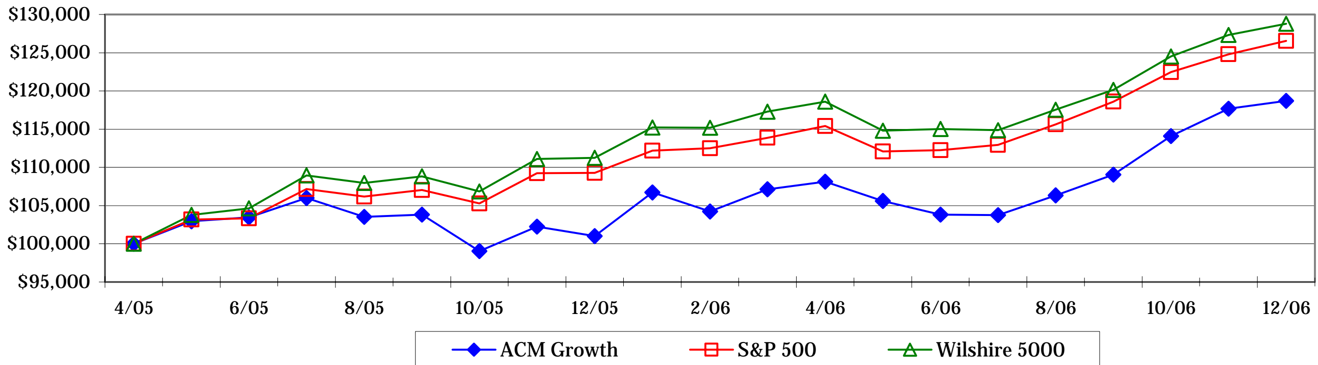
Athena Capital Management

Growth Performance

Performance as of 12/31/06	1 year	Since inception (4/30/05)
ACM Growth	17.49%	18.69%
S&P 500	15.80%	26.55%
Wilshire 5000	15.78%	28.80%

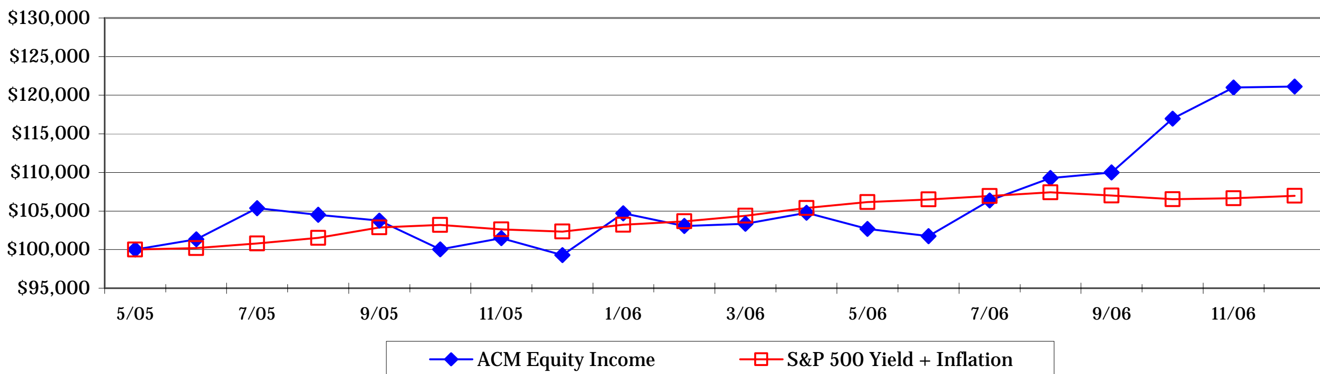
Comparison of the change in value of $100,000 investment in ACM growth versus S&P 500 and Wilshire 5000



Equity Income Performance

Performance as of 12/31/06	1 year	Since inception (5/31/05)
ACM Equity Income	21.99%	21.11%
S&P 500 yield + inflation	4.51%	6.96%

Comparison of the change in value of $100,000 investment in ACM equity income versus S&P 500 yield plus inflation



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. 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

January 18, 2007

Happy New Year and welcome to 2007! In this letter, I'll cover: how we are doing, six year market projections, how to identify good investments, performance slumps can last, Leucadia National, stock brokers, and J.P. Morgan. I hope you find it informative and entertaining.

How Are We Doing?

As the graphs and tables on the first page show, growth accounts had a good year and income accounts had an outstanding year. Although growth accounts performed well this year, they are still playing catch-up since inception. I feel confident that they will catch up, though, because my estimate of business value growth in our investments is up around 15% versus the S&P 500's trend-line growth of around 6%. In time, this underlying math will reveal itself in performance. Income accounts had a surprisingly good year. Although I'm quite happy to see this performance, such results can't be expected every year.

Growth accounts generated out-performance this quarter from **Fairfax Financial** and **Berkshire Hathaway.** Fairfax has been the victim of short sellers this year and it simply came back from its depressed price and then some. Berkshire Hathaway continues to show what an excellent business it is, especially on its insurance side.

Growth accounts' under-performers this quarter were **Pier 1** and **Wal-Mart**. Pier 1 continues to struggle with its merchandizing. As a result, its President is resigning and this will bring in new blood or a potential buy-out. Wal-Mart had a slow quarter due to both remodeling stores and slower spending by low-end consumers. I think Wal-Mart is simply one of the most efficient and merchandizing-savvy companies out there, so I feel confident that they will right their ship and get it sailing back towards growth over time.

Equity income accounts saw out-performance from **Berkshire Hathaway** (for the reasons mentioned above) and from **Scottish Power** and **Mercantile Bancorp**. Both Scottish Power and Mercantile out-performed because they are being bought out. Scottish Power is being bought by Spanish utility company, Iberdrola. Mercantile, on the other hand, is being bought by Pittsburg based PNC Financial. Although I'm sad to see these investments go, I think we're receiving excellent prices for both.

Equity income's under-performers this quarter were **Pier 1** (discussed above) and **Pfizer**. This quarter, Pfizer announced they halted development on a drug they were testing (to raise good cholesterol levels) because it showed poor results. Although this is a short term setback for Pfizer, I continue to believe that its portfolio of drugs will provide excellent income in the future.

6 Year Market Projections

The S&P 500 had another strong quarter and provided a total return of 6.7%. Not surprisingly, this continued run further reduces my expectations for the market's returns going forward.

Projected annualized returns over the next 6 years	
S&P 500 (growth benchmark)	-6.9% to 8.0%
S&P-500-yield-plus-inflation (equity income benchmark)	3.4% to 6.4%

How did I arrive at these numbers? Visit "Free Articles" at www.athenacapital.biz to see my 7/12/05 article.

As mentioned before, I continue to believe that our investments' fundamentals will grow faster over the long run than the market's fundamentals. This gives me confidence that we should receive better performance over the next 3 – 5 years than the market in general.

In the past, when long term interest rates were below short term interest rates, it indicated that the economy was slowing or perhaps even entering a recession. With long rates even more significantly lower than short rates, I continue to be concerned about how the economy will do in the short term. Added to this, the housing market continues to show weakness although with a less precipitous decline than was evident over last summer and early fall. Regardless of how the economy and the housing market does over the short term, your portfolio is well positioned to do well over the long run.

Identifying Good Investments

My final segment on identifying good investments integrates the three factors covered in my previous articles. Here, I bring together what I've learned about a business's management, economics and valuation, and decide whether to take action or not.

I utilize this process when looking at both new and current investments. Accordingly, I look at all three factors in deciding whether to buy, wait on or

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reject new investments, and whether to hold or sell current investments.

Buy, Wait or Reject

With any new investment, I can buy, wait or reject. I buy for clients and myself when a business meets my economic, management and valuation criteria. I wait when a business's economics and management look good, but the price is too high or I need more information. I reject a business when it is so lacking in good qualities that I dismiss it from further consideration.

I decide to buy based on a combined view of all three factors. As much as I'd like to always find excellent management, perfect economics and low prices, this is rare. In most cases, I find two factors look great, and one is merely good or acceptable. For instance, I bought Comcast when it had great economics and valuation, but only good management. Similarly, I bought McDermid with excellent economics and management, but merely a fair valuation. Even when one factor is lacking, a combined view of all three may lead me to buy.

I decide to wait and watch an investment when I think management and economics are good, but the price is too high or I need further information. I put such investments in my "watch" list, and wait for the right price or dig for more information. In such cases, I monitor the businesses and update my valuation at least quarterly. Markel Corp is a good example where I knew the price I wanted to pay and I waited for that price to buy. In a different vein, Comcast was a business where I needed more information to decide. I studied it for three years before I understood it well enough to make a decision to buy.

I rarely reject investments outright, but I do if certain conditions exist, like corrupt management. No price is low enough to justify aligning yourself with bad management. If you doubt this, talk to anyone who invested in Enron or WorldCom. Another reason to reject an investment is when I don't understand a business's economics. Without understanding a business, I can't do valuation. And, without valuation, one of three vital pillars is missing. For example, I understand insurance companies, but I've never understood bio-medical businesses, thus leading me to summarily dismiss them as an investment option.

Hold or Sell

I use the same basic framework when I decide to hold or sell an investment. When the three factors still look good, I continue holding a company. When one of the three factors looks sufficiently weak, I normally sell.

The decision to hold is usually pretty simple. As long as my opinion on management doesn't change, and I continue to understand the business's economics, and price-to-valuation doesn't get too high, I continue to hold. To evaluate this, I review and update my opinion of management, economics and valuation at least quarterly. To illustrate, I continue to hold Berkshire because I've reviewed and updated my opinion quarterly, and it continues to look great on all three factors.

Sell decisions have three main drivers: rejection, high price-to-value, or better opportunities. If I realize management is corrupt or I really don't understand a business's economics, I sell without hesitation. UTStarcom readily comes to mind as an example where management revealed their untrustworthiness over time and I sold. High price-to-business value is another reason to sell. If someone offered to pay $40,000 for my car, for which I paid $20,000 three years ago, I would gladly sell it to them. The same goes for investments. If Berkshire Hathaway were to rise to a market price of $9,000, far above my assessed value of around $4,500, I would probably sell it.

The final reason to sell is if a better opportunity comes along. In this case, I sell because the return I could get from a new investment is much more than I'd get on a current investment. This may happen if a holding has run up in price and a new option looks cheap. For example, if I found that Low-Priced Corp provided a safe return of 15%, I might sell A-Little-Expensive Corp to buy Low-Priced. I'd do this because A-Little-Expensive would probably return 7.5%, and Low-Priced would return twice that, or 15%.

To conclude, by combining my views of management, economics and valuation together, I make decisions to act or not. I can reject, wait on or buy a new investment based on my opinion of the three factors, or I can sell or hold current investments based on those same factors. New information can change the way I act, and that is why I must persistently stay current on each investment's characteristics. Further, I must vigilantly look for new opportunities that

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may meet all three criteria, so that I always have good opportunities in the pipeline.

This ends my series on identifying good investments. I hope it's been informative. The process starts with a hard look at management, then moves to grasping the economics of a business, and ends with valuation. Taking the output of these three analyses, in combination, I then make a decision to act or not.

Stay tuned for next quarter's letter, where I'll talk about assembling portfolios of companies with the goal of providing good returns while minimizing risk.

If you missed any of the first three articles of this series, please go to my website, www.athenacapital.biz, and visit my Free Articles page where I have the 1Q06, 2Q06 and 3Q06 letters posted.

What should you do when a manager's performance slump lasts?

A recent Wall Street Journal article reiterated a point I've made many times: investment performance slumps may last (10/6/06, by Shefali Anand). The article starts, "When the going gets tough, how long should you wait before you get going? For…investors, it is one of the thorniest questions to answer…there is no way to know if the manager has lost his or her touch, or if it is just a bad phase."

The article goes on to highlight recent research that shows it isn't unusual for good managers to have slumps lasting years. Specifically, the article says, "A new study examining historical data comes to some surprising conclusions: In the case of managers with very good 10-year track records, investors may have to be prepared to tolerate periods of below-average performance stretching as long as three or even five years."

Why do performance slumps last? The best performing managers tend to invest in only a few companies, and this may lead to several years of under-performance. As the article says, "Among the funds with good long-term records, one common thread seems to be that they hold relatively fewer stocks, which concentrates their bets." Such concentration may lead to under-performance in the short term, but may also generate out-performance for long term, patient investors.

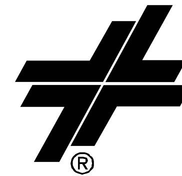
Picking the right manager and then holding for the long term is the key to success. The article continues, "Research has long shown that…investors do best when they hold for the long term. Many investors switch funds—ditching poorly performing ones to buy higher-performing ones—and end up losing out on gains from either end." Research shows that many investors do poorly because they chase recent high-performers. They sell recent losers and buy recent winners, only to find that the "loser" greatly out-performs the "winner" going forward.

In other words, don't give up just because performance looks weak over the short term. If you can focus on the long term and pick managers with good ten year records, chances are the manager has selected investments that will bloom in time.

Investment Spotlight: Leucadia National Corp.

Leucadia, like Berkshire Hathaway, is a holding company. The assets it holds principally consist of the stock of its direct subsidiaries and other non-controlling investments in debt and equity securities. Leucadia currently owns companies in the following fields: timber (Idaho Timber), plastics manufacturing (Conwed Plastics), gambling entertainment (Premier Entertainment Biloxi), oil and gas drilling (Goober Drilling), iron ore mining (Fortescue Metals), domestic real estate, two wineries (Pine Ridge and Archery Summit, shareholders receive a 20% discount on the honor system, call Pine Ridge at (800) 575-9777 or Archery Summit at (800) 732-8822).

Leucadia is run by the super investing team of Ian Cumming and Joseph Steinberg. Over the last 19 years, Cumming and Steinberg have generated 30.8% average, annualized returns for shareholders. In other words, if you had invested $100,000 in Leucadia back in November of 1987, it would be worth over $16 million now. That's what I mean when I say super-investors! Cumming and Steinberg collectively own almost 7% of the company, so they've put their money where their mouth is.



Leucadia National Corporation

Unlike Berkshire, Leucadia does not try to buy and hold great companies. In fact, Leucadia tends to purchase highly troubled companies at rock bottom prices and either help them recover or wait for the business to make its own turnaround. Most of the businesses they buy are very small and frequently

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privately owned, so don't expect to hear about them in the news. This methodology has served Leucadia investors very well.

Leucadia's model of buying troubled companies at deep discounts to value works. Cumming and Steinberg started Leucadia in 1978, and have demonstrated their competence as asset allocators. Leucadia is yet another example of exactly what I look for in a good investment: great economics, excellent management, and a valuation which, at times, doesn't fully reflect the business's underlying value.

Why Is…
…a stock broker called a stock broker

In the early 14th century, the word broker entered the English language from the French word, *brocour*. A b*rocour* was one who broached (tapped into) a cask of wine to sell it by the glass or bottle. By the 17th century, it had such a broad meaning that it applied to all wholesalers and retailers. By the 18th century, though, it came to refer to an intermediary in a financial transaction. In other words, a broker came to mean someone who brings together buyers and sellers and makes his profit by taking a commission on the resulting transaction.

Around the birth of the United States, a broker was a generalist who could have interests in a dozen different forms of trade. At that time, it was not unusual for a broker to buy and sell securities, run a private lottery, insure cargoes, and be a partner in a private bank. After Alexander Hamilton (the US's first Treasury Secretary) stabilized our young nation's finances, a flood of tradable securities hit the market. These securities included everything from federal and state bonds to stock in newly chartered banks and insurance companies. These new securities dramatically increased the volume of business for generalist brokers. Not surprisingly, this higher volume of trading led to specialization, but it would be another generation before brokers specialized only in securities trading.

Today, the term broker by itself frequently refers to a stock broker. These people rarely match end buyers and sellers by themselves anymore, instead working through another intermediary, the market maker (who works at an exchange like the New York Stock Exchange). Now, brokers (like the broker I recommend, Scottrade) tend to be order takers that send buy and sell orders to exchanges where market makers match buyers and sellers. Like all brokers, this function is vital for buyers and sellers who would otherwise have to spend the time, money and effort finding counterparties to sell to and buy from.

Admirable business people: J. P. Morgan (1813-1890)

This quarter, I'll take another page from history to examine one of our nation's greatest businessmen. John Pierpont Morgan was a brilliant financier and a visionary in building America's capital markets. Much of America's greatness has been attributed to our industrial might, but few recognize that such industrial capacity would never have existed without well functioning capital markets to finance them. And, no single American has been as influential as J. P. Morgan in building those markets.

Born into a wealthy family, Morgan grew up in Boston and went to college in Germany. In his first job at Duncan, Sherman (an investment bank) he entered into an unauthorized speculation with the firm's capital in New Orleans. A shipment of Brazilian coffee had arrived in port without a buyer. Morgan bought the entire shipment and resold it to turn a quick profit. Although he lacked the authority to effect this transaction, his dandy profit made it difficult for Duncan, Sherman to punish him. This event showed his self-confidence, his ability to recognize a mis-priced asset, and his willingness to take action when others were passive.

Morgan played an instrumental role in funding early railroad and industrial companies. At the time, bonds were the preferred method of funding ventures instead of stock. Morgan helped raise money by issuing bonds in Europe and then holding the American companies that received bond funding accountable to bondholders. He frequently tangled with the management of such companies to make sure they paid bondholders as promised. It took years of holding American managements accountable to build the trust of Europe's wealthy investors until it became easier and cheaper to raise capital for American business ventures. This proved invaluable in building American businesses because access to cheap, ready funding was key to U.S. growth.

Morgan recognized that weak competitors were better off consolidating into bigger businesses

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for the benefit of an industry. Cutthroat competition seemed to be a boon for consumers in the short run, but almost always led to underinvestment, higher prices and lower profits over the long run (today's airlines?). Morgan encouraged consolidation in several industries thus allowing them to profit and reinvest in the business. Of course, this led to lower prices for consumers and a healthy industry to serve them. Railroads and steel were good examples of industries that needed such consolidation.

Morgan was known to have a will of steel. Although vilified for this characteristic now, this willpower allowed him to save both our nation and the state of New York repeatedly from bankrupting themselves. It also helped Morgan build US capital markets, thus allowing our country to grow and flourish. For these reasons, I believe much of our country's greatness is both directly and indirectly owed to J. P. Morgan.

Until next quarter

This may seem like a hokey thing to say, but I really love my job and I'd like to thank you for giving me the opportunity to do what I love for a living. In time, I think our results will make you as happy as I am that I'm doing what I love for a living.

This business grows best through referrals. So, if you know anyone who could benefit from my services or advice, please send them to my website or provide them with my contact information. I'm always looking for more good clients.

Thank you for your business, and I look forward to hearing from you over the next quarter.

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

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