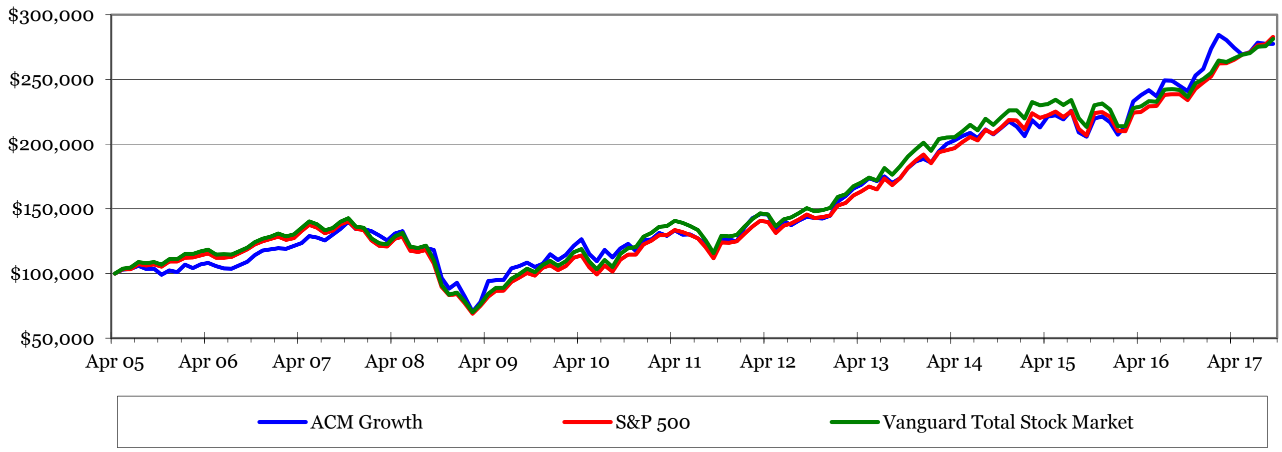
Athena Capital Management

Cumulative Growth Performance

Performance as of 9/30/17	Year to date	3 years	5 years	10 years	Since inception (4/30/05)
ACM Growth	7.44%	33.61%	92.86%	106.41%	177.47%
S&P 500	14.24%	36.07%	94.44%	104.89%	182.95%
Vanguard Total Stock Market	12.43%	30.96%	86.87%	100.91%	181.44%

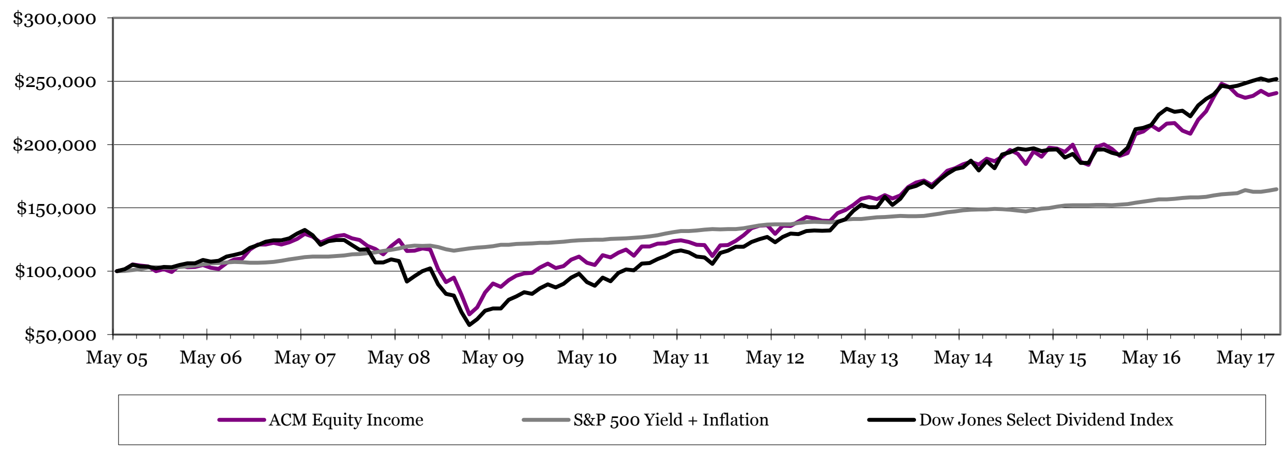
Comparison of the change in value of $100,000 investment in ACM growth
versus S&P 500 and Vanguard Total Stock Market



Cumulative Equity Income Performance

Performance as of 9/30/17	Year to date	3 years	5 years	10 years	Since inception (5/31/05)
ACM Equity Income	6.41%	28.91%	68.56%	88.71%	140.77%
S&P 500 yield + inflation	3.78%	10.45%	18.59%	46.98%	64.66%
Dow Jones Select Dividend Index	6.60%	38.74%	91.16%	102.06%	151.63%

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 and short positions, 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, sometimes short positions, 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 23, 2017

The S&P 500 posted a 4.5% return in the 3rd quarter. We, in contrast, under-performed that result by a couple of percentage points. Around 60% of our shortfall was due to value under-performing growth, and the rest was our particular holdings doing poorly. More on both below.

This quarter's letter covers our performance, what I'm seeing in markets and the economy, and a section on the complexities of picking and using performance benchmarks. I hope you enjoy it.

Performance this quarter

Growth portfolios out-performed over 10 years, but under-performed over all other periods. As mentioned above, our under-performance was mostly due to value lagging growth. This is very unusual: value consistently beats growth over time. That's why I think the current situation is unlikely to last. Adding to the drag from value, our particular picks did worse than average mostly due to market over-reactions rather than sales and earnings weakness. When the market reverses its opinion to align with underlying fundamentals, and value returns to its winning ways, I think we'll generate quite handsome returns.

Markel Corp. and **Berkshire Hathaway** were growth's out-performers this quarter.

Markel, a specialty insurance company, was up 9% this quarter on news of excellent earnings and a significant acquisition. Markel is acquiring State National, a $1 billion insurer of program and lender services, and the market took the price of the acquisition and how it positions Markel positively. Markel also announced excellent underwriting profit and investment returns, which are the two things an insurance company must do well. I expect Markel to continue producing good results in the future.

Berkshire Hathaway, the holding company run by Warren Buffett, was up 8% this quarter due to solid earnings and value-adding acquisitions. Berkshire posted better than expected results in its insurance operations as well as its industrial and services businesses. Also, Buffett and his managers continue making small acquisitions, thus expanding Berkshire's operations and growing the underlying value of our holding. Berkshire is getting so large it cannot continue growing at this rate forever, but it's one of the best investment options out there right now.

IBM and **Viacom** were, again, growth's under-performers this quarter.

IBM, one of the largest providers of information technology (IT) to large organizations, posted weak 2nd quarter results, leading the stock to decline 6%. IBM continues to struggle generating top-line growth as the IT industry shifts to cloud computing and competition intensifies. Against this, IBM's new mainframe, the z14, offers potential upside with a higher level of security than has ever been offered, likely boosting its software and service sales, too. IBM may be down but is not out, and its high profitability and generous dividend make it an attractive investment (it's already up over 12% in October on better than expected earnings in the 3rd quarter).

Viacom, the owner of Nickelodeon, BET, Comedy Central, and MTV cable channels and Paramount movie studios, declined 17% last quarter. It wasn't bad news from Viacom's results that led to the decline but fears that cable networks will disappear as video goes "over-the-top" instead of through cable bundles. As long as content providers have desirable programs, though, they will always find distribution whether through new or old channels. I believe Viacom's targeted audiences like children, young adults and African Americans are so dominant that Viacom will always find distribution. It may take time for industry dynamics to work out and for investors to recognize that, though, so patience will likely be necessary.

Equity income portfolios are still out-performing our long term benchmark over all periods, and under-performing the Dow Jones Dividend Select Index. I continue to emphasize growing and safe dividend yields over high ones, and this has produced lower returns as investors chase the highest yielding equities. In the long run, our strategy tends to work out better both in terms of lower volatility and higher total returns, so I plan to stay the course and expect this will generate respectable results.

Fairfax Financial and **Markel Corp.** out-performed for equity income portfolios this quarter. Please see my comments above on Markel.

Fairfax Financial, a specialty insurance company (based in Canada) gained 20% this quarter after entering a strategic alliance with a Japanese insurance company and selling a significant stake in an Indian insurance company it had invested in. Fairfax agreed to sell its Asian insurance business for part ownership of Mitsui Sumitomo Insurance, a large insurance company with operations all over Asia, and the market responded favorably to the arrangement. Fairfax also agreed to sell part of its ownership in ICICI Lombard, an Indian insurance company, booking a 300% return. I expect Fairfax to continue making good insurance deals and booking excellent long term returns on its investments.

IBM and **Philip Morris International** under-performed in equity income portfolios this quarter. Please see above my comments on IBM.

Philip Morris International, the largest tobacco company outside of the U.S. and China, suffered a 5% decline over the quarter as investors fear nicotine regulation will severely reduce tobacco consumption. What investors seem to be missing is that regulators *want* smokers to switch from combustible cigarettes to products like Philip Morris's IQOS, dramatically lowering health risks for nicotine consumers. In the long run, regulation will more likely assist than hamper PMI's strategy of moving to a smoke-free world, and this should generate profitable growth for PMI's thus far dominant non-combustible platform.

Market and economic outlook

The S&P 500 returned 4.5% last quarter and 14.2% year to date. Such above average returns, while pleasant, also mean lower returns going forward. My estimates indicate 2% average returns for growth and 5% returns for equity income. The market isn't grossly over-valued, yet, but it's heading in that direction.

Projected annualized returns over the next 6 years	
S&P 500 (growth benchmark)	-5.5% to 8.9%
S&P-500-yield-plus-inflation (equity income benchmark)	2.0% to 8.0%

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

World economic growth picked up steam in the third quarter. Russia, Brazil and Argentina are clearly rebounding, Japan and Europe are seeing accelerating growth, and China and India are witnessing slower but still enviably robust expansions. This could always change, but for now things look peachy.

Perhaps that's why nothing can perturb stock or bond markets: not a potential war with North Korea, two powerful hurricanes hitting the second and third most populous U.S. states, nor political brinksmanship and a virtual standstill in Washington. You could call this the Teflon Market—no bad news seems to stick. This, too, could change, but no deviation seems imminent. In the meantime, stock and bond valuations look increasingly stretched.

High *average* prices, however, doesn't mean bargains are nonexistent. I'm finding good deals amidst a bombed out sector I know and love: value investments. Looking there, I'm finding solid companies with sustainable competitive advantages and years of predictable growth ahead. Even though prices don't reflect this underlying reality, they will in time. That means patience is a virtue in the Teflon Market, and we'll get to exercise that virtue for a bit before reaping the rewards.

By what yardstick?

How do you measure results? In high school or college, you look at grade point average; for a baseball pitcher: earned run averaged (ERA); in golf or tennis: major tournaments won; with actors and directors: Oscars. How do you measure investment managers? Compare them to a benchmark, yes, but which one?

There are more yardsticks than you might image. Do you use a broad benchmark, like the S&P 500, Russell 3000, Wilshire 5000 or Morgan Stanley Capital International All Country World Index (MSCI ACWI)? Or, do you pick a benchmark based on company size: large versus mid-size versus small, or all of the above? Or, do you select the investing style a manager uses: value, growth, momentum, quality, low volatility, industry sector, etc.? Or, do you choose the geographic region: domestic, international, global (domestic *and* international). Indexes exist for all these options, and much more.

The choice isn't trivial. **If you pick the wrong yardstick, you risk comparing apples to oranges and drawing the wrong conclusion.** For instance, if an index has little overlap with where a manager picks stocks, you might conclude a manager is good when they're just choosing securities outside the index during a period when those investments are doing well. Or, if a manager focuses on one part of an index and that part is under-performing, you might conclude the manager is no good when it's a temporary phenomenon that will soon reverse. Benchmark options are numerous; choosing wisely is neither simple nor easy.

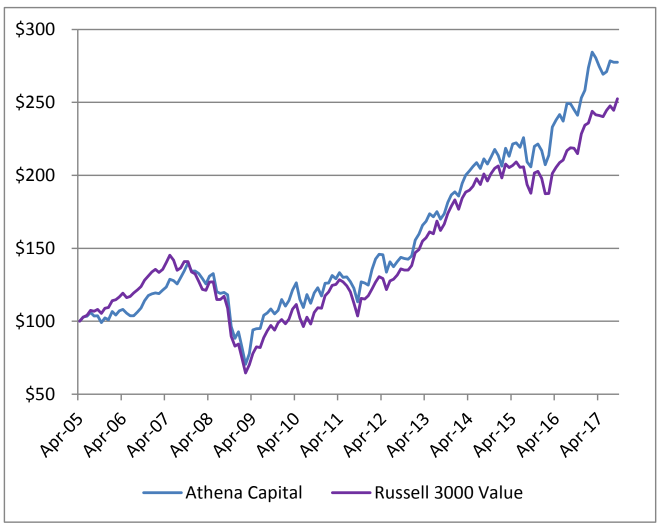
As you know, I use a broad market index, the S&P 500. Why? Because it's the biggest and cheapest available: the largest, lowest cost mutual funds and exchange traded funds (ETFs) use the S&P 500 as their standard (Vanguard 500 mutual fund: $205 billion, 0.04% fee; SPDR S&P 500 ETF: $243 billion, 0.05%). Plus, the S&P 500 is *the* default investment option for most professional and individual investors, which makes it a logical choice.

The S&P 500 might be the right benchmark over the long run, but that doesn't mean it provides flawless guidance over all sub-periods. After all, it might not overlap with where a manager picks securities. For example, the S&P 500 has a large company bias, doesn't include non-U.S.

based companies, and doesn't account for a manager's style within the index. If a manager tends toward small, foreign, or value investments, the S&P 500 may prove a misleading yardstick over any particular period.

For us, style tilt is a critical factor because my method skews heavily towards value investing: I assess the worth of businesses and try to buy them cheap. Put differently, I'm not chasing the highest priced stocks that make up a large part of the S&P 500, so comparing me to that yardstick misleads when high priced stocks are crushing it—and they have been *for over a decade*. Expensive stocks winning that long is *very* unusual: cheaper stocks have won 96% of the time over 10 year periods since 1926.

In other words, **our value bias makes the S&P 500 a misleading yardstick during precisely the kind of period we've been going through** (since inception). Look at how we've done relative to the Russell 3000 Value Index (graph) and S&P 500 Value Index (table) below and you'll see we're out-performing most value stocks, thus handily beating the universe of securities where I tend to select.



	3 years	5 years	10 years
S&P 500 Value	29.2%	85.9%	72.4%
Athena Capital	33.6%	92.9%	106.4%

Value indexes may help you understand sub-period performance, but I don't think they're the right benchmark for the long run. Investing in the market with a broad, low cost index is the best comparable for investors even if it makes our performance over long periods—12+ years—look dingy. But, knowing we have a value tilt makes an awareness of how we're doing relative to value benchmarks important additional information.

Given the above, what can we expect going forward? First, the good news. **I strongly believe value will win over the long run.** Human psychology hasn't changed and people haven't become more successful at overcoming their impulses. Value works because people tend to seek comfort and avoid pain, thus paying too much for what is doing well and selling too cheap what's doing poorly. **As long as human nature doesn't change and people still succumb to their emotions, value will win.** That's value's theoretical support.

On the empirical side of the argument, **value has won so strongly over time that it's always the smart bet to make** (even if it looks feeble over the last decade). Specifically, value has out-performed growth by over 4% annualized since 1926, a huge margin of victory generating 40% more money over 10 year periods. This is too big a margin of victory to ignore. Put plainly, it never makes sense to choose one-in-25 odds expecting to end up 29% worse off.

Now, the bad news. Passive investing is a long term trend that favors growth over value because it buys more of what's large and growing, **so don't be surprised if value's under-performance continues for some time**. I expect this to reverse suddenly and unpredictably to our great advantage, but I don't know when.

Keep in mind, too, that **we don't rely solely on value to succeed** (which is why we're keeping pace with the market and beating value indexes). We should expect to do well, even if not spectacularly, until value resumes its winning ways. This is where value benchmark comparisons help un-muddy the waters.

My final point: remember the lessons of history. The last time value's under-performance was as extreme as now was early 2000, and what followed should quicken your pulse. Over the five years from February 2000 to February 2005, value beat growth 8.5% to -9.6% a year, an 18.1% per annum difference. In other words, if you'd invested $100,000 in growth on 2/29/2000, you'd have $60,000 five years later; if you'd invested in value instead, you'd be sitting on $150,000. History won't repeat precisely, of course, so I don't mean to suggest this exact outcome, but it supports why I'm sticking to value with conviction and a bit of excitement.

Benchmarking performance is harder than it may seem. Using the right yardstick is important, but even that can muddle comparisons over seemingly long sub-periods. That's why it's helpful to consider how a manager is doing with respect to their method, like value, instead of relying solely on a broad benchmark over all periods. I'm utterly convinced value will prove its worth, but it may take time. Enticingly, history suggests our patience will be handsomely rewarded.

Until next quarter

If you have any questions or comments about my letter, markets, returns, value versus growth, etc., please feel free to contact me at your convenience. It's always fun hearing from you.

Patiently,
Mike

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