SHENANDOAH ASSET MANAGEMENT, LLC

121 Shockoe Slip
Richmond, VA 23219
(804) 343-1400
www.samllc.com

Quarterly Review: September 30, 2004

Source: Vestek & Frank Russell

Index	Month	Q3'04	1 Yr
S&P 500	1.1%	-1.9%	13.9%
Dow Jones Industrials	-0.8%	-2.9%	11.1%
NASDAQ	3.2%	-7.4%	6.2%
S&P/BARRA Value	1.9%	1.0%	20.5%
S&P/BARRA Growth	0.2%	-4.8%	7.5%
S&P 500 Equal-Weighted	2.8%	-2.0%	20.2%
S&P 400 Midcap	3.0%	-2.1%	17.6%
Russell 2000	4.7%	-2.8%	18.8%

	Q3'04	YTD '04
Basic Materials	6.7%	16.9%
Capital Goods	-2.7%	7.7%
Communication Svc	-1.4%	2.4%
Consumer Cyclicals	-3.7%	1.8%
Consumer Staples	-3.8%	1.4%
Energy	12.2%	30.7%
Financial	2.6%	7.4%
Health Care	-5.6%	5.5%
Technology	-10.6%	-10.3%
Transportation	1.8%	10.4%
Utilities	4.7%	7.2%

Although not totally unexpected, the realization that corporate earnings were not going to continue to grow at the 20+% rates seen during the prior four quarters was enough to move markets significantly lower in July. For the remainder of the quarter the three I's (Interest rates, IRAQ and Inflation/oil) continued to be the key drivers of daily market performance/volatility. Market performance was mixed in August and September. The net result was that the major indices recorded negative results during the quarter: NASDAQ -7.4%, DJIA –2.9% and the S&P 500 –1.9%. More specifically, a number of underlying factors drove the market's performance during the quarter~~:~~

- ***Fed raises rates, again and again.*** After beginning its much-anticipated move higher on the last day of Q2, the Fed added +0.50% (two +0.25% increases) to the Fed Funds rate this quarter. The rate now stands at 1.75%. After its most recent meeting in September, the FOMC noted that it remains comfortable with the plan to continue to raise rates at a measured pace. This reaffirmation signaled that rates should continue to move steadily higher toward a more neutral position (possibly 2.5% to 3.0%). With the next regularly scheduled FOMC meeting set for November 10, there should be no further Fed action until after the Presidential election.
- ***Value back in style.*** Along with the slowdown in growth expectations came a move back into value stocks. Value was the performance winner across all capitalization levels. For the quarter, the S&P/BARRA Value index out-performed its Growth counterpart, returning +1.0% vs. –4.8%, Mid-cap Value outperformed Mid-cap Growth –0.8% vs. –3.4% and Small-cap Value out-performed Small-cap Growth +0.3% vs. –3.04%
- ***Large-cap stocks outperform small-cap stocks.*** Large-cap stocks benefited from the value bias of the markets outperforming their Small-cap counterparts this quarter. The cap-weighted S&P 500 index out-performed the equal-weighted version by +10 bps in the quarter (-1.9% vs. -2.0%), however, the equal weighted index still leads the cap-weighted index by +630 bps over the past 12 months (+20.2% vs. +13.9%). The equal-weighted index also dominates the cap-weighted index over the 2, 3, 4, 5 and 10-year time periods.
- ***Corporate earnings expectations cool to mid-teens!*** After the recent downshifting of earnings expectations, we enter the Q3'04 EPS season with S&P 500 operating earnings expected to grow +14% year over year. Although historically strong, this is well below the 30%+ year over year growth recorded in Q2'04 and marks the first quarter in over a year that quarterly EPS growth expectations are below 20% heading into the reporting season. A pickup in the number of companies that pre-announced weaker than expected Q3 EPS guidance could result in an increase in positive EPS surprises. In addition, with +15.5% growth already penciled in for Q4'04, a positive outlook in company guidance will be required to avoid near term downward pressure on equity markets, in our opinion.

For the quarter, Energy, up +12.2%, was the best performing sector. All of the strong performance was generated in September (+12.2%) after oil traded over $50 barrel for the first time. Technology, down –10.8% was once again the worst performing sector. Investors continue to grapple with the outlook for growth, which is expected to slow as we move further in 2004 and into 2005 versus valuation levels.

Model Attribution: *Third Quarter, 2004*

Quint	Opt E/I	Earnings	Insider	DDM	Cashflow
5 (high)	0.4%	0.0%	0.9%	-0.1%	-1.9%
4	0.1%	-0.4%	0.4%	-1.0%	-1.9%
3	-1.2%	-2.1%	-1.3%	-2.3%	-0.4%
2	-2.5%	-2.5%	-1.8%	-1.3%	-0.4%
1 (low)	-2.8%	-1.0%	-4.1%	-4.4%	-1.6%
Spread	***3.3%***	***1.0%***	***5.0%***	***4.3%***	***-0.3%***

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 spreads for the quarter except the Cashflow model, which was slightly negative. The Insider and OPT E/I models exhibited the most monotonic inter-quartile pattern while the Earnings, DDM and Cashflow model spreads exhibited no clear pattern. Once again sector and industry moves, especially the Technology and Energy sectors, were primary drivers of the model performance at the extremes.

As expected, companies found it difficult to top the high Q2 earnings expectations. More specifically, it was future guidance that came under the most pressure. The ratcheting down of earnings expectations triggered a sell-off in the equity markets with Technology companies coming under the most pressure. Subsequent to the earnings related sell-off, we have seen the markets meander higher against a back drop of mixed economic data, higher oil prices and interest rates, the war in IRAQ and the gearing up of campaigning for the U.S. Presidential election.

- The Earnings model spread was +1.0%. The model performance was driven in large part by the strong performance of Technology stocks with the strongest earnings score during September, as investors shifted out of and then back into this sector during the quarter.
- The Insider Transactions model spread was +5.0%. The monthly Insider model performance mirrored that of the Earnings model with strong performance coming in July and August when Technology stocks ranked the weakest, quintile 1 under-performed. **We did see a pickup in Insider selling during the quarter, which has moved back to a bearish reading. We believe that this is a negative signal for the near-term performance of equities**.
- The OPT E/I model (Earnings and Insider Transactions) spread was +3.3%. The positive performance of the Earnings model, which is the most heavily weighted model in our process, was aided by the strong Insider model performance.
- Our Value models recorded mixed results: DDM +4.3% and Cashflow –0.3%. Both models recorded positive spreads in July during the broad market sell off. However, the valuation measures moved in opposite directions in August and September driven by sector ranking differences, primarily Technology and Energy stocks, that ranked at the extremes (strongest on the Cashflow model vs. weakest on DDM model) of each model.

Year to date all of the Shenandoah models are adding significant value. The Insider and DDM models exhibit a clear intra-quartile spread pattern (monotonic). While the Cashflow and Earnings models intra-quartile spreads are mixed (non-monotonic). The Earnings model, +2.5% (the most heavily weighted factor in our process) and the Insider Transaction model, +7.6% combined to provide an OPT E/I model spread of +6.0%. The valuation models have both been strong performers; DDM spread of +7.6% and Cashflow model spread +5.3%.

Model Attribution: *YTD 2004*

Quint	Opt E/I	Earnings	Insider	DDM	Cashflow
5 (high)	8.0%	8.1%	9.0%	8.0%	6.5%
4	10.4%	8.4%	7.7%	7.7%	6.6%
3	6.5%	3.9%	6.8%	6.7%	6.6%
2	1.8%	2.6%	3.8%	3.0%	6.1%
1 (low)	2.0%	5.6%	1.4%	0.3%	1.2%
Spread	***6.0%***	***2.5%***	***7.6%***	***7.6%***	***5.3%***