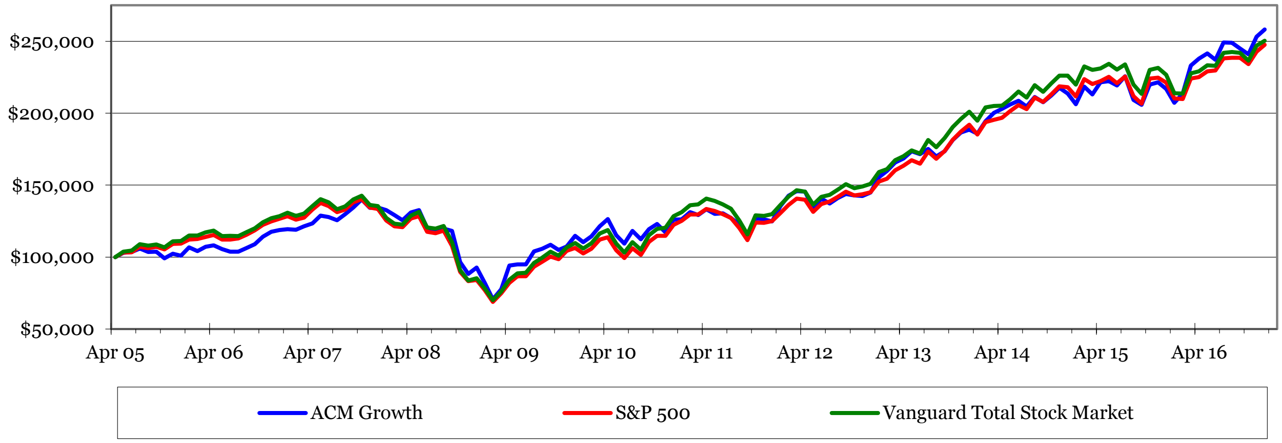
ATHENA CAPITAL MANAGEMENT

Cumulative Growth Performance

Performance as of 12/31/16	Year to date	3 years	5 years	10 years	Since inception (4/30/05)
ACM Growth	18.98%	36.85%	106.88%	117.47%	158.17%
S&P 500	11.96%	29.05%	98.18%	95.72%	147.68%
Vanguard Total Stock Market	10.40%	24.46%	92.94%	94.95%	150.32%

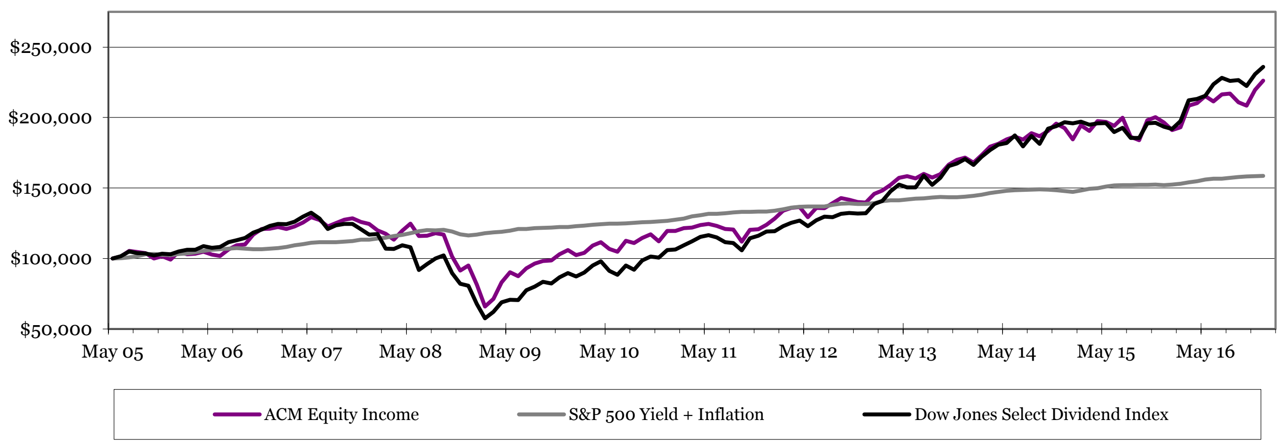
Comparison of the change in value of $100,000 investment in ACM growth
versus S&P 500 and Vanguard Total Stock Market



Cumulative Equity Income Performance

Performance as of 12/31/16	Year to date	3 years	5 years	10 years	Since inception (5/31/05)
ACM Equity Income	15.11%	31.81%	82.61%	86.72%	126.17%
S&P 500 yield + inflation	4.33%	10.38%	19.10%	48.34%	58.66%
Dow Jones Select Dividend Index	21.98%	38.41%	97.99%	91.59%	136.04%

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. The returns provided are a combination of client accounts and might not represent individual accounts accurately. The firm puts clients into securities that are on a continuum of the two strategies based on their individual level of risk tolerance.

Athena Capital Management

January 18, 2017

The S&P 500 returned 12% in 2016, an above average year, but we did even better: growth portfolios were up 19% and equity income was up 15%. Value investing was a meaningful tailwind for the first time since 2006, but that was't the only story—our specific security selection, especially Joy Global and USG Corp, provided additional upside.

In this quarter's letter, I'll review our portfolio performance, what happened in the markets and economy, what I expect going forward, and a deeper look at our quarterly performance numbers: is there a seasonal pattern?

Performance this quarter

Growth portfolios out-performed over all periods reported and by the largest amount in some time. As referenced above, value investing was a tailwind as were our specific investment selections. I continue to stack the deck in our favor by tilting toward value investing—which might be starting a long, bumpy period of out-performance—and by digging deep to find unique businesses with sustainable advantages and great management selling at reasonable prices.

Wells Fargo and **M&T Bank** out-performed for growth portfolios this quarter.

Despite its on-going fake account scandal, Wells Fargo, the nation's third largest bank, climbed 24% on news of Donald Trump's election. One reason was the assumption that a Trump presidency will lead to higher interest rates (increased government spending and tax cutting tends to generate inflation). Another reason was speculation that Trump's team will decrease banks' regulatory burden. Whether or not Trump leads to higher interest rates or lower regulation, I think Wells Fargo is well positioned to generate growing earnings over time with its broad portfolio of financial services and low cost funding.

M&T Bank, one of the U.S.'s top 15 community banks (operating mostly in the Northeast and Mid-Atlantic regions), climbed 35% this quarter on news of Trump's election (for the same reasons as Wells Fargo). In addition, M&T has been successfully integrating its largest acquisition to date, Hudson City Bancorp, leading to growth as it shifts Hudson's operations from thrift to commercial banking. I think M&T's conservative business model will continue growing for many years to come.

Liberty Global and **Liberty Latin America** under-performed in growth portfolios this quarter.

Liberty Global, Europe's largest cable telecom operator, declined 10% over fears of what Brexit (Britain voting to exit the European Union) and Trump's election might mean for its business. Although Liberty has 30% of its operations in Britain, I don't think Brexit will cause major changes in the profitability or growth of its operations. Nor do I see how Trump's presidency will significantly impact cable operators in Europe. One potential concern is currency declines, but I think Liberty has prudently hedged those risks with exchange rate derivatives and debt in local currencies. On the upside, Liberty expects to grow its underlying profits by 7% to 9% over the next three years, which is a very good reason to hold on for now.

Liberty Latin America, a hodgepodge of cable operations in Puerto Rico, Chile, Panama and the Caribbean as well as an undersea cable segment, declined 25% on news of—drum roll—Trump's election. My best guess is that investors fear protectionism and a rising U.S. dollar. But, I think this under-estimates Liberty Latin America's growth potential in the region, estimated at 7% to 9%, and their ability to hedge currency risk. Such worries also fail to consider the tremendous merger and acquisition opportunities open to Liberty (an area its expertise). It may be a wild ride, but I expect it will also be quite profitable (it's already up 4.8% to the market's 1.3% year to date).

Equity income portfolios out-performed our long term benchmark over all reporting periods, and did some nice catching up against the Dow Jones Dividend Select Index. I still see too many investors—desperate for yield—chasing income investments to unreasonably high prices. We'll gladly avoid playing that over-crowded game, and I expect to see those investors trampled when they all rush to the exits (higher interest rates being the most likely cause).

Wells Fargo and **M&T Bank** out-performed for equity income portfolios this quarter. Please see my comments above on both.

Philip Morris International and **Fairfax Financial** under-performed in equity income portfolios this quarter.

Philip Morris International (PMI), the world's largest cigarette company outside the U.S. and China, declined 6% on—wait for it—news of Trump's election. I believe currency concerns are the culprit, but such worries underestimate PMI's dominant position in cigarettes and the popularity of its rapidly growing reduced risk product, iQOS (heat-not-burn). I continue to see PMI as a very strong company that will benefit from international growth into the distant future.

Fairfax Financial, a Canada-based specialty insurance company, declined 16% partly due to increasing interest rates and partly due to its decreased stock market hedges. Higher interest rates means Fairfax's bond portfolio declined, and the market took that unfavorably even though Fairfax sold 90% of its Treasury bonds before the election and its bond portfolio is short duration. Fairfax also decided to remove 50% of its stock market hedges, initiated 6+ years ago, on a positive view of a Trump presidency, and investors didn't like that, either. Fairfax has since announced the acquisition of a sizeable insurance company, Allied World, which I view very favorably, and has an outstanding record of underwriting insurance and investing the premiums. I think we are in very good hands with Fairfax.

Market and economic outlook

The S&P 500 returned 3.8% in the fourth quarter and 12.0% for the year. These above average results—again—lowered my six year average projections, this time to 3.3% for growth and 5.1% for equity income. Not surprisingly, these are the targets I aim to beat when examining investment opportunities. I like our odds.

Projected annualized returns over the next 6 years	
S&P 500 (growth benchmark)	-4.0% to 10.6%
S&P-500-yield-plus-inflation (equity income benchmark)	2.1% to 8.1%

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

U.S. economic growth picked up in the third quarter, topping out at 3.5% (the best in two years). Retail and housing sales climbed strongly, unemployment is low at 4.7%, and transportation companies from airlines to UPS and FedEx showed increasing unit growth over last year.

Internationally, it's still a mixed picture. The economies of Brazil, Russia and Argentina look like they're finally bottoming, China's growth continues to decline at a measured pace, and Japan and Europe are still stagnant; but India, Indonesia and the Philippines are growing briskly. Another sign that international demand might be rebounding: increasing commodity prices, especially copper, iron ore and oil.

President-elect Trump has been moving markets, too. Bonds fell on the assumption of increasing inflation, and stocks rose strongly on the perception of a more pro-business administration. Not all companies benefited equally, though. International consumer goods companies have been punished by the threat of protectionism, while banks rallied on hopes for higher interest rates and lower regulation. The guessing game about what Trump and Congress will do is likely to continue into the New Year, leading to higher volatility in 2017 and beyond.

Volatility is not a bad thing—at least, not for us. When stock prices swing broadly, some stocks tend to rise at the same time others decline. This creates excellent opportunities to sell winners whose prospects haven't changed and buy recent losers whose outlook is better than many realize. It's the perfect environment for our style of investing, and we've been active as a result.

Apophenia? Or Underlying Pattern?

If you've never heard of apophenia before, you're not alone—I'd never heard of it, either (until I looked it up for this article). But, if you've ever heard of someone seeing implausible patterns, a potato shaped like Hitler or a set of numbers that just "couldn't be random," then you know what apophenia is: **seeing patterns in random data that don't really mean anything.**

In the investing world, there's a cottage industry of Technical Analysts who study stock price charts looking for "head and shoulder" and "cup and saucer" patterns. Scientific research and my personal experience indicate such pattern recognition lacks proof.

That doesn't mean all pattern recognition is hooey. Newton and Darwin found definite patterns in reality—recognizing underlying truths in the data. Such findings transformed our understanding of the world and dramatically improved our lives.

I, too, look for patterns in the data. I try to figure out why investments have or haven't worked, and which companies and managers succeed and which ones don't. I also look for patterns in our performance data.

Looking there, I've noticed our quarterly performance shows seasonality: how we perform seems to fluctuate in a pattern over the year. Specifically, **we tend to out-perform the market in the first quarter and under-perform in the other three quarters.**

Our batting average shows what I mean. Batting average is the percentage of the time we beat the market divided by the total number of quarters examined. The table below shows the data:

	Q1	**Q2**	**Q3**	**Q4**
Batting average	73%	45%	33%	42%

See the pattern? We beat the market almost three quarters of the time in the first quarter, less than half the time in the second quarter, only one third of the time in the third quarter, and less than half the time in the fourth quarter.

There is a lot of variability in the data, though, so the pattern isn't strikingly consistent. For example, below is a table of our maximum out-performance per quarter over the last 11 ½ years:

	Q1	Q2	Q3	Q4
Out-performance	6.1%	6.2%	6.7%	3.4%

Does that match the batting average pattern? I don't think so. Our biggest win was in the third quarter, when we've typically lost to the market, conflicting with the pattern I suggest. Our smallest win, however, was in the fourth quarter, when we usually lose, supporting my pattern. Below is a table of our worst under-performance per quarter:

	Q1	Q2	Q3	Q4
Under-performance	-5.2%	-1.7%	-4.1%	-5.2%

Again, this data doesn't support the batting average data. Our biggest losers were in the first and fourth quarters, both contradicting *and* supporting my seasonality observation. Our smallest loss was in the second quarter, when we've tended to lose, thus going against my pattern. Below is an account of our average and median performance against the market each quarter since inception:

	Q1	Q2	Q3	Q4
Average	1.4%	0.5%	-0.6%	-0.7%
Median	1.8%	-0.7%	-1.0%	-0.9%

On average, we beat the market 1.4% and 0.5% in the first and second quarter, and lost to the market by 0.6% and 0.7% in the third and fourth quarter. That seems to support my seasonality claim. Looking at the median, which represents the middle (50th percentile) of the data set instead the arithmetic mean (more affected by very large and small data points), we beat the market by 1.8% in the first quarter, and lost by 0.7%, 1% and 0.9% in the second, third and fourth quarters. Median definitely supports my seasonality observation. With all that data reviewed, where does that leave us?

On the one hand, batting averages, averages, and medians seem to exhibit seasonality; on the other hand, max and min performance doesn't show a clear pattern. It's not glaringly obvious the data shows seasonality, perhaps just a tendency. If, however, the seasonality is real, it shouldn't surprise you to see us win in the first quarter, or lose in the other three.

Seasonality isn't a problem to be fixed or improved, just an observation. Sometimes such tendencies highlight issues requiring solutions, and I'm always on the lookout for such problems. At other times, they simply acknowledge the way things are. As I'll describe below, **the reason why our performance might exhibit seasonality is probably *also* why we out-perform over the long run, and should be openly acknowledged instead of snuffed out.**

So, why do I think our performance may exhibit seasonality? I can think of three potential reasons: 1) analyst revisions, 2) tax loss selling, and 3) annual bonuses.

<u>Analyst revisions</u>

During the year, companies and security analysts tend to focus on the next quarter's earnings estimates. This quarterly focus biases analyst estimates, giving benefit to companies that report good earnings and detriment to those that report poor results. But, the process is overly influenced by short term data, which inherently includes random noise as well as underlying information. That means analyst estimates are revised up and down over the year due—to some degree—to noise rather than underlying trends.

Because we tend to buy out-of-favor securities and sell those in favor, we are punished by that short term noise. **Analysts upgrade the companies we sell and downgrade the ones we buy, and that could explain our under-performance during the last three quarters of the year.**

But, as the New Year arrives, companies and analysts turn their attention away from quarterly numbers and on to the next full year and beyond. This shifts their estimates away from short term data and back toward longer term trends. **When short term noise leaves the estimates, this tends to boost previous under-performers (our holdings) and hamper prior out-performers (the things we don't hold),** which could explain our first quarter out-performance. Or, at least, that is what I theorize might be happening.

<u>Tax loss selling</u>

Another explanation for our seasonality could be tax loss selling. **Investors with taxable accounts tend to sell their losers in the third and fourth quarter to book losses,** thus lowering their year-end tax bill. That makes securities that have fallen over the year go down even more as additional selling pressure pushes them down further. Those securities just happen to be the ones we buy because we usually buy out-of-favor securities, leading us to under-perform in the third and fourth quarter.

Then, in the New Year, those same investors either buy back those stocks, or simply cease their selling pressure, leading the recently downtrodden (our holdings) to rally in the first quarter. I see this explanation as a potential cause or contributor, but not as likely a cause as analyst revisions.

Bonus payments

At the beginning of a New Year, bonuses are paid to many employees for their prior year's achievements. **If those bonus receivers buy our out-of-favor securities, that could explain why we seem to out-perform in the first quarter.** I tend to discount this explanation because it assumes that those receiving bonuses buy downtrodden securities, and that's unlikely given investors' general tendency to follow the crowd. Perhaps I'm under-estimating the savviness of those receiving bonuses.

Regardless of the reason, over the last 11 ½ years, we have tended to win in the first quarter and lose in the other three. I think this happens because we buy out-of-favor securities that suffer during the last three quarters from market scorn, and are resurrected in the first quarter as investors adjust their portfolios in the New Year. If that is the case, it is the source of our out-performance and something to be cheered. If not, then future data will show that I was seeing a pattern in random data, and thus exhibiting apophenia.

Until next quarter

If you have any questions or comments about this letter or anything else for that matter, please contact me at your convenience. I always love hearing from you.

Also, it's been a while since I asked, but if you know anyone who might be interested in my services, please let me know. Referrals are how I grow my business. I'd be happy to help anyone looking for better than average results.

Unstintingly,
Mike

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