

Market Data & Commentary:

Source: Vestek & Frank Russell

Index	Month	Q1'04	1 Yr
S&P 500	-1.5%	1.7%	35.1%
Dow Jones Industrials	-2.0%	-0.4%	32.6%
NASDAQ	-1.8%	-0.5%	48.7%
S&P/BARRA Value	-0.7%	3.4%	44.2%
S&P/BARRA Growth	-2.3%	0.0%	26.7%
S&P 500 Equal-Weighted	-0.6%	3.9%	54.0%
S&P 400 Midcap	0.4%	5.1%	49.1%
Russell 2000	0.9%	6.3%	63.8%

	Q1'04	1 Yr
Basic Materials	1.4%	47.4%
Capital Goods	2.7%	50.5%
Communication Svc	2.9%	44.6%
Consumer Cyclical	5.6%	57.0%
Consumer Staples	4.1%	36.1%
Energy	7.4%	31.8%
Financial	5.6%	43.5%
Health Care	8.1%	48.9%
Technology	1.8%	62.1%
Transportation	-4.2%	23.2%
Utilities	3.4%	30.7%

The US equity markets began the year with the same positive tone that resonated throughout 2H'03 posting solid returns in January and February. However, in March, an increase in terrorist activity, higher oil prices and a lack of job growth combined to dampen investor enthusiasm and equity returns. The major indices recorded mixed results during the quarter: The S&P 500 was up +1.7%, while the DJIA and NASDAQ were both down (-0.4% and -0.5%, respectively). More specifically, a number of underlying factors drove the market's performance during the quarter:

- *Fed leaves rates unchanged.* Apart from a change in the wording of the FOMC meeting statements, nothing changed this quarter. The Fed governors reiterated that they did not see a need to raise interest rates in the near-term. At the same time, the governors began to prepare the market for the inevitable increase in interest rates from their current, 40-year low levels. The lack of job growth, in an otherwise strengthening economy, is viewed as the missing piece in the FOMC's economic puzzle. Assuming other things remain on track, a pick-up in job creation should be a signal that the FOMC is likely to begin to raise interest rates.
- *Value dominates Growth across all capitalization levels.* Once again a value bias was a winning strategy. For the quarter, the S&P/BARRA Value index out-performed its Growth counterpart, returning +3.4% vs. +0.0%. Mid-cap Value outperformed Mid-cap Growth +5.5% vs. +4.6% and Small-cap Value outperformed Small-cap Growth +6.6 vs. +5.7%
- *Small-cap stocks outperform large-cap stocks, again.* Small-cap stocks had the edge on their large-cap counterparts. The equal-weighted S&P 500 index out-performed the cap-weighted version by +220 bps in the quarter (+3.9% vs. +1.7%) and now leads the cap-weighted index by a whopping +1,890 bps over the past 12 months (+54.0% vs. +35.1%). The equal-weighted index also dominates the cap-weighted index over the 2, 3, 4, 5 and 10-year time periods.
- *Corporate earnings expectations remain high.* We enter the Q1'04 EPS season with expectations for an 18% increase in S&P 500 operating earnings. The S&P 500 gained approximately 4% in the three weeks leading up to the start of the Q3'03 and Q4'03 corporate earnings season. However, unlike in Q3'03 when equities went on to record double digit gains for the quarter, the market reaction to the better than expected Q4 results was muted. This was exacerbated by the negative headlines related to increased terrorist activity and higher energy prices. With that in mind, without a subsequent catalyst, such as the 8% Q3 GDP number reported in late November of '03, we could see any gains made in the lead up to the Q1 EPS season evaporate later in the quarter. An improvement in the job market could provide the necessary positive catalyst. However, then investors would have one more thing to worry about--higher interest rates.

For the quarter, Healthcare, up +8.1% was the best performing sector. Investors looked to gain from the expected positive demographic, new product and regulatory trends. Higher oil prices played a primary role in the performance of the Energy sector, up +7.4% and Transportation sector, down -4.2%. As Energy companies stood to benefit from higher oil prices, Transportation companies, especially those in the battered Airline industry, scrambled to recover some of the increased cost via an increase in fuel surcharges. Continental Airlines recent failure to implement a \$5 a ticket increase, up from \$10, in its fuel surcharge is an example of the difficulty that companies have trying to pass along higher costs to their "price sensitive" customers.

Model Attribution: *First Quarter, 2004*

Quint	Opt E/I	Earnings	Insider	DDM	Cashflow
5 (high)	5.4%	5.0%	5.8%	5.9%	6.4%
4	5.5%	5.0%	5.6%	5.4%	7.0%
3	5.7%	4.4%	4.8%	6.1%	4.6%
2	3.9%	5.1%	4.4%	3.4%	4.1%
1 (low)	3.3%	4.2%	3.0%	2.9%	0.0%
Spread	2.1%	0.7%	2.7%	3.1%	6.4%

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

The Shenandoah models all posted positive results for the quarter. Every quintile reported positive performance vs. the flat to negative performance of the market. (Our quintile returns are equally-weighted and as previously noted equal weighted indices outperformed cap-weighted.) The models exhibited a relatively monotonic pattern. The primary driver of the positive model performance was the considerable underperformance of stocks with the weakest characteristic in each model, quintile 1. Apart from the DDM model, which reported a negative spread in February, model performance was positive in all months of the quarter. The Earnings model added value throughout the quarter. The Insider model posted strong results and our valuation models, Cashflow and DDM, continue to record excellent performance.

The muted quarterly US equity index returns masked the underlying volatility that occurred at the sector and industry level. Although the consensus view is that an economic recovery is underway, the lack of job creation and a benign inflation environment left investors grappling with the question of when the Federal Reserve will begin to raise interest rates from the current (40-year low) level. As a result, we saw rotation in and out of economic and interest rate sensitive areas of the market throughout the quarter.

- The Earnings model spread was +0.7%. In prior quarters we have seen evidence that investors were turning their attention back to corporate earnings. However, the positive performance impact of this has often been overwhelmed by subsequent speculative rallies that occurred during the same period. Therefore, it was encouraging to see the model add value in every month of the quarter. This model continues to generate excellent positive quarterly EPS surprise prediction results. For Q4'03, approximately 80% of our Long holdings reported a positive EPS surprise vs. 65% for the market and 60% for our Short holdings.
- The Insider Transaction model spread was +2.7%. This model also consistently added value throughout the quarter. **Although down from the record levels reached last year, our Insider model remains decidedly bearish (large amounts of insider selling), which we believe continues to be a very negative signal for the near-term performance of equities.**
- The OPT E/I model (Earnings and Insider Trading) spread was +2.1%. The positive performance of the Earnings model, which is more heavily weighted in our process, was amplified by the positive Insider model performance.
- Our value models, Cashflow, +6.4% and DDM, +3.1% were the best performing models for the quarter. After the generally better than expected Q4'03 EPS results, valuation concerns were raised, especially in the Technology sector. The relative underperformance of Technology stocks ranked weakest by our valuation models (quintile 1) benefited the performance of these models.

Model performance over the past 12 months was mixed. The Earnings model, -13.8% spread (the most heavily weighted factor in our process) and the Insider Transaction model, +13.0% combined to provide an OPT E/I model spread of -7.2%. The valuation models have generated significant positive returns with the DDM spread of +25.8% and Cashflow model spread +17.0%

Model Attribution: *One Year*

Quint	Opt E/I	Earnings	Insider	DDM	Cashflow
5 (high)	46.2%	47.2%	57.0%	68.9%	59.7%
4	45.8%	42.4%	51.5%	53.3%	53.9%
3	51.9%	45.9%	49.5%	49.3%	45.9%
2	49.8%	51.9%	44.1%	40.3%	45.6%
1 (low)	53.4%	61.0%	44.0%	43.1%	42.7%
Spread	-7.2%	-13.8%	13.0%	25.8%	17.0%