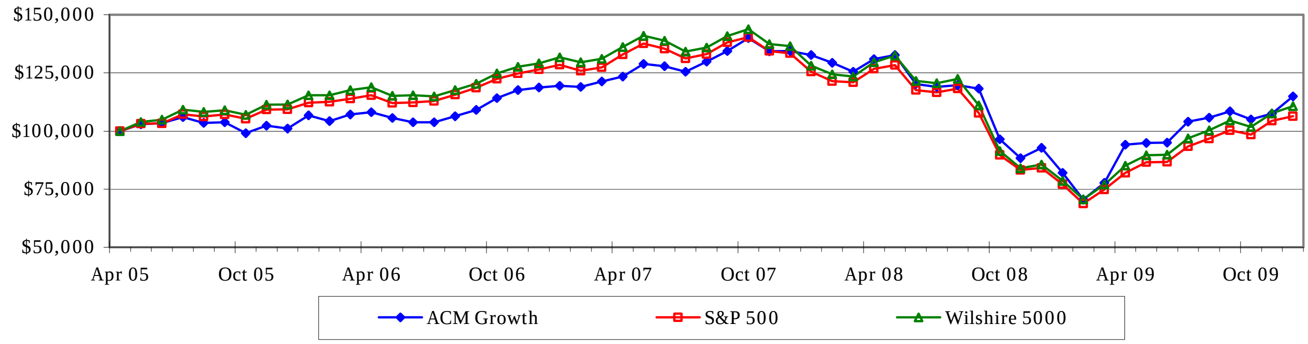
# Athena Capital Management

## Cumulative Growth Performance

| Performance as of 12/31/09 | Year to date | 2 years | 3 years | 4 years | Since inception (4/30/05) |
|---|---|---|---|---|---|
| ACM Growth | 23.88% | -14.58% | -3.24% | 13.72% | 14.87% |
| S&P 500 | 26.46% | -20.33% | -15.95% | -2.67% | 6.36% |
| Wilshire 5000 | 29.42% | -18.90% | -14.25% | -0.64% | 10.73% |

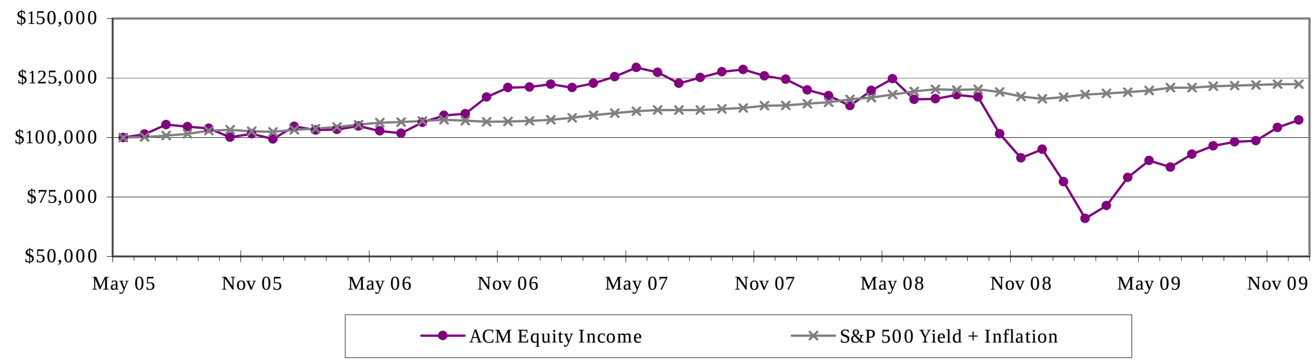
Comparison of the change in value of $100,000 investment in ACM growth versus S&P 500 and Wilshire 5000




## Cumulative Equity Income Performance

| Performance as of 12/31/09 | Year to date | 2 years | 3 years | 4 years | Since inception (5/31/05) |
|---|---|---|---|---|---|
| ACM Equity Income | 12.95% | -13.81% | -11.43% | 8.07% | 7.29% |
| S&P 500 yield + inflation | 5.23% | 7.87% | 14.40% | 19.56% | 22.36% |

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.

# Athena Capital Management

**January 15, 2010**

Fourth quarter 2009 was another terrific quarter both for markets and our portfolios. Although the economy looks to be rolling full-steam ahead, there are good reasons for caution as well as optimism looking forward.

In this quarter's letter, I will discuss our performance, my view of markets and the economy, the potential impact of government stimulus withdrawal, and our investment in Canadian Natural.

## Performance this quarter

**Growth portfolios under-performed for the year, but handily beat our benchmark over 2-, 3-, and 4-years, and since inception.** 2009 began with a brutal sell-off in the first quarter, followed by a significant rally over the rest of the year. This rally was characterized by the "dash to trash," where unprofitable companies with high debt and poor business economics soared most. Although I prefer beating benchmarks every period, I don't think buying weak companies during the worst economy since the Great Depression is the most prudent way to get there—especially with your money. Instead, I used the rally as an opportunity to upgrade the quality of our portfolio in high profit, rock-solid businesses that can succeed in almost any kind of market. As the dash to trash fades—and it will—I believe this prudence will be richly rewarded.

Growth's out-performance came from **Sears, POSCO** and **Microsoft** this quarter**.**

Sears is a company people love to hate. Despite this, it continues to produce stronger operating results than Wall Street or shoppers expect. During the fourth quarter, when retailers make more money than any other time of year, it became obvious that the Christmas shopping season would be far better than expected. Sears is likely to benefit and post strong results; investors sent its share price up 27.9%. I expect Sears to continue delighting shoppers and investors in the future.

POSCO, a South Korean steel manufacturer (4th largest in the world), continues to benefit from selling its higher end steel products to huge markets like Japan and China. Its share price climbed 26.1% during the quarter as Asian economies continued to grow faster than expectations. Though I think highly of the company, I used its recent climb as an opportunity to book some profit.

Microsoft is another company people love to hate. The more people hate it emotionally, the less rationally they judge its value, and the greater the investment opportunity. Microsoft's share price climbed 18.5% this quarter due to the success of its Windows 7 operating system and its Bing search engine. Although it faces significant threats from Apple and Google over time, I think it will continue to pleasantly surprise investors with high profits.

**USG** and **Ryanair** were growth's under-performers this quarter.

USG, the largest wall-board manufacturer in North America, suffered this quarter on doubts about both residential and commercial real estate markets. Though I share such concerns, I continue to believe USG can survive the extended real estate bust and emerge as the strongest player when housing recovers for good.

Ryanair, Europe's largest and—by far—most efficient airline, was punished this quarter for managing shareholder capital prudently. Instead of paying too much for new aircraft from Boeing to continue its high-growth trajectory, it decided to significantly slow growth around 2012 and return cash to shareholders. When a company's share price declines due to good capital management, buying more shares comes to mind—and we did.

**Equity income portfolios climbed 9% this quarter and 13% for the year,** out-performing our benchmark by 9% and 8% respectively. Although we continue to lag our long term benchmark, it's by a decreasing amount over time. As you can see in the graph on the first page, our course could intercept and surpass the benchmark over the next year or two. To get there, I continued making adjustments this quarter to increase yield and lower risk. This will both improve returns and reduce the impact of market volatility. I look forward to reporting on this progress.

Equity income out-performance this quarter came from **Pfizer** and **Altria Group**.

Pfizer, the world's largest pharmaceutical firm, climbed 9.9% after successfully closing its merger with Wyeth. I think the market reacted positively both to projected merger efficiencies and to less onerous healthcare legislation likely to emerge from Washington. I don't claim to know the result of the healthcare debate, but I do think the market will react positively when the uncertainty surrounding such legislation ends.

Altria Group, the parent company of Marlboro cigarettes, Copenhagen smokeless tobacco, St. Michelle

Winery and part owner of Miller beer, climbed 10.2% this quarter as investors seemed to realize higher tobacco taxes won't kill tobacco profits. Federal tobacco taxes climbed 158% this year, an amount so high that many feared its impact on tobacco companies. Although the taxes did significantly impact tobacco volumes, smart companies like Altria were able to adjust and did better than most expected. Deciding to buy more last quarter paid off handsomely.

Equity income's under-performers were **Phillip Morris International** and **Treasury Bonds**.

Phillip Morris International is the non-U.S. arm of Altria Group, which was spun off last year to separate U.S. litigation liabilities from Altria's international tobacco operations. Phillip Morris International took a small dip as investors continued to fret that higher taxes in Japan will hurt profitability. Like with Altria above, I think these fears are over-blown. Guess what we bought more of this quarter.

I bought a large position in an Exchange Traded Fund (ETF) that holds 1-3 year Treasury Bonds. This security pays a nice dividend, is extremely high quality, and tends to climb when stock markets go down, providing us with a safe haven for cash while we wait for better opportunities. Not surprisingly, when the market is chasing risky investments, high qualities securities like this decline. It declined a small 1.25% over the quarter while paying a 2% dividend, so there is little cause for concern and it is performing as designed.

## Market and economic outlook

The S&P 500 climbed 6% this quarter and 26.5% for the year. Impressive, but the faster it climbs ahead of fundamentals, the lower my expectation for returns going forward: 5¼% annualized over the next 6 years. It's possible to do better than this, but you have to be invested in companies different than the market. We are.

| Projected annualized returns over the next 6 years | |
|---|---|
| S&P 500<br>(growth benchmark) | -0.8% to 11.3% |
| S&P-500-yield-plus-inflation<br>(equity income benchmark) | 3.8% to 6.8% |

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

**The U.S. economy returned to growth in the third quarter, 2.2%.** And, it looks like growth accelerated in the fourth quarter, perhaps to around 4%. U.S. factories are booking strong growth, housing prices are climbing, and commodity prices have rebounded strongly. There are good reasons to believe that world economic growth is back on track and running full steam ahead.

Except, of course, to worry-warts like me. **You pay me to worry for you, so let's just say I'm earning my keep.** The U.S. government threw a big party with around $2 trillion of stimulus, and every other government in the world pitched in their share to get things really rolling. They succeeded. But, like all parties, you have to wonder if things will get out of control, and, even if they don't, what happens when the bill comes due?

**It looks to me like we just exchanged our private debt crisis for a future public debt crisis.** You can't stop a hangover by drinking more booze; you just put off the inevitable. Property values need to be written down and prudent financial practices must be restored, but that doesn't seem likely to happen.

**I also don't understand the idea of bail-outs paid for by the prudent.** We bailed out the least efficient companies (GM, Chrysler, General Electric), and we're making the more efficient companies pay for it (Ford, United Technologies). We're bailing out imprudent borrowers (subprime) and lenders (Goldman Sachs, big banks), and we're making the more prudent borrowers (you and me) and lenders (small banks) pay for it. That seems to turn capitalism on its head, and will lead to easily predictable results.

**Although the outcome seems obvious, the timing is anything but.** The party will almost certainly get out of control, but when and in what way is unpredictable. As Warren Buffett put it, "The fact that people will be full of greed, fear or folly is predictable. The sequence is not predictable." In the long run, I expect several government debt crises, both local and national, and much higher inflation. But, in the short term, I expect the party to continue briskly.

**How do you prepare for such a scenario?** Carry a little extra cash to benefit from unforeseeable but inevitable dips, and buy quality companies with solid finances, adaptable management, necessary products and broad profit margins. Such companies will do better than expected in both good and bad times, especially at today's prices. Come what may, we're ready.

## Stimulus Withdrawal

**Like a patient addicted to pain medication, the world economy has become addicted to**

**leverage**—the use of debt to increase growth and consumption. When the pain medication was reduced last year due to frozen credit markets, the patient went into acute withdrawal. But, fear not, for Dr. Central Bank and Nurse Treasury were quick at hand with stimulus—low interest rates and federal spending—to prevent the patient from feeling the sharp pains of withdrawal. Unfortunately, such stimulus cannot be applied indefinitely; the withdrawal of stimulus may lead to stimulus withdrawal.

**There's no arguing whether government stimulus has worked so far**—the U.S. economy is doing better than almost anyone expected 9-12 months ago. Gross domestic product (GDP) grew 2.2% in the 3rd quarter and is predicted to have grown around 4% in the 4th. Since last spring, copper prices have doubled, oil prices are up 75%, and steel prices are up 60%, all indicating strong global demand for inputs to production. So far, this recovery looks like every U.S. recovery since the end of World War II. The patient that was so recently in critical care just signed up to run a marathon. How did it go from near-death to vigorous recovery?

**The reason, quite simply, is massive fiscal and monetary stimulus spread by the governments of the world.** The U.S. Federal Reserve unleashed over $1 trillion of monetary stimulus, mostly used to support ailing financial institutions. The U.S. Treasury and Congress sponsored almost $800 billion in fiscal programs like cash for clunkers, new homebuyer rebates, infrastructure projects, and business tax incentives. European, Chinese and Japanese central banks and governments have opened their monetary and fiscal floodgates as well. Given this amount of stimulus, there's little wonder why the patient is up and running again. But, can these stimulus levels be maintained indefinitely?

The short answer is "no." **Even governments don't have unlimited resources or borrowing ability.** The U.S. government is printing money and issuing debt at unprecedented levels, and maintaining or increasing that pace would almost certainly lead to dollar collapse, high inflation, and skyrocketing interest rates. Continued or increased stimulus would almost certainly put the patient back into the emergency room. Japanese and European governments are in similar situations—they too are stimulus limited. The Chinese government is in a slightly better situation but can't alone produce enough stimulus to make up for everyone else's withdrawal. Knowing stimulus can't be maintained or increased, it's clear the world economy must recover its vigor aside from stimulants. Is this happening?

**It's clear a recovery is in process, but it's not clear it will advance far enough before stimulus must be withdrawn.** Consumers, who account for almost 70% of the U.S. economy, are saving more and spending less, but this is bad for short term economic growth. Credit, which usually produces strong rebounds after economic contraction, is hard to come by for businesses and consumers. Businesses, except financials, are generally in strong financial positions, but without fundamental demand from consumers it's unclear how 30% of the economy can sustain 100%. What happens if stimulus is withdrawn before the patient recovers on his own?

In a word: withdrawal. When Norwegian and Australian central banks started removing stimulus in late October, the U.S. stock market was down 4%; world markets were down more. If stimulus withdrawal from countries with a combined population of 27 million (Norway and Australia) can cause markets to drop 4%, what will happen when the stimulus of a combined population of 2.29 *billion* (U.S., Europe, Japan and China) withdraws? It could be ugly. And, **if the patient goes into withdrawal again, doctors and nurses won't have enough stimulants to ease the pain.**


This is not a prediction, just a possibility. Governments of the world may be able to provide more stimulus and for longer than I predict. The world economy may regain health on its own before stimulus is removed. But, it's best to be prepared. **If, or when, stimulus is removed, the market may take a big hit.**

**Regardless of the outcome, I think we're well positioned to handle either growth or a declining market scenario.** I've bought companies likely to grow earnings even if the economy does poorly. Our companies also have less financial and operational risk than average. If the economy continues to burn rubber, we'll likely under-perform, but not by much. If the economy tanks, we're likely to significantly out-perform. Given the economic situation highlighted above, I think the odds are stacked in our favor.

# Athena Capital Management

## Investment Spotlight: Canadian Natural

**Canadian Natural's most significant asset is 115,000 acres of land with 16 billion barrels of oil**—its Horizon Oil Sands project. Located in Alberta, Canada, the Athabasca Oil Sands are extremely heavy crude oil trapped in sand, and make Canada the world's second largest oil reserve after Saudi Arabia. The oil/sand mixture is messy and requires a lot of energy to "melt" oil out of sand, which is why it's only tapped with higher oil prices. Only 6-8 billion barrels of Canadian Natural's 16 billion are economically recoverable given current technology, but that could last 30 to 150 years compared to reserve lives of 10 to 15 years for the largest oil companies. It's an extremely valuable asset and what initially interested me in Canadian Natural.

RH 400 Shovel Moving Dirt into 797B Mining Truck

**Canadian Natural is an oil and natural gas exploration and production company based in Calgary, Alberta.** It operates in Western Canada, the North Sea, and offshore Western Africa (Gabon, Cote d'Ivoire) with an intense focus on low costs and high returns on equity. It produces some of the lowest cost oil and natural gas in North America because of its detailed approach to cost containment in drilling, production and corporate overhead. It generates high returns on equity by flexibly switching from producing natural gas to heavy oil to light oil depending on relationships between production costs and ever-changing market prices. Such switching may sound basic for an oil and gas business, but I've never seen a company do it so competently.

**Canadian Natural's gem is its oil sands project.** Phase 1 of 3 ramps production to 110,000 barrels of oil per day. That would increase Canadian Natural's current production by over 20%. Phase 2 and 3 will extend production to 230,000 and 500,000 barrels per day, effectively doubling production. The project's value derives from the fact that it's a huge reserve of oil in a politically stable area of the world. The downside is a cost of production 8 times higher than in the Middle East and 50% more than world average. Canadian Natural's advantage, compared to other oil sands projects, is its low cost of producing *the* key input for oil sands: natural gas to "melt" oil out of sand.

**Such an ambitious project comes with both risks and opportunities.** The risks are low oil prices (making production unprofitable), high tax regimes in Canada and Alberta, political backlash against "dirty" energy, and carbon emission limitations. In my opinion, such risks are outweighed by opportunities, such as high and rising oil prices (supply hasn't kept up with demand), and the ability to hedge against inflation (likely) and political risks (Iran attacking Israel). It's prudent to hedge against these risks even while hoping they don't occur.

**Management at Canadian Natural is excellent.** Its executives and board members own 3.7% of the company—$1.5 billion worth. Its top four (chairman, two vice chairmen, and president) represent over 90% of that ownership and average more than 25 years in the Canadian oil and gas business. We have a well-seasoned team with a successful track record working for us. Perhaps most importantly, management is properly incentivized to perform where it matters most to shareholders—return on equity and low cost production. Canadian Natural's goal is 15% per annum return on equity. Because management has no control over the end price of oil or natural gas, the most logical measure of effectiveness is cost of production. Executives receive bonuses when production and corporate overhead costs are kept below very aggressive benchmarks. The right combination of ownership, experience and compensation makes Canadian Natural unique.

**Valuing Canadian Natural is complicated because energy prices are volatile.** If I knew oil and natural gas prices over the next 10 years, and the company's production costs and volumes with precision, valuation would be a piece of cake. That's not possible, but I can make reasonable assumptions and calculate potential returns. Canadian Natural produced $4.69 per share of free cash flow with $50 oil and $3.50 natural gas in the 2nd quarter this year. Though I believe $65 oil and $5 natural gas more likely, I use lower estimates to provide a margin of safety. With these modest assumptions, free cash flow yields, relative to our average purchase price of $46.64, would be 13%, 16% or 23% (depending on whether oil sand production ramps to 110,000, 230,000 or 500,000 barrels per day). Such returns would be very satisfactory compared to 5¼% from the S&P 500.

Canadian Natural offers unique assets, low cost production, a hedge against risks, properly incentivized managers, and a low stock price relative to likely earnings over the next 5 years. To me, that's an offer I'll eagerly take.

## Until next quarter

**2009 was a wild ride, but very profitable.** We made money despite the downturn because we held on to under-valued securities mis-priced by the market. When the market plunged, we bought at generational-low valuations. When the market rallied, we sold what climbed and bought high quality companies that didn't. Volatility is the friend of the value-focused investor.

**Thank you for enduring this difficult period with patience and trust.** Most of the people I've talked to over the year assumed I was having a terrible couple of years because markets did so poorly. I've happily related that everything worked out well because my clients were patient and well-informed. You didn't panic; you contributed more capital. And that's why we'll build significant value together.

**If you know someone unhappy with their investment results, please put them in contact with me.** I'm looking for patient, long term oriented clients who are looking for better than average returns (and have at least $100,000 to invest). Many investors have learned that their investing experts aren't really experts, or that diversification isn't the end-all cure to investment volatility. If you know anyone like that, put them in contact with me.

**If you get a chance, visit my blog: www.mikerivers.blogspot.com.** I've received a lot of positive feedback recently that my blog is informative, interesting and fun to read. If you find it any of those, I will consider it a success.

**Feel free to call or email with any questions.** It's great to hear from you, so don't hesitate to contact me.

Respectfully yours,

Mike

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