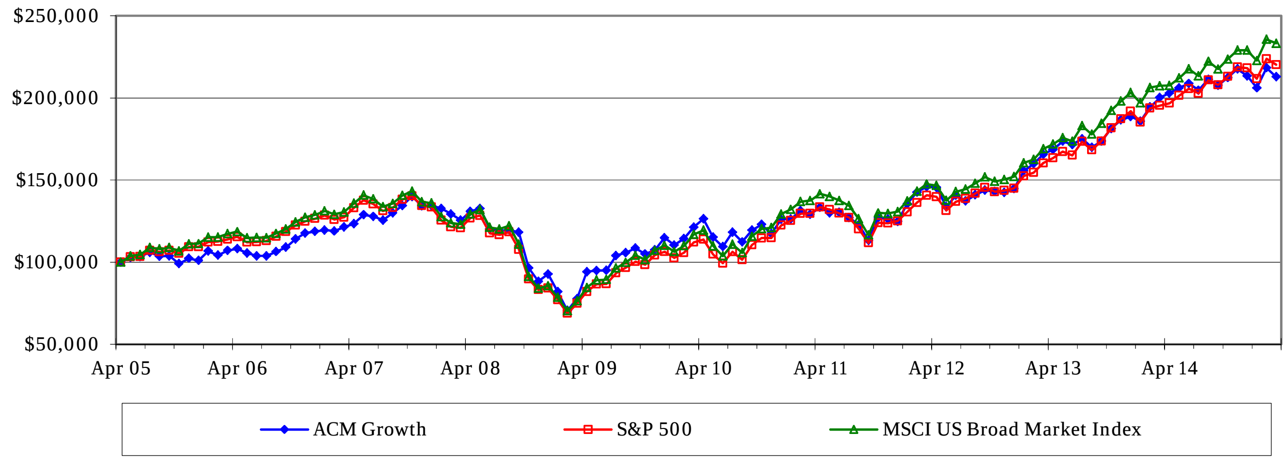
ATHENA CAPITAL MANAGEMENT

Cumulative Growth Performance

Performance as of 3/31/15	Year to date	3 years	5 years	7 years	Since inception (4/30/05)
ACM Growth	-0.31%	45.91%	75.45%	69.52%	112.82%
S&P 500	0.95%	56.55%	96.50%	82.21%	120.28%
MSCI US Broad Market Index	1.84%	58.04%	99.56%	89.51%	133.27%

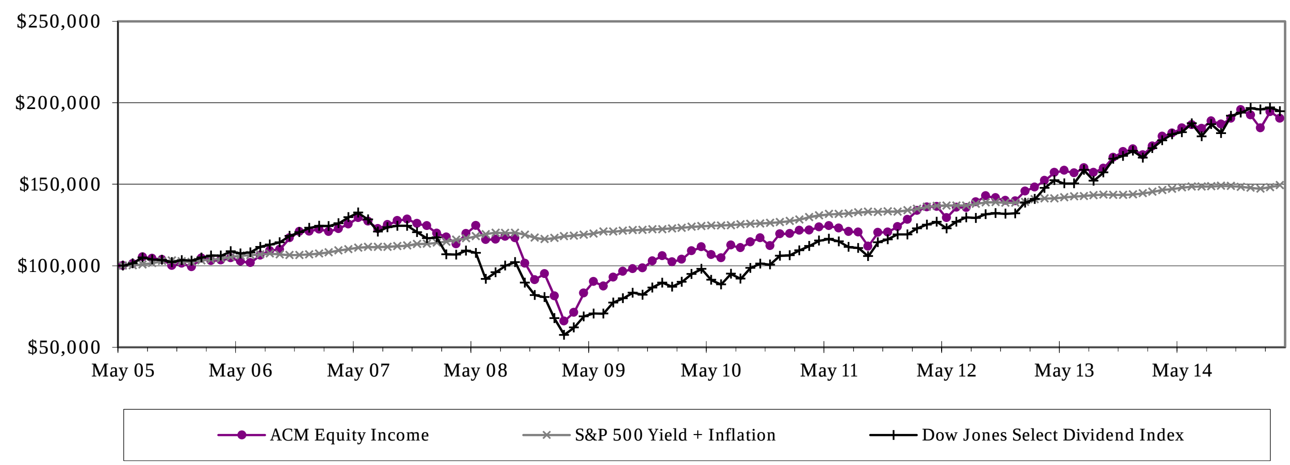
Comparison of the change in value of $100,000 investment in ACM growth
versus S&P 500 and MSCI US Broad Market Index



Cumulative Equity Income Performance

Performance as of 3/31/15	Year to date	3 years	5 years	7 years	Since inception (5/31/05)
ACM Equity Income	-1.12%	40.01%	74.46%	68.03%	90.35%
S&P 500 yield + inflation	1.08%	9.76%	20.57%	28.88%	49.41%
Dow Jones Select Dividend Index	-0.96%	55.57%	105.20%	82.48%	94.85%

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

April 17, 2015

The market started the year down in January, up in February, and back down again in March, finishing with a mere 1% return. Welcome back volatility. Our portfolios did worse than that mostly because of our exposure to international investments that under-performed as the U.S. dollar climbed over 20%. More on this below.

This letter discusses our performance this quarter, what I expect from markets and the economy, and an after action report on our successful investment in Hewlett-Packard.

PERFORMANCE THIS QUARTER

Growth portfolios under-performed over all reporting periods. The major reason for this under-performance is a greater than 20% rise in the U.S. dollar over the last nine months. Because we are heavily weighted to international companies that report in U.S. dollars but earn much or most of their profits in other currencies, our holdings have reported lower earnings—in dollar terms—than solely U.S. based companies. Currency moves such as this tend to be a temporary phenomenon, especially for strong businesses with pricing power—like we own. It will take time for the currency impact to subside, but when it does I think our results will match underlying fundamentals, which continue to look strong.

Growth's out-performers this quarter were **Markel Corp.** and **M&T Bank**.

Markel is a specialty insurance company that led our out-performers for the second quarter in a row. Even though the insurance market has been soft for a decade, Markel has managed to grow its business through acquisitions, new product lines, and outstanding investment returns. I expect Markel's fundamentals to continue improving, but I'd be surprised if it led out-performance for a third quarter in a row.

M&T Bank is a top 25 bank based in Buffalo, New York covering much of the northeast and mid-Atlantic regions. It has been trying to acquire New Jersey based Hudson City Bancorp for almost three years, but regulatory issues continue to impede the merger. Every few months, negative sentiment about the acquisition drives down the price of fundamentally sound M&T. That happened again this quarter and we were able to purchase shares on the lowest priced day of the quarter. The price has since recovered, which is why it out-performed. Whether the acquisition happens or not, M&T is a solid bank with temporarily high expenses due to regulatory issues, and I believe it will provide solid returns over time.

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

Microsoft, the largest software company in the world, posted weaker than expected results last quarter and suffered due to the dollar's rise. The strong dollar hurt Microsoft's earnings as overseas profits declined in dollar terms. Currency impacts, though, tend to equalize over time, so I think that's a short term phenomenon. On quarterly results, strong growth in new business lines with lower margins and weak growth from legacy segments with higher margins surprised the market. I expect Microsoft's fundamentals to improve as its new segments post rapidly growing profit margins, thus taking the baton from legacy segments.

Philip Morris International (PMI), the largest non-Chinese tobacco company in the world, suffered due to the rising dollar. PMI only sells products outside of the U.S., but reports its financials in the U.S. dollar. This means that a rising U.S. dollar reduces PMI's results no matter how well it is doing fundamentally. For example, Russia is the largest tobacco market outside of China, and one of PMI's largest markets. With the Russian ruble down over 50% recently, PMI's results were significantly impacted. PMI is gaining share against competitors and has the pricing power to adjust to currency moves, but it may take time for that to be fully reflected in PMI's results (after releasing earnings in April, PMI is up 12.8% versus 1.8% for the S&P 500).

Equity income portfolios under-performed in the 1st quarter, but out-performed our long-term benchmark over all other periods. Equity income accounts felt the same pain as growth accounts: the rising U.S. dollar. As I've already mentioned, currency impacts such as this tend to equalize over time, but we will feel the consequences over the short term. In the meantime, our holdings continue to pay solid dividends in U.S. dollars that I believe will continue to grow faster than inflation. Stay tuned for the bounce-back.

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

Fairfax Financial, a specialty insurer like Markel, is posting excellent results despite a highly competitive insurance market. Fairfax is doing well because of acquisitions, organic growth and excellent portfolio returns (similar to Markel). What sets Fairfax apart is that its investment portfolio is significantly hedged against a downturn in equity markets, and it made a low-cost bet that deflation could occur in the U.S. and

Europe, which is starting to pay off. Fairfax isn't as cheap as it once was, but I expect its fundamentals to continue performing well.

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

Market and economic outlook

The S&P 500 returned 0.95% so far in 2015. These lower than average returns mildly boosted my projections over the next six years, but not enough to become enthusiastic. With an expected mid-point return of 3.7% on the S&P 500, I continue to urge caution and recommend investment selectivity.

Projected annualized returns over the next 6 years	
S&P 500 (growth benchmark)	-4.6% to 12.0%
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. growth continues to drive the global economy, with growth from India and Southeast Asia providing a helping hand. Europe and Japan continue to struggle with near zero growth. China is officially accepting lower growth as they transition to a more consumption-based economy. Major oil and gas exporters like Russia, Nigeria, Saudi Arabia and Venezuela are struggling with much lower oil prices. South America is facing major political and economic headwinds, especially in Brazil and Argentina.

The downside—for us—of strong U.S. growth is a major rally in the U.S. dollar relative to other currencies. The U.S. dollar has climbed over 20% since last July, and that makes U.S. goods cost more to foreigners and foreign goods less expensive here in the U.S. It also means profits made overseas are worth less here at home. Such impacts tend to be short-lived because markets adjust prices to reflect exchange rate changes, but in the short run the impacts are real.

This affects our investments because we own large positions in several companies with significant international operations: Philip Morris International, Microsoft, Coke, IBM and John Deere. In an economy growing 5-6% annually, a 3-7% currency headwind can make even excellent fundamental performance look lousy in the short run. We're feeling that pain for now, but I am convinced it is only temporary.

This is a big part of what makes successful long term investing so difficult: if you don't look deep into what is going on behind the numbers, it is easy to think things are going poorly when they aren't, and vice versa. This is where a long term view and in-depth research really pays off. The payback may not be swift, but it is fruitful.

After Action Report: Hewlett-Packard

I've found two ways to achieve investment success: 1) buy solid companies that perform well, and 2) buy weak companies very cheaply. Hewlett-Packard (HP) illustrates the second category. I can't say all my investments work out this way, but this example does give you a flavor of why value investing works.

<u>Research</u>

I started following HP in 2008 to better understand the industry and its competitive landscape. HP is the #1 supplier of PC's in the U.S. and #2 in the world (after Chinese company Lenovo). HP is the largest information technology (IT) company in the world based on revenues, with divisions covering desktop and laptop computers, printers, enterprise hardware (servers, storage, networking), services (IT consulting, out-sourcing, back-office automation) and software.

HP's end markets have been facing a difficult competitive environment. The substitution of smartphones and tablets for PC's, decrease in printer usage, and highly competitive market for enterprise hardware, services and software have led many to question the viability of companies like HP, even as earnings declined but little.

Added to this, HP had been under a cloud of controversy. HP's CEO, Mark Hurd, had resigned because of an inappropriate relationship with a contractor. His replacement, Leo Apotheker, was forced out after just a year when he made strategic blunders: paying too much for a software company and hastily proposing to break HP in half. HP's board of directors was also under scrutiny for its repeatedly poor hiring and acquisition decisions. That's when Meg Whitman, former CEO of EBay, was brought in to fix the mess.

The combination of a dicey competitive situation and executive missteps had laid HP's stock price low. So low, in fact, that it no longer reflected the fundamentals of the business.

Buying the position

I watched HP's price drop from 2011 into 2012, and spent that time trying to understand whether Meg Whitman, HP's new CEO, would make things better or worse. **I started to buy after I concluded that the economics of the business were not crumbling, and that Whitman had the right strategy for the business and attitude towards shareholders.**

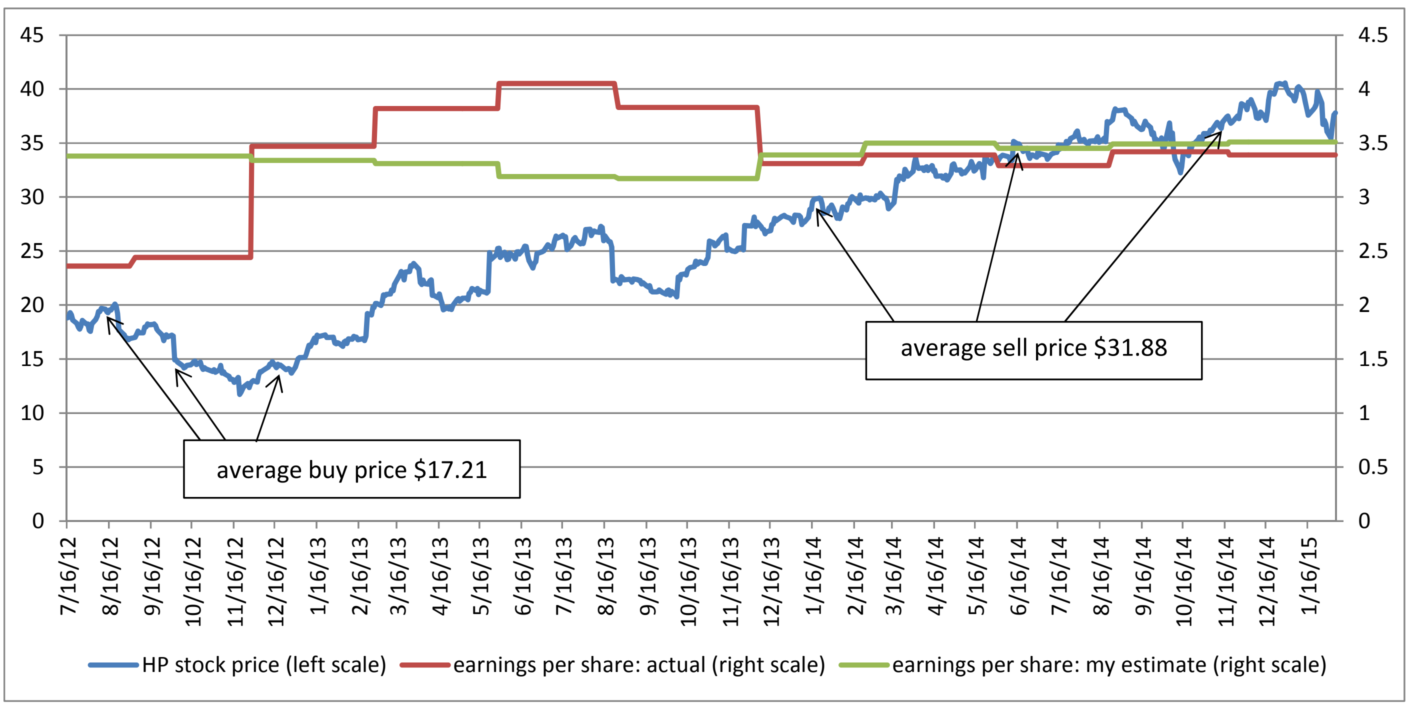
The first small position I bought was in August 2012 at just below $20 a share. I continued buying larger positions through December 2012 as HP's price plunged to rock bottom at $11.35. Our average buy price was $17.21 and we bought as low as $14.23 per share.

Relative to those purchase prices, HP was earning $2.40 per share, and I was predicting normalized earnings of $3.40 per share. The average price we paid showed an actual earnings yield of 14% and a predicted earnings yield of 20%. **Those seemed like good numbers after fully evaluating HP's situation and management's strategy.**

Over that same time, HP's earnings per share climbed from $2.40 to $4 and then back down to $3.40 (the red line in the graph below). My normalized estimate stayed at around $3.40 to $3.50 over this entire time (The green line below). **HP's fundamentals had recovered, but the competitive situation had not dramatically improved.** The bad news flow about management and directors had ebbed, and investors were refocused back on the fundamentals.

Selling the position

I sold the first chunk of HP in January 2014 at around $30 per share. At that point, the earnings yield was around 11% and I concluded that was cheap, but not excessively cheap considering HP's difficult headwinds. I sold more in June 2014 at around $35 per share. An earnings yield of just below 10% seemed like a fair price for a company with HP's growth and competitive characteristics. Finally, I sold the last position in HP in November 2014 at around $38. **With an earnings yield below 9%, I no longer thought the price justified holding.**



Holding the position

After hitting rock bottom at $11.35, HP's price climbed and passed $20 in February 2013. From there, the price bumped up and down between $20 and $27 from February 2013 to November 2013. It then climbed consistently from November 2013 to August 2014 from $27 to $38 per share.

Conclusion

HP was a successful investment because we bought when investors were overly emotional about bad news, and sold after they calmed down and focused on the facts. Although HP faced difficult headwinds and a lot of bad news about management, its price at $23 to $11 per share was too low: indicating a 15% to 30% earnings yield. Staying focused on underlying earnings and earnings power, we were able to buy low and lower, and then sell high and higher.

Until next quarter

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

Industriously,
Mike

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