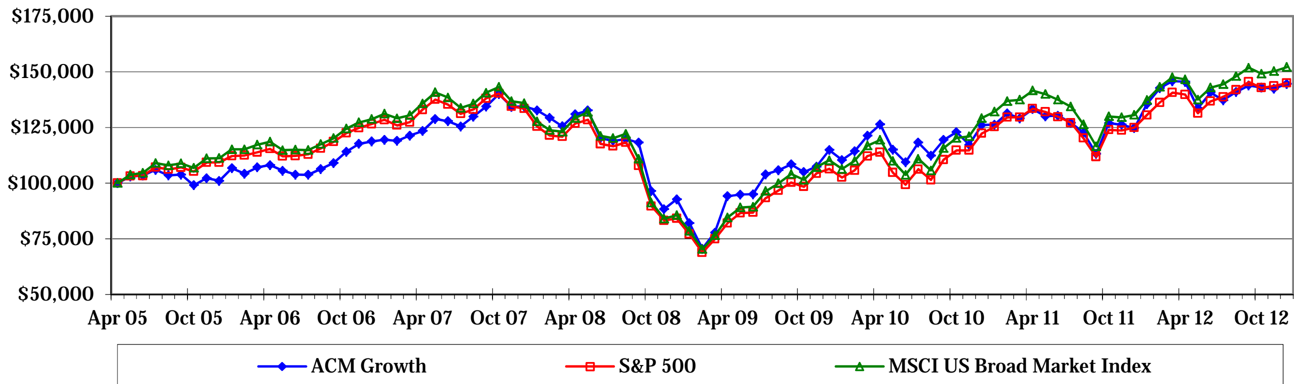
ATHENA CAPITAL MANAGEMENT

Cumulative Growth Performance

Performance as of 12/31/12	Year to date	3 years	5 years	7 years	Since inception (4/30/05)
ACM Growth	15.91%	25.92%	7.56%	43.19%	44.65%
S&P 500	16.00%	36.31%	8.60%	32.66%	44.98%
MSCI US Broad Market Index	16.44%	38.04%	11.91%	36.74%	52.16%

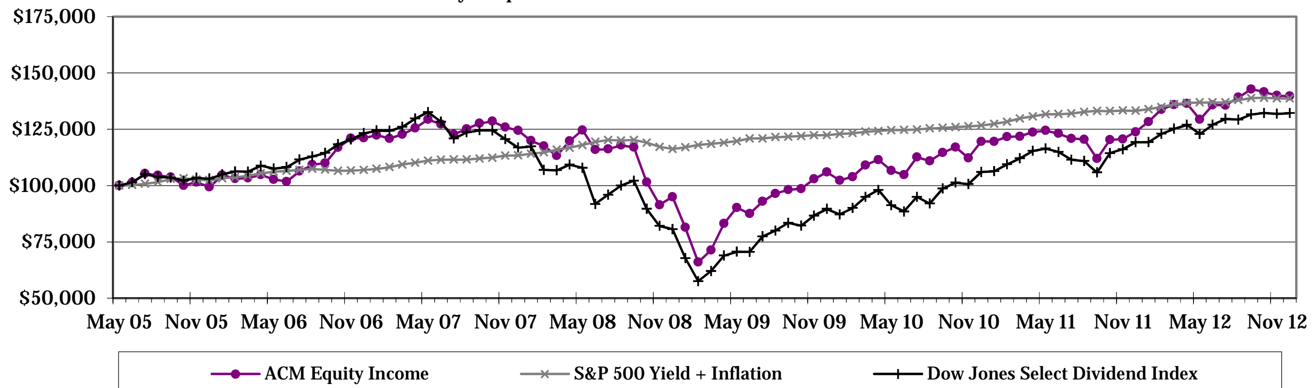
Comparison of the change in value of $100,000 investment in ACM growth versus S&P 500 and MSCI US Broad Market Index



Cumulative Equity Income Performance

Performance as of 12/31/12	Year to date	3 years	5 years	7 years	Since inception (5/31/05)
ACM Equity Income	12.80%	31.83%	12.23%	40.72%	39.71%
S&P 500 yield + inflation	4.07%	13.30%	22.22%	35.46%	38.64%
Dow Jones Select Dividend Index	10.84%	47.43%	13.09%	28.23%	32.14%

Comparison of the change in value of $100,000 investment in ACM equity income versus S&P 500 yield plus inflation and Dow Jones Select Dividend Index



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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January 16, 2013

Despite remarkable economic and political headwinds, the stock market gained 16% in 2012, while our portfolios grew just slightly less. Any year you receive double digit returns is quite nice, and considering the seemingly dire circumstances of 2012, such growth was welcome indeed.

This letter will cover our investing results; my view on markets and the economy; and why savings rate has a bigger impact on your results than anything I can do.

Performance this quarter

Growth portfolios out-performed the S&P 500 over the 7 year period, but under-performed over all other periods. Some of our holdings, particularly housing related, grew exceedingly well this quarter, while others, particularly technology, did unusually poorly. This reflects high optimism about the housing recovery (which was heavily doubted 1 ½ years ago), and high pessimism about personal computers (where almost no one, today, can perceive *any* upside). As emotions diminish over time, though, I expect the market to refocus on underlying fundamentals and our results to correspondingly improve.

Growth's out-performers this quarter were **USG** and **Ryanair.**

USG, a building products company, jumped 28% as the housing market and demand for USG's products continued to recover. Although I think USG still has more room to grow, I used its price run-up as a chance to reduce our position and redeploy the proceeds into better opportunities.

Ryanair, a discount European airline, moved up in response to good growth in passenger volumes and ticket prices, and less bad news about Europe's economic problems. I cannot accurately guess what will happen in Europe, but I am confident Ryanair's underlying business will continue to grow profitably over time.

Microsoft and **Hewlett-Packard** were growth's under-performers this quarter.

Microsoft declined as investors soured on the prospects of its Windows 8, Windows Phone 8 and Surface products. I think the market is overly focused on consumer products and under-focused on Microsoft's business side. Only time will tell, but we own a very profitable company with strong products at a cheap price, and that tends to work out well over time.

Hewlett-Packard sank on a write-down of its investment in a software company (not done by current management). Beneath that write-down is a business with $120 billion in annual sales and under-appreciated earnings power. Its turn-around will likely take time, but has the potential to be very profitable for investors focused beyond one quarter or year's results.

Equity income portfolios out-performed our long-term benchmark over all periods except for 5 years. Our equity holdings ended up hurting the portfolio this quarter, but not by enough to undermine our record for the year. I don't perceive changes in the underlying value of such equities, just short term market fluctuations. With a 3.7% yield and a good balance between fixed income and dividend paying equities, I think we are well positioned to generate growing income.

Equity income saw out-performance from **Comcast** and **M&T Bank**.

Comcast continues to benefit from strong cable operations and improvements in its NBCUniversal subsidiary. Although its competition is stiff, Comcast is very well positioned for continued growth and dividends over the intermediate to long term.

M&T Bank, a northeastern bank holding company, proved that its acquisitions of Wilmington Trust and Hudson City Savings Bank were wisely done. When a conservatively run bank buys troubled banks at cheap prices, good things happen for shareholders.

Frontier Communications and **Microsoft** were equity income's under-performers this quarter. Please see my comments above on Microsoft.

Frontier Communications announced improved metrics along almost every dimension this quarter, but its price went down. The only explanation I can offer is that short sellers (who bet a company's price will decline) have borrowed 22% of Frontier's shares. As long as Frontier continues to perform well, the shorts will eventually go away and its price will recover. In the meantime, Frontier's 9% dividend yield is pleasant consolation.

Market and economic outlook

The S&P 500 lost 0.37% this quarter, which means my return projections improved *just* slightly. This increase is too small to become excited about, so it's wise to continue expecting low single-digit returns from the market over the next six years. I'll do my utmost to best that expectation with careful security selection.

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Projected annualized returns over the next 6 years	
S&P 500 (growth benchmark)	-2.9% to 9.0%
S&P-500-yield-plus-inflation (equity income benchmark)	3.7% to 6.7%

How do I arrive at these numbers? Visit "Athena Capital Articles" at www.athenacapital.biz to see my 2Q2005 article.

Global markets and economies are unsightly. China is rebounding, but depends on the same debt financing used by the U.S. and Europe to prop things up between 2003 and 2007 (and we know how that ended). Europe continues to wallow with high unemployment, inflexible labor markets, too much debt, and bureaucratic can-kicking. In the U.S., we're still growing at just above stall speed, but with spending declines almost guaranteed to cause deceleration in 2013.

If that synopsis depresses you (and I don't see how it can't), **please keep in mind that the investment outlook was worse in 2000 and 2007.** As unpleasant as those memories may be, you can find some consolation that those terrible investment outcomes are behind, not in front, of us. If that doesn't help (and I'd be surprised if it did), then keep in mind that good businesses bought at reasonable prices always have and always will produce investment growth and income *over the long term*.

If nothing in the last paragraph assuaged the feelings I elicited in the prior paragraph, then **perhaps my next section *will* make you feel better.** Though we can't control our external circumstances, we can set ourselves up for long run investment success by focusing on something entirely within our control—savings.

How Much You Save: The *Biggest* Impact on Your Investment Plan

As much as I love to dwell on annualized returns, the reality is that ***your* investment growth depends much more on *you* than me.** Put differently, I can do an exemplary job managing your money and never have as large an impact on your portfolio as the amount you save into your account. I'll make this point clear with the help of a recent paper published by the Putnam Institute.

Putnam's study started with a base case scenario for judging investment plan alternatives. Specifically, they assumed an investor who:

- Started saving at 28 years old, in 1982, and saved until 2011
- Saved 3% of income each year (50% matched by the employer up to 6%)
- Received 3% raises each year
- Implemented a conservative asset allocation (30% stocks, 60% bonds, 10% cash)
- Did no rebalancing to maintain beginning allocation
- Picked mutual funds in the worst 25% of performance over the prior 3 years and stuck with them over the entire 29 year period

As you can see from the list above, there are **four key variables in an investment plan:**

1. Savings rate
2. Asset allocation
3. Account rebalancing
4. Investment selection

I'll examine each one in turn.

1. Savings rate refers to the percentage of your income you save each year. If you save 3% of your income each year ($3,000/year or $250/month on a $100,000 per year salary), you have a 3% savings rate. If you double those savings, you'd have a 6% savings rate ($6,000/year or $500/month on $100,000 annual salary). How does altering the savings rate impact investment results?

3% savings rate	$136,400 base case scenario
4% savings rate	$181,800 33% more money
6% savings rate	$272,700 100% more money
8% savings rate	$334,000 145% more money

The lesson: **the more you saved, the larger your resulting investment portfolio.** The more important point: this boosts your final outcome *much* more than asset allocation, investment selection or rebalancing, as I'll show below.

2. Asset allocation refers to how you allocate your money between stocks, bonds, commodities, real estate, cash, etc. For example, an aggressive allocation puts all your money in stocks, and a conservative allocation invests mostly in bonds, real estate and cash. How would investing more or less aggressively change the outcome?

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Conservative allocation: 30% stocks/70% bonds & cash	$136,400 base case scenario
Balanced allocation: 60% stocks/40% bonds & cash	$150,400 10% more money
Growth allocation: 85% stocks/15% bonds & cash	$159,200 17% more money

The lesson: **the more you invested in equities, the better your results** (even with equities unusually under-performing bonds & cash over much of the period). But, those changes have much less impact than savings rate: boosting your savings rate from 3% to 4% per year had *twice* the impact of going from a conservative to a growth allocation.

3. Account rebalancing means selling what goes up and buying what goes down to maintain asset allocation. For example, if you aim for 60% stocks and 40% bonds, and the stocks go up 20% and bonds stay flat, then you'd have 72% stocks and 28% bonds. To rebalance your account, you'd sell 12% of your stocks and use the proceeds to buy bonds, thus restoring the 60%/40% allocation. How would rebalancing have affected the plan?

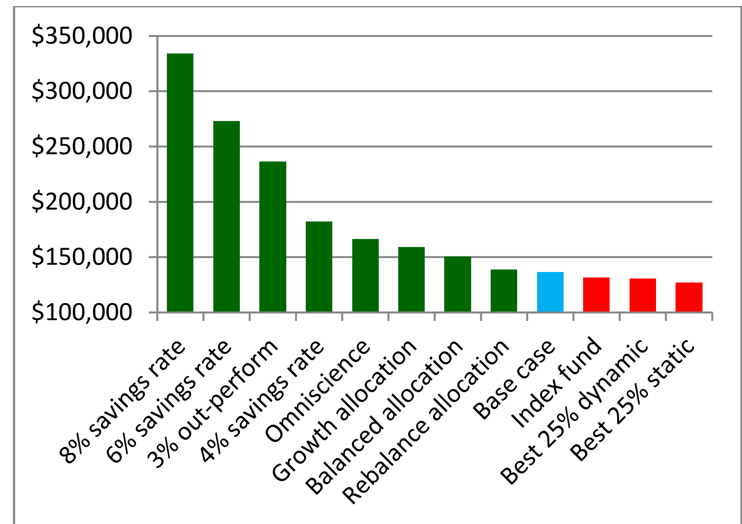
Don't rebalance	$136,400 base case scenario
Rebalance quarterly	$138,500 1.5% more money, 27% less volatility

The lesson: **rebalancing reduces how much your portfolio bounces around**, but that reduction isn't much (for example, 27% less volatility means seeing a $100,000 portfolio *briefly* bottom out at $63,000 instead of $50,000). And, rebalancing provides a tiny benefit to how much money you end up with—miniscule in comparison to boosting your savings rate.

4. Investment selection varies what *specific* securities you buy within your asset allocation. For instance, should you own Vanguard's index mutual fund or FPA Capital's mutual fund; Apple or Nokia stock; Exxon or BP bonds; gold or silver; and so on? How would changes in investment selection have impacted the plan?

Select the **worst** 25% of funds over the prior 3 years and **stick with it** 29 years	$136,400 base case scenario
Select the **best** 25% of funds over the prior 3 years and **stick with it** for 29 years	$126,700 7% *less* money
Select the **best** 25% of funds over the prior 3 years and **change** every 3 years	$130,600 4% *less* money
Select an **index fund** and **stick with it** for 29 years	$131,500 3.5% *less* money
Omniscience: know ahead of time the best 25% funds and change every 3 years	$166,200 22% more money
Athena Capital goal: **3% annualized out-performance**	$236,400 73% more money

The lesson: surprising to most, **superior investment selection had a much lower impact than savings rate,** and investor attempts at better selection tend to yield worse results than sticking with initial choices. As the last line of the table above shows, even if we beat the market by 3% per year over 29 years—a heroic accomplishment putting us in the top 5% of all investors—we'd have less impact than bumping your saving rate from 3% to 5.2% (raising your savings from $250/month to $433/month on a $100,000 salary).



The graph above nicely summarizes this article. The blue bar represents the base case scenario, and the green and red bars represent better and worse results relative to that base. **Savings rates have the biggest impact, followed by outstanding security selection, and then asset allocation.** Attempts to improve results through security selection—other than picking outstanding performers (a *very* difficult task)—generated worse results than selecting the worst 25% performers of the prior 3 years. The clear winner is

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beyond my control (but not out of my influence—that's why I'm writing this section!), and fully in yours.

UNTIL NEXT QUARTER

Strong economic growth and booming investment markets are probably not in our short term future. But, this need not depress us because we control our investment future through:

1. Savings rate
2. Investing for the long term

The first is up to you. The second is my full time passion regardless of how much you save.

I continue to be optimistic about the long run. I say this not as some blathering Pollyanna, but as someone who vigilantly studies the investment markets. Droughts *never* last. And when they end, those with seeds in the ground generate an immense harvest. As long as we keep planting the right seeds in the right places, I am extremely confident the rains will come and we'll yield a bumper crop.

If you have any questions, comments or feedback for me, please feel free to contact me any time. I always enjoy hearing from you.

Respectfully,
Mike

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