

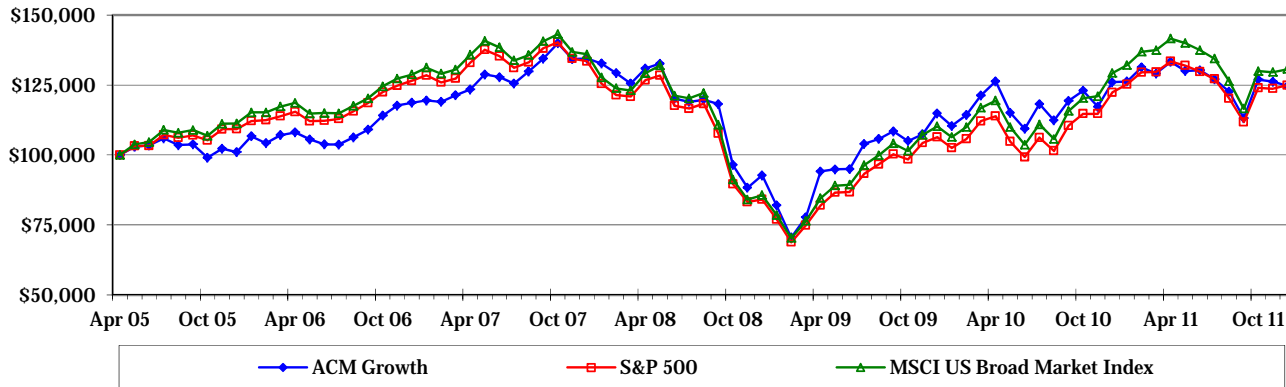


Athena Capital Management

Cumulative Growth Performance

Performance as of 12/31/11	Year to date	1 year	3 years	5 years	Since inception (4/30/05)
ACM Growth	-1.13%	-1.13%	34.39%	4.97%	24.62%
S&P 500	2.12%	2.12%	48.60%	-1.24%	24.98%
MSCI US Broad Market Index	1.08%	1.08%	52.66%	1.48%	30.68%
Wilshire 5000	0.59%	0.59%	53.45%	1.67%	31.29%

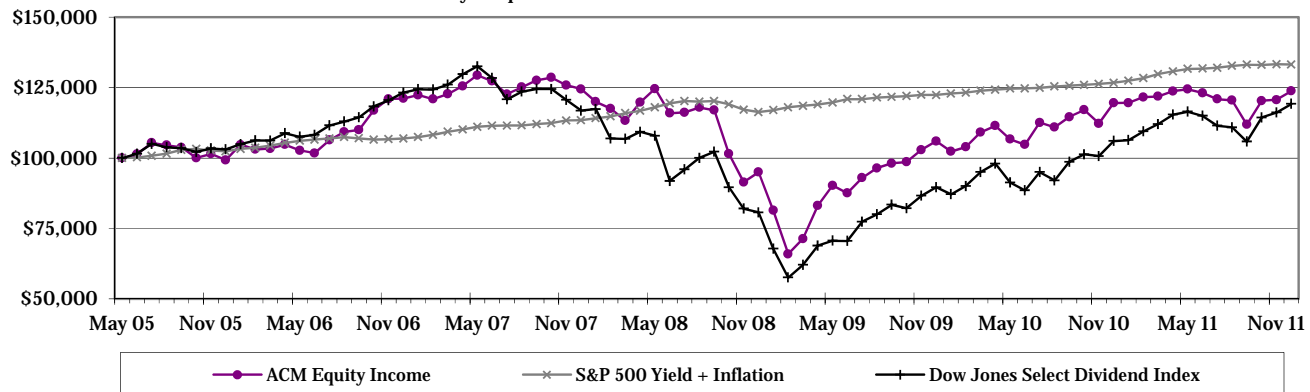
Comparison of the change in value of \$100,000 investment in ACM growth versus S&P 500 and MSCI US Broad Market Index



Cumulative Equity Income Performance

Performance as of 12/31/11	Year to date	1 year	3 years	5 years	Since inception (5/31/05)
ACM Equity Income	3.55%	3.55%	30.33%	2.20%	23.80%
S&P 500 yield + inflation	5.15%	5.15%	14.57%	24.55%	33.22%
Dow Jones Select Dividend Index	12.42%	12.42%	47.82%	-3.23%	19.22%

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.

© Copyright 2012 Athena Capital Management Corp. All rights reserved. Permission is hereby granted to electronically link, forward, or store this document in its entirety or to quote passages as long as source is attributed to "Michael Rivers, CFA, Athena Capital Management." Nothing in this letter should be considered investment, financial, tax, or legal advice. The opinions, estimates and projections contained herein are subject to change without notice. Information throughout this letter has been obtained from sources believed to be accurate and reliable, but such accuracy cannot be guaranteed.



Athena Capital Management

January 19, 2012

After another wild ride, stocks and our accounts generated double digit gains in the 4th quarter, ending 2011 basically flat for the year. Our results reflect markets that have been trading on front page news over the last four years instead of underlying fundamentals. Eventually, this will end and we'll get back to performance tracking profits rather than headlines.



This quarter's letter covers: our investing performance; my view on markets and the economy; my thoughts on whether stock picking is dead; and an update on another of our high conviction holdings: Microsoft.

Slight index change

For growth accounts, **I'm replacing the Wilshire 5000 with the MSCI US Broad Market Index.** On the first page, you'll see both reported this quarter, but I'll only report the MSCI going forward. I decided to make the switch because all the largest mutual funds and Exchange Traded Funds (ETFs) track to the S&P 500 or MSCI and none to the Wilshire 5000 anymore.

Performance this quarter

Growth portfolios out-performed over the last 5 years, but have under-performed over all other periods. As mentioned above, individual stocks are trading based on headlines rather than underlying fundamentals. I discuss this phenomenon more thoroughly below in my section "Is stock picking dead?", but I'll briefly summarize here: *such periods always end.* No one can predict when, and it's frustrating to wait, but it will likely occur so quickly that few will notice until *after* the profits have been booked.

Growth's out-performers this quarter were **USG Corp** and **Pfizer**.

USG is a building materials company best known for its gypsum wallboard: Sheetrock. It's been losing money since the housing market tanked in 2007, but with signs that home prices may be stabilizing and building could pick up next spring, its stock price has jumped. I believe it's too early to consider housing healed, but I'm confident it *will* grow again, eventually. If that time is now, great; if not, then we may have to wait to enjoy the full fruits of our USG investment.

Pfizer's blockbuster drug, Lipitor—representing 15% of sales—went off patent at the end of November, and the stock market oddly responded by sending Pfizer's shares

up over 17%. I think there is more to Pfizer than one product, and it appears other investors are coming around to my way of thinking. Only time will tell, but it's possible Pfizer can re-achieve growth, in which case I may have more good news to report in the future.

Frontier Communications was growth's under-performer this quarter.

Frontier is a rural telecom company struggling to cope with a massive acquisition, a declining customer base, and fierce competition from cable and wireless companies. I think Frontier is executing well despite some very difficult headwinds, but it may take a year or two to fully right the ship. In the meantime, we're reaping a double-digit dividend yield from a business with steady recurring revenue and strong cash flows.

Equity income portfolios out-performed over the last 3 years, but have under-performed over all other periods. Our 4th quarter results were particularly strong—with double digit gains—as the stock market embraced dividend paying equities. I'm uncertain this trend will continue uninterrupted, but strongly believe a portfolio of companies with steady cash flows and a 3.7% dividend yield (easily covered by profits) has excellent prospects over the long run.

Equity income, like growth, saw out-performance this quarter from **Pfizer** and **USG Corp**, and under-performance from **Frontier Communications**. Please see my comments above for more information.

Market and economic outlook

The S&P 500 climbed 11.8% in the fourth quarter and ended 2011 with a 2.1% gain. The annual gain came entirely from dividends as the S&P 500's price was actually down 0.003% for the year. I estimate we're looking at 5% returns over the next 6 years (highlighted in the table below), which may not *seem* exciting, but beats almost all the alternatives—especially bonds.

Projected annualized returns over the next 6 years	
S&P 500 (growth benchmark)	-1.1% to 11.0%
S&P-500-yield-plus-inflation (equity income benchmark)	3.6% to 6.6%

How do I arrive at these numbers? Visit "Athena Capital Articles" at www.athenacapital.biz to see my [2Q2005](#) article.

While the economies of Europe, Asia and South America have been rolling over, the U.S. economy proved more resilient. Growth seems to



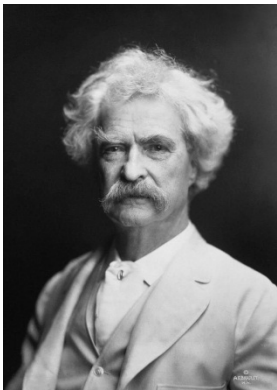
Athena Capital Management

have accelerated in the U.S. throughout 2011 despite lousy job numbers and a housing market on life support. Whether that acceleration continues into 2012 is the \$64,000 question, but no one—including me—has the answer. It's hard, but not impossible, to imagine the U.S. economy can hold up despite substantial problems elsewhere, but we'll have to wait and see.

The flow of bad news from everywhere has led stock, bond, currency and commodity markets to march in lock-step (much to the irritation of this stock-picker). One day, good news out of Europe causes stocks and commodities to rocket; the next, bad news leads to collapse. Day after day, the bulls or the bears prove momentarily right and markets stampede in that direction. Not being a herd animal, nor desiring to be trampled, I'm sticking to a disciplined approach of investing in businesses, not markets.

One year, stock investing seems as boring as watching paint dry; the next, as terrifying as a horror movie; the following, as exciting as winning the lottery. I believe we'll get to that lottery-winning feeling again, but only with patience, discipline and perhaps some Pepto. I'll supply the discipline if you can stomach the patience. Soon enough, buying good businesses at reasonable prices will be back in favor, as my next section highlights.

Is stock picking dead?



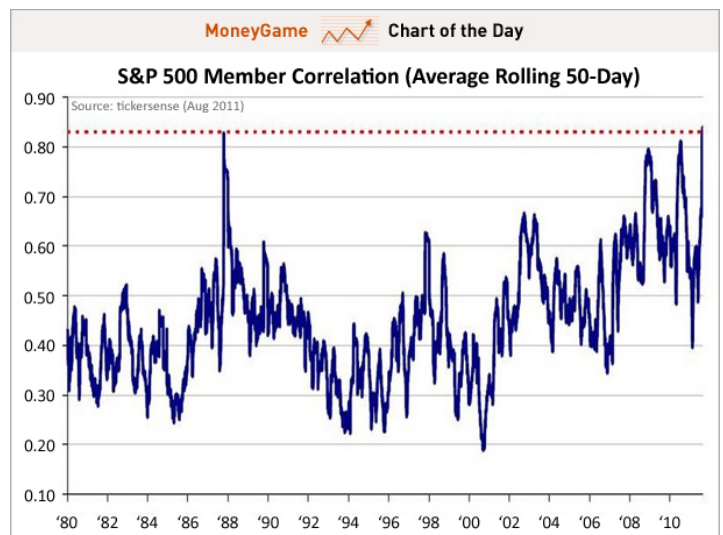
In 1897, a reporter went to investigate the rumored death of Mark Twain. When the surprised reporter found him very much alive, Twain made the now famous remark, "The report of my death was an exaggeration." Just as the rumor of Twain's death was ill-informed, **I'm confident the death of stock picking is, too.**

What do I mean by stock picking? There are two basic ways to invest in stocks: 1) indexing: buying a basket of stocks (like the S&P 500); or 2) stock picking: buying individual stocks (what I do). Indexing has the advantage of lower effort, cost and volatility, but less potential reward. Academic support for indexing is strong: less than 80% of investors—individual or professional—beat indexes after fees. **Stock picking, on the other hand, has the drawbacks of higher effort, cost, and volatility, but with the upside potential of much higher reward.** If you can beat the index by 3% annually over 25 years (not an easy task), you'll end up with double the

portfolio, and therefore double the standard of living—nothing to sneeze at.

Even when stock picking works, though, it goes through unpleasantly long periods of appearing to provide little benefit relative to indexing (after all, if it were easy, everyone would do it!). Such periods are characterized by stocks moving in lemming-like unison—all up, all down or all flat. When that happens, picking specific stocks doesn't produce results much different from the index. Such herd-like periods are described mathematically as having "high correlation."

Stock correlation is just a statistical measure of how the stocks in an index move with respect to the index as a whole. When correlations are high, significantly different companies like Caterpillar (the bulldozer manufacturer) and Apple (the consumer electronics company) move up and down in lock-step. High correlations tend to occur during market panics, like 2008 to 2009. When correlations are low, however, Caterpillar and Apple move independently of one another. An example of this was seen in the dot-com bubble of 1999 and 2000 when investors dumped bricks & mortar companies to buy technology, media & telecom.



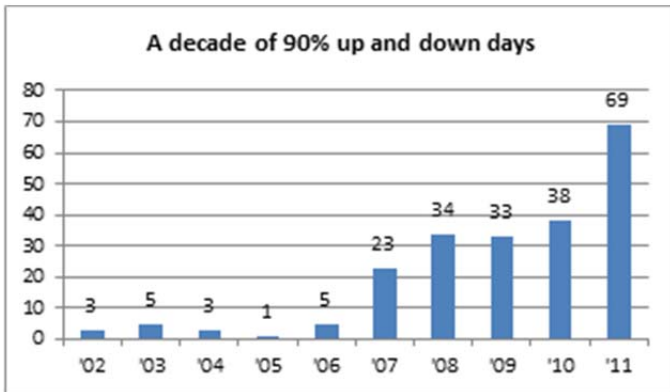
The graph above illustrates how correlation has trended up and down from 1980 to 2011. Observe how much higher correlations have been since late 2007—mostly staying above levels indicating extreme, short-lived market turmoil (e.g. 1987, 1998, and 2003).

Another measure of correlation is referred to as "90% days." These are days when 90% of the companies in the S&P 500 move in the same direction. As you can see in the graph on the next page, such days were rare from 2002 to 2006, averaging 3 to 4 times a year, but have



Athena Capital Management

been **10 times** more frequent—30 to 40 days a year—since late 2007 (with 2011 a blow-out year at 69 days!).



Source: Strategas Research Partner

As I said above, **high correlation periods make stock picking produce very similar results to indexing.** Relating to my Twain comments above, this situation has led to headlines like:

- “Is stock picking dead? (or why is correlation so high?) – Nomura Equity Research, 10/11/10
- “High correlations in equity markets—the death of stock picking?” – Hargreaves Lansdown, 2/9/11
- “So Long, Stock Picking” – Seeking Alpha, 9/3/11
- “Correlation Spikes: Why Are You Still Picking Stocks?” – The Street, 10/13/11

To which I say, “The reported death of stock picking is an exaggeration.” Periods of high correlation come and go, as do all fads. This one, too, will pass when investors find a new trend to chase. This may occur when the problems in Europe settle down, or when the strong growth of emerging markets resume, or after the U.S. government takes firm steps to reduce its debt and deficit. More likely, correlations will shrink because some companies inherently perform better than others, and investors will want to buy the stocks of those companies instead of an index that contains them (which will therefore be performing worse). I don’t know when that event will occur, but I’m confident stock picking is alive, and its death but a rumor.

Investment Spotlight: Microsoft

Instead of covering a new investment idea, I decided to take a page from last quarter’s letter and update my thoughts on Microsoft. Like Dell, **it’s been posting excellent results and getting no credit.**

Since spotlighting it in my [3rd quarter 2007 client letter](#) four years ago, Microsoft’s:

- sales climbed 32%, operating income is up 36% and net income soared 58%
- on a per share basis, those numbers climbed 57%, 63% and 88%, respectively
- cash per share on the balance sheet rose 210%
- free cash flow per share is up 73%
- and, the stock price...**dropped** 12%

As with Dell, **Wall Street is looking at Microsoft as a lowly frog and ignoring its princely crown.**

When a company is generating excellent results and its stock price goes down, investors are likely dwelling on the case *against* a company, not the case for it. With that in mind, I aim to rebut the case against Microsoft.

This effort starts by breaking Microsoft’s business into manageable pieces, reported as five divisions:

- 1) Business – Office software: word processing, spreadsheet, presentation, database, email
- 2) Windows – operating system installed on more than 85% of all personal computers (PCs) worldwide
- 3) Servers & Tools – enterprise software and consulting for: servers, databases, back-office email, development tools for creating software
- 4) Entertainment – Xbox, Kinect, smartphones
- 5) Online Services – MSN, Bing search engine

The case against Microsoft contends that it is losing dominance in its biggest and most profitable divisions—Business and Windows—and that it isn’t and can’t succeed in new markets—Servers & Tools, Entertainment, and Online. If Microsoft is 1) shrinking where it makes most of its money *and* 2) not growing sufficiently (to replace such shrinkage) in new markets, then, the case goes, Microsoft’s stock is inevitably headed down.

The structure of this argument requires both parts be true. If Microsoft’s Business and Windows divisions succeed, they don’t *need* success in new markets (though, that would be some nice gravy). Or, if Microsoft thrives in new markets, then Business and Windows can go the way of the dodo and Microsoft can grow and prosper elsewhere (consider that IBM was once dominant in hard disk drives and PCs, but has since left both businesses and gone on to dominate new markets). If *both* parts of the argument are wrong, which is my stance, the argument against Microsoft completely falls apart.

So, let’s examine each argument in detail starting with the first part: **has Microsoft been shrinking where it makes most of its money? Not really.** Microsoft has lost some *market share* in both Business and Windows, but that’s not the same as declining in



Athena Capital Management

absolute terms. A business can lose market share in rapidly expanding markets and still generate respectable growth. Even as Google and Apple have made small gains in market share, PC end markets have been growing at 10-15% (think emerging markets like China and India), allowing Microsoft to generate 6-7% annualized growth over the last four years—even through the Great Recession! Quite simply, Microsoft's most profitable divisions are still growing.

Further, Microsoft has not thrown in the towel in competing with Google and Apple.



Microsoft has its own version of Google's Apps, Office 365, that is an online-only service and similarly cheap. Microsoft is also coming out with a new operating system, Windows 8, to compete with Apple's popular PC and tablet operating systems. These efforts may or may not succeed, but even if they don't, Microsoft hasn't lost forever in legacy markets.

To fully grasp my comments above, it may be helpful to



point out an important difference between computer users: a) some use computers to consume content (read articles, stay in touch with friends & family, play games, etc.), and b) others use computers to create content (write articles, design buildings, crunch numbers, manage databases, etc.). The consumer group is likely to shift to tablets and phones as a substitute (or addition) to PCs. The creative group, in contrast, is quite likely to *continue* using PCs. Microsoft possesses a strong and growing presence in the content creation market—a market that will *continue* growing along with the economy. Microsoft's Business and Windows divisions are, therefore, very likely to thrive in those markets. **Shrinking legacy markets might happen in time, but it isn't happening now and, with dominance in content creation, isn't likely to happen soon.**

As for the argument that Microsoft isn't and can't grow sufficiently in new markets, my answer is: wrong. The Servers & Tools division has grown sales and profits 11% and 13% annually over the last four years and now represents over one-quarter of Microsoft's sales and profits. The Entertainment division has grown sales 7% annually over the last four years, and gone from losing \$1.6 billion a year to making \$1.3 billion. Xbox and Kinect have clearly been hits. The Online Services division, in contrast, has been a big loser, with no growth in sales and increasing losses. But, even with Online losing, Microsoft's three new markets together have grown **sales and profits 8% and 37% annualized** over the last four years! Just as it's hyperbolic to say Bing is beating Google in search or that

Xbox is pulverizing Apple's iPhone and iPad, it's just as much of an exaggeration to say that Microsoft's new markets aren't and can't grow sufficiently to keep Microsoft's overall growth from declining.



Microsoft is clearly growing in new markets, but what about the future? Microsoft's Servers & Tools business is very sticky because changing back-office software is risky, expensive and time-consuming. It's not impossible to shrink that business, but it's very unlikely to occur or, if it does, for it to happen quickly. In Entertainment, Xbox and Kinect have an impressive and growing lead over Nintendo and Sony in games, and are far ahead of Apple and Google's TV efforts. Apple's iPad and iPhone may crush handheld players from Nintendo and Sony, but are unlikely to easily unseat Xbox's dominance in TV-based (living room, interactive) games and content distribution. Microsoft's smart-phone software, which operates from the Entertainment division, could potentially build and grow market share, too. If it succeeds, that would be great for building Microsoft's content consumption business; if not, that's one less development expense generating little or no sales.

It's harder, but not impossible, to be optimistic about Microsoft's Online Division, which is *far* behind Google in search and advertising. The worst case scenario is that Microsoft quits the field, thus removing \$2.5 billion in annual losses (yes, it's that ugly). More hopefully, Microsoft's Bing could *continue* growing market share in search, providing Google's advertising customers a much desired alternative to Google's *über*-dominance (and pricing power in advertising costs). Whether Microsoft quits or pushes on to success, shareholders win.



Recapping my answer to the two-part argument above: **Microsoft has neither irredeemably lost in legacy markets nor conclusively failed in new markets.** Quite the opposite, a well-supported argument can be made that Microsoft still dominates content creation in PCs and is growing strongly into new and faster growing markets.

As one final footnote to my rebuttal, I believe an underlying assumption of the argument against Microsoft is: if Apple and Google succeed, Microsoft necessarily fails. But the former doesn't imply the latter. People—I'm an example—may be quite happy to own an



Athena Capital Management

Apple iPad *and* a Google Android phone to consume content, *and* a Microsoft laptop *and* desktop to do work. In that case, everyone wins. Microsoft may not beat Apple and Google in new markets and yet still go on to dominate other profitable, growing niches. It's my opinion they have a very good chance of doing so.

Microsoft isn't as dominant as it was 10 or 15 years ago, but that doesn't necessarily make it a bad investment. **The best protection against negative downside is paying a low enough price to do well even if the future isn't as good as the past.** I think that's where we sit. Relative to our \$27 price, Microsoft has \$5.37 per share of net cash, \$2.75 of earnings per share, \$2.94 of free cash flow per share, and an \$0.80 dividend (yielding 3% and growing more than 15% a year over the last 6 years). Those figures seem good support for limited downside.

Microsoft's past double digit growth may or may not continue, but I think we'll still get a respectable result. **More likely, Microsoft will find ways to succeed in old *and* new markets, in which case our returns will be more than merely respectable.** I've looked hard at lots of frogs and found one with a sparkling, golden crown—let the kissing begin!

Until next quarter

Thanks again for your business, and unerring patience. Great investment records are made, not born. I was reminded of this when reviewing the investment record of one of my heroes, Robert Rodriguez, who under-performed during 15 of his first 18 five-year-periods up until 1990—on his way to generating results *three times* the S&P 500 (9/30/1968-9/30/2011, Morningstar). Talk about patience!

Excellent investment results are less about finding golden geese or magic beans and more about sticking with an investment discipline that has stood the test of time through thick and thin. We've got the right investment discipline, now we just have to stick to it. Lucky for me, **I've got the right kind of clients, too.**

If you're interested in seeing my thoughts on investments, markets and economics between letters, please visit my blog: www.mikerivers.blogspot.com. Each week, I provide useful, insightful, or at least entertaining information. It's fast approaching 300 posts and 10,000 pageviews, so there's something for everyone and a large and growing following!

As usual, if you have any questions, comments or feedback for me, please contact me at your convenience. I always enjoy hearing from you.

Respectfully,
Mike

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