Athena Capital Management Corp.

January 18, 2006

Happy New Year!

I hope you had an enjoyable holiday season! I had a wonderful vacation visiting family in Albuquerque, NM and Nashville, TN. It was great company, great food and a great time.

In this letter, I will discuss how our growth and income accounts are performing, and what I expect for the market as a whole over the next 6 years. Then, I will step out of character to take a look at broader issues: interest rates, the housing market, and the overall economy.

How are we doing?

From April 30, 2005 until the end of the fourth quarter, our **growth accounts** averaged returns of 1.57% versus 9.29% for the S&P 500 and 11.25% for the Wilshire 5000. Our greatest price appreciation this quarter came from companies involved with oil and gas exploration & production, telecommunications, and gold mining. Our price declines, on the other hand, came from telecommunications equipment, specialty retail, and insurance. I sold the telecom equipment company because I began to doubt management's integrity, and better opportunities were available. The specialty retailer and insurance company are discussed below.

From May 31, 2005 until the end of the fourth quarter, our **equity income accounts** returned -0.73% versus 2.82% returns from S&P-500-yield-plus-inflation. Price appreciation this quarter came mostly from pharmaceutical companies and partly from a conglomerate we hold that is involved in both insurance and industrial operations. Price declines, in contrast, came from two of our insurance holdings and one specialty retailer.

In my opinion, the specialty retailer and insurance companies that hurt performance this quarter represent great long term investments. The retailer has excellent management and a strong track record of exploiting new retailing trends. The insurance companies are simply feeling short term pain to pay out hurricane losses, but should do well going forward as insurance prices rise.

Short term price fluctuations, such as we are seeing in our performance numbers, reflect psychology and recent news more than company fundamentals. Over the next couple of years, however, the fundamentals will begin to overwhelm that background noise. I feel comfortable with our current holdings, I continue to find new investment opportunities, and I am optimistic about how our investments will do over the next 3 to 5 years.

As all of you have heard before, it is not unusual for me to invest in companies that appear in the news for negative reasons or that are experiencing poor results. These are frequently great investment opportunities. In the short run (1-3 years), these investments can under-perform the market. In the long run (3-5 years), however, such investments usually provide excellent results. **Although some patience and intestinal fortitude may be necessary in the short term, I think you will find my approach quite satisfactory over the long term.**

How does the market look going forward?

The overall stock market continues to seem over-valued relative to historic growth rates, valuations and dividend yield levels. This does not mean the market will do poorly in the short term, but it does mean that over the long haul, returns will be lower than an extrapolation of history might suggest.

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With the S&P 500 at $1,248 at quarter end, my long term projections for market returns are as follows:

Projected annualized returns over the next 6 years	
S&P 500 (benchmark for growth accounts)	-6.1% to 7.8%
S&P-500-yield-plus-inflation (benchmark for equity income accounts)	3.3% to 6.3%

Interested in my method for deriving these numbers? Visit www.athenacapital.biz under "Free Articles" to see my 7/12/05 article.

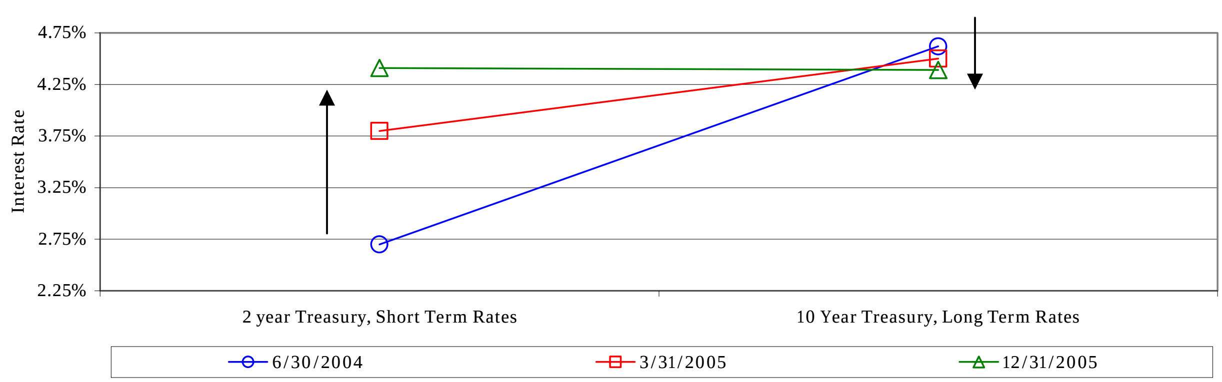
Although my projection for the market doesn't look exciting, we don't need to follow that path. Stocks trend with the economy over the long term, but we can choose companies that have different characteristics than the market. Specifically, we can pick companies that are priced *lower than the market*, have *better dividends* than the market, or just plain *grow faster* than the market. That is the path we seek to follow, and the long term outlook looks good.

Interest Rates

The Federal Reserve has raised short term interest rates 13 times over the last 18 months. At the same time, long term interest rates have been flat or decreased (the fed has a lot of control over short term rates, but the marketplace sets long term rates).

The chart below is a graphical depiction of this situation. The diamonds represent a snapshot of 2 year (short term) and 10 year (long term) interest rates on 6/30/2004 (18 months ago), the squares represent 2 and 10 year interest rates on 3/31/2005 (9 months ago), and the triangles represent 2 and 10 year rates on 12/31/2005.

Short versus Long Term Interest Rates



What is causing long term rates to fall even though short term rates are rising? Some analysts believe long term bond investors are forecasting low inflation and slower economic growth, which is leading them to buy long term bonds and drive down long term interest rates. Other analysts believe that China & Japan are buying long term bonds with surplus dollars they are getting from US consumer spending. I think it's a little of both. If long term bond investors or Japan & China reduce their buying of long bonds, expect long term rates to rise.

How do interest rates impact us? Long term interest rates are used as an input to value stocks. When rates go lower, stock prices tend to rise. Similarly, when rates rise, stocks tend to decline. Because of this interest rate/stocks connection, a *further* decrease in long term interest rates will probably lead to

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higher stock prices. The decline of long term rates over the last few years is one of the reasons why the stock market seems over-valued to me. If long term rates rise because of higher inflation, higher economic growth, or Japan & China finding other places to invest their trade surplus, expect stocks to decline.

Interest rates also impact mortgage rates. Lower long term interest rates mean lower house payments for those who lock in 30 year mortgages. Further, short term interest rates determine adjustable rate mortgages, which have become popular over the last 5 years. All things being equal, higher interest rates tend to slow the housing market and reduce economic growth, whether short or long term rates are rising.

One of the most reliable predictors (meaning somewhat better than a random guess) of future economic growth is the *difference* between short and long term interest rates. When short term interest rates are much lower than long term rates, the economy tends to grow strongly. When short term interest rates are close to long term rates, *like at present*, the economy tends to grow a bit slower. If short term rates rise above long term rates and stay there for a few months, the economy tends to slow and could even decline (a recession).

Forecasting or reacting to interest rates is difficult, and I'm not trying to make a forecast or suggest action. **We should, however, pay attention to interest rates in the future because they are likely to indicate changes in the economy and stock market.** Stay tuned for future updates.

The Housing Market

Is the housing market a bubble about to pop? I am not an expert in this field, but I am fairly certain the housing market will never tank like the NASDAQ did from 2000 to 2002 (down 78%). However, home prices could decline, remain flat for a while, or simply grow more slowly.

There are good reasons to think that recent rapid home price increases will end. If you look at housing statistics, you will find:

- The average person owns less equity in their home than ever before (historically 65-80%, currently 55%)
- The expense of owning a home is high relative to people's income (incomes have risen much more slowly than house prices)
- Rental income on homes is very low relative to corresponding mortgage payments, housing expenses, and home prices

In other words, this is as stretched as the housing market has been for quite some time.

Is it true that housing prices have never gone down? No. Since the 1970's, aggregate housing prices have never gone down for the nation as a whole. But, anecdotal information suggests that national housing prices almost certainly went down during the Great Depression in the early 1930's. Further, Japanese housing prices went down for 14 straight years (until this year) after their housing market peaked in the early '90's. Finally, consider the housing price peaks in southern California and Texas in the '80's, where housing prices *adjusted for inflation* <u>still</u> haven't regained prior peaks.

Housing markets are much more *locally* based than stock or bond markets. Even if the prices for condominiums declined steeply in San Diego, that doesn't mean that housing prices in Minot, ND will go down as well. If you own your home for the long haul and don't think of your home as a short term investment, you are unlikely to be affected by slower growth or even a decline in housing prices. The only people that may get hurt are those speculating on housing prices over the short term, and those who have taken on too much debt to buy a house they really couldn't afford.

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The Economy

The economy performed very well in 2005 despite record trade deficits, high government budget deficits, hurricane Katrina and Rita, record high gas and oil prices, and a host of other worries. Although I would love to see this outstanding performance continue, there are reasons to expect the economy to slow.

- Rising short or long term interest rates could crimp both consumer and company spending. Higher interest rates increase expenses for both individuals and companies because it raises the amount of interest they both have to pay.
- If the housing market slows, it would impact jobs and people's perceived wealth.
  - Many of the new jobs created since the 2001 recession have been in home building and housing finance. A slowdown (not even necessarily a decline) in the housing market could lead to layoffs and reduced incomes.
  - Housing has a big impact on people's perceived wealth. When people's home price grows quickly, they can use a home equity loan to cash out the equity value of their home to spend on goodies. And, people don't feel they have to save as much because their growing home price has become their savings. If you remove these benefits, spending will decline as people stop cashing out their home equity and start saving their money.

Predicting economic growth is not my specialty, nor does anyone else seem very good at it. But, I do know that economic growth tends to fluctuate above and below a consistent average. And, because growth in the economy over the last 2 ½ years has been above average, **it would not surprise me to see growth return to average and maybe even below average.**

If you are curious about how the economy will do going forward, pay attention to short versus long term interest rates and to the housing market. If long term interest rates decline below short term interest rates, this indicates the economy is slowing and, if the difference is large enough, could signal a recession. Further, if the housing market slows or goes into decline, the economy will slow as well.

Fortunately, predicting the economy is not necessary for our long term investing success. If the economy keeps chugging along, we are well positioned to benefit from its growth. If, on the other hand, the economy does start to slow or decline, it will be an excellent opportunity to buy great companies at bargain prices. **Regardless of what the economy does, I will continue to position your portfolios to achieve good long term returns.**

If you have any questions or concerns about the economy or how your portfolio will do in various scenarios, feel free to contact me at your convenience and I'll be happy to talk with you about it.

How am I doing?

How do you feel about my service so far? **Your feedback is eagerly sought.** If you have any questions or comments about reports, letters, specific investments, whatever, I'd love to hear from you. Or, if there is a subject you would like me to address in future letters, please feel free to contact me with your idea.

Do you know anyone who may be looking for sound investment management? If so, feel free to pass my name, number or website on to them. My business works best through referrals, so interested friends or relatives of yours would be welcome contacts.

Many happy returns (pun intended),

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