

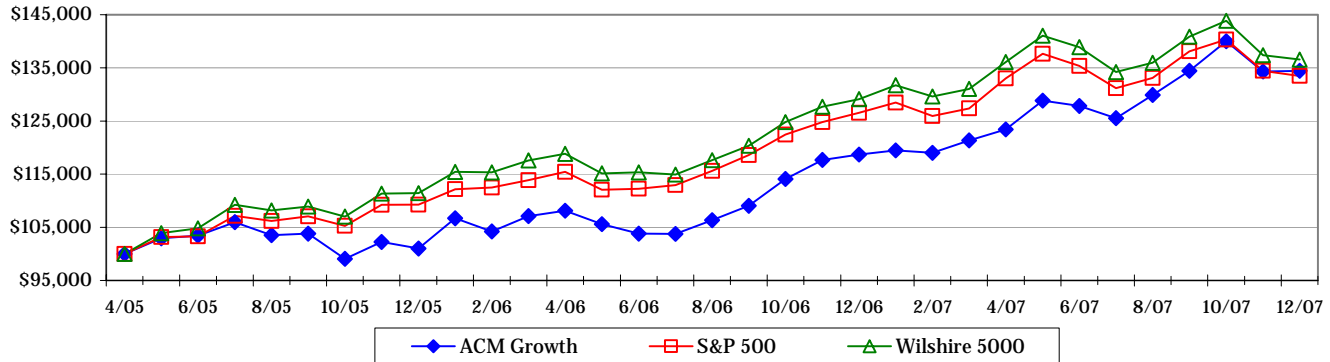


# Athena Capital Management

## Growth Performance

| Performance as of 12/31/07 | Year to date | 1 year | 2 years | Since inception (4/30/05) |
|----------------------------|--------------|--------|---------|---------------------------|
| ACM Growth                 | 13.26%       | 13.26% | 33.11%  | 34.46%                    |
| S&P 500                    | 5.49%        | 5.49%  | 22.16%  | 33.50%                    |
| Wilshire 5000              | 5.74%        | 5.74%  | 22.52%  | 36.54%                    |

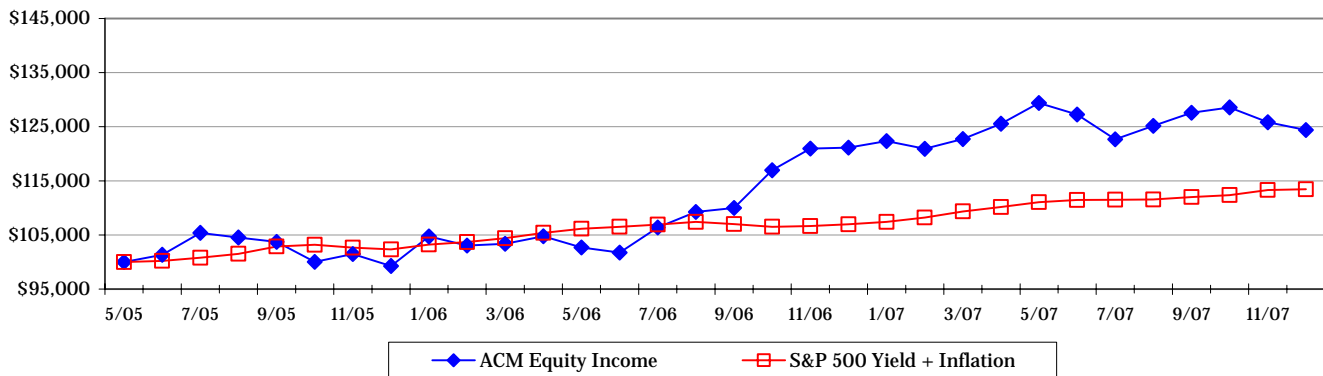
Comparison of the change in value of \$100,000 investment in ACM growth versus S&P 500 and Wilshire 5000



## Equity Income Performance

| Performance as of 12/31/07 | Year to date | 1 year | 2 years | Since inception (5/31/05) |
|----------------------------|--------------|--------|---------|---------------------------|
| ACM Equity Income          | 2.69%        | 2.69%  | 25.29%  | 24.39%                    |
| S&P 500 yield + inflation  | 6.05%        | 6.05%  | 10.83%  | 13.43%                    |

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

January 16, 2008

Happy New Year! I hope you had a wonderful holiday season and are looking forward to all that 2008 will bring.



In this quarter's letter, I'll cover how our investments are doing, what I expect from the market and economy, why avoiding losses leads to better returns than solely seeking gains, our investment in Wal-Mart, why the US dollar has been declining, and über-investor Eddie Lampert.

## How Are We Doing?

**All client accounts are beating their benchmarks, after fees, since inception.** Growth accounts have significantly out-performed the S&P 500 over the last one and two years, and I believe a slowing economy and our superior investments will continue to provide good results going forward. Income accounts are significantly out-performing their benchmark since inception and over the last two years, but has lagged over the last year. Credit market and real estate turmoil is impacting equity income's short term performance, but I believe our better positioned investments will benefit from this turmoil in the long run.

**Growth accounts** generated out-performance from **Berkshire Hathaway** and **Microsoft**. Berkshire increased because its underlying performance continues to be solid, and because investors are beginning to realize that Buffett will be able to put his large cash position into cheap investments. Microsoft climbed after its latest earnings report showed stellar results from its operating software, business software and gaming businesses.

Growth's under-performers included **Comcast** and **POSCO**. Comcast's price came under pressure after it announced slower growth projections and higher expenses. Because they only decreased sales expectations from 12% to 11%, and their higher expenses now will generate very high returns in the future, I don't believe its 24% price drop was warranted. POSCO seems to have pulled back on fears of a slowing global economy. Although slower growth may hurt POSCO in the short run, its low cost production will allow it to emerge stronger, relative to competitors, over the long haul.

**Equity income accounts** saw out-performance from **Berkshire Hathaway** and **Altria Group**. Like I said above, Berkshire increased based on fundamental performance and expectations for bargain hunting. Altria Group climbed on news it will split its US and international businesses, fostering high dividends for its

US business and more capital to grow its international business.

Equity income's under-performers were **Winthrop Realty** and **iStar Financial**. Both Winthrop and iStar dropped as everything related to real estate financing was spurned by the market. In my opinion, the market is throwing the baby out with the bath water. The babies, in this case, are two extremely well run niche businesses that should benefit—not be hurt by—market turmoil. It wouldn't surprise me to see both investments continue to decline as fears escalate, but benefit inordinately when such fears prove temporary.

## 6 Year Market Projections

The S&P 500 had another very volatile quarter. It started the quarter up 2.5%, reaching a new all-time high, then dropped 10.1%, then rallied 7.7%, then fell 3.1% to finish the quarter down 3.3%. My 6 year projections for the market look better with this drop, but still look uninteresting. As usual, I expect our superior investment picks to continue to out-perform the market over the long run.

| Projected annualized returns over the next 6 years        |               |
|---|---------------|
| S&P 500<br>(growth benchmark)                             | -6.2% to 8.0% |
| S&P-500-yield-plus-inflation<br>(equity income benchmark) | 3.4% to 6.4%  |

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.

**The economy finally seems to be slowing after a year of flashing recessionary signals.** The housing market was the first to roll over in the summer of 2006. Next, came short term interest rates moving above long term interest rates. Then, the subprime market showed stress in March and July. Finally, credit markets seized up as lenders and investors worked to get a handle on the situation.

**Now, industrial activity is contracting, employment growth is slowing, and housing prices are tanking nationally.** The Federal Reserve is cutting interest rates to try to right the economy, but such cuts take 6 to 18 months to have an impact.

**A recession is not the end of the world.** They happen every 5 years on average. The economy tends to emerge stronger, and large diversified businesses tend to out-perform—both during and coming out of—recessions. We are well positioned for such an eventuality if it comes.



# Athena Capital Management

## Assembling Your Portfolio, Part IV

Warren Buffett, the best investor alive, has two simple rules for investing:

- **Rule No. 1: Never lose money**
- **Rule No. 2: Never forget Rule No. 1**

This may sound like a gross over-simplification, but it holds a kernel of truth.



**The best investors do well because they avoid huge**

**losses.** That doesn't mean they don't lose, but they never bet so big they lose their shirt. In contrast, people who have trouble accumulating wealth usually swing for the fences and end up striking out—over and over again.

### Winning by not losing

To support this assertion, let me show you some examples of how the math works.

Lets say John and Brad each make 10 investments. John's smart and safe investments provide 12% returns. Brad is much more aggressive: 9 of his investments go up 17% and one declines 50%. In other words, Brad bets right 90% of the time and out-performs John by 5% with 9 investments—except for one big loser. Who does better? John ends up with a 12% return whereas Brad ends up with 10.3%. **Avoiding big losses is more important than picking big winners.**

**This difference may seem small, but applied over time it has a huge impact on your wealth.**

Suppose John invests to avoid big losses and under-performs the market by 2% a year (sound familiar?) over 20 years. The benefit he reaps with this approach is that he only goes down 1/3 as much when inevitable market downdrafts occur.

Suppose Brad invests with the market. He gets 18% returns when the market goes up, but suffers several market downdrafts over 20 years (these happen more frequently and severely than people care to remember—e.g. the over-40%-decline from 2000-2002).

Who does better, Brad or John? Once again, John is the victor. He generates 10.6% returns whereas Brad receives 7.5% returns.

If this doesn't sound like much of a difference to you, keep in mind such returns would cause a \$200,000 initial investment to turn into \$1.5 million for John versus \$854,000 for Brad over 20 years. **That's the difference between a \$60,000 a year income in retirement versus \$34,000 a year!**

### There's a big difference between short and long term performance

As the above example illustrates, it may pay to under-perform the market in the short run *if* that means you don't suffer as much during the market's periodic downdrafts.

Be forewarned: investing to avoid losses may look dumb in the short run. **In following this policy, you will under-perform the market part of the time.**

The reason for this? Big losers frequently win big before they crash. Enron, WorldCom and Countrywide were huge out-performers before they tanked. In the short run, they led to out-performance, but in the long run, they crashed, dragging down their investors.

### How to avoid big losses

“Okay Buffett-wanna-be, if avoiding losses is so important, how do you do it?” **To prevent losses, invest in companies that won't go to zero—companies that aren't built on sand.**

Some of the things I look for include:

- Fuzzy accounting – think Enron
- Arrogant CEO's – think Countrywide
- Pie-in-the-sky ideas – dot.com's without profits
- Businesses whose economics can change over night – NASA contractors dependent on government programs
- Businesses that can be destroyed by “100 year floods” – subprime lenders

That's not everything I look for, but you get the idea. **If you avoid things you know can go to zero, you can avoid big losses.** The key is to invest where the worst case scenario is still okay. Then, if things go wrong, you maintain the money you invested instead of fighting for years just to achieve breakeven.

### Conclusion

**When I invest your money, I seek to avoid big losses.** With this focus, your investment returns will be much better over the long run, even if they look below average in the short run.



# Athena Capital Management

## Investment Spotlight: Wal-Mart

**Why would anyone in their right mind want to invest in Wal-Mart?** It's the press's favorite punching bag, with vivid stories about discrimination suits, labor troubles, inadequate employee medical care, and so on. And, its stock price hasn't gone anywhere since 1999. So, why do I like it? Because Wal-Mart is a truly great company selling at a very reasonable price.

**Wal-Mart is the largest and most successful retailer ever.** This scale allows it to save the average US family—even those who don't shop there—over \$2,500 a year! How? When Wal-Mart lowers prices, its competition has to lower prices, too. Wal-Mart can drop prices because it has superior logistical systems and has squeezed suppliers to constantly lower their prices.

**It's the largest private employer in the world,** with more than 1.9 million employees. Although Wal-Mart has a bad reputation as an employer, it's not uncommon for 5,000 applicants to apply for 250 job openings at a new Wal-Mart. It can't be that bad if 20 people apply for *each* job opening.

**Wal-Mart has outstanding economics and growth characteristics.** Wal-Mart sports the highest returns on equity in the industry, even though it's almost 6 times larger than Target (its next largest rival). Many big companies find it hard to grow, but Wal-Mart has grown sales at 12.3% and earnings at 13.9% over the last 10 years.

**It's expanding internationally, with fabulous successes in Mexico, South America and the UK.** Plus, Wal-Mart demonstrated intelligent asset allocation by exiting Germany and Korea, where it couldn't profitably implement its unique value proposition.

**Wal-Mart has outstanding management.** The Walton family still owns over 40% of the company, Sam Walton's son is the Chairman of the Board of Directors, and Wal-Mart promotes almost exclusively from within. This company takes the long view and acts as a true trustee of shareholder wealth.

**Its stock seems cheap to me.** With growth projected at over 11%, returns on equity of over 20%, reduced capital expenditures from slower US growth, and share buybacks, there are good reasons to believe Wal-Mart will continue generating excellent returns for shareholders. Usually, large and dominant companies



like Wal-Mart sell at a significant premium to the market. But, in a strange turn of events, small companies are selling at a premium and large companies are trading at a discount. This will not last.

Why would anyone want to invest in Wal-Mart? Because **it's a dominant company with great economics and growth, excellent management, and a cheap price relative to fundamentals.**

*Why is...*  
**...the US dollar declining?**

The dollar's decline has been predicted for years by smart people like Warren Buffett and Alan Greenspan. Why is it happening, and why now?

US consumers and the US government have been spending more money than the income and taxes they are bringing in. How is that possible? Foreign consumers and governments have been saving money and lending it to the US so we can spend beyond our means. **This has led to our large trade deficit** (we're buying more from them than they are buying from us).

**Until relatively recently, foreigners have been eager to play this game.** The money they've made by lending us dollars has allowed their economies to grow quickly and created millions of jobs. The trade deficit has existed for years without the dollar going down, but, over the last several years, the dollar has gone down as foreigners have decided they don't want to continue lending the US money. Why would they do that?

**Foreigners are beginning to doubt the US's ability to pay back our debts.** The US's slowing economy, tanking real estate market, strained incomes, and declining asset values make it harder for the US to pay back debt. This has foreigners quite worried, and worried foreigners are looking to sell their dollars instead of lending money to the US.

Added to this, **the US government faces a grave temptation to devalue the dollar to "fix" our economic problems.** This may make it seem easier for the US to recover and pay back its debts, but it comes at the expense of foreigners, whose loan repayments will be received in less valuable dollars. Foreigners, not wanting to get stuck with dollars worth less due to inflation, are selling their dollars at lower and lower prices.



# Athena Capital Management

Although the dollar may temporarily rebound, **the longer term trend is unlikely to reverse until the initial cause is eliminated.** That means the US needs to spend less by saving and investing more of its income. Until that happens, I believe the dollar's long term trend will continue to be down.

## Admirable business people: Edward "Eddie" S. Lampert (1962 – present)

**You may never have heard of Eddie Lampert, but his story is amazing.** He went from childhood tragedy to Yale, from Goldman Sachs to running his own hedge fund, from being kidnapped to becoming a billionaire and running two of the world's most iconic retailers.

**Eddie's father, a lawyer, died at 47 of a massive heart attack, when Eddie was only 14.** Eddie's mother had to work as a clerk at Saks Fifth Avenue, and Eddie worked in various warehouses—stocking shelves, picking orders—after school and on weekends to support his mom and younger sister.

**Eddie did well in school, getting good grades and finding time to play both soccer and basketball.** Eddie received financial aid to help pay for Yale, where he majored in economics and was inducted into Phi Beta Kappa and the secretive Skull & Bones society. Eddie made his mother cry when he decided to work for Goldman Sachs instead of becoming a lawyer like his father.

At Goldman, Eddie worked for future Treasury Secretary Robert Rubin doing risk-arbitrage (investing in merger announcements prior to approval). Although successful there, **he decided to launch his own hedge fund, ESL** (with the help of Richard Rainwater, a Texas billionaire). Eddie was 25 years old.

A year and a half later, Eddie split with Rainwater, but continued his hedge fund. Eddie was a very successful investor, with one of his first big returns coming from IBM's turn-around in the '90's. Although successful as a passive, outside investor, **Eddie had always hoped to get more involved in the investments he made.**

Eddie got his chance in the late '90's when he purchased big stakes in Auto-Zone and AutoNation and pushed for

corporate change. He succeeded in these efforts, **attacking capital spending and playing a role in replacing top management**, and made a bundle as his plans paid off handsomely. He still owns both investments.

Eddie's next big chance came with Kmart. As the company was about to enter bankruptcy, Eddie invested heavily in the debt of Kmart. When the bankruptcy restructuring finished, **Eddie came out as the majority owner and Chairman of Kmart.**

**In the middle of the Kmart deal, Eddie was kidnapped at gunpoint.** Four masked men grabbed him in the parking garage of ESL's building. They told him they were hired to kill him, but it was obvious they wanted to hold him for ransom. They kept him in a motel bathroom bound and blindfolded for 39 hours. When one of the kidnappers used Eddie's credit card to buy pizza, Eddie was able to convince them to let him go before they were caught (all four kidnappers were later caught, anyway).

Eddie has since used Kmart to buy Sears, where he's Chairman of the Board of the combined company, Sears Holdings. **His ESL fund has a record of providing 30% returns, after fees, to its investors since 1988** (which would have turned \$100,000 into \$14.6 million). Surely, Eddie's

mother isn't shedding tears over his choice not to become a lawyer, now.

The big question now is: can he turn two iconic, but very poorly performing, retailers into highly profitable businesses again. **I'm not betting against Eddie, he seems to do well under pressure.** (Source for much of this article: *Fortune*, February 6, 2006, Patricia Sellers)

## Until next quarter

**Thank you for choosing me to help you reach your financial goals.** It's quite satisfactory to finally be able to report that all clients are beating their benchmarks. I look forward to providing more good news soon.



PHOTO: NIGEL DICKSON



# Athena Capital Management

**I've recently decided to shorten your client letter.** It is my intention to eliminate the sections “*Why is...?*” and “Admirable Business People” after receiving feedback from clients. If you think I've been hasty in making this decision, please let me know and I'll consider leaving them in.

Until next quarter, dress warmly and don't throw out your back shoveling snow. I look forward to hearing from you throughout the quarter.

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