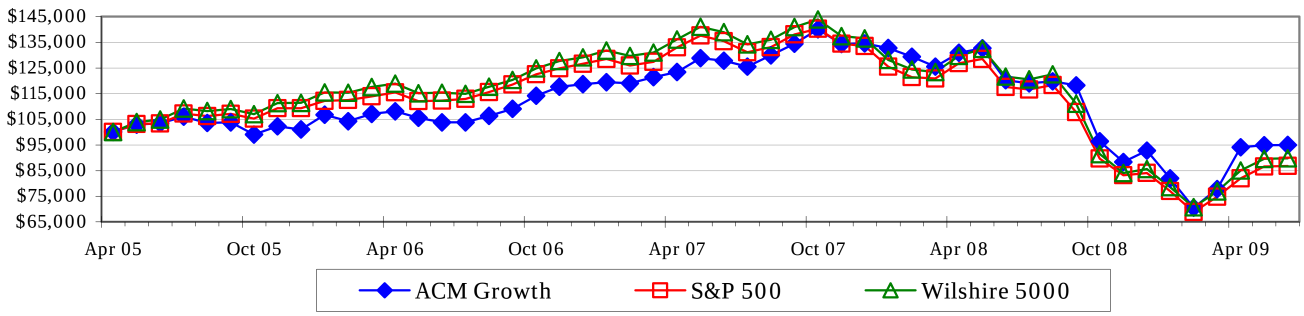
Athena Capital Management

Cumulative Growth Performance

Performance as of 6/30/09	Year to date	2 years	3 years	4 years	Since inception (4/30/05)
ACM Growth	2.41%	-25.72%	-8.53%	-8.22%	-5.04%
S&P 500	3.17%	-35.90%	-22.70%	-16.02%	-13.23%
Wilshire 5000	4.99%	-35.32%	-22.12%	-14.32%	-10.17%

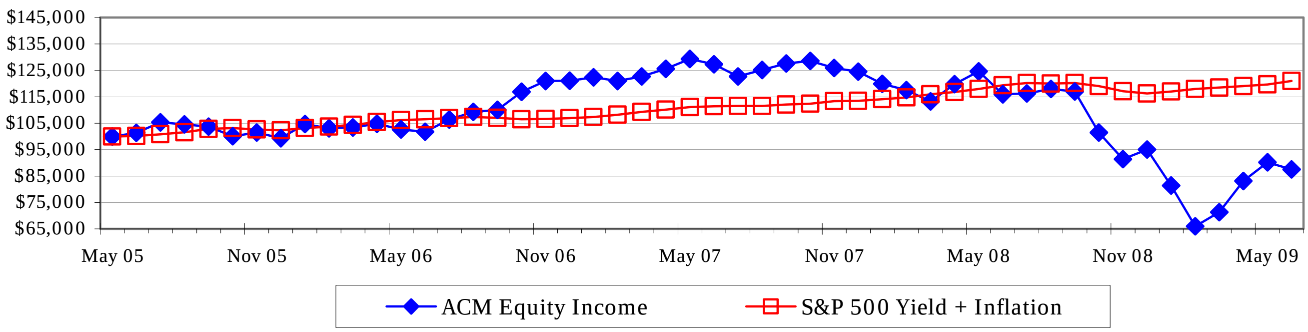
Comparison of the change in value of $100,000 investment in ACM growth versus S&P 500 and Wilshire 5000



Cumulative Equity Income Performance

Performance as of 6/30/09	Year to date	2 years	3 years	4 years	Since inception (5/31/05)
ACM Equity Income	-7.89%	-31.26%	-14.02%	-13.66%	-12.51%
S&P 500 yield + inflation	4.00%	8.50%	13.54%	20.68%	20.93%

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



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

July 15, 2009

Happily, the stock market climbed for the first time in seven quarters. Although such a rebound is very welcome, and I'm seeing wonderful opportunities to build wealth, I don't believe we're out of the woods, yet.

This quarter's letter, celebrating Athena's fourth year in business, will discuss our performance, the market and economic outlook, why holding extra cash is frequently prudent, and our investment in Markel Corp.

Performance this quarter

Growth portfolios under-performed year to date, but continue to out-perform over longer periods. Performance was excellent in April and the first week of May, but lagged as investors began to favor lower quality investments. Despite this, **we managed to beat the market by over 6% this quarter.** I used the market's run-up as an opportunity to improve portfolio quality by removing weaker investments and increasing our stakes in stronger investments, like Fairfax. I also decided to leave some of our money in cash to benefit from likely market volatility going forward (more on this in "Fortune favors the prepared," below).

Growth accounts received out-performance from **Leucadia National** and, like last quarter, **Sears Holdings**.

Leucadia, a diversified holding company, rebounded strongly as its investments in an iron ore mine and two financial companies rallied. Iron ore prices have climbed as China is building inventory, and its two financial investments came back to life as worries about the financial crisis abated. Leucadia is our largest holding and was up 41.6% this quarter.

Sears climbed 45.5% when it reported positive earnings and leaner than expected inventory. Surprising to many, Sears has *the* leading market share selling home appliances and has been growing that market share during the downturn. In my opinion, Sears still has a lot of room to grow because it's consistently misunderstood and under-estimated.

Growth's under-performers this quarter included **Fairfax Financial** and **Markel Corp**. Both Fairfax and Markel are diversified insurance holding companies that were down just slightly over the quarter. When investors realized a financial apocalypse wouldn't occur, they eagerly sold strong financials, like Fairfax and Markel, to chase the most junky financials (the ones that had gone down the most). Weak stocks tend to soar if investors believe such companies aren't facing imminent bankruptcy, and soar they did. But, such a run is unlikely to last, and over time strong businesses will do much better than their weaker brethren.

Equity income portfolios rallied strongly this quarter, with a 22.7% gain that out-performed our benchmark by over 20%. Unfortunately, this climb was not enough to get us back to break-even or allow us to beat our benchmark, which we continue to lag over longer time periods. I used the recent rally as a chance to trim strong performers, remove poor performers, and increase our cash position. Despite holding almost 24% cash, our portfolios sport a handsome 5.0% yield. This yield will increase as cash is redeployed into strong investments with growing dividends. Over the long run, I believe we will catch and surpass our benchmark, but it will take additional time and patience. Thank you for both.

Equity income accounts saw out-performance from **Wells Fargo** and, like last quarter, **Gladstone Commercial.**

Wells Fargo, which was one of our worst performers last quarter, rallied strongly as investors realized it wasn't going the way of the dodo. It rallied an amazing 70.4% shortly after the government stress test was released and Wells Fargo raised additional capital to shore up its balance sheet. Added to this, the company earned over $3 billion in the first quarter alone. Wells still has many issues to deal with, like integrating its purchase of Wachovia and dealing with rising credit losses, but I believe the company will do well over the long run.

Gladstone, a Real Estate Investment Trust focused on commercial real estate, climbed 46% this quarter. I believe part of that rally was due to relief from the credit crisis and part was due to Gladstone's better than average management and balance sheet. Gladstone still faces headwinds, as does every business in commercial real estate, but looks likely to be a strong survivor.

Equity income's under-performers this quarter were **Altria Group** and **Park National**. During a quarter when every holding goes up in value, you must dig to find the under-performers. In the case of Altria Group and Park National, they climbed in value but were our "worst" because they didn't go up as much as others.

Altria, the parent company of Phillip Morris USA, climbed less than others simply because investors chased higher risk investments and left solid companies like Altria behind.

Park National rose less than weaker competitors because it was strong and conservative when the market was chasing the risky and weak. In the long run, I believe strong financials like Park will continue to take market share from weaker financials as the credit crisis continues to unfold.

Market and economic outlook

The S&P 500 climbed 15.9% this quarter, the first increase in almost 2 years. The downside to such a climb is that future market returns look less interesting: I'm projecting average annualized returns for the S&P 500 of around 9% over the next 6 years. But, as I say every quarter, we don't have to buy the S&P 500—we can pick cheaper, higher quality investments with the goal of out-performing the market over the long run.

Projected annualized returns over the next 6 years	
S&P 500 (growth benchmark)	2.8% to 15.3%
S&P-500-yield-plus-inflation (equity income benchmark)	4.6% to 7.6%

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

The economy looks like it's starting to recover. As early as late summer, the economy will most likely be growing again. This turnaround can be seen in lower claims for unemployment, a rebounding manufacturing sector, and a stabilizing housing market.

But questions remain whether such a recovery is sustainable. The governments of the world, especially the U.S. and China, have provided huge stimulus to get economies growing again. It remains to be seen whether such artificial demand will turn into fundamental and sustainable demand. In addition, it's not clear that the problems that got us into this mess have been fixed. Housing prices haven't recovered and two more huge waves of mortgage resets confront us in 2010 and 2011.

Even if the economy does start growing again, that doesn't mean the stock market will climb as well. The last recession ended in late 2001, but the market didn't bottom until late 2002/early 2003. This year, the stock market has rallied in hopes that companies will post earnings growth by year end. Even if the economy is growing, that doesn't mean profitable growth. And without profitable growth, the stock market will almost certainly sink again if investors realize earnings won't take off. This scenario seems quite likely, but not certain.

Without a crystal ball, what's an investor to do? The same thing that has always made people rich over the long run: purchase good companies at low prices relative to fundamentals, and hold on until other investors realize that value. Additionally, as I'll talk about in the next section, hold on to some dry powder to benefit from volatile markets.

Fortune favors the prepared

Some of you might have noticed that our cash balances are higher than usual. This might lead you to ask: Why should you pay me to invest in cash? Isn't it best to be fully invested because cash returns are so low? Isn't holding cash an attempt to time the market (by attempting to go to cash when the market is "up," and put cash to work when the market is "down"), and haven't you said that's impossible to do? All good questions that deserve an explanation.

Most believe being fully invested all the time is the only way to go. The reasoning looks like this: 1) returns on cash are poor (especially now), 2) poor returns on part of the portfolio are bad for the whole portfolio, 3) therefore having any cash in the portfolio is bad. Or: 1) sitting in cash is an attempt to time the market, 2) timing the market is impossible, 3) therefore don't sit in cash.

In the first argument, I agree that returns on cash are terrible, **but I don't agree that lower returns on cash in the *short term* means bad performance for the whole portfolio in the *long run*.** Some professional investors carry a 20% cash position most of the time. Going into the summer of 2008 they had 80% of their portfolios in stocks and 20% in cash, and probably had been under-performing the market for several years. When the market tanked 40% in October 2008, their 20% cash didn't go down *at all* and ended up 30% of the portfolio (because portfolio value went down but cash didn't, the cash proportion of the overall portfolio went up).

Such investors were able to put that 30% cash position to work at historic, rock-bottom prices. Not only did they out-perform when the market collapsed, they've since out-performed because they were able to buy at the bottom when everyone else had no cash and were sitting on huge losses! Only those with lots of cash or those willing to book losses could capitalize on such great opportunities. By holding cash, such investors under-performed in the short run so they could out-perform in the long run.

From the second argument above, **I agree timing the market is impossible, but I don't agree that sitting in cash is timing the market.** During the Great Depression, Procter & Gamble decided to advertise heavily because ad rates were low and advertisers were desperate for business. P&G was able grab significant market share from its main competitor, Kimberly Clark, because P&G had cash and Kimberly Clark didn't. To this day, Kimberly Clark is still trying to catch up.

Those with cash aren't necessarily trying to time the market: they operate more conservatively than others in good times so they can pounce on opportunities in bad times. Almost all great companies operate this way (Microsoft, Wal-Mart, Berkshire Hathaway, Intel, Johnson & Johnson, etc.). Like I said above, some of the best investors in the world regularly carry 20% cash, especially when times are good or markets are volatile. Does this prevent them from having good performance? No. They might slightly under-perform in good times, but they greatly out-perform coming out of bad times ***because*** they have cash to invest when things are terrible.

I don't know if the market will go up or down in the short run. Sitting in a little extra cash allows me to be agnostic about short term market trends. If markets go down, I can buy at deeper bargain prices. If they go up, I can wait patiently. I know that markets are volatile—much more so than underlying fundamentals—so it's prudent to sit in a little extra cash waiting for sterling opportunities instead of chasing marginal opportunities. Or, as Warren Buffett put it, sitting in cash "is a painful condition to be in, but not as painful as doing something stupid."

Carrying extra cash, especially in good times or volatile periods, can be a competitive advantage. It takes courage and patience to sit in cash, especially when the market is taking off. But, extra cash isn't necessarily timing the market, and it doesn't necessarily lead to worse returns over the long run. It's recognition that better opportunities will almost always come along, and that fortune favors the prepared.

Investment Spotlight: Markel

In the early 1920's, Samuel Markel underwrote the first public transportation insurance policy on buses in Norfolk, Virginia. His business soon spread to buses in Richmond, Virginia, then to motor freight carriers. Samuel's sons, Lewis, Irvin, Stanley & Milton, continued growing the business from the 1930's into the 1950's, and a third generation of Markel descendants, Tony and Steve, run the business today.

Markel Corp. operates as an international specialty property and casualty insurance business. Specialty insurance includes unique insurance needs like liability coverage for highly specialized professionals, horse mortality and other horse related risks, personal watercrafts, high-valued motorcycles, aviation and energy, and wind and earthquake exposed commercial properties. Specialty insurance tends to be less regulated than life or auto insurance, which means pricing tends to be more rational.

To succeed, insurance businesses must do two things well: underwrite insurance risk and invest premiums. On the underwriting side, they must collect enough premiums to pay out claims. This may sound simple, but it's not easy. Contrary to popular belief, insurance companies, as a whole, tend to collect *less* in premiums than they pay out. The reason: it's difficult to know what you'll have to pay when a claim comes due (how much will it cost to mend a thoroughbred horse's leg in 5 years?), and competition tends to drive down premiums. For a specialty insurance company to do well, it must: 1) know what it will have to pay out over time, 2) charge enough to cover those claim payments, and 3) not let competition drive it to compete on price. Markel is unusually good in that it almost always collects *more* in premiums than it pays out.

On the investing side, **insurance companies must successfully invest capital**. Claims-paying money is mostly placed in highly liquid investments, like bonds, whereas surplus capital (money over that needed to pay claims) is invested in higher return investments, like stocks. Like with underwriting, this sounds simple, but it's not easy. Markel is lucky to have one of the best investors in the world working for them, Thomas Gayner. Gayner has been beating both the bond and stock markets since starting work for Markel in 1990.

If you can beat market returns and underwrite profitably, you're a rare and *great* insurance company; that's Markel. Insurance businesses don't succeed with proprietary manufacturing or patents—they must be managed well. And that's Markel's secret: superior management. Their team has a multi-decade record of profitably underwriting risk and beating market returns. One of the reasons they do so well is management owns almost 8% of the company—around $200 million worth. With that much net worth riding on the business, it's clear why they work hard to manage it prudently.

The major threat to an insurance company is mispricing risk. That's what killed AIG—collecting $1 of premiums and paying out $20 in claims (1 minus 20 = government bailout). AIG underwrote risks it didn't understand and confused quantitative risk assessment (using averages of what has happened in the *recent* past) with qualitative risk assessment (looking at *a lot* of history and applying a healthy dose of common sense). Markel has a well-founded reputation for properly assessing and pricing risk. They don't underwrite risks they don't understand or confuse quantitative with qualitative risk assessment.

The value of an insurance business is tied most closely to its net worth: assets minus liabilities. An insurance company that can grow net worth per share over time (without mispricing risk like AIG) builds value for shareholders. Markel's stated goal is to grow book value per share 15% per year averaged over 5 year intervals (focusing on long instead of short term results). Over the last 20 years, they've grown at 17%. By my estimates, such a company should sell at 2½ times net worth, whereas we've purchased it at 1½ times—whadda-bahgan!

Especially in tough times, you want to own superior businesses run by superior management. I'm very pleased to align ourselves with a company like Markel because it has the right approach, the right management, and is selling at the right price. This is the type of dream investment you can buy and hold for a very long time.

Until next quarter

It's been a fun and exciting 4 years running Athena Capital (perhaps *too* exciting over the last 2 years!). When I started Athena 4 ½ years ago, I wanted to provide my proven investment approach to friends and family. I've enjoyed doing that while expanding my business to include new friends and family over time. I've had a blast and I'm very excited about our future together.

Financial markets are volatile over the short run, but very profitable over the long run. It's hard to see it when the market drops by 50%, but over the long run I've found no better way to build wealth. It takes a lot of patience, but boy, oh boy, is it worth it!

As usual, I'm always looking for new clients. If you know anyone who might be interested in my investment services, please send them my way. I spend my time investing instead of marketing, so referrals are my "grand plan" for building the business. If you're happy with what I do, please refer me to your friends and family.

Feel free to visit my blog to see my views between client letters, www.mikerivers.blogspot.com. In fact, you can sign up there to receive my blog through email if you'd like—just enter your email address on the right side of my blog under, "Enter your email address." Don't worry, you won't be inundated with my blather—I only write once a week. I'd love to hear what you think, too, so feel free to leave comments and questions on the blog.

As usual, feel free to call or write with any questions you may have. I love to hear from clients and prospects, and would be happy to provide any support or advice you might be looking for.

Respectfully yours,

Mike

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