born from investor over-reaction now. The best approach is calm in the face of such swings, and a long term focus on net worth rather than short term returns. I've been finding better investment opportunities than I've seen in years, and that is very encouraging.

UNDERSTANDABLE...BUT MISUNDERSTOOD

When most people think of successful investing, they think of exciting trends, rapid growth, and bleeding edge technology. They think of Tesla, Fitbit, Uber, or Salesforce.com. But, the problem with this thinking is that stock prices reflect everyone's enthusiasm (and are thus too high), and the chances of long term success are frequently much lower than believed.

In contrast, I've found that the best investments are understandable, but misunderstood.

Understandable...

By understandable, I mean the chances of long term success can be grasped with a high degree of certainty. These are businesses that have sustainable economics you can predict for years, if not decades. Such businesses tend to have stable market share, high profit margins, excellent returns on capital, and few competitors.

Most businesses don't even qualify as understandable within this framework. There are many reasons, but here are three: 1) too complex, 2) too much competition, 3) too driven by unpredictable macro-economics/geopolitics.

1) **Some businesses are in fields that are just too hard to understand.** I tend to avoid companies in biotechnology or internet security because I don't understand the areas well enough to pick winners and losers, much less predict profits far into the future. If the technology is beyond me, so is valuing the business.

2) **Some businesses are in industries that are just too fiercely competitive.** Here, I think of restaurants and retail stores, where companies come and go so rapidly that it's almost impossible to know who will win and lose over time. People change their tastes in shopping and eating too erratically for accurate prediction.

3) **Other businesses are too much at the whim of macro-economic/geopolitical change**. Think about commodity producers like oil companies. Who accurately predicted

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that oil prices would fall by over 50% last year? If you valued an oil business in spring 2014, you almost certainly found that valuation wrong by 50% one year later.

The thing to look for in an understandable business is slow industry change. I avoid dynamic and fast-growing fields where picking winners is most difficult. Instead, I look for slow moving, stable, predictable industries.

...but, misunderstood

By misunderstood, I mean that most people hold a view that is at odds with the facts. When everyone thinks a business is great, but actually has poor odds of thriving long term, or when everyone thinks a business is dog meat, but it will really survive or thrive, then you've found something misunderstood.

Generally, I've found four reasons companies can be misunderstood and underpriced: 1) left for dead, 2) struggling but still alive, 3) downtrodden industry, 4) under-estimated growth.

1) **Sometimes, people think that a business that won't survive is necessarily worth nothing.** But, that's not always the case. Sometimes such lame businesses have a lot of cash on the books, or assets worth a lot of money (real estate, securities, inventory). In such cases, investors sometimes sell a business for much less than those assets are worth. Sears illustrated this in the past with its valuable real estate and dying retail business.

2) **At other times, people think that a business that is struggling simply can't survive or thrive *ever* again.** Such businesses are usually mature, and face stiff competition or industry change, but almost no one thinks the business will actually die. Investors frequently sell out of such a business even though it isn't collapsing. Here, I think of Hewlett-Packard, which tanked after several CEO changes and PC growth slowed.

3) **Periodically, industries go through long downturns where every business in the field sees its price plunge.** People may agree that an industry isn't going away and will someday rebound, yet still be unwilling to own any business in that area. USG, the wallboard manufacturer, went through such a period after the housing bust, and we were able to pick it up dirt-cheap five years into the crash.

4) **My last example is a solid business where investors under-estimate future growth.** These are usually businesses that are no longer the fast-growing super-stars of the past, but still have reliable growth prospects due to sustainable competitive advantages. In this case, I think of Ryanair, the discount European airline, which faced higher fuel costs and increasing competition in the late 2000's.

The most difficult part of my understandable-but-misunderstood framework is figuring out if a business is *truly* misunderstood. You have to do more work than other investors—frequently much more—to really understand a situation better than they do. When your competitors are intelligent, highly motivated and well trained, it's smart to assume that market prices are correct, and then gather overwhelming evidence to discover if other investors are missing something.

Great investments are seldom born of optimism, excitement or rapid change. In fact, they are frequently found in just the opposite direction. That is why I've found my best investments are understandable, but misunderstood.

UNTIL NEXT QUARTER

If you have any questions or comments about the economy, markets, financial planning, performance, or specific investments, please don't hesitate to contact me. It's always great hearing from you.

Tirelessly,
Mike

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

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