# Shenandoah Asset Management, LLC

*Quarterly Review: June 30, 2003*

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## Market Data & Commentary:

*Source: Vestek & Frank Russell*

| Index | Month | Quarter | YTD 2003 |
|---|---|---|---|
| S&P 500 | 1.3% | 15.4% | 11.8% |
| Dow Jones Industrials | 1.7% | 13.1% | 9.0% |
| NASDAQ | 1.7% | 21.0% | 21.5% |
| S&P/BARRA Value | 0.7% | 18.8% | 12.3% |
| S&P/BARRA Growth | 1.8% | 12.2% | 11.3% |
| S&P 500 Equal-Weighted | 0.8% | 21.9% | 16.6% |
| S&P 400 Midcap | 1.3% | 17.6% | 12.4% |
| Russell 2000 | 1.8% | 23.4% | 17.9% |

| | 2003Q2 | YTD 2003 |
|---|---|---|
| BASIC MATERIALS | 12.0% | 3.5% |
| CAPITAL GOODS | 15.1% | 3.6% |
| COMMUNICATION SVC | 23.8% | 17.5% |
| CONSUMER CYCLICALS | 21.6% | 15.1% |
| CONSUMER STAPLES | 14.3% | 9.4% |
| ENERGY | 9.2% | 8.5% |
| FINANCIAL | 15.1% | 10.4% |
| HEALTH CARE | 16.4% | 17.3% |
| TECHNOLOGY | 25.5% | 25.2% |
| TRANSPORTATION | 10.4% | 3.7% |
| UTILITIES | 16.0% | 13.1% |

The quarter began under the cloud of a longer than anticipated war with IRAQ, however; a concerted assault by allied forces resulted in the taking of Baghdad by early April. As expected, good news on the war increased optimism about the U.S. economy and corporate performance for 2H'03. Although the pace of the market rally slowed in June, the U.S. major indices were able to lock in their strongest quarterly gains in a number of years. As has been the case in other recent rallies, the NASDAQ was the best performing index, +21.0%, while the S&P 500 and the Dow Jones Industrials also posted impressive gains of +15.4% and +13.1%. More specifically, a number of underlying factors drove the markets performance during the quarter~~:~~

- *Fed cuts rates for the 13th time in this cycle*. After, deciding to leave rates unchanged during the period surrounding the IRAQ war, the FOMC lowered the Fed Funds rate by 25bps to 1% at its June 25th meeting. Debate ensued about the size of the rate cut, as some economists had been expecting a 50bps cut, and the somewhat ambiguous statement that accompanied the announcement. However, unless there is a visible pickup in U.S. economic activity, the FOMC will likely lower rates again prior to the end of 2003.
- *Value outperformed Growth*. Given the strong performance of the NASDAQ index and the Technology sector, it was somewhat counter-intuitive that Value indices outperformed Growth indices across all capitalization levels. The S&P/BARRA Value index out-performed its Growth counterpart, returning +18.8% vs. +12.2%. Mid-cap Value outperformed Mid-cap Growth +19.2% vs. +16.0% and Small-cap Value out-performed Small-cap Growth +22.7% vs. +16.9%
- *Small-cap stocks outperform large-cap stocks*. The equal weighted S&P 500 index out-performed the cap-weighted version by a whopping +650 bps in the quarter (+21.9% vs. +15.4%) and now leads the cap-weighted index by +470bps over the past 12 months (+5.0% vs. +0.3%). The equal weighted index continues to lead the cap-weighted index over the 2, 3, 4, 5 and 10-year time periods.
- *U.S. economic outlook remains uncertain, however; the pump is being primed*. Recent economic reports have been mixed. The housing market, driven by historically low interest rates, remains the standout sector of the economy. Record low interest rates and tax cuts, soon to hit consumers pocket books, are two of the primary drivers of the more optimistic 2H'03 economic view that is being factored into current stock prices.
- *Approaching an important Q2 EPS reporting season*. The equity market has clearly priced in a substantial improvement in 2H'03 and FY'04 economic and corporate profit performance. With that in mind, Q2 EPS results and more importantly 2H'03 EPS guidance will be crucial to the sustainability of the recent optimism and market gains. After two years of H2 corporate and economic performance failing to live up to expectations, anything less than a stellar EPS reporting season will likely result in a market sell-off, in our opinion.

As has been the case in recent rallies, the Technology and Communications Services sectors were the best performers, up +25.5% and +23.8%, respectively. The Energy sector, up + 9.2% was the worst performing sector as the end to the war with IRAQ and a relatively supportive stance by OPEC decreased fears of an oil supply shortage.

# Model Attribution: *Second Quarter, 2003*

| Quint | Opt E/I | Earnings | Insider | DDM | Cashflow | Technical | Size |
|---|---|---|---|---|---|---|---|
| 5 (high) | 16.9% | 16.8% | 20.2% | 25.3% | 23.6% | 15.5% | 15.8% |
| 4 | 16.6% | 16.6% | 18.6% | 19.4% | 18.8% | 19.2% | 17.3% |
| 3 | 18.6% | 16.3% | 18.6% | 17.4% | 16.6% | 18.0% | 19.4% |
| 2 | 19.5% | 18.0% | 16.0% | 14.4% | 15.2% | 18.1% | 17.4% |
| 1 (low) | 17.8% | 22.4% | 15.1% | 15.9% | 16.3% | 19.3% | 19.5% |
| ***Spread*** | ***-0.9%*** | ***-5.6%*** | ***5.1%*** | ***9.4%*** | ***7.2%*** | ***-3.7%*** | ***-3.7%*** |

*Note: "Spread" is the difference between the returns of the high (5) and low (1) quintiles by each model/measure.*

The Shenandoah models posted mixed results during the quarter. The speculative nature of the April/May rally resulted in the perverse performance of our Earnings model. Once again, investors took at "bet" that future earnings would be better than expected. Partly offsetting the negative Earnings performance was the strong performance of the Insider and Valuation models.

We believe that sector moves continue to drive the performance of fundamentals, rather than fundamentals driving performance. The negative Earnings spread was primarily due to the out-performance of the weakest stocks, quintiles 4 and 5, based on current earnings expectations. The spread between the Earnings model Quintiles 1 to 3 was slightly positive. The Insider and Valuation models exhibited more monotonic return patterns.

- The Earnings model, spread was –5.6%, a reversal of its strong Q1 performance. As was the case during the October/November speculative rally, investors appeared to disregard current earnings expectations in favor of "betting" that stocks with the weakest current earnings outlook would be more leveraged to an economic recovery.
- The Insider Transaction model spread was, +5.1%. A pickup in Insider buying in early March was rewarded in April and May. The June model spread was essentially flat as the overall model signal turned more bearish.
- The OPT E/I model (Earnings and Insider Trading) spread was –0.9%, as the negative Earnings performance was partly offset by the positive Insider Transaction model spread.
- Our value models produced the strongest model returns with the DDM and Cashflow models recording gains of +9.4% and +7.2%, respectively. The positive Cashflow spread was driven, in part, by the strong performance of the Consumer Cyclical sector (including Homebuilders) vs. the performance of the Basic Materials sector.
- Price momentum (our Technical model) returned a negative spread, -3.7%. The model exhibited somewhat random returns (non-monotonic pattern). (Note: We do not use price momentum in our investment process.)
- The smallest stocks out-performed the largest by +3.7% for the quarter although there was a lack of consistency to the monthly spreads. All capitalization levels appeared to benefit from the April relief rally, with Small cap and Large cap reporting positive spreads in May and June, respectively.

YTD, all of our models have recorded positive spreads. However, given YTD volatility, it not surprising that the quintile returns do not exhibit a clear monotonic pattern. The Earnings model, +1.7% spread (the most heavily weighted factor in our process) and the Insider Transaction model, +2.5% combined to provide an OPT E/I model spread of +2.2%. The valuation models have generated significant positive returns for the year with the Cashflow model spread +11.2% and the DDM spread +7.5%.

# Model Attribution: *Year to Date, 2003*

| Quint | Opt E/I | Earnings | Insider | DDM | Cashflow | Technical | Size |
|---|---|---|---|---|---|---|---|
| 5 (high) | 13.7% | 15.5% | 15.7% | 20.7% | 22.1% | 11.9% | 11.4% |
| 4 | 14.7% | 13.6% | 12.4% | 11.8% | 13.4% | 16.0% | 15.1% |
| 3 | 14.5% | 10.7% | 13.9% | 13.1% | 12.2% | 12.0% | 15.0% |
| 2 | 12.3% | 11.7% | 11.6% | 10.0% | 10.0% | 11.6% | 13.2% |
| 1 (low) | 11.5% | 13.8% | 13.3% | 13.2% | 10.9% | 16.1% | 12.1% |
| ***Spread*** | ***2.2%*** | ***1.7%*** | ***2.5%*** | ***7.5%*** | ***11.2%*** | ***-4.2%*** | ***-0.7%*** |