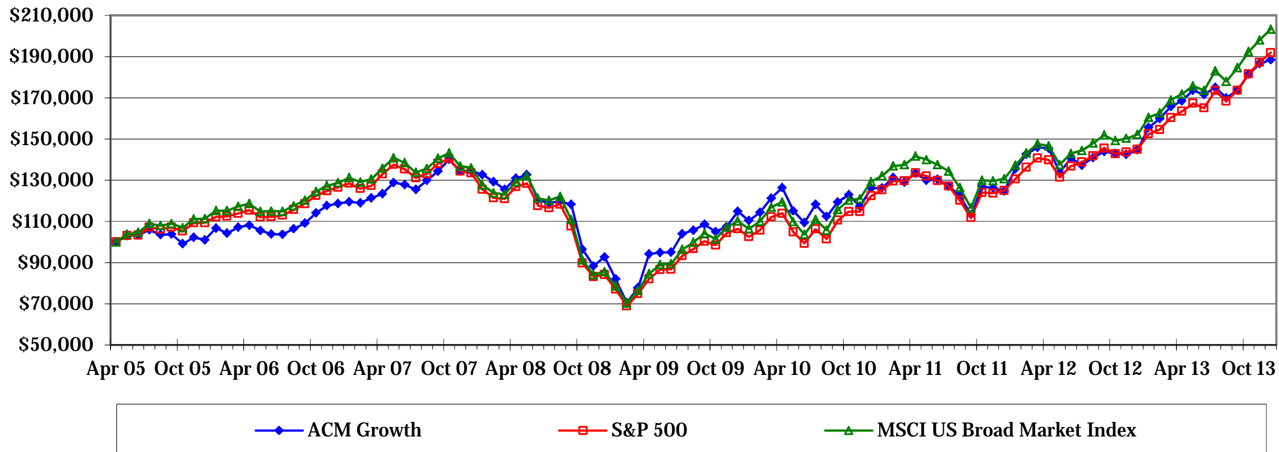
Athena Capital Management

Cumulative Growth Performance

Performance as of 12/31/13	Year to date	3 years	5 years	7 years	Since inception (4/30/05)
ACM Growth	30.17%	49.55%	103.27%	58.78%	88.49%
S&P 500	32.38%	56.82%	128.20%	51.66%	91.93%
MSCI US Broad Market Index	33.62%	57.26%	137.50%	57.89%	103.31%

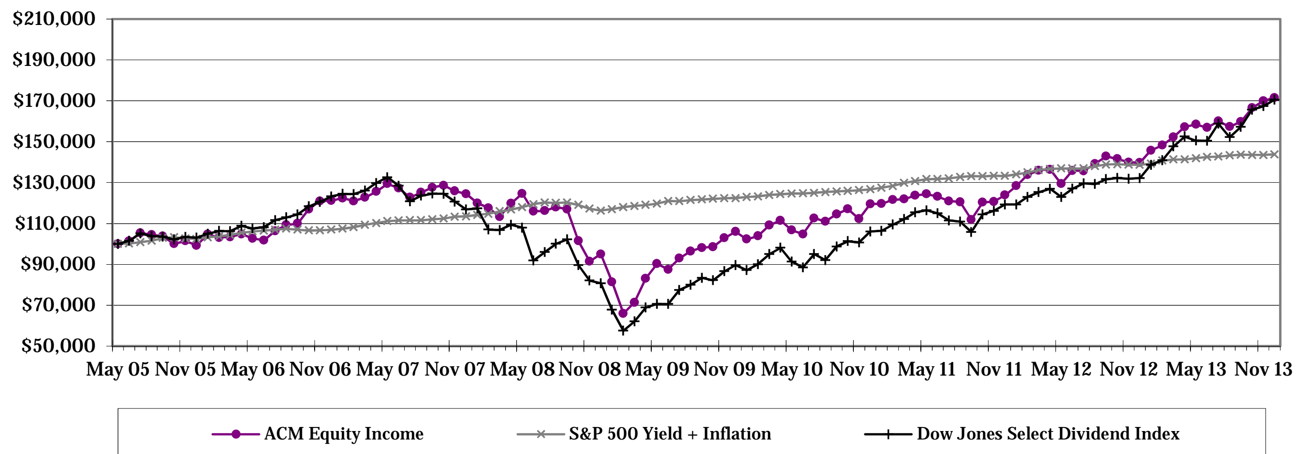
Comparison of the change in value of $100,000 investment in ACM growth versus S&P 500 and MSCI US Broad Market Index



Cumulative Equity Income Performance

Performance as of 12/31/13	Year to date	3 years	5 years	7 years	Since inception (5/31/05)
ACM Equity Income	22.77%	43.50%	80.62%	41.63%	71.56%
S&P 500 yield + inflation	3.68%	13.45%	23.62%	34.39%	43.75%
Dow Jones Select Dividend Index	29.06%	60.81%	111.44%	38.42%	70.54%

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, 2014

Without doubt, 2013 started with a whimper and ended with a bang! The S&P 500 returned *over 32%* this year despite all the angst over the economy, government spending, Federal Reserve actions, Europe, China, you name it. I guess that's why short term economic forecasts—including mine—make horoscope writers look good.

This quarter's letter reviews our growth and equity income performance, provides my commentary on markets and the economy, and finishes with what I look for in a business's management team.

Performance this quarter

Growth portfolios beat the S&P 500 over the last seven years, but lagged over all other periods. It's hard to feel good about losing to the market, but in a year when the market gains over 30%, I *expect* to trail by a little. After all, our value investing methodology can be *counted on* to lag when the market explodes like it did in 2013. It's the down years, not the up ones, when value tends to make hay. No worries, such times will come, and in the meantime our absolute gains are more than satisfactory.

Growth's out-performers this quarter were **Hewlett Packard** and **Markel**.

Hewlett Packard rebounded this quarter after a better than expected quarterly earnings report. HP's end markets—personal computers, printers, enterprise hardware and services, and software—face stiff headwinds due to tough competition and a slow information technology market, but that bad news still seems overly priced into HP shares. Even if HP doesn't regain its former glory, I think the shares have nice upside from here.

Markel, a specialty insurance company, reported excellent results following its large acquisition of Alterra, another specialty insurer. Markel paid a very nice price for the acquisition and will develop Alterra's business with better investing results and integration with Markel's proven underwriting platform. Markel is simply one of the highest quality businesses and management teams we own.

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

Ryanair's price dropped after management dampened analysts' overly enthusiastic expectations for profits this year. It is management's job to speak honestly to market participants when expectations get ahead of reality, and Ryanair's management upheld this responsibility this quarter. I think the drop is temporary, though, because management did not reduce its long run expectations for growth and profits. In other words, investors are reacting to short term issues instead of long term value.

Fairfax Financial, a specialty insurance company, dipped this quarter due to concerns over one of its investment portfolio holdings. Fairfax owns a big chunk of Blackberry, the troubled maker of cell phones, and the market is reacting unfavorably to Blackberry's prospects. But, Fairfax's position size in Blackberry is not that large, and Blackberry's patents are likely worth much more than the company's current price.

Equity income portfolios continue to out-perform our long-term benchmark over all periods. We benefited tremendously from the boom in stocks this quarter, and I'd love to take credit for that, but can't. As the Wall Street saying goes, "Never confuse brains with a bull market." I do think our portfolios are constructed to provide income and principal growth greater than inflation, though, and that's something we can take credit for over the long run.

Equity income saw out-performance from **Hewlett Packard** and **Wells Fargo**. Please see my comments above on HP.

Wells Fargo, like many banks this quarter, rose on higher interest rates and better than expected reported earnings. Banks make less money when interest rates are extremely low, like they have been, and more when rates move up, like they did recently. This trend is likely to continue. In addition, Wells Fargo reported earnings that exceeded Wall Street's expectations as its diversified businesses did well even as the mortgage business shrank. I expect more of the same over time.

Fairfax Financial and **Emerging Market Bonds Local Currency** were equity income's under-performers this quarter. Please see my comments above on Fairfax.

Our exchange traded fund (ETF) that holds emerging market bonds priced in local currency (as opposed to U.S. dollars) pulled back on rising interest rates and a stronger dollar. Rising rates will probably be a temporary problem for emerging bonds because higher rates tend to come with stronger growth, which will be good for emerging markets over time. The rising dollar is likely to be a temporary headwind, too, as emerging currencies adjust to higher and more sustainable growth for the broader world economy.

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Athena Capital Management

Market and economic outlook

The S&P 500 returned 10.5% this quarter and an outstanding 32.4% for the year. I don't know when this wild party will end, but I know it will, and my six year projections reflect that knowledge. We, however, can do better over time, and our portfolios are positioned with just that purpose in mind.

Projected annualized returns over the next 6 years	
S&P 500 (growth benchmark)	-5.2% to 6.4%
S&P-500-yield-plus-inflation (equity income benchmark)	3.5% to 6.5%

How do I arrive at these numbers? See my 2Q2005 article.

The world economy is definitely on firmer footing. This has turned everyone's thinking away from perpetual crisis mode to when-and-how-much-will-interest-rates-rise mode. This is a better "problem" to have. No one knows precisely when or how rates will rise because it's up to the central bankers and fixed income traders of the world—and they're not showing their cards.

Rising rates, when they come, are a double-edged sword. On the positive side, higher interest rates mean better returns for retirees and savers who want more than 0.25% returns on their savings and money market accounts. On the negative side, borrowers will be paying more on loans, which isn't too bad as long as employment and the economy are growing. Less pleasantly, higher rates could also cause financial assets, like bonds, stocks, real estate and commodities, to temporarily fall in price (all financial assets use interest rates as their pricing base, so higher rates—all things equal—leads to lower prices).

The key question is *how* central banks raise interest rates. If they do it too slowly, we'll get accelerating inflation, which initially could be very rough for bonds and stocks, but not commodities. If central bankers do it too quickly, they can choke off growth and temporarily tank stocks, bonds, real estate and commodities. Getting this balancing act just right is enormously difficult, and almost no central bank has managed to do it well.

What's an investor to do? If anyone could predict the timing and change in interest rates and inflation, they could make a bundle. The problem is that *no one* can do it. So instead, it's best to buy securities that don't require such predictions: securities that will do well over the long run *regardless* of what the Fed does or how. The asset class that best fits that description at present is equities, particularly higher quality companies with pricing power and sustainable economic advantages. That's where we're focused.

Investing: Who's In Charge?

Every fortress requires leaders. An impregnable fortress needs capable but not brilliant defenders. The less defensible the fortress, however, the more important the people in charge become. So, too, when evaluating the management of business fortresses. Management genius is less important when a business is strong, but with a weaker business, the quality of management becomes paramount.

Honesty and integrity are the most important test of management. If you can't trust those in charge, all else becomes irrelevant (clever, dishonest managers are just better at pilfering shareholders). I look for a management team that speaks as frankly about their failures as their successes. For example, Berkshire Hathaway's Warren Buffett discusses his poor investments—like his investment in U.S. Air preferred stock—just as eagerly as his more numerous successes.

Next, you want a management team with broad and deep knowledge of all aspects of their business. The better they know the business, the better they can fend off competitors. Preferably, I like managers who have spent their whole career in a single field. Brian Roberts, CEO at Comcast, grew up in the cable business because his father, Ralph Roberts, started the company.

The most important job of managers is to effectively allocate valuable corporate resources to their highest return uses. Unfortunately, this skill is rare among business chiefs because most get there by being excellent salespeople, efficient operators, or good at organizational politics. I look to see how successfully earnings are reinvested, and if management is overly focused on short term profits instead of long term wealth creation. For instance, Prem Watsa at Fairfax Financial has hedged the stock exposure of his insurance portfolio, thus forgoing short term stock gains to protect against an eventual market pullback.

Managers work for shareholders, and they should treat their employers right. Their attitude should not be benign neglect or grudging attention, but stewardship. I look at management's actions instead of words: do they hire tough over-seers for the board of directors, or complying lapdogs? Do they spend capital on expensive redecorating, or do they run things lean and mean? In all its meetings and reports, Markel's management treats shareholders as partners, speaking respectfully and acting as if they are allocating other people's money (which, of course, they are).

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Finally, I prefer to see a management team that doesn't predict growth rates. This may seem counter-intuitive: shouldn't you want managers who set stretch goals—solid growth rates—and work hard to achieve them? Business is inherently unpredictable, and competitive managers can be tempted to take imprudent actions to reach the goals they set. By not predicting growth rates, managers can avoid painting themselves into a corner. At Wells Fargo, management sets goals for the things they *can* control—expenses, cross-sell efforts—but not growth rates, thus preventing the temptation to "make" their numbers.

In business, you must evaluate the people in charge. Capable leaders are always desirable, and become vitally important with weaker businesses. **To compound wealth over many years, the quality of management must be assessed along with the defensibility of their fortress.** The effort is well worth it: the right combination of these two attributes can yield exponential benefits for years.

Until next quarter

Thank you for your business, and please contact me if you have any questions, comments or feedback for me. I'm always interested to hear what's on your mind.

Solicitously,
Mike

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

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