# Shenandoah Asset Management, LLC

*Quarterly Review: September 30, 2003*

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## Market Data & Commentary:

*Source: Vestek & Frank Russell*

| Index | Month | Quarter | YTD 2003 |
|---|---|---|---|
| S&P 500 | -1.1% | 2.7% | 14.7% |
| Dow Jones Industrials | -1.4% | 3.8% | 13.2% |
| NASDAQ | -1.3% | 10.1% | 33.8% |
| S&P/BARRA Value | -1.8% | 2.6% | 15.2% |
| S&P/BARRA Growth | -0.3% | 2.8% | 14.3% |
| S&P 500 Equal-Weighted | -1.6% | 5.5% | 23.0% |
| S&P 400 Midcap | -1.5% | 6.6% | 19.8% |
| Russell 2000 | -1.8% | 9.1% | 28.6% |

| | 2003Q3 | YTD 2003 |
|---|---|---|
| BASIC MATERIALS | 5.3% | 9.1% |
| CAPITAL GOODS | 6.4% | 10.2% |
| COMMUNICATION SVC | 2.2% | 20.1% |
| CONSUMER CYCLICALS | 7.1% | 23.2% |
| CONSUMER STAPLES | 2.8% | 12.4% |
| ENERGY | -1.8% | 6.5% |
| FINANCIAL | 4.8% | 15.7% |
| HEALTH CARE | 6.9% | 25.4% |
| TECHNOLOGY | 9.8% | 37.4% |
| TRANSPORTATION | 6.7% | 10.6% |
| UTILITIES | 0.7% | 13.9% |

Buoyed by a relatively positive Q2 EPS reporting season, investors continue to gain confidence in the expected recovery in the US economy and corporate earnings, which led to solid gains in July and August. However, in September, nagging concerns about the lack of US job growth, the late quarter weakness in the $US, continued unrest in the Middle East and the unexpected announcement by OPEC that they would lower oil output beginning November 1 all worked to moved the markets lower. For the quarter, the NASDAQ continued to lead the way higher, driven by the strong performance in the Technology sector, up 10.1%. In comparison, the Dow Jones and the S&P500 were able to log solid returns of 3.8% and 2.7%, respectively. More specifically, a number of underlying factors drove the markets performance during the quarter.

- *Fed leaves rates unchanged.* Although rates remained on hold at 1%, the FOMC has been widely criticized for the lack of clarity in its post meeting statements. This has been the subject of discussion since the Fed first mentioned the risk of deflation that was incorrectly interpreted to mean that the Fed was likely to be a buyer of bonds, triggering a wild ride in the bond markets. The risk of any near-term interest rate increase, even with a pickup in economic activity, appears to be small as the FOMC's August meeting minutes indicate a willingness to keep policy accommodative for a longer period than in past periods of economic activity.
- *Growth versus Value performance mixed*. As was the case in Q2, the strong performance of the NASDAQ index and the Technology sector did not result in Growth outperforming Value across all capitalization levels. The S&P/BARRA Growth index out-performed its Value counterpart, returning +2.8% vs. +2.6%. Mid-cap Value outperformed Mid-cap Growth +7.2% vs. +6.0%; however, Small-cap Growth out-performed Small-cap Value +7.8 vs. +6.3%
- *Small-cap stocks outperform large-cap stocks, again*. Smaller cap stocks continued to lead the way. The equal weighted S&P 500 index out-performed the cap-weighted version by +290 bps in the quarter (+5.5% vs. +2.7%) and now leads the cap-weighted index by +1,460 bps over the past 12 months (+39.0% vs. +24.4%). The equal weighted index also leads the cap-weighted index over the 2, 3, 4, 5 and 10-year time periods.
- *High expectations for Q3 EPS reporting season*. During the quarter, analysts have become increasingly optimistic about the prospects for continued improvement in the performance of corporate earnings. Current expectations are for S&P500 Q3 operating EPS to increase approximately +18% y/y, up from +12% in Q2. The relatively positive pre-announcement season has added to the optimism. Against this backdrop, it is likely that anything less than spectacular EPS results will be considered a disappointment and result in downward pressure on equity prices.

The Technology sector, up +9.8% for the Qtr and +37.4% YTD, continues to be a key beneficiary of the focus on beta and earnings leverage companies. Investors are betting that an improving economic outlook will result in increased corporate technology spending. Energy, was the worst performing sector, down –1.7%. Concern about possible oil shortages and the resulting higher prices appear to have largely abated, for now.

# Model Attribution: *Third Quarter, 2003*

| Quint | Opt E/I | Earnings | Insider | DDM | Cashflow | Technical | Size |
|---|---|---|---|---|---|---|---|
| 5 (high) | 5.0% | 5.8% | 6.8% | 7.3% | 6.1% | 3.6% | 3.4% |
| 4 | 4.0% | 3.4% | 5.3% | 7.4% | 6.6% | 2.7% | 5.2% |
| 3 | 6.5% | 5.5% | 5.5% | 5.1% | 5.1% | 6.9% | 6.0% |
| 2 | 5.6% | 6.9% | 5.3% | 5.0% | 6.0% | 6.8% | 7.8% |
| 1 (low) | 8.8% | 8.4% | 7.1% | 6.3% | 6.4% | 9.9% | 7.6% |
| ***Spread*** | ***-3.8%*** | ***-2.7%*** | ***-0.3%*** | ***0.9%*** | ***-0.3%*** | ***-6.3%*** | ***-4.1%*** |

*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 July/August rally resulted in the perverse performance of our Earnings model. Once again, stocks with stronger current earnings expectations lagged those with high beta, poor or negative current earnings and perceived earnings leverage. The solid absolute performance, up 5.0%, of OPT E/I quintile 5 stocks, strong current earnings expectations and insider buying, was swamped by quintile 1 stocks, weak current earnings expectations and insider selling, up 8.8%. The performance of the Insider and Valuation models was essentially flat for the quarter. As has been the case since last October, solid, stable growth companies have been relatively ignored in favor of speculative stocks.

We believe that sector moves continue to drive the performance of fundamentals, rather than fundamentals driving performance. As a result we observed a more random (non-monotonic) pattern in all of the model spreads. This was especially evident in the Earnings model. The negative Earnings spread was primarily due to the out-performance of the stocks with the weakest current earnings expectations

- The Earnings model, spread was –2.7%. Once again, 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, -0.3%. This spread was dampened by the strong performance of the stocks with the weakest Insider score, quintile 1. The spread between quintiles 5 and 2 was +1.5%. **Our Insider model remains at record negative levels (large amounts of insider selling), which is a very bearish signal for the near-term performance of equities**.
- The OPT E/I model (Earnings and Insider Trading) spread was –3.8%. The negative spread was driven by the negative Earnings performance.
- Our value models produced mixed results with the DDM model, +0.9% and Cashflow model –0.3%. The relatively narrow value model spreads indicate that investors were not as focused on value as a differentiating investment factor as they were earlier in the year.
- Price momentum (our Technical model) returned a negative spread, -6.3%. (Note: We do not use price momentum in our investment process; this model is only included for discussion purposes.)
- The smallest stocks out-performed the largest by +4.1% for the quarter. The small cap dominance in July and August was partly offset by a slight underperformance during the market reversal in September as investors sought shelter in larger cap companies.

YTD model performance is mixed. The Earnings model, -1.2% spread (the most heavily weighted factor in our process) and the Insider Transaction model, +2.3% combined to provide an OPT E/I model spread of –2.0%. Although spreads narrowed this quarter, the valuation models have generated significant positive returns for the year with the Cashflow model spread +11.6% and the DDM spread +9.1%.

# Model Attribution: *Year to Date, 2003*

| Quint | Opt E/I | Earnings | Insider | DDM | Cashflow | Technical | Size |
|---|---|---|---|---|---|---|---|
| 5 (high) | 19.4% | 22.2% | 23.6% | 29.5% | 29.6% | 15.9% | 15.3% |
| 4 | 19.3% | 17.4% | 18.3% | 20.1% | 20.9% | 19.1% | 21.0% |
| 3 | 22.0% | 16.8% | 20.1% | 18.8% | 17.9% | 19.7% | 21.8% |
| 2 | 18.6% | 19.4% | 17.5% | 15.5% | 16.6% | 19.2% | 22.0% |
| 1 (low) | 21.4% | 23.4% | 21.3% | 20.4% | 18.0% | 27.5% | 20.6% |
| ***Spread*** | ***-2.0%*** | ***-1.2%*** | ***2.3%*** | ***9.1%*** | ***11.6%*** | ***-11.6%*** | ***-5.4%*** |