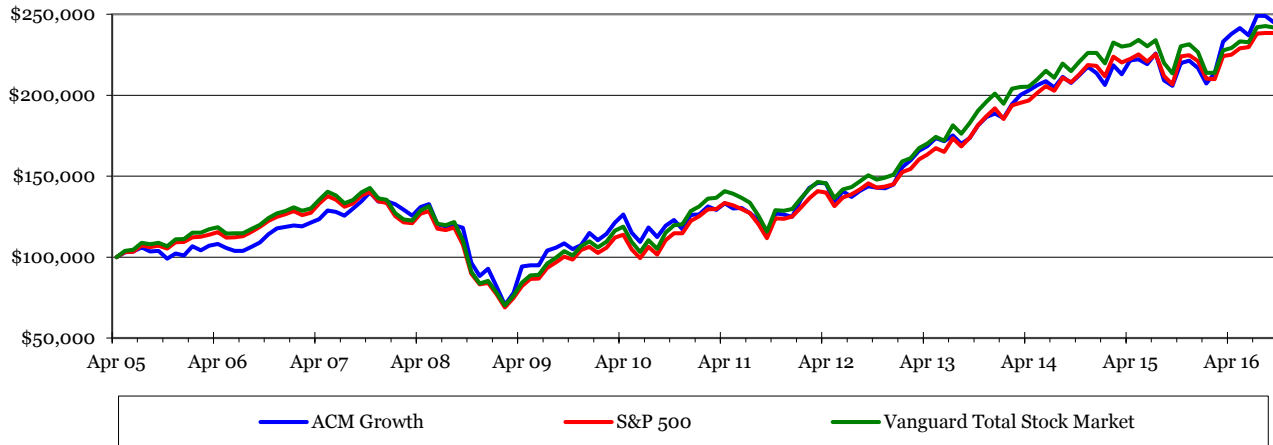


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Cumulative Growth Performance

Performance as of 9/30/16	Year to date	3 years	5 years	10 years	Since inception (4/30/05)
ACM Growth	12.94%	41.14%	116.48%	124.73%	145.07%
S&P 500	7.84%	37.36%	113.44%	101.14%	138.56%
Vanguard Total Stock Market	6.70%	32.37%	109.02%	101.67%	141.92%

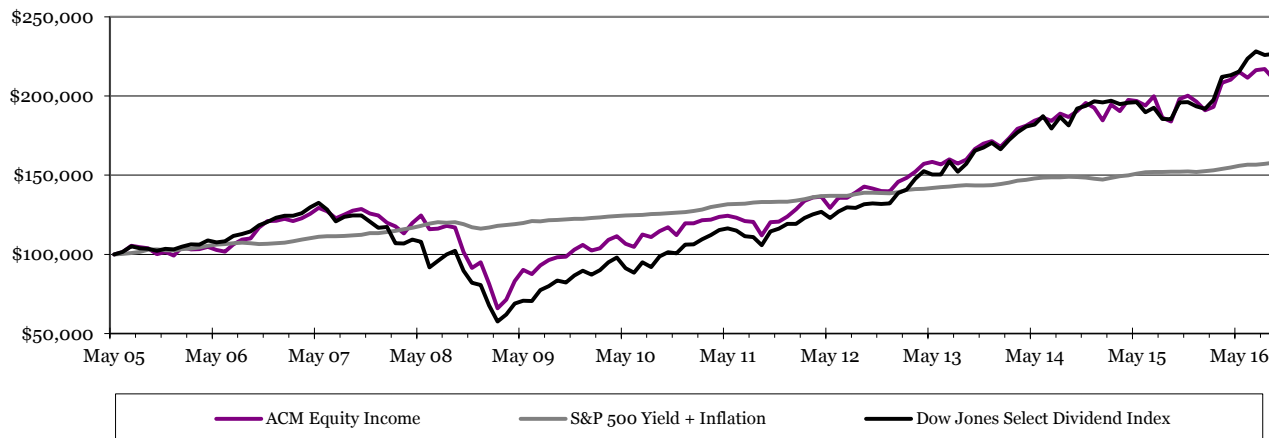
Comparison of the change in value of \$100,000 investment in ACM growth versus S&P 500 and Vanguard Total Stock Market



Cumulative Equity Income Performance

Performance as of 9/30/16	Year to date	3 years	5 years	10 years	Since inception (5/31/05)
ACM Equity Income	7.34%	31.97%	88.47%	91.76%	110.92%
S&P 500 yield + inflation	3.79%	9.87%	18.54%	47.49%	57.83%
Dow Jones Select Dividend Index	17.13%	44.14%	114.22%	98.04%	126.65%

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. The returns provided are a combination of client accounts and might not represent individual accounts accurately. The firm puts clients into securities that are on a continuum of the two strategies based on their individual level of risk tolerance.

ATHENA CAPITAL MANAGEMENT

October 18, 2016

The S&P 500 returned 3.9% this quarter after recovering from Brexit (Britain voting to leave the European Union). Most of that return was realized in the first two weeks of July, after which the market basically flat-lined. We lagged the market slightly this quarter, mostly because of the Wells Fargo scandal touched on below.



This quarterly letter covers the usual subjects: our portfolio performance and my market/economic outlook, as well as our successful—though short lived—investment in Joy Global.

PERFORMANCE THIS QUARTER

Growth portfolios out-performed over all periods reported. Although we lagged the market over the quarter, our strong returns from the 1st quarter were enough to overcome that slight headwind. I remain optimistic that our portfolio of better than average businesses, with shareholder focused managers and reasonable prices relative to fundamentals, will continue to provide us with a performance tailwind over time. Even better, our value tilt—which has been a drag on performance over the last 10+ years—could at any time become a lucrative and sustained performance booster.

Liberty Global and Joy Global were growth's out-performers this quarter.

Liberty Global is Europe's largest cable communications company, with operations in north, central and eastern Europe. As reported last quarter, Liberty's price dove after the Brexit news, but those fears quickly faded as investors more fully digested the situation. In the U.S., cable has come to dominate legacy wireline for video and broadband, and now that story is playing out in Europe, too. This gives Liberty years of growth from which I expect we'll benefit.

Joy Global is the world's largest manufacturer and servicer focused solely on mining equipment. Joy's stock took off this quarter on news that Komatsu, Japan's largest construction and mining equipment maker, is buying Joy for \$28.30 versus our purchase prices of \$9-\$13 (more on this below in my section: Joyous Joy Global). We've already sold three quarters of our position and I expect to exit the rest early in the 4th quarter.

Growth saw under-performance from **Wells Fargo** and **Philip Morris International**.

Wells Fargo, the largest community bank in the U.S., dropped over 8% relative to the market on negative

news about its unauthorized account opening scandal. Although the news highlighted Wells' too-high focus on cross-selling banking services, I think the press and politicians have greatly exaggerated the impact on Well's customers and what it might indicate about the bank's culture and accounting. Less than 3% of Well Fargo's customers were impacted, and improper accounts were opened by less than 2% of Well's employees—in direct violation of the company's policies (those employees and 10% of their bosses were fired accordingly). The improper accounts were charged only \$1.25 of fees on average, and those charges have already been refunded. The scandal actually broke three years ago and most corrective actions have already been taken. I believe Wells Fargo is still the best large bank in the country with a tremendous breadth of products and services, and a real focus on helping customers (despite the actions of a very small minority of errant employees). In the long run, I think this will be seen as an excellent buying opportunity, and I've acted accordingly.

Philip Morris International, the largest cigarette company outside the U.S. and China, took a dip this quarter mostly because it had climbed so strongly from September 2015 to June 2016 (up over 33%, not including dividends). To a lesser degree, it also declined on concerns about rising expenses related to its expansion into reduced risk products (RRPs): tobacco and nicotine products that don't require combustion, thus dramatically lowering health risks. I don't think a pause in Philip Morris' price rise or RRP costs are long term concerns, and expect its growth to resume as adverse currency headwinds fade and investors realize the monumental potential of RRP's.

Equity income portfolios out-performed our long term benchmark over all reporting periods, but continue to lag the Dow Jones Dividend Select Index. Income-oriented investors are still chasing high yields at their own peril, while we remain resolute in reaping sustainable and growing income over time. Our strategy will not reap windfall returns over any period, but is also less likely to give back gains or see income levels decline as a result. That is by design.

Liberty Global and IBM were equity income's out-performers this quarter. Please see my comments on Liberty Global above.

IBM, one of the world's largest information technology (IT) companies, rose this quarter on optimism about growth in its strategic imperatives: from cloud-based software and services to its Watson cognitive computing system. I think IBM has yet to fully prove its chops when it comes to the cloud and Watson, but its relationships with large users of IT is seldom questioned, and I think will allow IBM to become a

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transformational partner to such steadfast clients. Only time will tell, but the incoming data indicates that IBM is starting to make progress in these burgeoning sectors.

Equity income saw under-performance from **Philip Morris International** and **Wells Fargo**. Please see my comments above on both.

MARKET AND ECONOMIC OUTLOOK

The S&P 500 returned a satisfying 3.9% this quarter. Because this is an above average quarterly result, my six year projected returns moved lower looking forward. I continue to seek out returns better than the 4-5% averages implied below.

Projected annualized returns over the next 6 years	
S&P 500 (growth benchmark)	-4.6% to 12.0%
S&P-500-yield-plus-inflation (equity income benchmark)	2.2% to 8.2%

How do I arrive at these numbers? See my [2Q05](#) and [3Q14](#) articles.

The global economy continues to limp along uninspiringly. The U.S. looks like the best house in a lousy developed-markets neighborhood (compared to Europe and Japan), with mere 2% growth. India and Southeast Asia are growing strongly, but China's much larger and impactful economy has been experiencing consistently shrinking growth. Most observers believe this slow growth is being successfully combated by central banks. I, however, think central banks are *causing* slow growth.

The financial crisis of 2008-2009 led the world's largest central bankers to work in concert flooding the system with money. That effort attempted to prevent a huge debt overhang—mostly deployed in real estate—from dragging down the rest of the financial system. Although those efforts stopped a short term liquidity crisis, it also led to massive misallocations of capital and dramatically increased government debt burdens.

Fast forward to today, and central banks are still trying to use printed money to reignite growth. It's not working. Even worse, economists are calling for 4% inflation and negative interest rates to spur growth. They seem to be saying: "If low and zero interest rates didn't work, then let's try negative interest rates!" But, economies grow due to positive returns on capital, not manipulated interest rates or printed money, so increasing inflation and negative rates won't work.

I think the next policy call will be for government spending and higher government debt (especially in an election year). But, that didn't work in the U.S. in the 1930's or 1970's, or Japan in the 1990's and 2000's, or China and Europe in the 2010's, so expecting it to work now seems naïve or even foolish. Borrowing or taxing money from one person and spending it on another doesn't create *real* growth—only well-invested capital does the trick.

And, that is why I'm not focusing on central banks, Congressional stimulus, or promises from Presidential candidates. They simply can't generate growth. Instead, I'm focusing on businesses that are generating sustainable, high returns on capital. Such businesses have the pricing power to deal with inflation, deflation or no-flation. With such businesses, you don't need to guess what reactionary government policy is next. A good example of such a company is the subject of my next section.

JOYOUS JOY GLOBAL

Sometimes we buy a company cheap and it takes years for the market to agree it's worth more. At other times, market participants go from negative to positive in a matter of mere months. Happily for us, Joy Global was a case of the latter.

Joy Global was started in 1919 by Joseph Joy, a coal miner who learned mechanical engineering by mail order course. His business started off developing underground mining equipment to extract coal. Joy was purchased in 1994 by a company called P&H, named for its founders: Alonzo Pawling and Henry Harnischfeger. P&H was founded even earlier than Joy, in 1884, as a surface mining equipment business. After the merger, P&H elected to adopt the Joy name (can you blame them?).

Today, Joy serves the coal (58% of revenue), copper (20%), iron ore (6%), gold/nickel/zinc (5%), salt/potash/soda ash/gypsum (3%), oil sands (2%), and tunneling (2%) markets worldwide (40% North America, 60% rest of world).



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Joy's underground mining equipment and services are marketed under the Joy brand name. The company makes underground drills, loaders (pictured above), trucks, continuous miners (pictured below), feeder breakers, haulers, long wall systems, room and pillar systems, and crushing and conveying equipment.



Joy's surface mining equipment and services are marketed mostly under the P&H brand name. This segment makes drills, draglines, electric rope shovels (pictured above), conveyer systems, excavators and wheel loaders (pictured below).



Joy's equipment is rugged, highly specialized, linked to information technology systems, and massive in scale. It's designed to maximize mining

efficiency and uptime while keeping operating and maintenance costs low.

Just as important, Joy makes money servicing that equipment in the field. Mining equipment needs to be frequently overhauled and maintained. The operating environment is as harsh as it gets—wearing out equipment and parts quickly. Some pieces of equipment, like mining heads, are even designed to wear out during the mining process, making for a steady stream of revenue. In fact, Joy's servicing business is sometimes bigger than selling new equipment: servicing has been 73% of total company sales over the last 2 1/2 years. Because of servicing, Joy has a robust business even when new equipment sales are down.

This is a good thing, because mining has collapsed since 2011. Beginning around 2000, emerging market growth (especially from China) led to a decade-long boom in mining. That unusually large demand for manufacturing inputs like iron ore, copper, coal, oil, natural gas, and aggregates (for making cement) led to high commodity prices and large expansions in mining operations.

But, as the rest of the world slowed in 2008, so did China and other emerging markets. Government stimulus programs kept the mining boom going into 2010, but the party ended abruptly in 2011. Commodity prices have since dropped precipitously on low demand and high supplies. **This led to a collapse in the demand for original equipment from mining supply companies like Joy Global.**

More troublesome for Joy, its biggest sector—coal—had its own unique collapse. The petroleum sector's fracking boom led to a surging supply of very cheap natural gas, *the* key competitor to coal in generating electrical power. Low cost, abundant natural gas caused the price and demand for coal to collapse, and pulled all five of America's largest coal companies into bankruptcy. This didn't spell doom for Joy because bankruptcy judges know that maintaining mining equipment and keeping operations going at lower levels is actually better for creditors. So, even as Joy's sales have declined, they haven't disappeared.

Watching mining's devastation from the sidelines, I started following mining manufacturers like Joy and Caterpillar in 2014. In a case like this with cyclical industries, **my strategy is to think about how bad it can get before deciding what price I'd be willing to pay for a particular company, if at all.**

In my bad case scenario, I assumed Joy would sell *no* new original equipment, and that its servicing business would decline 25%. In that case, Joy Global would still

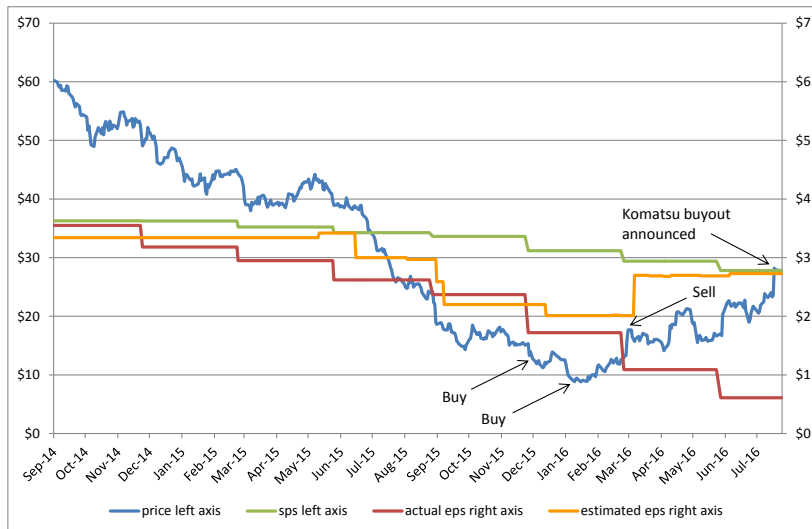
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earn \$1 per share of annual profit. In my worst case scenario, I assumed no original equipment sales and an *additional* 25% drop in servicing revenues. In that situation, Joy would earn over \$0.70 per share per year. **Even in painting dire scenarios, I couldn't see Joy losing money or failing to pay its maturing debt.**

Better still, an eventual return to normalized mining markets would mean excellent growth for Joy. My low end normalized estimates were for \$2-\$3 per share in earnings each year with the potential to reach \$4.50 in good and \$6 in great times.

A business that can generate \$0.70 per share in earnings worst case, \$1-\$3 bad to normal case, and \$4.50-\$6 good to great case shouldn't sell at \$9-\$13 per share. But Joy did, implying 6%-8%, 11%-25% and 50% earnings yields, respectively. **6%-50% annualized returns are what I call a golden opportunity.**

As you can see in the chart below, Joy's stock price (the blue line below) tanked from \$60 per share in September 2014 to under \$10 per share in January 2016. Fundamentally, Joy's sales per share were declining gradually (green line) and its earnings per share were falling sharply (red line), but my estimate of normalized earnings (orange line) didn't sink quite as much.



Why did things get so bad for Joy's stock price?

Fears about mining were high in late 2015 and early 2016, as coal, oil and gas, and other extraction companies went bankrupt and cut production. Continued slowing in China and other emerging markets added to those fears, creating a perfect storm—or perfect opportunity in our case. That's why I bought in late 2015 and early 2016 at around \$12.50 and then \$9 per share: because investors had become

too pessimistic and the numbers proved Joy wasn't in real danger.

And then the clouds began to part. At first, fears faded that China and emerging markets were doomed to collapse, and Joy's price stopped going down in late January 2016. Then, Joy announced better than expected quarterly earnings in March 2016 and its price strongly rebounded above \$15. I took that opportunity to reduce our position because I knew the mining market was still very troubled. In fact, I was initially surprised at the strength of Joy's stock rebound even as Joy and Caterpillar's management teams were saying they saw no light at the end of the mining tunnel (and still don't).

But then, Komatsu announced a bid for Joy at \$28.30 on July 21st, and I understood why Joy's stock had rebounded so strongly: investors had been speculating that another company wanted to buy Joy. Komatsu hopes that acquiring Joy will help it gain scale and broaden its product lines, in particular to compete with Caterpillar (twice Komatsu's size). The buy-out price is not overly generous, but it does seem a good price considering where the mining market is in its super-cycle.

Joy Global is a solid business with leading products and a large, stable servicing business. But its price collapsed as a market downturn morphed into panic and unreasonably low prices. Even though many imagined the worst happening to Joy with daily headlines about coal businesses going the way of the dodo, the underlying reality was nowhere near as bad. **It just goes to show that when terrible news happens to a good company, it's a great thing for investors with cooler heads.**

UNTIL NEXT QUARTER

If you find yourself with any burning questions or useful comments about this letter, investing, financial planning, or anything else, please don't hesitate to contact me. I love hearing from you.

Unwearyingly,
Mike

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