

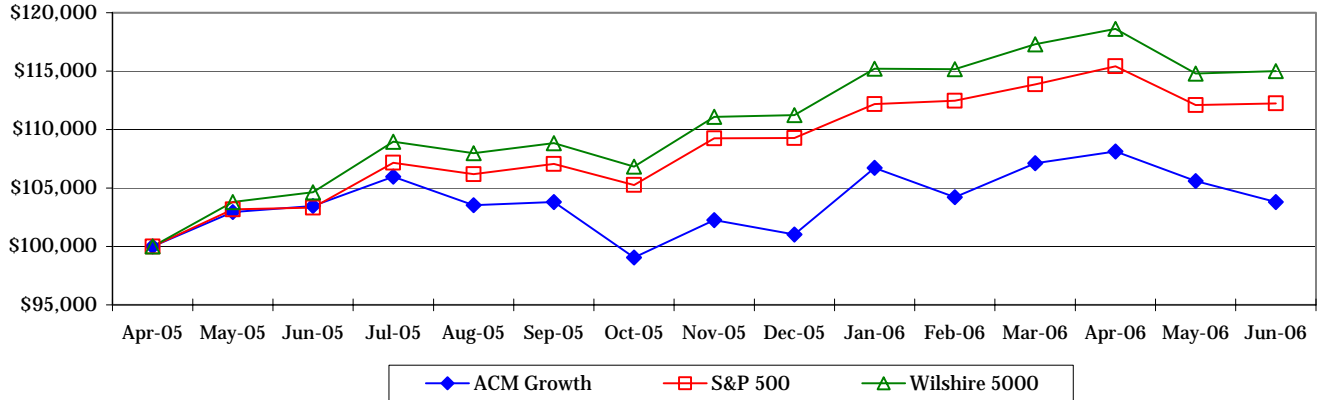


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	Growth Accounts	S&P 500	Wilshire 5000
Year to date: 12/31/05 – 6/30/06	2.77%	2.71%	3.38%
Since inception: 4/30/05 – 6/30/06	3.81%	12.25%	15.01%

Growth Performance

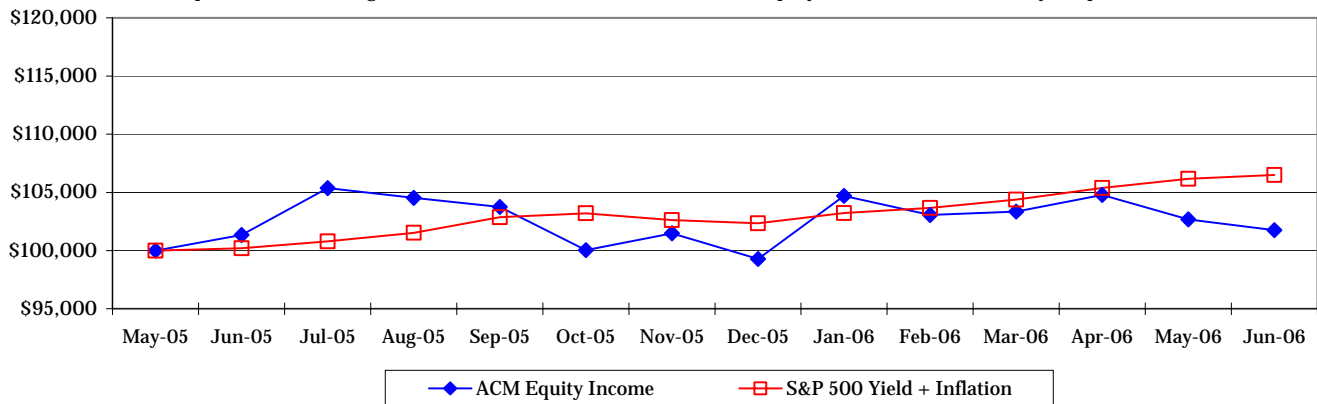
Comparison of the change in value of \$100,000 investment in ACM growth versus S&P 500 and Wilshire 5000



	Income Accounts	S&P 500 yield + inflation
Year to date: 12/31/05 – 6/30/06	2.49%	4.06%
Since inception: 5/31/05 – 6/30/06	1.75%	6.51%

Equity Income Performance

Comparison of the change in value of \$100,000 investment in ACM equity income versus S&P 500 yield plus inflation



Notes on performance presentation:

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. 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. 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 results.



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July 19, 2006

Graphs and tables! I hope you find our new performance graphs and tables easier on the eyes. I created this new display to more clearly illustrate our performance over time and to detail my performance tracking method and disclaimers. As usual, if you have any questions or comments, send them my way!



How Are We Doing?

Although the opening graphs and tables may seem to indicate that things aren't going well, these results are typical for early-stage value investments. I can assure you that the business fundamentals of our investments continue to out-perform the fundamentals of our benchmarks. In time, the market will recognize those fundamentals and I believe our performance will reflect that as well.

Our **growth accounts'** biggest gains this quarter came from **Comcast Corp.** and **Kinder Morgan.** Comcast jumped when it announced good quarterly earnings, and Kinder Morgan zoomed on news it's being bought out. That means the company will be taken off the public market and we can no longer invest in it. Even though it's a winner this quarter, I'm disappointed to see it go because I think it's worth more than we'll get for it.

Price declines in growth accounts came from **Pier 1** and **USA Mobility.** Pier 1 continues its roller coaster on takeover speculation instead of underlying business fundamentals. If Pier 1 turns its business around, as I suspect it will, its fundamentals will shine through. USA Mobility declined due to a restatement of its accounting numbers, which were caused by its former independent accountant. In the long run, I think the market will recognize USA Mobility's strong cash flows.

Equity income's best returns came from **Kinder Morgan** and **National Presto.** As mentioned above, Kinder Morgan soared because it's being bought out. National Presto, on the other hand, climbed due to speculation that its business is turning around.

Price declines for equity income accounts came from **Pier 1** and **Kimco Realty.** Pier 1 sank on the takeover speculation mentioned above. With Kimco, however, its price dipped in response to recent interest rate moves. In time, I think Kimco will grow its dividends fast enough to overcome interest rate concerns.

6 Year Market Projection

Every quarter, I provide projections on how I expect the stock market to perform over the long term. This keeps you informed of what to expect from stocks, helps you plan for the future, and allows you to focus on the long run.

The S&P 500 finished the quarter at \$1,270. My long term projections for market returns are:

Projected annualized returns over the next 6 years	
S&P 500 (growth account benchmark)	-5.6% to 8.0%
S&P-500-yield-plus-inflation (equity income account benchmark)	3.4% to 6.4%

How did I arrive at these numbers? Visit "Free Articles" at www.athenacapital.biz to see my 7/12/05 article.

As you can see, the recent market pullback has mildly lifted my expectations for benchmark returns. Don't get too excited, though. My market projections are still uninspiring and I would not be surprised to see the market decline further over the next year. But don't worry too much either. I think we'll do fine over the long haul.

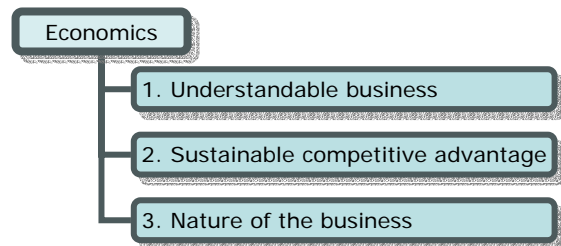
As for the U.S. economy, roughly equal short and long term interest rates and on-going weakness in the housing market indicate a slowing, but not recessionary, economy. Neither rates nor housing, though, decisively indicate what will happen to the economy going forward.

Identifying Good Investments

In part two on good investment traits, I discuss how I analyze the *economics* of a business.



For me, business economics includes three areas:





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1. Understandable business

The most important element in selecting an investment is deciding whether I can *really* understand it—whether I can grasp the basic structure of a business.

To think this through, I ask myself several questions:

- What product or service does it sell?
- How is it sold?
- What are its costs?
- How do sales and costs change over time?
- Can I reasonably forecast what will happen to these elements over the next five years?

Let me use insurance as an example of a business I do understand. I understand what the product is: offloading the expense of uncertain events. I understand how it is sold: through brokers who help customers find the right product at the right price. I understand that insurance premiums (sales) must cover claim expenses (costs). I also grasp how premiums and costs change over time because I understand the competitive landscape. Because I understand these issues, I can reasonably forecast an insurance business's performance in five years.

Bio-medical companies, on the other hand, are *not* something I understand. I don't know how the product works, I don't know how it is sold to hospitals or doctors, I don't understand how much it costs to develop such products, and I have no idea which products will still be on the market in 5 years. For these reasons, I don't feel comfortable projecting a bio-medical business's performance in five years.

So, when I *can* grasp a business with effort, I know I've found a potential investment.

2. Sustainable competitive advantage

Great businesses have unique traits that make them difficult to compete with over time. For instance, they tend to have barriers to entering the industry, bargaining power with suppliers and buyers, limited competitive rivalry, and products that are not easily substituted.

Good businesses tend to have barriers that make it difficult for new competitors to enter an industry. For example, Wal-Mart's huge scale is hard to compete with. So is Coca-Cola's proprietary product backed by years of marketing goodwill. Because scale and unique products are hard to imitate or overcome, few want to compete with these businesses.

Superior businesses tend to have bargaining power with their suppliers and buyers. If a business must buy supplies from only one company, it's difficult to

extract lower prices (jewelry companies must buy diamonds from DeBeers). If, on the other hand, a company has many suppliers, it can exert bargaining pressure on them (Wal-Mart has many options when buying clothing from suppliers).

Buyers tend to present the same issue as suppliers. If there is only one big buyer, it's difficult to haggle over price (think Boeing selling rockets to the government). If, instead, there are many small buyers, it's easier to increase prices (think Marlboro selling cigarettes to smokers).

Intense competitive rivalry makes for a poor business. If there are many competitors fighting for a share of a declining market, like newspapers, they tend to start price wars where no one wins. If, however, two large competitors dominate a market, like Coke and Pepsi, they can both thrive by catering to unique segments within a market.

Good businesses tend to sell products that aren't easily substituted. For instance, buggy whip makers were in trouble when Ford started producing good automobiles. Scotch Whiskey, on the other hand, is a product many consumers feel can never be replaced.

Sustainable competitive advantages allow a business to maintain higher profitability over time. If the favorable industry traits discussed above exist, then I've found a business that may make a good investment.

3. Nature of the business

Nature of a business is a hodge-podge of things I look at that impact a business's economics.

First, I consider the type of business: manufacturing, service or retail. Manufacturers face challenges like outsourcing to China, whereas service industries, like haircutters and restaurants, do not. Retail and services tend to have better economics than manufacturing.

Next, I consider how fast the industry is growing. Growing industries, like computers 10 years ago, allow weak businesses to succeed despite a lot of competition. But, when market growth slows, cutthroat competition will destroy profits for everyone in the industry, like telecom equipment now. Fast growing industries tend to have better economics than slow growth industries.

I also consider the length of a product or service's lifecycle. Some products have short lifecycles that require expensive innovation to keep up with technology, like Intel's microchips. Other businesses, in contrast, seem immune to the need for innovation, like Scotch Whiskey.



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In general, short-cycle products have higher costs and worse economics than long-cycle products.

Another important issue is unionized workforces. Unions tend to lead to high costs and, potentially, crippling strikes. Businesses with unions usually under-perform competitors without unions.

Finally, I look at a business's regulatory framework. Sometimes regulations change rapidly, like in telecommunications, and make it difficult for a business to maintain profitability. In other cases, though, regulations provide a company with an exclusive market, as it does in cable TV. Regulations can make a business have terrible or wonderful economics, depending on the situation.

By examining the nature of each business, I come to grasp which businesses have a more or less favorable nature and, as a result, better or worse economics.

To sum up, I examine all three economic dimensions discussed above (understandability, competitive advantage, business nature) **and judge each business's economics as good, average or poor.** This effort is necessary before I can assess a business's worth. And worth, or valuation, is the third segment of my good investments series to be discussed in next quarter's letter.

Investment Spotlight: Mercury General Corp.

Mercury General sells auto insurance. In fact, it's the leading independent broker and agency writer of auto insurance in California. Mercury also sells auto insurance in 12 additional states, and, to a limited degree, writes mechanical breakdown and homeowners insurance.



Mercury is the lowest cost provider of auto insurance through agents. Although some drivers seek direct insurers like GEICO, Progressive and USAA for insurance, other drivers still prefer sitting down with a knowledgeable agent. And, when people choose to work with agents, Mercury usually provides the lowest cost option.

Auto insurance is a great business because every driver—by law—must buy it. As a result, there's little

threat this business will become obsolete. Because insurance is so widely available, though, insurers must have low underwriting costs to succeed. Put simply, the lowest cost provider makes the most money. Mercury fits this low cost description, and its great reputation for cost controls and profitable underwriting is due, in part, to George Joseph.

Joseph, who founded Mercury in 1961, still runs the company and owns 35% of the business. He created a company culture that emphasizes profitable underwriting, strict cost controls, and efficient claims management. This culture leads to excellent service and affordable insurance rates. Wisely, Joseph built a great team to maintain this culture when he retires.

Mercury provides a necessary service with low costs, disciplined operations, and committed management. That's why I like it as a business and as an investment.

Why Is...

...an upward trend in prices called a bull market and a downward trend called a bear market?

There are a couple of unlikely origins for the terms bull and bear market. One explanation is that bulls attack sweeping *up* with their horns and bears attack swiping *down* with their paws. Another doubtful explanation refers to the speed of each animal's attack: bulls charging at high speed and bears moving cautiously.

The most likely origin of "bear market," though, comes from 16th century London. Bearskin brokers there sometimes sold the deeds to bearskins *before* the bears were even caught. Such an effort generates a profit if bearskin prices collapse (called short selling now). This led to the use of the term bear to refer to someone betting prices would go down. Hence, a bear market refers to a market where the bears—people betting on declining prices—are in control.





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“Bull market” probably refers to the blood sport of bull and bear baiting. In Europe around this time, men and dogs baited bulls and bears for entertainment. This led, over time, to the pairing of bulls and bears as opposites in people’s minds. As a result, bull market refers to a market where the bulls—or people betting against the bears for a market rise—are in control.

Although bull and bear references are common to this day, no precise definition exists for how long a trend must last to merit the term. This means a bull or bear market may refer to anything lasting from minutes to decades. As a general rule, though, most market followers say a bull or bear market commences any time the market trends up or down by 20% or more.

Admirable business people: Andrew Carnegie (1835-1919)

I’ve discovered some of my favorite business people by reading history. Carnegie is unique, though, in that he practically invented so many of the business traits I look for in admirable business people today.

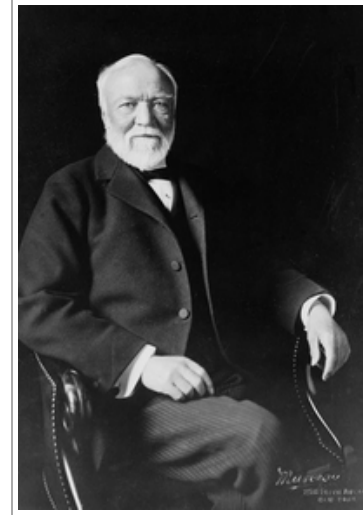
An immigrant from Scotland born poor, Carnegie made his way by working hard. As a young boy, he lived in a Pennsylvania slum and worked 12-hour days as a bobbin-boy at \$1.50 a week. Carnegie’s big break came when he got a job as a telegraph messenger. Later, at age 23, Western Union picked him to be their Pittsburgh superintendent because of his demonstrated work ethic.

Carnegie learned thrift from his mother and put this lesson to work early. While working for Western Union, he saved his money and invested it so successfully that he made more from investing than salary. From his investing experiences, he learned to put his eggs in one basket (instead of over-diversifying) and to watch that basket closely.

After successfully working for others and investing on his own, he decided to concentrate his time and money into one project. He looked hard for a growth industry and found it in steel. It fit his maxim, “Capitalism is about turning luxuries into necessities.” Steel was a luxury at the time, and he realized that producing it at low cost would turn it into something everyone could afford and a hugely profitable venture.

As a manufacturer, Carnegie was one of the first to put laboratory chemists to work on steel-production. He recognized that a scientific understanding of what happens in the blast furnace would lead to greater productivity. This focus and experimentation allowed him to produce more and better quality steel than his competitors.

As an accountant, he was one of the first to recognize the importance of unit costs—pounds of steel per dollar of capital or hour of labor. By understanding his costs in detail and reducing those costs persistently, he greatly increased his factory’s output per unit of input. This meant he could provide the market with steel at lower cost than his competitors.



Carnegie’s life teaches many valuable business lessons: hard work, thrift, invest early and intelligently, find businesses that turn luxuries into necessities, understand an industry’s technology, and reduce unit costs. Though he lived long ago, his example provides an excellent model to compare with today’s managers.

Until next quarter

As usual, I’d love to hear what you think about my services. Feel free to contact me any time with your questions, comments and suggestions. Very soon, in fact, my website will provide an anonymous way to do this.

And, *if you know anyone who would benefit from my investment services*, feel free to send them my website and contact information.

Thank you for your business, and I look forward to hearing from you over the next quarter.

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