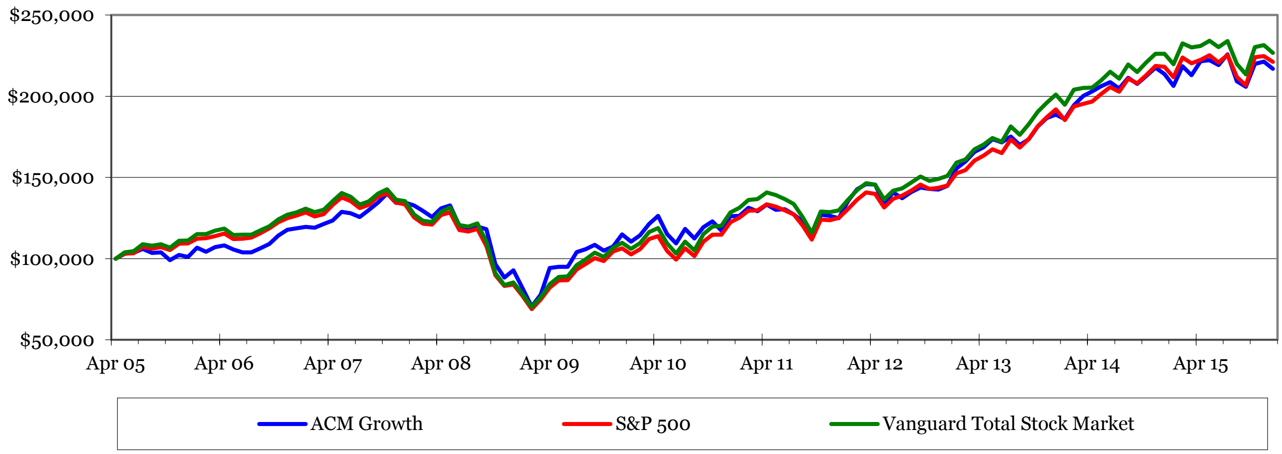
Athena Capital Management

Cumulative Growth Performance

Performance as of 12/31/15	Year to date	3 years	5 years	10 years	Since inception (4/30/05)
ACM Growth	1.54%	49.81%	72.10%	114.74%	116.92%
S&P 500	1.38%	52.59%	80.76%	102.42%	121.22%
Vanguard Total Stock Market	0.28%	50.33%	76.45%	103.98%	126.74%

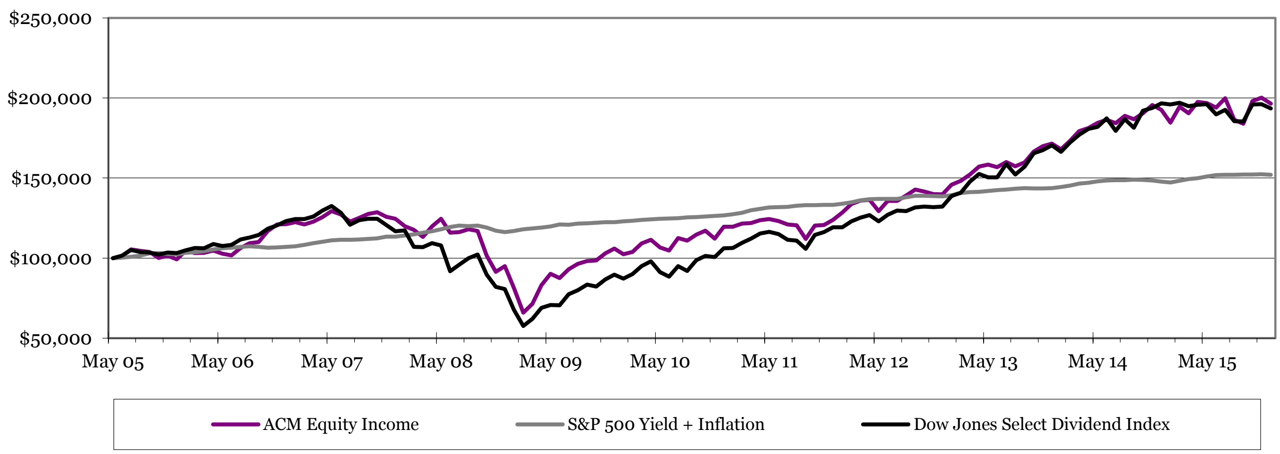
Comparison of the change in value of $100,000 investment in ACM growth
versus S&P 500 and Vanguard Total Stock Market



Cumulative Equity Income Performance

Performance as of 12/31/15	Year to date	3 years	5 years	10 years	Since inception (5/31/05)
ACM Equity Income	2.04%	40.59%	64.33%	97.88%	96.46%
S&P 500 yield + inflation	2.88%	9.69%	20.02%	48.59%	52.07%
Dow Jones Select Dividend Index	-1.64%	46.44%	82.47%	87.78%	93.51%

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 20, 2016

The S&P 500 rose and fell over the year only to finish down 0.7% (including dividends it returned 1.4%; our portfolios did slightly better). The market's lack of progress in 2015 was mostly the result of declining U.S. corporate profits, which were caused by tanking commodity prices and a strong U.S. dollar (Chinese turbulence at mid-year was also a contributing factor).

With that in mind, this letter covers our growth and equity income performance, my thoughts on markets and the economy, and an important section on Value versus Growth investing and what it means for future returns.

Benchmark Change

After data on the MSCI Broad U.S. Market Index became unavailable, I changed our secondary growth benchmark to the Vanguard Total Stock Market Index Fund (VTSMX). The Total Stock Market Index represents a good benchmark for growth accounts because it's readily available to investors as a low cost mutual fund (and ETF) and it includes many small capitalization businesses not included in the S&P 500. Please note that the S&P 500 index does not account for management fees, but both our portfolio returns and the Vanguard Total Stock Market do.

Performance this quarter

Growth portfolios out-performed in 2015 and over the last ten years, but trailed over three and five year periods, and since inception. Considering that most mutual and hedge funds lost to the market this year, this was a remarkably good outcome. It was a tough year to beat the market for anyone—including us—who didn't own the FANG stocks (Facebook, Amazon, Netflix and Google), which represented almost all of the market's return last year. Value investing, the method we use, has had a particularly difficult period. As highlighted in the Value versus Growth section below, we are positioned to benefit even if value doesn't come back into favor, and doubly so if it does.

Microsoft and **Philip Morris International** were growth's out-performers this quarter.

Microsoft continues to ride a wave of investor optimism due to successes with its cloud software, its new Windows 10 operating system, and even profitability at its web search engine, Bing. Although I expect such operational momentum to continue, I used the price run-up to trim our position and purchase alternative investments with greater upside potential.

Philip Morris International, the largest non-Chinese tobacco business in the world, climbed on both operational successes and decreasing currency headwinds. Its operational wins were seen in pricing power and market share gains. Philip Morris also benefited from smaller increases in the U.S. dollar versus other currencies. I expect its operating and currency gains to continue in 2016.

Growth saw under-performance from **IBM** and **Leucadia** this quarter.

IBM continues to face difficulties transitioning its clients from legacy information technology to hybrid cloud systems. Like Microsoft a couple of years ago, this manifests itself in rapid growth on a small base of new business versus declines in larger legacy software and services. In time, I expect the new business to grow in scale and profit margins until it overcomes legacy declines, just as it has been for Microsoft.

Leucadia, a holding company consisting mostly of investment banking and beef processing, suffered along with hard hit sectors this quarter. Because Leucadia's investment bank, Jefferies, does a lot of high yield and energy business, Leucadia's stock price suffered on pessimism related to those two sectors. Leucadia's diversified businesses, however, and the eventual rebound of high yield and energy markets, makes Leucadia's short term price move look more like investor panic than thoughtful evaluation. I expect its price to recover once investors refocus on underlying fundamentals instead of recent sector dynamics.

Equity income portfolios under-performed our main benchmark in 2015, but out-performed over all other periods. Our portfolios held up much better than most equity income investors because we minimized exposure to energy and high yield debt markets. I had shied away from those sectors in equity income accounts because income chasing investors seemed to be overweighting them. As usual, it took time for my risk avoidance to prove its worth. I think our portfolios will continue generating steady and growing income even if markets and our principal values swoon over the short term.

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

Equity income saw under-performance from **IBM** and **Viacom**. Please see my comments above on IBM.

Viacom, a cable network that includes Nickelodeon, MTV, VH-1 and The Comedy Channel, declined this quarter on news about its ailing, 92 year old Chairman, Sumner Redstone, rather than pessimism about operational performance. In fact, Viacom's stock price climbed 20% early in the quarter due to better than expected operating results. That is, up until headlines came out questioning Redstone's mental competency and highlighting struggles between heirs to his fortune. In time, I believe the underlying operating performance of Viacom will trump investors' short term focus on headlines.

Market and economic outlook

The S&P 500 returned 1.4% for 2015 and 7% in the 4th quarter. This better than average 4th quarter reduced my six year projected returns relative to my previous estimate. Now, I expect mid-point returns of 4.9% for growth and 5.2% for equity income.

Projected annualized returns over the next 6 years	
S&P 500 (growth benchmark)	-3.5% to 13.3%
S&P-500-yield-plus-inflation (equity income benchmark)	2.2% to 8.2%

How do I arrive at these numbers? See my 2Q05 and 3Q14 articles.

In December, the U.S. Federal Reserve raised interest rates for the first time in over nine years. Historically, the Fed raised rates because the U.S. economy grew faster than average and signs of higher inflation were apparent or imminent. Not this time. The Fed raised rates because it has held them so low for so long that many economists are worried monetary policy won't be available to fight the next recession.

In contrast, Europe, China and Japan, are keeping interest rates low trying to spur economic growth. This is an unusual situation: one major central bank tightening monetary policy while the other three are aggressively easing. Many economists and financial professionals are worried about the impact of these opposing moves. The most obvious consequence so far has been the U.S. dollar climbing around 30% over the last 1 ½ years relative to other currencies. This has led to reduced exports from the U.S. and lower profits for U.S. based firms with overseas business.

We are in uncharted waters with the world's monetary policies. Never before have central banks gone to such extreme measures to revive economic growth, and never have they worked so closely to overcome what has been a massive debt deflation. No one really knows how major central banks will react to incoming data or the consequences of their actions.

Given that, I think it's prudent to expect higher market volatility. After all, central banks aren't the only wild card right now. Global markets are also experiencing a major commodities crash, dramatic Chinese economic slowing, and increased terror attacks and geopolitical issues originating from the Middle East. In other words, there are plenty of reasons for markets to be edgy.

As I've said in prior letters, this is likely to yield excellent investment opportunities. Turbulent times are favorable periods to sell things that have done well and buy things that are diving below assessed value. I've already exploited such opportunities, and I expect that situation to continue. In short, I believe this difficult period will lay the groundwork for lucrative long term returns.

Value versus Growth

Suppose I made you a bet:

- You roll a 50-sided die
- If it lands on *any* number from 1 - 49, I pay you $16
- If it lands on 50, you pay me $9

Would you take that bet? **A 98% chance of winning $16 versus a 2% chance of losing $9?** I would, and I think you would, too.

We've taken that bet since 2005 and amazingly landed on 50, thus facing a $9 headwind. That doesn't make it a bad bet; it just means excellent odds don't guarantee a good outcome each and every time. The shrewd response is to keep playing until the bet pays off. To understand why we've made such a bet and what it means for future returns, I should first explain Value and Growth investing.

Value beats Growth

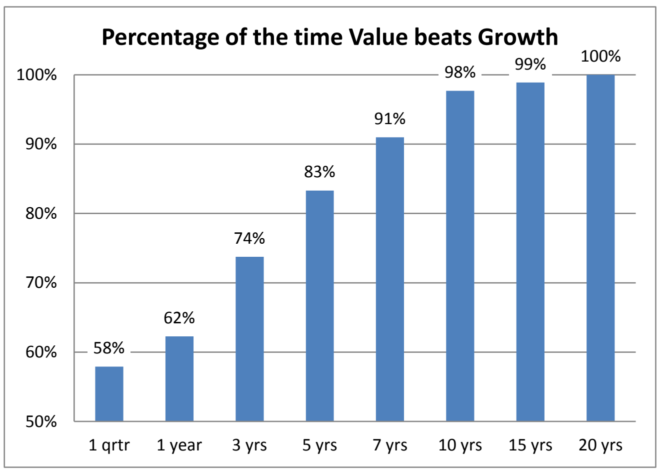
Value investing is buying the cheapest companies based on price to fundamentals (earnings, book value, etc.); Growth is buying the most expensive companies. Value has historically done much better than Growth. **From June 1926 to November 2015, Value beat Growth by around 4% a year.**

Given that the overall stock market has returned around 10% annually over the last 89 years, that means Value provided a return of around 12% and Growth of about 8%. That may not sound like a large difference, but it adds up over time, as shown in the table below:

Growth of $100,000 invested over time

# years invested	**Growth** 8% return	**Market** 10% return	**Value** 12% return
10	$215,892	$259,374	$310,585
20	$466,096	$672,750	$964,629
30	$1,006,266	$1,744,940	$2,995,992

That's why I'm a Value investor: because **the historical odds have greatly favored Value over Growth and the difference between outcomes has been huge.** But, there's a catch (there's no such thing as a free lunch). Value investing won *over* time, but not *every* time. Below is a chart showing how frequently Value beat Growth.



As you can see, Value won the vast majority of the time. And, the longer you played the game, the more likely Value triumphed. For example, over quarters, Value won only 58% of the time; but over three year periods, 74%; over seven year periods, 91%; over 17+ year periods, Value won 100% of the time.

It's important to repeat my point above: **Value beat Growth *most* of the time, but not *all* of the time.** There have even been long periods when Value lost to Growth. Specifically, ten overlapping, 15 year periods have occurred where Growth beat Value, all ending during the dot-com bubble (December 1984 to September 2000).

As hinted in my 50-sided die hypothetical, **we are going through one of those long periods of Value losing to Growth.** Through the end of November, Growth beat Value over the prior month, quarter, year, three years, five years, seven years, ten years and since inception. We've picked the right bet based on the odds—the one that won 98% of the time over ten year periods—and it hasn't paid off…yet.

<u>What does Value Losing to Growth mean?</u>

I think there are two potential conclusions to be drawn from Value losing over such a long period:

1) The nature of the game may have changed such that Value no longer beats Growth

Value would cease beating Growth if investors had finally gotten wise to the characteristics of Value and Growth and permanently repriced securities accordingly. Perhaps the success of Warren Buffett and the full academic exploration of Value beating Growth have convinced investors to adjust their buying and selling behavior. **If that were true, then Value would no longer be the winning bet to make** (nor would it be a losing bet, it just wouldn't consistently beat Growth anymore).

2) Or, the nature of the game may not have changed and we just need to keep playing until Value beats Growth

Growth investing is psychologically easier than Value investing. It's more comfortable to buy businesses that are succeeding in everyone's eyes. This desire for comfort leads investors to pay higher prices for Growth companies. That is why such companies trade at much higher prices relative to fundamentals.

Value investing, in contrast, is psychologically difficult. It is uncomfortable buying businesses that seem to be doing poorly. That is why they trade at low prices to fundamentals. In the past, Value beat Growth because investors over-payed for businesses doing well and under-payed for businesses doing poorly.

For Value to no longer beat Growth, this longing for comfort and avoidance of discomfort would have to permanently change or be overcome. Because I don't think investors have essentially changed or become stronger-willed, I think Value is just going through another long, episodic period of under-performance, which will end with Value returning to its winning ways. Of course, we've seen this happen before.

Back in the late 1990's, many thought Value investing no longer worked. At the time, countless commentators were saying that Value investors didn't "get it," and their method would never out-perform again. That period ended with the dot-com crash in 2000. What followed was the best three, five and seven year returns for Value in 89 years of recorded history, with Value beating Growth by 98%, 141% and 179%, respectively. That may not happen this time, but I like our odds (keeping in mind that we might only be

10 ½ years into a 16 year period of Value under-performing Growth).

Not resting on our laurels

"If you rest on your laurels, you'll get a thorn in your butt" —Herb Kelleher, former CEO of Southwest Airlines

Investing is essentially a game of odds. **To optimize your returns, you must put the odds in your favor.** We've done that by investing in Value over Growth. But, having the odds in your favor doesn't guarantee a win every time, and we haven't since inception (10 ½ years!).

To put the odds even more in our favor, I haven't been resting on my laurels (no thorns, thank you). Instead, I've been improving our investing process over the last six years, focusing more on in-depth research into specific kinds of businesses: those most likely to win. So, even if Value never beats Growth again, our better research process will, I'm convinced, put the odds in our favor.

And, if Value returns to its winning ways, as I think it will? Then we'll have the benefit of *both* Value *and* a greatly improved investing process. All the better.

Until next quarter

If you have any questions or comments about the economy, markets, financial planning, performance, Value versus Growth, or specific investments, please don't hesitate to contact me. I love hearing from you.

Patiently,
Mike

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