

## Market Data & Commentary:

Source: Vestek & Frank Russell

Index	Month	Quarter	YTD 2003
S&P 500	5.3%	12.2%	28.7%
Dow Jones Industrials	7.0%	13.4%	28.3%
NASDAQ	2.2%	12.1%	50.0%
S&P/BARRA Value	6.2%	14.5%	31.8%
S&P/BARRA Growth	4.3%	9.9%	25.7%
S&P 500 Equal-Weighted	5.4%	15.2%	41.8%
S&P 400 Midcap	1.7%	13.2%	35.6%
Russell 2000	2.0%	14.5%	47.3%

	2003Q4	YTD 2003
BASIC MATERIALS	23.3%	34.4%
CAPITAL GOODS	19.6%	31.9%
COMMUNICATION SVC	11.0%	33.3%
CONSUMER CYCLICALS	14.3%	40.7%
CONSUMER STAPLES	11.3%	25.1%
ENERGY	14.4%	21.9%
FINANCIAL	12.7%	30.3%
HEALTH CARE	10.7%	38.8%
TECHNOLOGY	15.6%	58.8%
TRANSPORTATION	9.2%	20.9%
UTILITIES	8.1%	23.2%

Continued improvement on the economic and corporate earnings fronts drove the impressive gains for the quarter and year ended 12/31/03. After a strong start, the markets took a breather during the October/November reporting season to reflect on the EPS strength. A BTE 8.2% Q3 GDP number, in late November, provided the catalyst to re-ignite buying interest. The continued strength in December performance was notable for the rotation into the Basic Materials and Capital Goods sectors and out of the previously raging Technology sector. The major indices all recorded double digit gains for the quarter with the DJIA leading the way, up 13.4%, however; this was closely followed by the S&P 500 and the NASDAQ, up 12.2% and 12.1%, respectively. More specifically, a number of underlying factors drove the market's performance during the quarter-

- *Fed leaves rates unchanged.* The continued strength in the economy was not enough to budge the FOMC to raise rates from the 40-year low of 1%. The consensus on when the Fed is likely to begin the inevitable increase in interest rates has been in flux. So far, low inflation and continued remarks by the Fed of its continued willingness to keep policy accommodative for a longer period than in the past have been enough to convince investors that the Fed is unlikely to raise rates until well into 2H'04.
- *Value dominates Growth across all capitalization levels.* A value bias was a winning strategy in each month throughout the quarter. For the quarter, the S&P/BARRA Value index out-performed its Growth counterpart, returning +14.5% vs. +9.9%. Mid-cap. Value outperformed Mid-cap. Growth +16.5% vs. +9.8% and Small-cap. Value outperformed Small-cap. Growth +16.6 vs. +13.0%
- *Small-cap stocks outperform large-cap stocks, again.* The strong relative performance of the Large cap. stocks in December was not enough to overcome the early quarter surge by Small cap. stocks. The equal-weighted S&P 500 index out-performed the cap-weighted version by +300 bps in the quarter (+15.2% vs. +12.2%) and now leads the cap-weighted index by +1,310 bps over the past 12 months (+41.8% vs. +28.7%). The equal weighted index also dominates the cap-weighted index over the 2, 3, 4, 5 and 10-year time periods.
- *After 3 years of waiting, the second half recovery has arrived.* The robust performance of Q3 EPS was enough to convince investors that the improvement seen in Q2 EPS was no fluke. In addition, the 2H sustainable economic recovery that the markets have been waiting for appears to have finally arrived. That said, we go into the Q4 EPS reporting season brimming full of optimism. Current expectations are for S&P500 Q4 operating EPS to increase approximately +23% y/y. Another relatively positive pre-announcement season has added to the optimism. Against this backdrop, it is likely that anything less than spectacular EPS results/guidance will be considered a disappointment and result in downward pressure on equity prices.

After trailing the performance of the "sexier" Technology and Consumer Cyclical sectors all year, the Basic Materials and Capital Goods sectors had their "quarter in the sun" returning +23.3% and +19.6%, respectively. Utilities were the worst performing sector logging a respectable +8.1% return. For the year, the Technology sector, up +58.8%, was a clear beneficiary of the expectation that this sector would be the market leader in the recovery. Transportation, dogged by higher fuel prices and uncertainty in the airline industry was the worst performing sector, +20.9%.

## Model Attribution: *Fourth Quarter, 2003*

Quint	Opt E/I	Earnings	Insider	DDM	Cashflow	Technical	Size
5 (high)	13.1%	13.5%	15.6%	18.7%	14.5%	16.9%	13.0%
4	14.1%	12.5%	14.8%	13.4%	13.6%	12.2%	14.6%
3	13.7%	13.8%	14.1%	14.0%	13.7%	12.6%	13.0%
2	14.2%	14.6%	12.9%	13.0%	14.5%	13.7%	14.3%
1 (low)	15.8%	16.4%	13.4%	12.9%	15.3%	15.6%	16.0%
<b>Spread</b>	<b>-2.7%</b>	<b>-2.9%</b>	<b>2.3%</b>	<b>5.8%</b>	<b>-0.8%</b>	<b>1.3%</b>	<b>-3.0%</b>

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. Quarterly spreads were heavily influenced by the December performance; model spread performance in October and November was muted. The Earnings model continues to record perverse performance. The negative spread was exacerbated by the sector rotation into the Basic Materials and Capital Goods sectors, which contain many stocks with the weakest current earnings expectations, quintile 1. Excluding this quintile, the model spread was slightly negative. The performance of the Insider and Valuation models was mixed.

We believe that sector moves continue to drive the performance of fundamentals, rather than fundamentals driving performance, which resulted in the extreme performance of the best/worst quintile within each model. This was especially evident in the Earnings and DDM models.

- The Earnings model spread was  $-2.9\%$ . The positive performance of the model during the Q3 EPS reporting month of October was overcome by the negative performance in December. 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  $+2.3\%$ . Monthly spreads were volatile, which we believe is an indication of sector and industry rotation. **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  $-2.7\%$ . The negative performance of the Earnings model, which is more heavily weighted in our process, more than offset the positive Insider model performance.
- Our value models produced mixed results with the DDM model,  $+5.8\%$  and Cashflow model  $-0.8\%$ . Why such disparate performance? As they are different models, quintile holdings differ. Also, the model spread is essentially flat when the extreme quintile performance is excluded.
- Price momentum (our Technical model) returned a slightly positive spread,  $+1.3\%$ . (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 stocks by  $+3.0\%$  for the quarter.

YTD model performance is mixed. The Earnings model,  $-4.9\%$  spread (the most heavily weighted factor in our process) and the Insider Transaction model,  $+5.4\%$  combined to provide an OPT E/I model spread of  $-5.5\%$ . The valuation models have generated significant positive returns for the year with the DDM spread of  $+17.7\%$  and Cashflow model spread  $+12.3\%$ .

## Model Attribution: *Year to Date, 2003*

Quint	Opt E/I	Earnings	Insider	DDM	Cashflow	Technical	Size
5 (high)	35.0%	38.7%	43.0%	53.6%	48.4%	35.4%	30.3%
4	36.0%	32.1%	35.8%	36.2%	37.4%	33.7%	38.7%
3	38.7%	33.0%	37.0%	35.5%	34.1%	34.7%	37.7%
2	35.4%	36.8%	32.6%	30.5%	33.6%	35.5%	39.4%
1 (low)	40.5%	43.7%	37.5%	35.9%	36.1%	47.4%	39.9%
<b>Spread</b>	<b>-5.5%</b>	<b>-4.9%</b>	<b>5.4%</b>	<b>17.7%</b>	<b>12.3%</b>	<b>-11.9%</b>	<b>-9.6%</b>