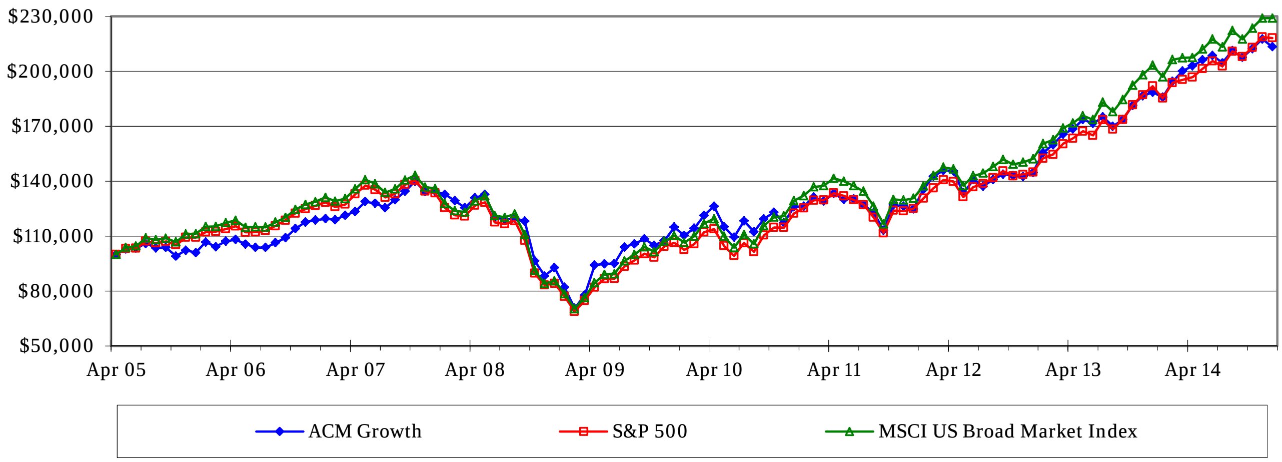
ATHENA CAPITAL MANAGEMENT

Cumulative Growth Performance

Performance as of 12/31/14	Year to date	3 years	5 years	7 years	Since inception (4/30/05)
ACM Growth	13.14%	71.03%	85.80%	58.71%	113.43%
S&P 500	13.69%	74.59%	105.14%	63.45%	118.20%
MSCI US Broad Market Index	12.66%	75.28%	107.80%	68.46%	129.05%

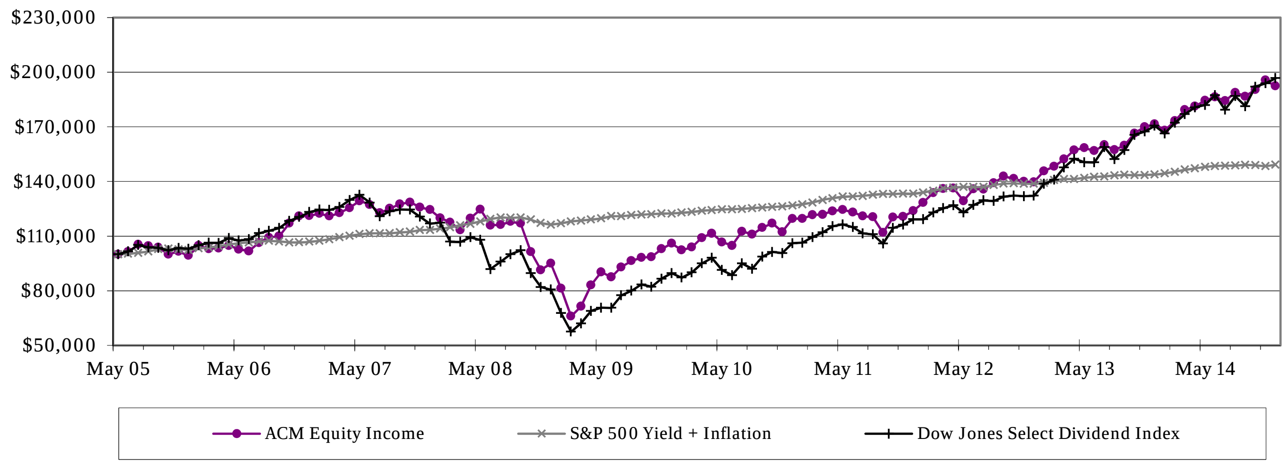
Comparison of the change in value of $100,000 investment in ACM growth versus S&P 500 and MSCI US Broad Market Index



Cumulative Equity Income Performance

Performance as of 12/31/14	Year to date	3 years	5 years	7 years	Since inception (5/31/05)
ACM Equity Income	12.16%	55.38%	81.59%	54.60%	92.45%
S&P 500 yield + inflation	2.83%	10.96%	20.81%	30.32%	47.82%
Dow Jones Select Dividend Index	15.36%	65.01%	119.49%	68.37%	96.73%

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.

ATHENA CAPITAL MANAGEMENT

January 16, 2015

The market was up 4.9% this quarter and finished the year up 13.7%—another very good year. After leading the market all year through November, our performance slipped slightly behind our benchmarks in December for reasons I'll discuss below.

In this letter, I discuss our new reduced management fees, our performance this quarter, what I expect from markets and the economy, and an important perspective on interpreting investment performance. Please enjoy.

Fee Reduction

To celebrate the 10 year anniversary of Athena Capital, and as reward for your loyal business, I have decided to reduce your asset management fees. This reduction begins in the 1^{st} quarter of 2015 and is a permanent reduction. All things equal, this will lead to higher investment returns for you (the fee as a percentage of assets reduces your returns by precisely the amount of the fees, so a lower fee means higher future returns for you). The reduction is an across the board 20% cut in fees:

Assets Under Management	Old Fee	New Fee
First $250,000	1.50%	1.20%
Next $250,000 to $500,000	1.25%	1.00%
Next $500,000 to $1,000,000	1.00%	0.80%
Next $1,000,000 to $2,000,000	0.75%	0.60%
Over $2,000,000	0.50%	0.40%

It is important to note that I believe our all-in fees (management fees, trading fees, marketing fees, front/back load fees, etc.) were below market before, and now they are even farther below (see Putting Investment Performance in Perspective section below for more detail).

The new fees cannot take effect until we complete some paperwork modifying our original Investment Management Agreement. I will send that paperwork along with this letter.

Performance this quarter

Growth portfolios have under-performed over all reported periods since inception. As mentioned above, we were beating the market in 2014 by a good margin up through November, but then hit the skids in December. The reason was that several of our international holdings—in particular Philip Morris International and Coca-Cola—fell along with oil prices and a rising U.S. dollar. Investors are concerned about how a rising dollar and falling oil will impact the international economy, but I believe these concerns are overdone. Excellent businesses like Philip Morris and Coke have the pricing power to keep up with currency moves over the long run, and they are likely to benefit from declining oil prices as lower spending on energy leaves more money in the pockets of consumers. Stay tuned for the bounce-back (Philip Morris and Coke are beating the S&P 500 by 4.9% and 3.6% so far in 2015).

Growth's out-performers this quarter were **Markel Corp.** and **Fairfax Financial**.

Markel and Fairfax are both specialty insurance businesses that sold off last quarter and then rebounded this quarter. I had originally thought the 3^{rd} quarter sell-off was due to the threat of rising interest rates, but now I wonder if it wasn't simply hurricane season coming and going without incident. The market's fickle reasoning is always dangerous to interpret, so I'll just say that Markel and Fairfax are solid companies with excellent management. I believe they will do quite well over the long run.

IBM and **POSCO** were growth's under-performers this quarter.

IBM sold off this quarter after management announced it was abandoning its forecast for $20 per share in operating earnings in 2015. Investors crave certainty, and some management teams unwisely cater to that craving with forecasts that are certain to fall short at some point. I believe IBM is making a wise transition to cloud computing and will benefit from the upcoming refresh cycle in mainframe computers. Contrary to popular belief, mainframes are still the workhorses of banks, insurance companies, airlines and large institutions with mission-critical databases. I think IBM's transition to the cloud, and its continued mainframe dominance will generate excellent results.

POSCO is a steel manufacturer—the 5^{th} largest in the world—based in Korea. POSCO's stock price fell on news of slower growth in China and weaker seasonal demand for steel products around the world. I think the market may be missing POSCO's low cost advantage, high end steel products, recent change in strategy, and lower input costs for iron ore, coal and energy. The short run may be challenging for POSCO, but the long run looks very promising.

Equity income portfolios continue to out-perform our long-term benchmark over all periods. At the same time, our portfolios are now under-performing the Dow Jones Select Dividend Index over all periods for the same reasons highlighted about growth above: international underperformance, particularly Philip Morris and Coke. I believe the market's reaction is short-sighted and will be reversed, and continue to be enthusiastic about our holdings' ability to generate reliable income and growth above inflation over time.

Equity income saw out-performance from **Fairfax Financial** and **Wells Fargo**. Please see my comments above on Fairfax.

Wells Fargo had an excellent quarter. Unlike larger competitors, Wells Fargo isn't suffering from investment banking problems and the higher regulatory burden that accompanies that business. Unlike smaller competitors, Wells Fargo has a large wealth management business that has offset the downturn in many other bank services, like mortgages. If interest rates rise this year, as many expect, Wells Fargo could see a jump in lending profitability, too.

IBM and **Philip Morris International** were equity income's under-performers this quarter. Please see my comments above on IBM.

Philip Morris International—the largest tobacco company outside of China—declined this quarter on concerns over Russia, cigarette demand, and the rising U.S. dollar. Russia is a huge market for Philip Morris' cigarettes and its economy is clearly under stress. Worldwide demand for cigarettes is down more than usual because of slow international growth. Lastly, Philip Morris sells its products outside the U.S. but reports results in U.S. dollars, so revenues and profits decline when the U.S. dollar rises. I think all of these issues are temporary in nature, though, and that Philip Morris has strong enough brands and products to succeed over time.

Market and economic outlook

As mentioned above, the S&P 500 returned 4.9% this quarter and 13.7% for 2014. These better than average returns leave my projections over the next six years lower than last quarter. With a mid-point return of only 3.5% on the S&P 500, this is a good time to be very selective of which securities you hold.

Projected annualized returns over the next 6 years	
S&P 500 (growth benchmark)	-4.8% to 11.8%
S&P-500-yield-plus-inflation (equity income benchmark)	2.0% to 8.0%

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

U.S. economic growth has been accelerating while the rest of the world economy muddles along. China is slowing more than expected, Japan has re-entered recession, Europe is flat-lining, Brazil and Argentina face daunting structural problems, Russia is courting depression, but the U.S. economy motors on. Although this situation is happy for now, the U.S. could eventually get pulled down by global growth declines.

The big news this quarter was the huge decline in oil prices. Oil fell 45% from June to December, from over $100 a barrel to under $55. This seems like good news: lower transportation and input prices, right?—but the cause of decline makes for scarier interpretations. Saudi Arabia, as the lowest cost and highest reserve producer, is setting prices lower for reasons that could include U.S. fracking competition to fears of geopolitical turmoil (Islamic State, Iran, Russia). Without doubt, higher oil supplies due to fracking and lower demand from emerging markets are playing significant parts, but they seem like incomplete explanations.

How will the fall in oil prices impact the economy? That's a hard question to answer. Falling oil could be an indication of a severe demand drop-off and impending recession. Or, lower oil could dramatically decrease input prices and spur growth from developed and developing economies. As amusing as it is to speculate, only hindsight will reveal the cause and results from falling oil.

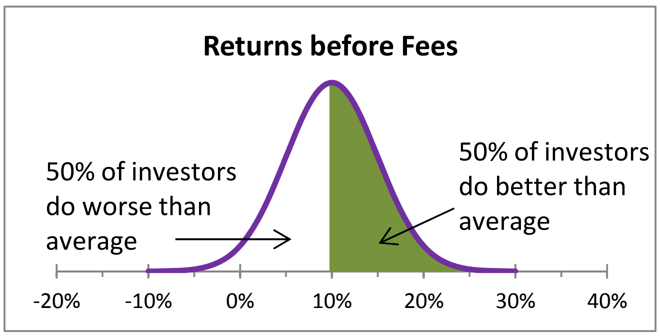
More interestingly, falling oil will almost certainly create investing opportunities. Human psychology shows that investors over-react to news, and that may lead them to throw investing babies out with the market bathwater. Not surprisingly, that means I will be sniffing around the oil sector for such "babies."

Putting Investment Performance in Perspective

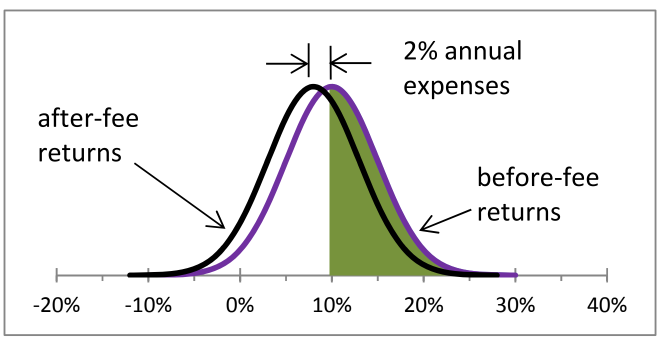
Judging investment performance may seem simple: just look at how you've done relative to a benchmark; if you're doing better than the benchmark, then good; if not, then bad. Intuitively, most people think smart professionals with lots of training, working long hours, should be able to beat the market easily. The reality is quite different, and changes over time in unpredictable ways. In this article, I hope to put investment performance in clearer perspective.

First, investing is an inherently competitive endeavor. Like in sports, you're competing with other investors for returns, not just trying to fix something or be productive (like a plumber fixing pipes or an engineer designing a new rocket). In this context, average returns are a zero sum game. If you take all of the people investing in the market, they are buying and selling to each other. That means any one person's gains are another person's losses. On average, everyone's gains and losses cancel each other out leaving the average investor with average returns.

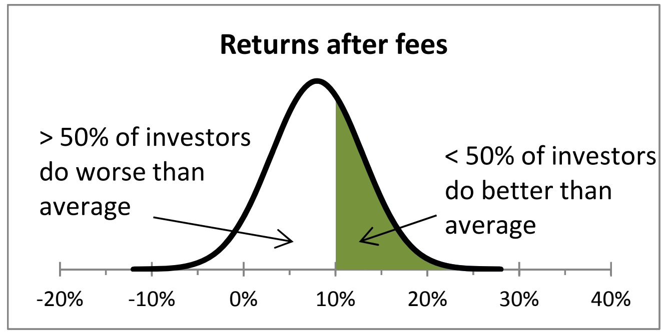
This can be represented graphically to make understanding easier. Below is such a graph where the height of the purple curve is the number of people generating the returns shown across the bottom. The bell-shaped curve means that most do average, a few do much worse than average, and a few do much better than average. **In aggregate, 50% do better than average and 50% do worse**. The green area represents those doing better than average.



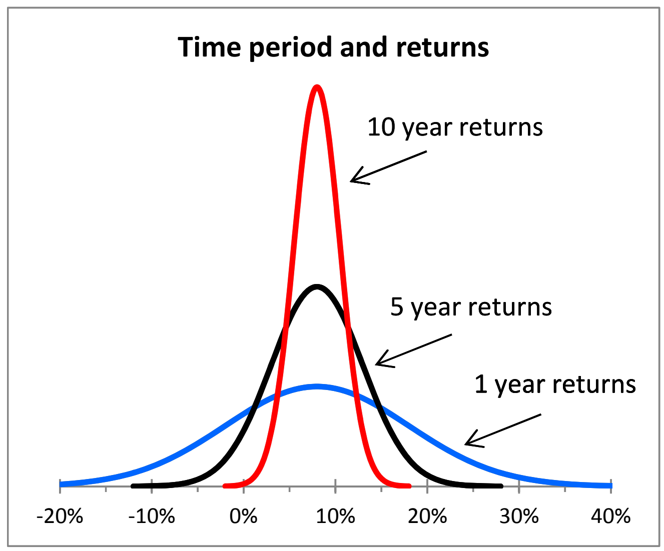
Importantly, those returns are ***before fees***. When you include fees, the whole bell-shaped curve shifts to the left, as shown below.



These fees include not just the obvious investment management fees (like I charge), but also hidden trading expenses, bid-ask spreads, marketing fees, etc. (John Bogle estimates these fees average 2.27% per year; our all-in fees were below that even before the new 20% fee reduction). As you may be able to see in the graph above, and is made more clear in the graph below, **the green area under the after-fee curve (black curve) is less than the area under the before-fee curve (purple curve).**

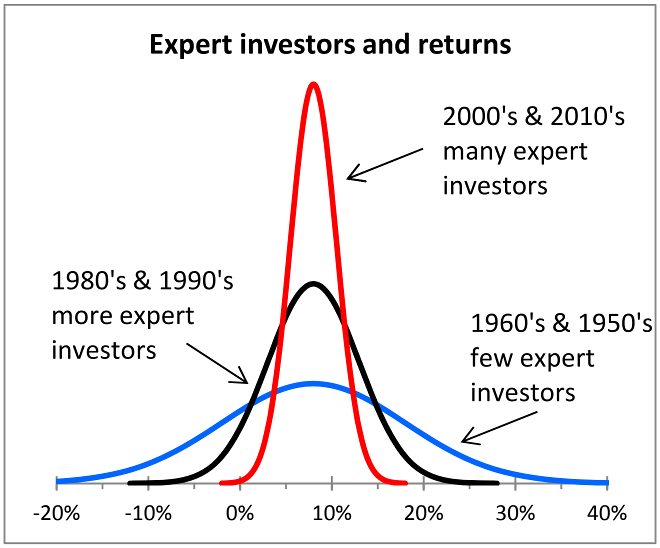


And, here is a very important point: **after fees, less than 50% of investors beat average pre-fee returns** (that is why so many financial experts recommend low cost index investing). How much less than 50%? It depends. To answer that question, we'll have to dig deeper. Let me start with another graph (below).

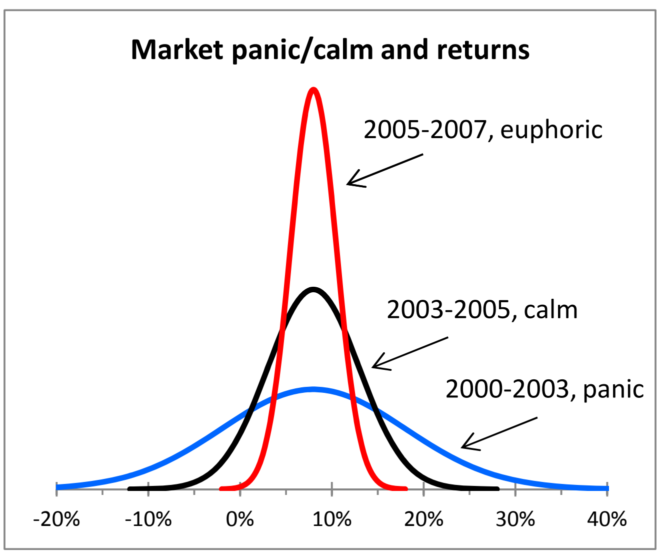


The black curve is the after fee curve I showed before. The blue curve is flatter and looks more "squished." This is how returns look in any given year, with a broader distribution of some doing much worse or much better than average. When you combine several years of returns, the curve gets taller and more "squeezed." **The more years of returns, the more squeezed the distribution looks**. So for example, the blue curve could be 1 year returns, the black curve 5 year returns, and the red curve 10 year returns.

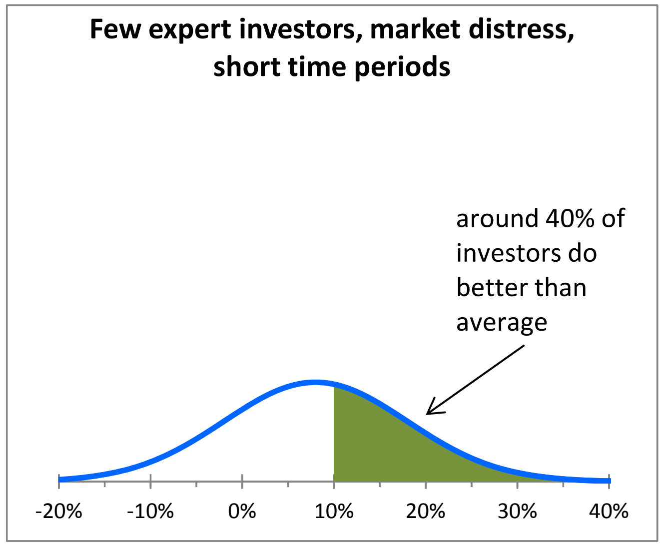
Another factor leads the curve to be squished and squeezed: the number of smart, hard-working investors rationally buying and selling in the market. Back in the 1950's & 1960's, the market's participants were mostly individual investors who were not particularly knowledgeable about valuing investments. During that time, the curve looked like the blue, squished curve (see below). In the 1980's and 1990's, the curve looked like the black curve, squeezed and taller as more knowledgeable investors came to dominate the market. In the 2000's and 2010's, the curve became farther squeezed, looking like the tall, red curve as investing was left almost exclusively to expert professionals.



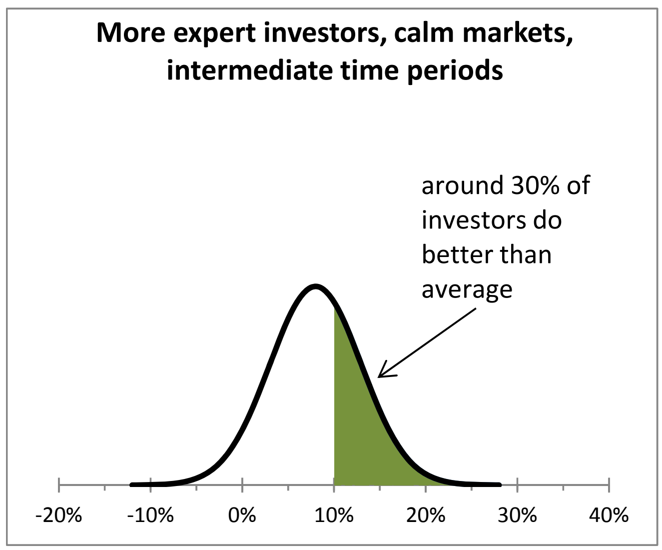
Yet another thing makes the curve squish and squeeze: market calm and market panic. During panic periods like 2000-2003, returns squish down like the blue curve (see below), with a broader distribution around average. During calmer periods, like 2003-2005, returns squeeze up like the black curve, with a narrower distribution around average. During euphoric markets, like 2005-2007, returns squeeze up even farther like the red curve, with a much tighter distribution around average.



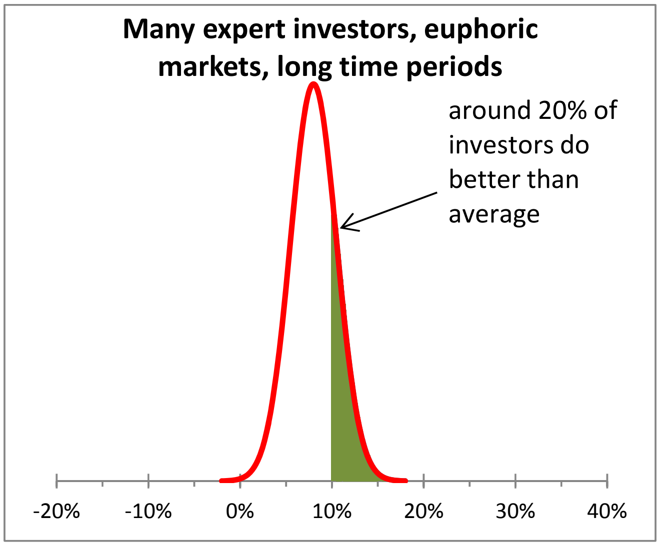
With that information, we can now consider how many investors do better and worse than average. **When the returns are squished, like in the 1950's (few expert investors), or during 2002 (panic), or over short time periods (1 year), somewhere around 40% of investors do better than average after fees.** The graph below illustrates this situation.



When returns are squeezed, like they were in the 1990's (more expert investors), or in 2005 (calm, but not euphoric), or over intermediate time periods (5 years), around 30% of investors do better than average after fees, as illustrated below.



When returns are further squeezed, like in the 2010's (many expert investors), or in 2007 (euphoric), or over long periods (10 years), then around 20% of investors do better than average after fees, shown below.



One last thing I want to make clear before I get into my table-pounding points: **some investors in the green areas above—beating the market—are lucky, and some are good**. Investing is such a probabilistic endeavor that both good and lucky people win during any particular period. The difference is: those who are good win in multiple periods; those who are lucky win infrequently. It is very hard to tell who is lucky or good over the short term or in certain types of markets, but over the long run, the truth will out.

Now, I can get to my points:

- **Beating the market after fees is very difficult to do over time**.
- **Doing as well as the market or slightly worse means beating 80% of investors over long time periods.**
- **It is easier to beat the market during distressed periods**.
- **It is easier to beat the market when fewer smart, knowledgeable people are investing**.

Just to make it clear how difficult it is to beat the market over time, Eugene Fama, a Nobel Prize winning economist, believes that *only the top 3% of managers* match or beat the market after fees over the long run. That means that matching or beating market returns, especially over more than 5 years or with highly competitive or calm markets, is a truly remarkable feat.

I still believe we can beat the market over time, but I want you to understand how hard that is to do, and that distressed markets and neglected markets are when we should expect to win, not during calm or exuberant markets. Seen in this light, we are doing quite well.

Until next quarter

If you have any questions or comments for me, about the economy, markets, financial planning, fees, performance, or specific investments, please don't hesitate to contact me.

Diligently,
Mike

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