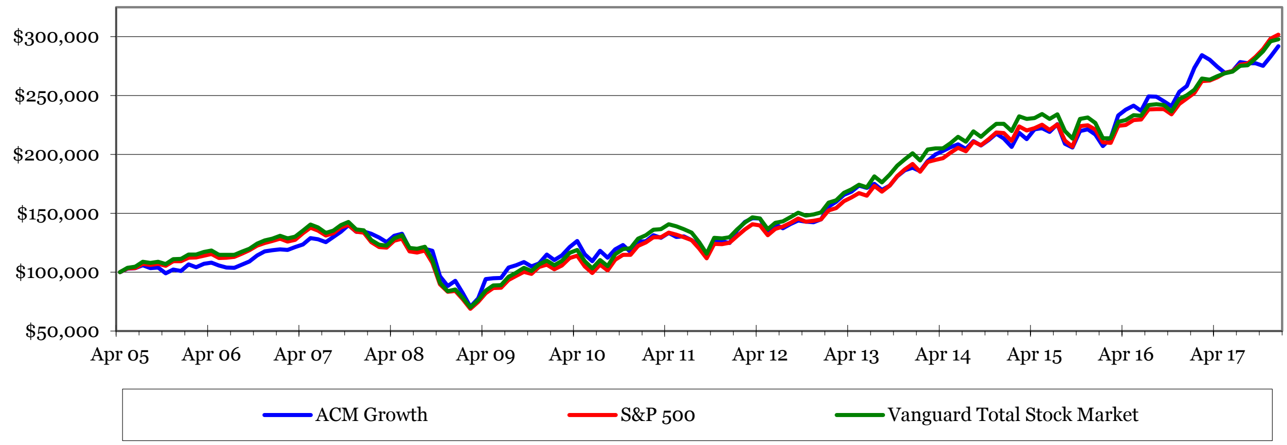
ATHENA CAPITAL MANAGEMENT

Cumulative Growth Performance

Performance as of 12/31/17	Year to date	3 years	5 years	10 years	Since inception (4/30/05)
ACM Growth	13.07%	36.70%	101.67%	117.15%	192.02%
S&P 500	21.83%	38.29%	108.13%	126.03%	201.74%
Vanguard Total Stock Market	18.98%	31.71%	97.45%	119.87%	197.82%

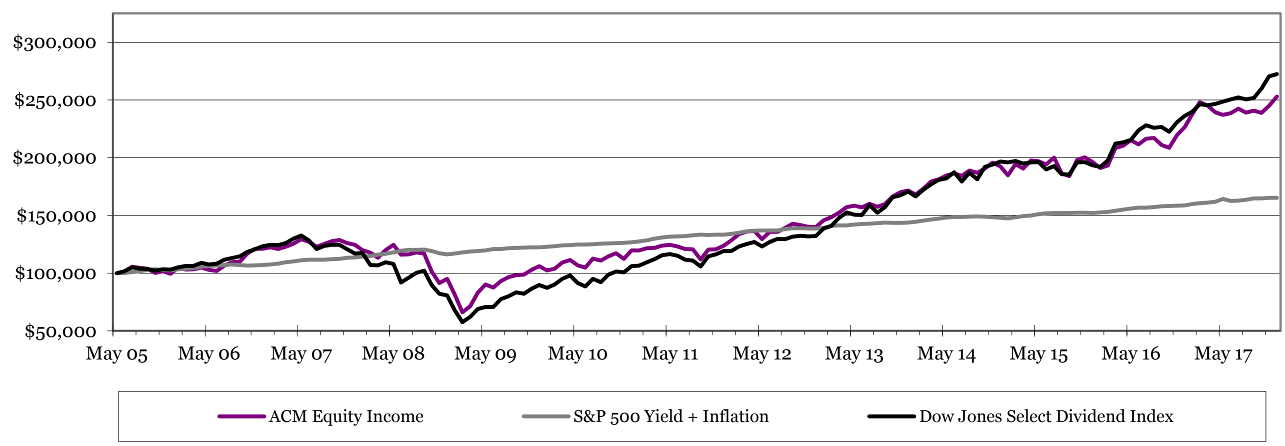
Comparison of the change in value of $100,000 investment in ACM growth versus S&P 500 and Vanguard Total Stock Market



Cumulative Equity Income Performance

Performance as of 12/31/17	Year to date	3 years	5 years	10 years	Since inception (5/31/05)
ACM Equity Income	11.80%	31.38%	81.01%	103.20%	152.95%
S&P 500 yield + inflation	4.16%	11.80%	19.21%	45.70%	65.27%
Dow Jones Select Dividend Index	15.44%	38.50%	106.21%	133.20%	174.48%

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 and short positions, 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, sometimes short positions, 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.

January 12, 2018

When the growth investing beats value by 30% to 13% (*a 17% difference!),* I don't expect to win, and that was indeed the case in 2017. The S&P 500 gained 22% to our 13%, due entirely to value under-performing growth. I remain resolutely commited to value, however, because it's won 96% of the time over 10 year periods since 1926. That means I'm eagerly anticipating a reversion to the mean and believe we'll be richly rewarded for our patience.

Your quarterly letter reviews our performance, what happened in the economy and markets, what I expect going forward for both, and a discussion of concentrated investing—why focus works in investing as in much of life.

Please note: TD Ameritrade's acquisition of Scottrade was completed last September. Scottrade has notified me that our accounts will be switched over to TD Ameritrade some time in the first half of 2018. I will provide more information about this as soon as I receive it.

Performance this quarter

Growth portfolios under-performed the S&P 500 over all reported periods. There's no denying that markets go through unpredictable and sometimes long cycles, much like the weather and other natural phenomenon. It's best not to get lost in such fickle trends, though, but to understand their nature and align yourself with what works over the long term. We are positioned just so, and I expect to reap the rewards of our consistency in time. As mentioned last quarter, measuring ourselves against a value benchmark gives an idea of whether we're on track or not, and it's clear to me we are. For this reasons, I'm expecting good things in our future.

Wells Fargo and **USG Corp.** out-performed for growth accounts this quarter.

Wells Fargo, the largest community bank in the U.S., rose 10% this quarter for three reasons. First, the Federal Reserve continues raising interest rates as good economic news keeps coming out. Wells Fargo, like all banks, makes most of its money on the spread between deposit and loan interest rates, so increasing rates tends to improve profits as loan rates climb earlier and faster than deposit rates. Second, corporate tax rates going from 35% to 21% next year will greatly benefit Wells Fargo's bottom line. And last, Wells Fargo's fake account scandal is finally moving from front to back page news, and investors are accepting that most of the underlying problems have or are being fixed. I expect Wells Fargo to continue benefiting as the economy improves and interest rates ratchet up.

USG Corp., the largest wallboard manufacturer in the U.S., climbed 18% due to an expanding housing market and higher demand caused by hurricane Harvey. Flood damage in Houston has raised the need for wallboard, so USG is being rewarded with higher sales volumes and better pricing. Added to that, millennials are slowly but surely moving into starter homes, and that's similarly increasing wallboard end-demand. USG's valuation is starting to become stretched, though, so it wouldn't surprise me if we trimmed our position to buy cheaper options.

Liberty Latin America and **Philip Morris International** under-performed in growth accounts this quarter.

Liberty Latin America, a significant provider of cable and wireless services in the Caribbean, Central and South America, declined 15% because of growth difficulties and damage from hurricane Harvey. Some of Liberty's markets were recently acquired, so Liberty is going through an adjustment process of eliminating unprofitable business and facing new competitors, slowing short term growth. Also, one of Liberty's larger operations is in Puerto Rico, which was devastated by hurricane Harvey. Restoring operations there will require a large additional capital commitment. Both these issues are temporary, though, so I think investors are overlooking Liberty's growing scale and long term prospects. I'm optimistic enough to consider acquiring a bigger stake.

Philip Morris International (PMI), the largest tobacco company outside the U.S. and China, declined 5% over fears about government regulation of tobacco. The Food and Drug Administration (FDA), which regulates tobacco in the U.S., published its intent to reduce combustible tobacco's nicotine levels to non-addictive levels over time, and this sent markets scurrying. Overlooked by investors was the fact that a) PMI does no business in the U.S., and b) PMI leads world markets in non-combustible tobacco products that the FDA *wants* smokers to switch to. I don't expect this tempest in a teapot to last long.

Equity income portfolios continue to out-perform our long term benchmark over all periods and lag the Dow Jones Dividend Select Index. I've positioned our portfolios to generate consistent and growing income, with a focus on safety and reliability. That doesn't generate barn-storming excitement quarter after quarter, nor does it prevent principal draw-downs during economic malaise. But, it should minimize interest rate and credit risk while producing a growing stream of income ahead of inflation. We are achieving that handsomely, so I'm happy with our results and expect more of the same going forward.

Wells Fargo and **Deere & Company** were equity income's out-performers this quarter. Please see my comments above on Wells Fargo.

Deere & Company, the largest agricultural equipment manufacturer in the world, rose 25% this quarter as the agricultural market seems to be bottoming. The farm market went into decline several years ago, but that finally reversed this year. Deere's sales are rebounding and its earnings jumped significantly, making investors very enthusiastic. Added to this, Deere recently closed the acquisition of Wirtgen, a dominant niche maker of road construction and maintenance equipment. Investors are correctly interpreting this news well, and I expect Deere to continue to be a winner for us.

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

Market and economic outlook

The S&P 500 returned 6.6% last quarter and 21.8% in all of 2017. Wow, what a year! Higher results in the past means lower results in the future, though, so I'm expecting average returns of 1% for growth and 5% for equity income. If that fails to excite you, then you understand why I wouldn't recommend investing in a broad market index at these levels.

Projected annualized returns over the next 6 years	
S&P 500 (growth benchmark)	-6.3% to 8.0%
S&P-500-yield-plus-inflation (equity income benchmark)	1.9% to 7.9%

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

The global economy is in a synchronized upswing for the first time in a decade. South Asia (including India) is leading the pack with 6.5% growth, East Asia (with China) is close behind at 6%, Eastern Europe and Sub-Saharan Africa are rebounding to 2.5% growth, the U.S. is firmly above 2% and approaching 3%, the Middle East and North Africa are seeing 2% growth (down from 3%), Europe is growing between 1.5% and 2% (which is strong for them), Japan is accelerating from 1% to 1.5%, and Latin America is rebounding from negative to positive growth. Even Russia, Brazil, Argentina and Nigeria, which saw negative growth in 2016, have returned to positive numbers in 2017.

As expected, this upturn is leading to further gains in equity markets and rising interest rates (which means declining bond prices). If world markets continue this coordinated expansion, it could lead to even higher interest rates as investors predict accelerating inflation. At some point, such inflation concerns could generate still higher rates that would likely bring about significant declines in equity and bond prices. Investors seem unconcerned about this for now, but such a possibility warrants careful attention.

Good economic news caused market participants to finally shift their focus from macro-economics to individual company performance. So far, this has looked like under-performance for us because the market's darlings have taken off as our out-of-favor positions have remained flat or declined. Fear not, though, this is a normal pattern as investors adjust their expectations away from central bank policy and back towards specific business results. Eventually, they'll recognize they're over-paying for growth and under-paying for value.

I can't predict when that turn will occur—I learned long ago that no one can time the markets' twists and turns. Instead, I've been digging deep to better understand market sectors where value exists but is not yet recognized. This has been the best path to building wealth over time (as a sharp-eyed reading of the Forbes 400 reveals), so it's the tried and true method I use. Despite our short term headwinds, I'm becoming increasingly excited about our prospects.

Concentration: To *Beat* Average, don't *be* average

It's often best to follow the herd. If you're in a restaurant and you hear a fire alarm, it's best to follow the crowd outside and *then* find out if it's safe to go back. If you're driving in heavy traffic and see all the brake lights come on ahead, it's best to slow down like others to assess the situation. If you're in a foreign country and notice everyone walking and driving on the left, it's best to adopt their convention rather than fight it.

Following the herd isn't always the right choice, though, and investing is a field that clearly illustrates this. Following everyone into tech stocks in 1998-1999 was disastrous. So was crowding into real estate in 2005-2006. The same can probably be said for buying cryptocurrencies now. With investing, it's often best to zig when everyone else zags.

Put another way, to do *better* than the herd, you must do something *different* than the herd. This is hard, though, because it feels unpleasant—we humans evolved to feel most at ease going with the flow. Deviating from the crowd leads to self-doubt, discomfort and criticism. Despite these ill feelings, it's a better way of building and sustaining wealth.

One way to diverge from the herd is by concentrating your investments. Concentration is the idea that it's best to focus your efforts narrowly instead of broadly, putting full effort in one area. Instead of putting your eggs in many baskets, you put your eggs in one basket and watch it like a hawk.

Academic and anecdotal research shows concentration works in investing. Only investors who concentrate beat the averages. They tend to hold fewer companies with larger position sizes, and their research tends to be narrowly focused. Such investors look wrong and out of synch at times—often with *years* of under-performance—before generating out-sized results that make the wait worthwhile.

As hinted above, there are two ways to concentrate: position size and research focus. **Concentrated position size means buying portfolio weightings different than an index.** For instance, if the S&P 500 holds 3.8% Apple, 2.9% Microsoft, 2.8% Google, 2.0% Amazon, 1.8% Facebook, etc., a concentrated investor might buy 0% Apple, 13% Microsoft, 0% Google, 0% Amazon, 0% Facebook, etc. As you've seen in your quarterly portfolio appraisals, I don't own 500 stocks like the S&P 500, nor do I try to mirror the index by monitoring its holdings or position sizes.

Instead, I put our money in a few areas I know well, and that seem most out of synch with underlying value. This concentration means we can meaningfully out-perform the market over time, but it also *guarantees* we'll be out of step at other points. Why? It's impossible to correctly forecast underlying earnings *and* market participants' reactions to those fundamentals each and every period. That means our portfolios frequently decline at times when the market is going up (sound familiar?). This is an underlying reality that must be accepted to out-perform.

(Surprisingly to me, we've tracked fairly closely to the S&P 500 over the last 12+ years despite being invested with significantly different weightings than the market. In my opinion, this shows how the Federal Reserve's decade-long easy money policy has influenced stock prices, leading them to march in lock-step up and down together. Periods like this happen from time to time, but never last—as we're starting to see.)

Concentration doesn't just apply to position size, but also to research. Before deciding what to buy, it's wise to focus your study in narrow areas, too. This is an acknowledgement that no one can understand and predict all 3,600 actively traded U.S. companies, or the over 100,000 actively traded global stocks, much less the additional 500,000+ less actively traded businesses.

Instead, I focus on the areas where I can understand things and gain an edge over other analysts who track many more investments. For example, the average mutual fund owns 90 stocks and tracks over 500. The 20% most diversified mutual funds own over 200 stocks, meaning they monitor at least a thousand. In contrast, we own 18 businesses and track less than 70 closely. I like our odds when competitors spread themselves thin and we're focused.

Accordingly, I stick to the universe of industries I understand and have studied for years, like banking, insurance, heavy equipment, railroads, tobacco, beverages, telecom, entertainment, and enterprise information technology. By focusing my time and effort in narrow areas (and growing into new areas over time), I can become more knowledgeable than my competitors and better able to predict fundamentals and thus long term investment results.

Perhaps more controversially, I think concentration reduces risk over the long run. Many, including finance professors, equate risk with volatility, by which they mean stocks moving up and down differently than the market as a whole. I disagree. I see risk as permanent impairment of capital—losses that don't recover.

That means I don't see risk in market prices going down, but only in underlying business value permanently shrinking. But, the market frequently misjudges such fundamentals, latching on to incomplete narratives. Most frequently, investors focus on short term issues while ignoring a more certain long term future.

By concentrating research and position sizes, I think we minimize the risk of permanently losing capital. Thorough understanding is crucial to avoiding losses, and requires deep focus. Such narrow application doesn't mean we're never out of synch with the market or always right, but it does mean that concentration can make losses for the portfolio as a whole, over the long run, less likely.

Concentration is a method that works with investing as in much of life. To do better than average, you must invest differently than average. This isn't easy because it feels uncomfortable at times. It does work, though, and research supports the focused approach. I concentrate both position size and research effort. This may seem riskier to some, but I believe it reduces the probability of permanently impairing capital. More significantly, it makes beating the market both possible and more likely.

Until next quarter

If you have any questions or comments about my letter, our returns, markets, the economy, interest rates and inflation, concentrated investing, or anything else, don't hesitate to contact me.

I hope you have a great three months and look forward to updating you in April.

Sedulously,
Mike

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