

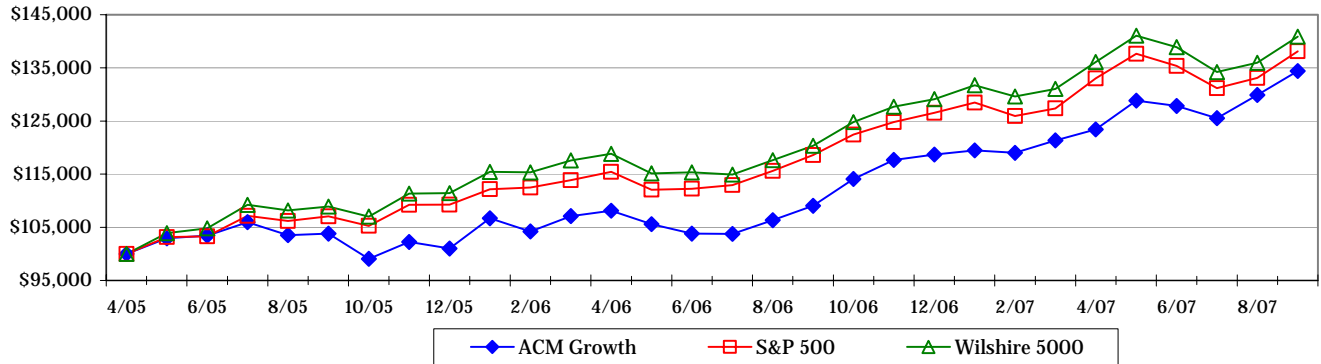


# Athena Capital Management

## Growth Performance

| Performance as of 9/30/07 | Year to date | 1 year | 2 years | Since inception (4/30/05) |
|---------------------------|--------------|--------|---------|---------------------------|
| ACM Growth                | 13.21%       | 23.25% | 29.48%  | 34.40%                    |
| S&P 500                   | 9.13%        | 16.44% | 29.00%  | 38.10%                    |
| Wilshire 5000             | 9.09%        | 17.07% | 29.34%  | 40.87%                    |

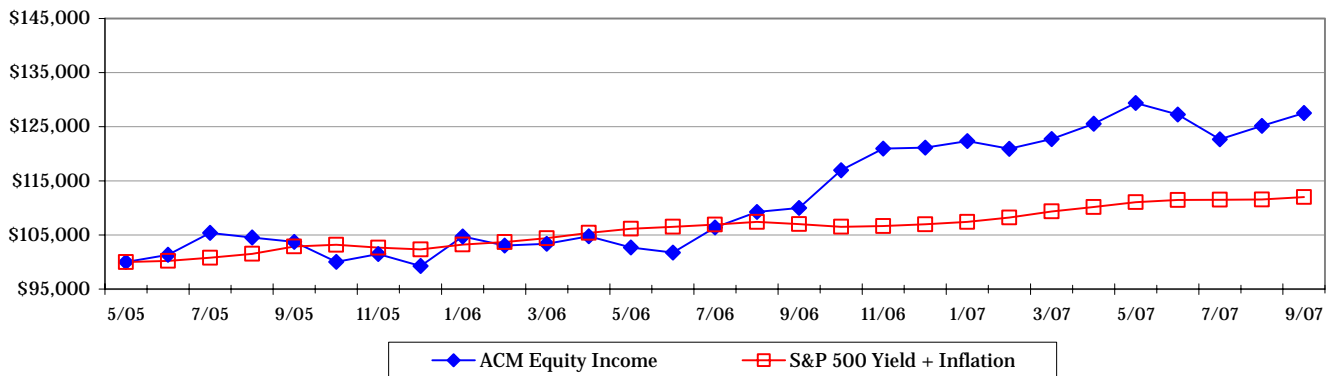
Comparison of the change in value of \$100,000 investment in ACM growth versus S&P 500 and Wilshire 5000



## Equity Income Performance

| Performance as of 9/30/07 | Year to date | 1 year | 2 years | Since inception (5/31/05) |
|---------------------------|--------------|--------|---------|---------------------------|
| ACM Equity Income         | 5.29%        | 15.95% | 22.94%  | 27.54%                    |
| S&P 500 yield + inflation | 4.74%        | 4.69%  | 8.89%   | 12.03%                    |

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. 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

October 18, 2007

As many of you know, I became a father recently. This has been both a wonderful experience and a powerful lesson in exercising patience. Not surprisingly, I find it much easier to be patient with our investments.



In this quarter's letter, I'll cover how our investments are doing, what I expect from the market and economy, how I measure and use the concept of probability to assemble your portfolio, our investment in Microsoft, why the subprime market impacted stocks so much, and the father of value investing—Benjamin Graham.

## How Are We Doing?

**As you can see on the first page, our accounts continue to make good progress.** Growth accounts out-performed the market year to date, over the last year, and over the last two years, but have under-performed since inception. We're catching up rapidly and, if current trends continue, should be out-performing since inception in the not-too-distant future. Equity income accounts have, again, out-performed in all periods so far. Although this won't happen every quarter, I think our results will continue to out-pace our benchmark over the long term. Equity income provides a 4.3% yield and has been growing faster than inflation.

**Growth accounts** generated out-performance from **Leucadia National** and **POSCO**—for the third quarter in a row! Leucadia (a diversified holding company) climbed as the market believes it will capitalize on recent market turmoil. It's up 101% from our average purchase price. POSCO (a Korean steel manufacturer, 3<sup>rd</sup> largest in the world) surged along with other steel companies and emerging market stocks. POSCO is up an eye-popping 250% from our average purchase price!

Growth's under-performers included **Comcast** and **Pier 1**. Comcast (the largest US cable company) seems to have pulled back as investors fret about cable's competition. I believe such concerns are overblown and view Comcast as one of my highest conviction investments. Pier 1 declined as its turnaround continues. Its new CEO is trimming costs while re-livening Pier 1's quirky product line-up. I still believe Pier 1 could prove a successful turnaround story (its stock has rallied 35% since quarter end).

**Equity income accounts** saw out-performance from **Kimco Realty** and **Crosstex Energy**. As you may recall, Kimco (a Real Estate Investment Trust) has gone from out-performer to under-performer and back again

over the past several quarters. The market can't seem to make up its mind, but I continue to believe it's one of the best real estate investment trusts in the world. Crosstex (a natural gas pipeline company) soared after announcing excellent results in its most recent quarter.

Equity income's under-performers were **National Presto** and **USA Mobility**. National Presto (a maker of small appliances, defense products and absorbent products) declined as the market seems to believe its strong growth cannot continue. In contrast, I believe its excellent management will continue to prudently and successfully manage the company's growth for long term shareholders. USA Mobility (the largest pager company in the US), like Kimco, has bounced from out- to under-performer over the last several quarters. Nothing substantial occurred this quarter, but the market continues to worry about USA Mobility's long term growth. I think its business remains viable and will continue to pay strong dividends.

## 6 Year Market Projections

The S&P 500 had an extremely volatile quarter. It began the quarter by climbing 3.3% to a new all-time high, then dropped 9.4% as credit markets seized up, then rallied 8.5% to finish the quarter up 2.0%. This type of volatility frequently precedes economic difficulties, and my 6 year projections for the market look uninspiring. I expect our investments, with their better fundamentals, to out-perform the market over the long run.

| Projected annualized returns over the next 6 years     |               |
|--|---------------|
| S&P 500 (growth benchmark)                             | -7.0% to 7.9% |
| S&P-500-yield-plus-inflation (equity income benchmark) | 3.3% to 6.3%  |

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

Long and short interest rates dropped over the quarter. Although the spread between the two has widened, usually indicating stronger economic growth ahead, recent credit market turmoil is distorting the picture as bond buyers have run to the safety of government-backed debt instruments.

The housing market has experienced significant stress as homes sales have plunged, credit markets for loans have seized up, and a record inventory of homes for sale continues to build. This market is too big and illiquid to turn on a dime, so its impact on the economy has yet to be fully felt. It's my opinion the housing market will impact the US economy for years to come.



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## Assembling Your Portfolio, Part III

In last quarter's letter, I discussed how impact drives portfolio assembly. To me, impact is the return I expect to get from investing over the next five years. For instance, a 15% return doubles your money every 5 years—that's impact.

**The problem with focusing solely on impact is that it's only half the story.** The other half is probability. A 100% chance of a 15% return is clearly better than a 50% chance of a 15% return. As I'll show, looking at impact without probability leads to bad investment decisions.

### What are the chances that...

**The question in investing is, how do you assess probability**—how do you know if there is a 50% or 100% chance of getting 15% returns? I've got my own methodology, but I must admit it's qualitative and judgmental rather than quantitative and precise. It's not like knowing the odds on rolling dice. Companies operating in a complex economy don't come equipped with predetermined probabilities.



When I assess an investment's probability of impact, I **like to examine three things: business economics, management and valuation.** I've already discussed these issues at length in prior client letters ([1Q06](#), [2Q06](#), [3Q06](#)), but I still want to give brief examples of what I mean.

### Coke is easier than Intel

It's easier to estimate the probability of Coke making money selling sugar water than Intel making money manufacturing microchips.

**Intel's business is hard to understand.** Its product life cycles are short—they *must* constantly change their product to stay competitive—and its inventory becomes almost worthless in months. Designing and fabricating new chips is very expensive, requiring costly equipment upgrades and new factories that cost billions.

**Coke is simple to understand.** Its product lifecycle is endless—they *can't* change the product without getting

into trouble (remember New Coke)—and their inventory is consistently consumed. Coke's plants are cheap, and upgrades are infrequent. Coke is simply more likely to achieve an estimated return than Intel.

### Solid versus Shaky Management

**Berkshire's management has been in place since 1965.** They've been growing its underlying businesses at over 20% per annum through excellent capital allocation. Managers and board members own over 35% of the company, and are therefore personally committed to growing and sustaining the company's value.

**Home Depot's management was just replaced this year,** so they're "hired help" who didn't build the company from the ground up. The company is currently being significantly influenced by an outsider who owns only 1.6% of the company, so a very small shareholder may be steering the company for short, rather than long, term results. Managers and board members own only 2.7% of the company, so they aren't as personally committed to the business.

I believe Berkshire Hathaway's management has a greater probability of achieving a predictable impact than Home Depot's management.

### Auto Insurance versus Computer sales

**Mercury General sells auto insurance, which people must purchase by law,** and is less affected by economic cycles. Mercury's growth rate only needs to be around 10% to provide a 19% projected return. Mercury pays a 3.8% dividend. Each trait makes Mercury's valuation easier to predict and less sensitive to inputs.

**Dell manufactures, markets and sells computers.** Their business is plagued



by swings in demand due to software releases and economic cycles. Dell's growth rate needs to be 16% to provide a 19% projected return. Dell doesn't pay a dividend. These issues make Dell's valuation harder to predict and more sensitive to inputs.

In my opinion, Mercury has a higher probability of achieving its projected return than does Dell.

### You gotta have both

**Good portfolio assembly decisions must include both probability and impact.** An investment with a low probability of achieving a high impact is not as good



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as an investment with a high probability of achieving a high impact. Berkshire Hathaway has solid economics, great management and a relatively less sensitive valuation. Intel has tough economics, poorly incentivized management, and a very sensitive valuation. That's why I've invested you in Berkshire instead of Intel.

I'm simplifying things a bit to make my point, but **I can't emphasize too strongly how important probability is in addition to impact.** The lottery is high impact, but I wouldn't recommend playing because the probability of winning is so low (you have a better chance of being struck by lightning or being attacked by a shark).

A poorly run bank looks like a smart investment as long as everything goes right (which is highly likely most of the time), but there is a low—and very important—probability of that investment going to zero (losing all your investment). **A wise investor must always take account of such low probability impacts because they can really hurt your returns.** As Warren Buffett says, Rule #1: don't lose money, Rule #2: don't forget Rule #1.

## Conclusion

To make good investment decisions for you, I *must* think about probability as well as impact. This probability assessment is a qualitative exercise, but absolutely vital in generating superior investment returns.

Next quarter, I'll discuss further Warren Buffett's Rule #1 and #2, and how lagging the market in the short term may lead to beating the market in the long term.

## Investment Spotlight: Microsoft

**You've heard the jokes about Microsoft making cars?** Occasionally your car would just die for no reason and you'd have to restart it. A 2007 model car wouldn't be available until 2009. All joking aside, it's hard to argue with Microsoft's dominance. Most companies wish they were well known enough to be the target of such jokes.

**Microsoft is the world's largest**

**software maker.** The company divides its operations into 5 groups: 1) operating system software like Windows, 2) server software like database software, 3) online services like MSN and web search, 4) business software like Office, and 5) entertainment like the Xbox home video games and Zune MP3 players.

**Microsoft possesses dominant market share in its two major segments,** Windows and Office (as high as 90%). With computer sales growing at over 10% worldwide (think China and India), Microsoft will continue to grow robustly for years to come. Although Microsoft faces threats from the likes of Google and Apple, I believe these threats are grossly exaggerated because they neglect Microsoft's competitive reaction and their large base of loyal customers.

**Microsoft generates operating margins of 36%.** This means that it makes around \$0.36 for every \$1.00 of sales before tax (the average company makes less than half that, 16-17%). 83% of Microsoft's revenues come from its operating, business and server segments as do 142% of its profits. You read that right, online services and entertainment are actually losing money, and yet Microsoft still has 36% operating margins! Just by shutting down those businesses, they could boost their current profitability by over 42% (although I think their plan is to make those divisions profitable).

**Managers and executives at the business are outstanding.**

Bill Gates started the company and Microsoft's current CEO, Steve Ballmer, joined the company in 1980, only five years after its founding. They've built the company from the ground up and take care of it like it's their baby. Management at Microsoft owns around 14% of the company, so their interests are aligned with shareholders.



Although it's a large company, **it will probably be able to grow profits at over a 13% rate for the next several years** as they continue to market their new operating, business and server software and bring to profitability their other divisions. It's hard to find another company this size with such dominance and growth potential.

If Microsoft designed cars, you would probably have to press the start button to turn the engine off, but it's hard to deny the impact Microsoft has had on the productivity of the world's office workers. Despite the jokes and criticism it faces, **Microsoft clearly has dominant products, high margins, excellent executives and growth prospects that make it an outstanding company.** Perhaps that's why I find it such an attractive investment for your accounts and mine.



# Athena Capital Management

*Why are...*

**...subprime mortgages impacting the stock market so profoundly**

**The mortgage market can be broken into three sectors: prime, Alt-A, and subprime.** Prime mortgages are those made to consumers with excellent credit. Alt-A mortgages are loans made to people with good credit, but with unusual circumstances, like someone buying a very expensive home or someone who has lumpy income (e.g. real estate agents). A subprime mortgage is a home loan made to less credit-worthy borrowers and is considered more risky for the lender.

**Few mortgages are held by banks anymore.** You may get your mortgage loan from Bank of America, but they soon rid themselves of the obligation by packaging your loan along with other mortgage loans and selling them to the bond market (as something called a mortgage backed security—MBS). This packaging of multiple loans is referred to as securitization and has greatly increased the ease of getting a loan and breadth of loans available to consumers (e.g. adjustable rate loans, interest only loans, bad credit record loans). The buyers of these securities (mostly institutional investors like pensions, insurance companies, hedge funds, etc.) have also benefited from the higher returns received from buying MBS.

**Because of strong demand for MBS (due to high returns), almost anyone was able to get a loan in 2005 and 2006.**

Unfortunately, many of these loans were made to people without documented income and who could barely pay temporarily low adjustable rate monthly payments. Not surprisingly, many of these loans have gone into delinquency and default. The buyers of these loans in the form of MBS have been watching their investments disintegrate as many subprime borrowers have stopped making payments.

**The subprime problem has since spread to other credit markets.** Now, adjustable rate Alt-A and prime loans are having record high defaults because people with good credit tried to buy too much house, perhaps assuming house prices would keep climbing or that they could refinance whenever they wanted. This has made many institutional investors who had been buying MBS become wary of the credit quality they receive when



buying credit securities of *all* sorts, like corporate loans and asset backed securities (e.g. credit card loans, auto loans). When institutional investors become scared to lend to borrowers, a credit crunch occurs.

**Investor's wariness of credit markets has spread to the stock market.** Not surprisingly, many banks (like Countrywide Financial) have significant exposure to credit markets both in terms of their primary business, like making loans, and in financing their business by borrowing money to make loans to others. Such financial institutions have seen their stocks crushed.

**Further, many professional investors try to boost their returns by borrowing money to buy stocks.** Such borrowing enhances returns on the way up but leads to large losses on the way down—debt is a double-edged sword. Making matters worse, if prices go down enough, lenders get squeamish and force borrowers to sell stock to cover debt. This has happened a lot recently, especially for investors who borrowed to buy companies like Countrywide that are down over 50%. Forced selling by one borrowing investor leads to lower prices, forcing other borrowing investors to sell, too. This downward spiral is self-reinforcing and helped lead to the stock market declines we saw this quarter.

**Common sense would lead you to believe that borrowing to buy something can lead to problems.** Have you heard the joke about bankers being generous enough to lend you an umbrella when the sun is shining, but demanding it back when it starts to rain? Lenders want their money back at precisely the time when it's hardest for the borrower to pay. It's always prudent to avoid risks you don't have to take, and those who've taken risks by borrowing too much or lending to bad credits are paying the price.

**Knowing about credit crunches allows you to avoid them,** and that is precisely what I've done in your account. I've dodged this risk by not buying companies who play the debt game. This stance led us to underperform relative to risk takers in the past, but to outperform now that bad weather has arrived.

**Admirable business people:  
Benjamin Graham (1894 – 1976)**

**Benjamin Graham has been called the “Dean of Wall Street” and the “Father of Value Investing.”** But, he's most famous outside the investing field because of his pupil, Warren Buffett, who's become the 3<sup>rd</sup> richest man in the world (by using the value investing method).



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**Graham was born in London, but moved with his family to the U.S. when he was only a year old.**

Graham proved an extraordinarily good student and excelled both at one of New York's premier high schools and then at Columbia University, where he graduated as salutatorian. Upon graduating, he was offered teaching positions by the Philosophy, English and Math departments. He turned them down to go work on Wall Street in 1914.



**Math was always Graham's best subject, so it's no surprise that he loved the statistical analysis of financial statements.** He soon made a name for himself as someone who could spot value in the numbers. For example, Graham noticed in the early 1920's that the value of Du Pont stock was trading for no more than the market value of the General Motors stock Du

Pont owned! He loaded up on Du Pont and made a bundle (John Steele Gordon, *The Great Game*, 256).

**This example illustrates the Graham technique: look for undervalued companies, invest, and wait for the market to catch on.** Graham paid particular attention to the balance sheets of companies, which list the assets (cash, inventory, factories), liabilities (debt, accounts receivable) and equity (ownership interest) stake of each company. By his reasoning, if you could buy a company for 2/3 of the value of its balance sheet equity, there was a "margin of safety" protecting the value of your investment.

**Graham went on to have a very successful career managing other's money.** Although he lost a lot during the 1929-1933 crash, he earned back his client's money before 1940, a feat the market didn't achieve until 1954! He went on to manage several successful investment partnerships until his retirement.

**During the crash, he started teaching classes at Columbia.** It was during this time that he formalized his investing method. He later came out with the standard texts in the field, *Security Analysis* in 1934 and *The Intelligent Investor* in 1949 (this last is Warren Buffett's favorite book on investing). Both books are still in print today and are mandatory reading for any budding value investor (*Security Analysis* was the book the Will Smith character studies to become a stock broker in the movie *Pursuit of Happyness*). Graham also played a part in creating the professional designation for

security analysts, which is known today as the Chartered Financial Analyst designation.

**Graham's impact on investing has been monumental.** Graham was one of the first to formally spell out the process of analyzing debt and equity securities. He trained several generations of students in his method. He ran several successful investment partnerships. And he trained the best-known investor today, Warren Buffett. His contribution to the field and his success as a businessman prove an excellent example that intellectual curiosity can be profitable.

## Until next quarter

Thank you for choosing to do business with me. I appreciate your confidence and look forward to reporting our progress in coming quarters.

This business is almost entirely built on referrals from happy clients. For me to succeed, I must first succeed for you. As most of you have seen—and all of you will see in the future—I can add great value to your portfolios with intelligent investment management. If you believe I'm adding value to your portfolio, please refer me to others who can benefit from my approach to investing.

Until next quarter, enjoy fall and the holiday season, and I look forward to hearing from you throughout the quarter.

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