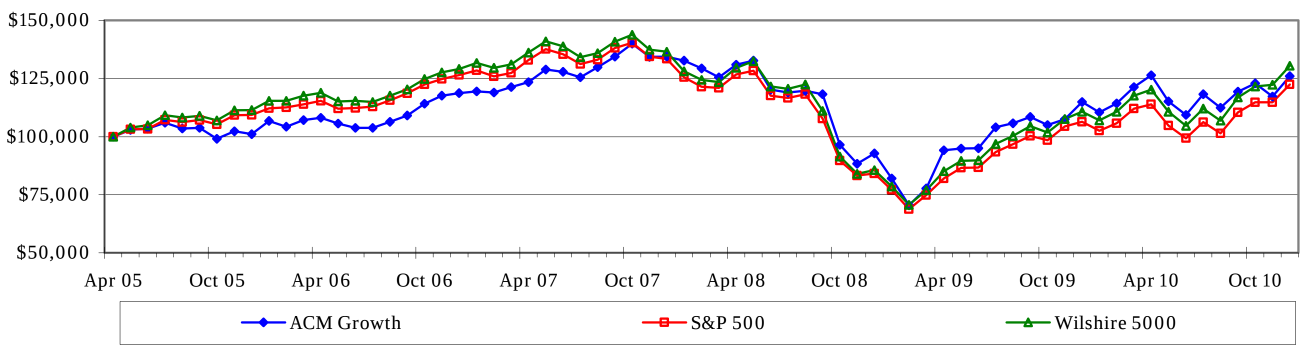
Athena Capital Management

Cumulative Growth Performance

Performance as of 12/31/10	Year to date	1 year	3 years	5 years	Since inception (4/30/05)
ACM Growth	9.72%	9.72%	-6.28%	24.77%	26.04%
S&P 500	15.06%	15.06%	-8.32%	11.99%	22.39%
Wilshire 5000	17.86%	17.86%	-4.42%	17.11%	30.51%

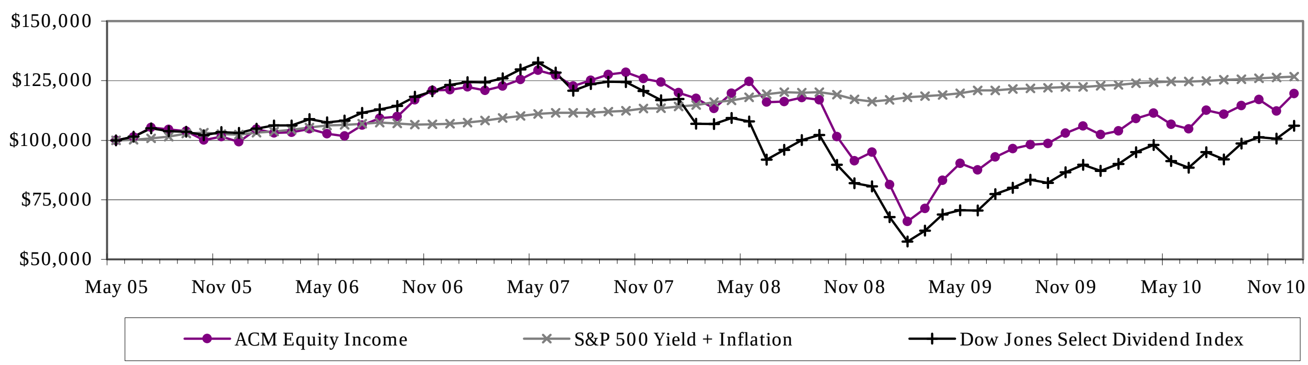
Comparison of the change in value of $100,000 investment in ACM growth versus S&P 500 and Wilshire 5000



Cumulative Equity Income Performance

Performance as of 12/31/10	Year to date	1 year	3 years	5 years	Since inception (5/31/05)
ACM Equity Income	12.80%	12.80%	-3.96%	20.42%	19.55%
S&P 500 yield + inflation	3.45%	3.55%	11.70%	23.80%	26.70%
Dow Jones Select Dividend Index	18.32%	18.32%	-9.24%	2.91%	6.05%

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 14, 2011

2010 ended with a bang—the best 4th quarter for the market in almost two decades—thanks to the Federal Reserve's endorsement to speculate. Our portfolios fared well, too, rising at an annualized rate of 24%, but didn't experience the same over-enthusiastic growth as the market.

In this quarter's letter, I discuss our performance; my view on markets and the economy; why I think the headwinds we've faced over the last six years will likely become favorable tailwinds; and our investment in an out-of-favor telecommunications company: Verizon.

New benchmark

You may notice a new benchmark on your performance report and the first page of this letter: the Dow Jones Select Dividend Index. It's now included for all clients with some sort of income focus. Though I think the S&P 500 Yield Plus Inflation is the best long run benchmark for equity income clients, our new benchmark will more closely mirror shorter term portfolio fluctuations (it includes a basket of dividend paying stocks). More specifically, whereas the S&P 500 Yield Plus Inflation does *not* reflect price fluctuations (i.e. changes in principal value), this new index *will*.

On your performance reports going forward:

- Aggressive growth and growth clients will continue to be compared to the S&P 500 and Wilshire 5000.
- Growth clients with some focus on income will be compared to the S&P 500 and Dow Jones Select Dividend Index.
- Equity income clients will be compared to the Dow Jones Select Dividend Index and the S&P 500 Yield Plus Inflation.

If you have any questions about the new index or how I report your performance, please feel free to contact me at any time.

Performance this quarter

Growth portfolios out-performed the S&P 500 over 3 & 5 years and since inception, but under-performed over the quarter, year to date and 1 year periods. This was yet another quarter—like much of the last six years (see Headwinds article below)—when low quality, high-priced, high-momentum stocks out-performed high quality, low-priced, safe investments. In taking a more prudent, long-term approach (almost certain to out-perform over the long haul), our portfolios missed out on the market's steroid high. Rest assured, prudence will be rewarded in time.

Growth's out-performance this quarter came from **Comcast** and **Microsoft.**

Comcast is inching closer to completing its purchase of NBC Universal from General Electric, and the market seems to be looking more favorably on that prospect. I continue to be impressed by Comcast's earnings power apart from the acquisition. If the merger is finally completed, Comcast will be free to use its prodigious cash flow to purchase shares or increase its dividend (risky to do while in merger limbo). This could give Comcast shares more momentum in early 2011.

Microsoft impressed Wall Street with its big earnings last quarter from its Windows and Office franchises, then further surprised with the strength of its Server & Tools segment and strong Kinect sales (a motion control sensor for its Xbox video game console). Microsoft may not be as dominant as it once was, but it continues to generate tremendous cash flow. Though considered passé by many, its low price to fundamentals is likely to yield additional upside surprises in the future.

S&P 500 VIX futures and **POSCO** were growth's under-performers during the quarter.

Purchasing S&P 500 VIX futures ended up looking like buying fire insurance and not having the house burn down—we paid our premiums but didn't need the protection. When it dawned on me that the insurance was unnecessary and too expensive, I cancelled our policy by selling the shares. Lesson learned: the Federal Reserve has a stunning power to promote speculation.

POSCO, a Korean steel manufacturer, declined over concerns about Asian demand for steel and war-like aggression by North Korea. Neither of these concerns will disappear in the short run, but over the long haul the market is likely to be pleasantly surprised by stronger than expected steel demand. North Korea's saber rattling, though a short term negative, may give us profitable opportunities to acquire more of an outstanding company on the cheap.

Equity income portfolios out-performed the S&P 500 Yield Plus Inflation over the quarter, year to date and 1 year, but lagged over 3 & 5 years and since inception. Each quarter our performance gets closer to catching our long term benchmark, but with significantly less risk than the stock market. With a 3.6% dividend yield and growth to overcome inflation's

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erosion of spending power, we're well positioned to continue closing the gap going forward.

Equity income out-performance this quarter came from **Comcast** and **Frontier Communications**. Please see my comments above regarding Comcast.

Frontier is a rural telecommunications company formed by the merger of the legacy Frontier Communications with the spin-off of Verizon's rural business. The new company is generating more cash flow than the market expected and may continue to benefit from cost reductions and service improvements after its recent merger. It wouldn't surprise me to see the market further pleased by how well Frontier is managed.

Equity income under-performance came from **S&P 500 VIX futures** and **Sears**. Please see my comments above regarding VIX futures.

Sears hit the *tenth* quarter in a row of being an out- or under-performer. This time, it under-performed due to concerns about consumer spending generally, and a loss of appliance market share specifically. To judge these issues, we'll have to wait for Sears' earnings report covering the all-important holiday season (when many retailers make more money than the rest of the year). Sears may soon hit its eleventh quarter in a row, this time in the 0ut-performance list.

Market and economic outlook

The S&P 500 climbed 10.8% in the fourth quarter and 15.1% in 2010. Though robust performance is welcome, it results in a stock market 20% above fair value and destined to provide paltry 3.5% annualized returns over the next 6 years. I believe that's an easy target to beat.

Projected annualized returns over the next 6 years	
S&P 500 (growth benchmark)	-2.5% to 9.5%
S&P-500-yield-plus-inflation (equity income benchmark)	3.4% to 6.4%

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

The economic and market slowdown last summer turned out to be temporary. New claims for unemployment insurance are diving, manufacturing activity is picking back up, banks are increasing lending, and railroad loadings are inching toward new highs. The economy seems to be back on its feet, and the stock market is back above pre-crisis levels.

All is not rosy, however. The housing market is still bumping along the bottom, debt problems in Europe, Japan and the U.S. hang over markets, commodities are back to new highs, and bonds have been taking a beating. These are not trivial issues.

This tug-of-war between positive and negative developments will most likely lead to a strong stock market in the short term and a difficult one in the intermediate to long term. Predicting the timing of that switch will prove impossible, so **I'm sticking to what works—buying out-of-favor businesses at low prices relative to underlying fundamentals.** It won't work quickly, but it does work nicely over time.

Headwinds to Tailwinds

Reviewing our performance since inception, it appears we've barely kept pace with benchmarks. But, if you better understand the unusual circumstances of the last six years, you may view our results more favorably. That is, **we've been invested in large, cheap stocks during a period of unusual under-performance for that group.** This headwind will end, though, providing us with a nice future tailwind.

To understand this unusual situation, I'll start by assigning stocks to groups by 1) size—Small and Large—and 2) valuation—Value is cheap and Growth is expensive. The table below shows stocks in the resulting four groups.

Small and Cheap: **Small Value**	Large and Cheap: **Large Value**
Small and Expensive: **Small Growth**	Large and Expensive: **Large Growth**

Benchmark returns can then be separated by group and analyzed independently. This is important because **each group goes in and out of favor over time, frequently showing *years* of out- and under-performance.** For instance, Large Growth did very well from 1995 to 2000, but dreadfully from 2000 to 2005. I think our dominant investment group—Large Value—has been in one of those poor periods, and thus has distorted our long term relative returns.

In the table below, column II illustrates what I consider the normal order of things: returns from 1928 to 1999 ranked in order of performance by the four groups described above. ('28-'99 shows returns from one market peak to another, a proper way to examine long term returns.) As you can see, **Small Value historically generated the highest returns,**

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followed by Large Value, Small Growth, and finally Large Growth. In contrast, column III reveals how the last six years have differed from the historical record.

	Annualized Returns			
I	II		III	
Groups	**70-years: 1928 to 1999**		**4/30/05 to 11/30/10**	
Small Value	14.6%	Best	6.3%	Better
Large Value	12.7%	Better	1.2%	Worst
Small Growth	10.6%	Poor	8.1%	Best
Large Growth	10.4%	Worst	4.6%	Poor
ACM Growth			2.9%	

Source: Ibbotson Associates, Wilshire Associates

Several observations spring from this table:

a) Small Growth—the second worst historical performer—has curiously been the *best* group over the last six years
b) Large Value—usually second best—has strangely been the *worst* by a wide margin
c) Small—normally *mildly* better than Large—has been *hugely* better
d) Value—characteristically *much* better than Growth—has been the *opposite: much worse!*

As you know, I tend to be a Value investor (it has roundly beaten Growth over the long run). More narrowly, I buy Large or Small within Value depending on whichever is cheaper. Six years ago, I started transitioning from buying the cheapest—Small Value—to what was becoming cheaper—Large Value. **In the table above, you can readily see the headwinds we've faced over the last six years with Large Value investments** (1.2% versus 6.3% on average from the other groups).

(Geek's note: If you want to know why we barely beat the S&P 500 since inception, look no further than the headwind of how much Large Growth beat Large Value: 3.4%. If you want to know how we lost to the Wilshire 5000, look no further than the amount by which Small Growth beat Large Value: 6.9%)

With stiff headwinds for the Large Value group, how did we do as well as we have since inception? 1) Stock-selection and 2) variations from the Large Value group. **Though group performance explains headwinds and tailwinds, it's not destiny.** Our cheaper, better quality picks within the Large Value group out-performed the less cheap, lower quality picks we didn't own. Also, some of our investments were picked from or drifted outside the Large Value group. Though small, such variations from Large Value diminished the headwinds we faced.

Which brings me to the good news: abnormal results from Large Value and Small Growth never last long, and will most likely end soon. At that point, **mean reversion—the extremely strong tendency of markets to shift back to average—will swing our headwind to a tailwind**, assisting results going forward. Such reversals can't be marked on a calendar, but are inevitable.

Investment Spotlight: Verizon

Perhaps you're as irritated by Verizon's ubiquitous "Can you hear me now?" commercials as I am. Perhaps investing in the former Ma Bell company seems as exciting as watching paint dry. Perhaps you've spent frustrating hours waiting for service from Verizon as a customer. Despite these issues, **Verizon is a solid franchise generating tremendous cash flows for investors.**

Verizon is one of the two largest telecommunications companies in the United States (AT&T being the other). Verizon resulted from the merger of Bell Atlantic with NYNEX, then GTE, then MCI, then ALLTEL (investment bankers must ***love*** Verizon). It offers both wireless (cell-phone) and wireline (voice, broadband, video) services to consumers, businesses and the government.

Verizon Wireless is the largest cell phone service provider in the U.S. by customers—93.2 million at last count. Verizon Wireless offers both prepaid and postpaid plans and a national footprint across the U.S. To complicate matters, Verizon doesn't own 100% of Verizon Wireless. In 1999, Verizon needed a partner with cell phone expertise to help build its wireless network, so it partnered with Vodaphone (the European cell phone company). As a result, Verizon owns 55% and Vodaphone owns 45% of Verizon Wireless.

The wireless side of Verizon has long been considered exciting because cell phone growth exploded over the last decade. But, as the wireless

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market has come closer to saturation, with 93% owning mobile phones, investors have abandoned Verizon. I think this attitude is misplaced for three reasons.

First, smart phone usage is only 25-30% and destined to grow to the 90% level over the next decade. Not only do smart phones generate higher base revenues, but they also open up huge new markets for phone usage besides phone calls (text messaging, internet surfing, applications, games, music, etc.). I believe smart phones will allow Verizon to experience continued growth, especially with the roll-out this year of its 4th generation (4G) mobile network that sports speeds 10x today's 3rd generation (3G) phones.

Second, as Verizon Wireless completes the build-out of its 4th generation network, its capital expenditures will decline—precisely as more and more people with higher cost plans are adopting smart phones. **I think the expansion of revenues and reduction in costs will strongly drive profit growth for years to come.**

Third, Apple's iPhone is coming to Verizon's network in the first quarter of 2011. When this occurs, it will allow Verizon to expand market share by taking customers from AT&T—its chief mobile phone rival.

Verizon's other business, wireline, provides communication services in: New York, Massachusetts, Rhode Island, Pennsylvania, New Jersey, Delaware, Maryland, Virginia, Florida, Texas, California and West Virginia. These services include voice, broadband video and data, network access, long distance to residential and small business customers, and network services and communications solutions to medium and large businesses. In 2004, Verizon started building its fiber optic services (dubbed FiOS) network to replace slower copper wires with faster fiber-optic cable. This build-out is almost complete.

Verizon's wireline business is not seen as exciting by investors, and for good reason. The legacy phone business is disappearing due to mobile phone use and competition from cable companies, and this is causing revenues and profits to decline—wireline is barely breaking even. I don't think the future will look like the past, though, for two reasons.

First, though it's a small part of the wireline business, **FiOS TV and broadband internet is growing very quickly.** In time, legacy wireline business will fade and FiOS will take over and continue growing with the economy and household formation.

Second, the FiOS build-out is almost finished, so capital expenses will decline even faster than revenues. And, this fiber build-out will dramatically lower costs and increase reliability of both wireless and wireline businesses. You read that right: the fastest, most reliable wireless networks are those that get mobile voice and data traffic onto wires as *quickly* as possible. The FiOS build-out will reduce costs for wireless and wireline sides of the business as revenues for both grow with the economy.

Verizon's valuation looked particularly compelling at our purchase price. This valuation is complicated by the fact that Verizon recently spun off much of its rural phone business to Frontier Communications in July 2010. To understand why it was cheap and what we received, it's necessary to combine the economics of both companies. Our average purchase price for Verizon was $30.85, and for that we received 1 share of Verizon and 0.24 shares of Frontier. The Verizon part had a 15% free cash flow yield and a 7% dividend yield; the Frontier part had a 22% free cash flow yield and a 10% dividend yield. Even assuming no growth from either company (which I believe is unlikely), those are very high cash flows and dividend yields. Factor in likely 6% growth—along with the rest of the economy—and we're walking in tall cotton.

Like Rodney Dangerfield (dating myself?), Verizon doesn't get much respect. Its wireless and wireline businesses will never generate the jazz of Apple or Google, but **solid underlying economics combined with a rock-bottom price, substantial cash flows and high dividends** makes for a compelling investment story to me. "Can you hear me now?"

Until next quarter

I'll readily admit, the last six years have been unusually frustrating for me—**I'm used to more significantly beating the market.** I suppose I should be happy to beat more than 80% of money managers (less than 20% even *match* market returns over long periods), but I'm

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not. I know we can do better, and it's only a matter of time before we see the results.

Knowing market history intimately, it's easy to be patient. You, however, don't eat, drink and sleep market history as I do, so I appreciate your patience all the more. Seth Klarman, an Investing Great most have never heard of, has repeatedly said that **patient, long-term clients are the most important ingredient for great results.** Lucky for me, you exemplify these virtues.

Please visit my blog (www.mikerivers.blogspot.com) and website (www.athenacapital.biz) if you get a chance. **As usual, I welcome your comments, questions and feedback.** If you know someone interested in services like mine, feel free to send them there, too.

Respectfully yours,
Mike

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