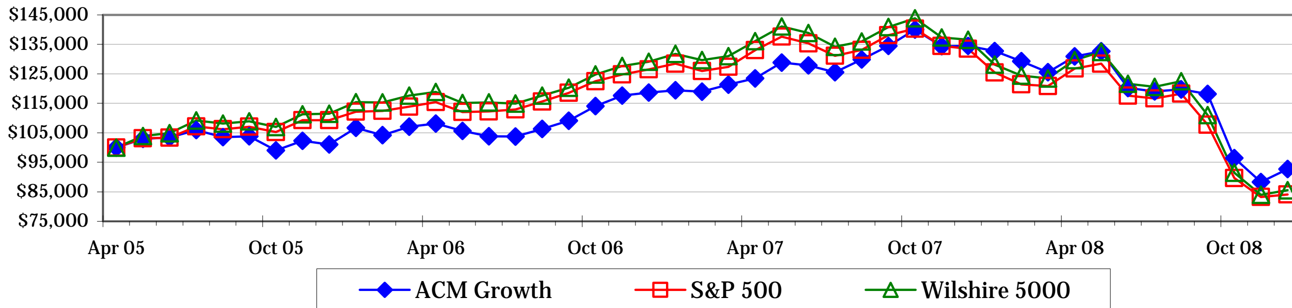
Athena Capital Management

Cumulative Growth Performance

Performance as of 12/31/08	Year to date	1 year	2 years	3 years	Since inception (4/30/05)
ACM Growth	-31.05%	-31.05%	-21.89%	-8.20%	-7.27%
S&P 500	-37.00%	-37.00%	-33.54%	-23.04%	-15.89%
Wilshire 5000	-37.34%	-37.34%	-33.74%	-23.22%	-14.44%

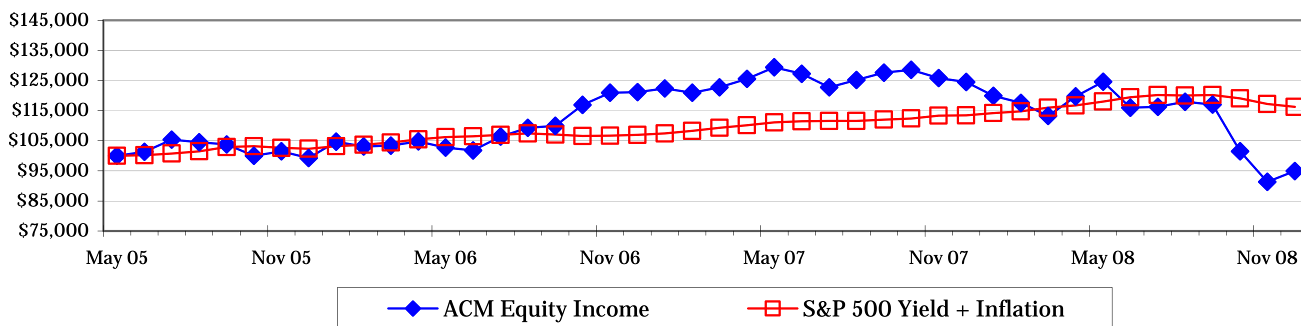
Comparison of the change in value of $100,000 investment in ACM growth versus S&P 500 and Wilshire 5000



Cumulative Equity Income Performance

Performance as of 12/31/08	Year to date	1 year	2 years	3 years	Since inception (5/31/05)
ACM Equity Income	-23.73%	-23.73%	-21.61%	-4.36%	-5.05%
S&P 500 yield + inflation	2.51%	2.51%	8.71%	13.62%	16.28%

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 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

January 16, 2009

The stock market crashed this quarter as it became obvious that housing and credit markets are significantly impacting the economy. Our portfolios were hit, too, but not as badly as the market. Even better, severe market turmoil brought us excellent investment opportunities that will almost certainly lead to outstanding returns going forward.

In this letter, I'll discuss our performance over the quarter, my market and economic outlook, how forced selling is impacting returns and opportunities, selling cheap stocks to buy even cheaper stocks, and our investment in POSCO.

Performance this quarter

Growth portfolios out-performed our benchmark this quarter, and we continue to beat the market over every time period measured. Since inception, growth portfolios have out-performed our benchmark by over 2.5% a year after fees. This is an achievement fewer than 20% of investors can match over the long term.

Relative out-performance, however, does not mean positive absolute returns. When the market crashed, it took everything down with it, regardless of investment merit. Our portfolios were not immune to this downtrend. Such times bring extraordinary opportunities for long term investors, though, and I believe our portfolios will generate better long term returns with this severe decline than would have been possible without it (see "Selling cheap…to buy even cheaper" below).

Growth accounts received out-performance from **Ryanair Holdings** and **Mohawk Industries**.

Ryanair is Europe's largest discount airline. It benefited from rapidly declining fuel prices and a growing recognition that its low cost model is primed to outperform the competition despite slowing demand. I believe Ryanair will continue to extend its lead as market turmoil provides opportunities to lower costs and take market share from competitors.

Mohawk is one of the largest manufacturers of floor covering products in North America and Europe. Despite the decline in demand for its end products, Mohawk is one of the lowest cost producers and will benefit when demand rebounds. The panic of October and November allowed us to buy Mohawk low during the quarter and benefit from its rally in late November and December.

Growth's under-performers this quarter included **Leucadia** and **Sears Holdings**.

Leucadia is a diversified holding company. It recently made unpopular, but intelligent, purchases of a depressed auto lender and a specialized investment bank. Leucadia's management has a lot of experience and success buying beaten down investments, so I'm quite confident the market's reaction will turn out to be wrong over the fullness of time.

Sears Holdings is the parent company of Sears and Kmart stores. Sears stock price suffered this quarter as the short selling ban on its stock was lifted and the market became increasingly alarmed at the decline of real estate prices and retail sales. Although the market's concerns are valid in the short term, I believe Sears will weather this storm and emerge as a strong survivor with a share price reflecting these characteristics.

Equity income portfolios declined in value this quarter even as dividend payout increased. The market panic caused every security, other than U.S. Treasuries, to decline significantly, and our portfolios sunk, too. Despite these difficulties, equity income portfolios are down only 4.4% from contributed capital, meaning principal has declined only slightly, while our dividend yield is up from 2.8% at inception to 6.3% at quarter end. The result is a portfolio that throws off 110% *more* pretax dividend income than it did at inception. In the long run, I believe our principal value will not just recover, but increase significantly, and our dividend payout will continue to climb faster than inflation.

Equity income accounts saw out-performance from **POSCO** and **National Presto** this quarter**.**

POSCO is a South Korean steel manufacturer (see the article later in this letter). Korea's currency, the won, declined precipitously this quarter, and POSCO's price declined with it. This provided a unique opportunity to buy this excellent company cheap, after which its price rallied over 55%.

National Presto makes small appliances, defense products and absorbent products. It provided out-performance this quarter by going *up* slightly as the rest of the market tanked. Apparently, its diversified businesses and rock-solid management were seen as a safe haven in a storm of economic uncertainty.

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Equity income's under-performers this quarter were **Crosstex Energy** and **Berkshire Hathaway**.

Crosstex Energy is a natural gas treatment and pipeline company. Its share price declined significantly due to concerns about its heavy debt load. Although not out of the woods, yet, I believe improving credit markets and Crosstex's steady revenue stream will allow the company to survive and thrive over time.

Berkshire is a highly diversified company run by Warren Buffett. Berkshire declined this quarter over concerns about a couple of obscure derivatives written by the company and a decline in its publicly held securities. These concerns are far out of proportion relative to the facts of the case, and represent what will mostly likely be a short-lived low in Berkshire's share price.

Market and economic outlook

The S&P 500 tanked 21.9% this quarter. Financial markets finally seemed to recognize the seriousness of this economic downturn. Although such downturns are unpleasant to watch, they provide excellent investment opportunities. For the first time in 3 ½ years, I'm projecting meaningfully high returns from our benchmarks. Not surprisingly, I expect the superior companies in our portfolios to do even better.

Projected annualized returns over the next 6 years	
S&P 500 (growth benchmark)	4.1% to 16.9%
S&P-500-yield-plus-inflation (equity income benchmark)	4.9% to 7.9%

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

It's official: the U.S. economy has been in recession since late 2007. I started warning about this in early 2007, but it only became obvious recently—almost 2 years later (better early than never?). Housing and the financial sector have dragged the rest of the economy down and this is showing up in employment statistics, production numbers, and—of course—the stock market.

The good news is: the stock market is providing the best bargains I've seen in my investing career. I've only been investing for 13 years, but I'm a dedicated student of economic and market history. Prices are as low as they've been, compared to fundamentals, since the mid 1980's—in the early innings of the last bull market.

The bad news is that this recession looks worse than average. Even though stock prices are cheap, they could become even cheaper. How much cheaper? The market could decline another 33% and not be outside historical precedent. It may sound crazy for me to say so, but that wouldn't necessarily be a bad thing. It would allow us to buy companies at even greater discounts and lock in even better future returns! **Just be prepared for lower markets in case they happen, and know that I'll be exploiting them to your advantage.**

Frankly, I have no idea when the economy or market will recover. What I *do* know is the market almost always anticipates an economic recovery by several months, so waiting for things to start looking better will only lead you to miss a huge rally. **When the market does take off, it will be a party you won't want to miss.** As Warren Buffett put it recently, "if you wait for the robins, spring will be over."

Will Rogers had the best quote along these lines. His financial advice was to buy a stock that goes up and hold on. But what if it doesn't go up? Don't buy it, of course (har-dee-har-har). **You can't maximize returns waiting to buy after something goes up.**

I certainly don't mean to imply that watching the market go down is fun. Quite the opposite—I hate seeing our portfolios decline (at all, let alone this much). But, we have no control over the market. As long as we use the market's short term gyrations to our advantage, we can greatly benefit from what looks like a bad situation.

Forced selling

I've argued for some time that value investing minimizes market plunges. And, yet, our portfolios are down along with the market. Why is that? The reason, in two words: forced selling.

Many hedge funds borrow money to buy stocks. When prices go down, they have to sell stocks to pay back loans—referred to as a margin call. Usually, they sell the stocks that have gone down least—the highest quality companies. As they sell, the market goes down more, leading to more margin calls. Rinse and repeat and you have a recipe for *all* stocks going down.

Many individual investors are panicking and selling their mutual funds. When they sell their funds, their mutual fund manager must sell stocks to cash-out investors. Once again, they tend to sell their highest quality, lowest declining companies first. This leads to a vicious cycle as selling begets more selling. Rinse and repeat.

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Managers with bad records have been and will be fired. As newly hired managers take over, the first thing they do is sell off holdings they don't like. Many of those holdings have done poorly and new managers want to remove that taint. Other holdings have done well and thus have less upside, so managers sell them off, too.

During the 4th quarter, many investors sold shares to book losses in taxable accounts (including me). By selling stocks that are down, investors can offset gains they took earlier in the year. In this case, they are mostly selling the stocks that have gone down most. Needless to say, this artificially depresses the prices of stocks that have already gone down farthest.

Put these factors together, and forced selling causes *all* stocks to go down, *regardless of investment merit*. In my opinion, that is why our portfolios are down with the market. **There is a silver lining to forced selling, though: it allows us to buy great companies at record low prices.** Read on.

Selling cheap…to buy even cheaper

You may have noticed I sold some of our holdings recently. Some companies have disappeared from the ranks while others have merely been trimmed back. In some cases, we made money and in other cases we didn't. Because I don't tout frequent trading as the way to investing success, you could be surprised to see me selling businesses at a loss or small gain. It's logical to wonder why I'm selling.

Usually, I like to buy cheap and sell dear. I spend the vast majority of my time trying to buy companies with good management and economics selling at bargain prices. I tend to hold until such companies become expensive. Such holding periods can be long because it may take the market some time to recognize value. Long holding periods allow us to reduce turnover (minimizing trading expenses and taxes), and benefit from the underlying growth of superior businesses.

But sometimes, it makes sense to sell cheap to buy cheaper. On occasion, market prices move so far and fast that it makes sense to sell good companies at cheap prices to buy other good companies at even *cheaper* prices. Selling a house that's worth $100,000 for $70,000 makes sense if you can buy an equally good house worth $100,000 selling for $30,000. Obviously, such dire conditions don't happen often. But, when they do, it's smart to act. The market's recent crazies made this the best time to take action since the early 1980's.

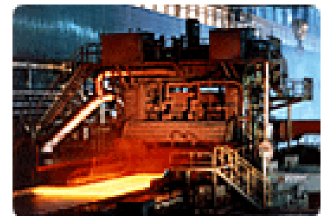
I believe it's prudent to sell one business at a discount if I can double projected returns. For example, I recently sold all or parts of Wal-Mart, USA Mobility, Covidien, and Johnson & Johnson to buy POSCO, Dell, USG, Leucadia, Kimco Realty and Mohawk. In each case, I believe we at least doubled projected returns and upgraded portfolio quality.

Frequent trading and selling businesses below value is not the path to investing success. But, once or twice in a lifetime—and this was one of those times—the market provides us with an opportunity to sell cheap and buy even cheaper. Taking action allowed us to lock in better projected returns while maintaining or improving portfolio quality. I look forward to reporting on the results of these actions in the future.

Investment Spotlight: POSCO

Frequently, the businesses I spotlight have some pizzazz. Perhaps it's a company you love to hate, like Wal-Mart or Comcast. Or, there's a super-star CEO involved like Warren Buffett or Eddie Lampert. But sometimes the company seems, well… a bit boring. Boring doesn't have to be bad, though. Getting great returns isn't about pizzazz, it's about fundamental performance. In the case of POSCO, boring is beautiful.

POSCO, based in South Korea, is the fourth largest steel producer in the world. It produces basic inputs for steel pipes and ship building like hot and cold rolled steel, and higher end inputs like stainless steel and silicon steel sheets. POSCO runs two major plants in Korea and is in the process of opening additional plants in Vietnam, India and Mexico to serve a broader range of markets. POSCO sells its steel to the U.S., the European Union, China, Japan and the rest of Asia. Korea's location is advantageous for serving Korean, Chinese and Japanese markets, which each have high and growing demand for both basic and high grade steel. In fact, Toyota just signed a contract with POSCO to buy steel for manufacturing cars in Japan, which is unusual because Toyota has historically bought from Japanese steel manufacturers.



POSCO's competitive advantages include efficient operations and high end steel products. POSCO generates higher margins and returns on capital

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than almost any competitor, and does it through innovation and tight operational controls. No company runs a tighter ship than POSCO when it comes to making steel, and no company has been as successful as POSCO at innovating and implementing new steel-making technology. POSCO also chose to produce more complex and profitable products than its competitors. The harder a steel product is to manufacture to stiff tolerances, the higher the price buyers will pay and the fewer companies who can meet requirements. High margin products and few competitors is a recipe for high, and sustainable, profitability.

Management at POSCO is excellent. The team includes outstanding engineers and managers that, on average, have been with the firm for 30 years! Their dedication to constant improvement is why POSCO is so successful. Unlike in the U.S., it's very rare to find Asian companies with a lot of management ownership, and POSCO is no exception. In the U.S., I'd take this as a bad sign, but given cultural differences and much lower executive compensation than in the U.S., I'm willing to overlook this blemish.

POSCO has generated average returns on equity of over 16% for the past 10 years. After paying an average 2.5% dividend, this has allowed for 12% earnings growth. During the last economic downturn, POSCO generated 8% returns on equity. With a cost basis of around $58 a share, that translates into a 10% earnings yield during recession and 20% earnings yield over the full economic cycle. Adding a 2.5% dividend provides a projected 22.5% annualized return. That's what I call a bargain!

Although POSCO may *seem* boring, **I'm downright excited about buying a world class company selling at a bargain price.** POSCO possesses solid competitive advantages, excellent management, solid growth, and—of course—a cheap price. With those attributes, *boring is beautiful*.

Until next quarter

To long-time clients: thank you for continuing to do business with me. I really appreciate your support and know it takes a lot of patience to hold on during a crazy market like this. I look forward to rewarding your patience with results we can brag about.

To recently joined clients: welcome to the Athena Capital family. Thank you for becoming clients and picking such an amazing time to invest! I look forward to providing you with excellent investment results and advice, and thought-provoking commentary.

2008 was an amazing year of growth for Athena Capital. Contributed capital increased by over 90% this year! Because of this growth and my desire to fully support current clients, I'm raising my minimum account size for *new* clients to $100,000 (this has no impact on current clients).

This doesn't mean I don't want new clients—I most certainly do! So, if you know anyone who could benefit from my investment approach and has $100,000 to invest, please send them my contact information or send them to my website (www.athenacapital.biz) and blog (www.mikerivers.blogspot.com).

I probably sound like a broken record, but **if you have additional funds to invest, this is an historical time to do so!** I believe we are currently witnessing, and will continue to witness, a once or twice in a lifetime chance to invest in great companies at rock-bottom prices. I feel absolutely giddy about our long term return prospects!

Feel free to call or write me with any questions you may have. I love to hear from clients and would be happy to provide any support or advice you might want. Until next quarter…

Respectfully yours,
Mike

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