Shenandoah Asset Management, LLC

Quarterly Review: December 31, 2004

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Market Data & Commentary:

Source: Vestek & Frank Russell

Index	Month	Q4'04	1 Yr
S&P 500	3.4%	9.2%	10.9%
Dow Jones Industrials	3.5%	7.6%	5.4%
NASDAQ	3.8%	14.7%	8.6%
S&P/BARRA Value	3.3%	9.9%	15.7%
S&P/BARRA Growth	3.6%	8.5%	6.1%
S&P 500 Equal-Weighted	3.7%	12.5%	17.4%
S&P 400 Midcap	4.2%	12.2%	16.5%
Russell 2000	3.0%	14.1%	18.3%

	Q4'04	YTD '04
Basic Materials	9.2%	27.6%
Capital Goods	14.1%	22.9%
Communication Svc	10.5%	13.1%
Consumer Cyclicals	14.8%	16.8%
Consumer Staples	13.5%	15.1%
Energy	5.3%	37.6%
Financial	11.0%	19.3%
Health Care	11.2%	17.3%
Technology	17.5%	5.4%
Transportation	18.8%	31.1%
Utilities	10.1%	18.0%

After failing to gain any traction in Q3, the markets were biased to the upside throughout the latest quarter. The realization that oil at $50+ a barrel was not going to derail the US economic recovery, a quick resolution to the US Presidential election, the retreat of oil back to the mid $40's and the anticipation of a year end "Santa Claus" rally were some of the positive catalysts that moved markets higher. The net result was that the major indices recorded strong results for the quarter: NASDAQ +14.7%, S&P 500 +9.2% and DJIA +7.6%. More specifically, a number of underlying factors drove the market's performance during the quarter:

- ***Fed continued to raise rates.*** The Fed added a further +0.50% (two +0.25% increases) to the Fed Funds rate this quarter. The Funds rate ended the year at 2.25%. In the statement that accompanied the two recent increases the FOMC reiterated its comfort with continuing to raise rates at a "measured pace." At the current pace we are only three meetings away from a Fed Funds rate of 3%, which many believe is the neutral level. As we move further into 2005 investors will be monitoring the economy for any signs of a sharp drop in economic growth or conversely, inflationary pressure. The former may see the FOMC take a break from its current pattern of +25 bps increases while the latter could trigger more aggressive rate increases. Both of these scenarios would likely be viewed as at least a short-term negative for equity markets.
- ***Mixed style results.*** Style performance was not consistent across market capitalization levels. We believe that this was due to sector and industry rotation driving performance during the quarter. Value and Growth were the clear winners in Large-cap. and Small-cap., respectively. Mid-cap performance was essentially flat. For the quarter, the S&P/BARRA Value index out-performed its Growth counterpart, returning +9.9% vs. +8.5%, S&P/BARRA Mid-cap Value outperformed Mid-cap Growth +12.3% vs. +12.1%, and S&P/BARRA Small-cap Growth out-performed Small-cap Value +14.0% vs. +12.0%
- ***Small-cap stocks outperformed Large-cap.*** The equal-weighted S&P 500 index out-performed the cap-weighted version by +330 bps in the quarter (+12.5% vs. +9.2%) and leads the cap-weighted index by +650 bps over the past 12 months (+17.4% vs. +10.9%). The equal-weighted index also dominates the cap-weighted index over the 2, 3, 4, 5 and 10-year time periods. Furthermore, the Russell 2000 (small) out-performed the S&P 500 (large) by almost 500 bps for the quarter.
- ***Corporate earnings outlook – significant cooling expected in 2005.*** If Q4'04 S&P 500 operating earnings come in as expected (+17%), 2004 full year earnings will be 23% higher than 2003. The current expectation for growth in S&P 500 EPS growth during 2005 is less than half this years level (+10%). The possibility of an interest rate driven hard landing in the US and slowing economic growth abroad has skeptics arguing that even this level of EPS growth is too optimistic. Therefore, Q4 EPS reporting season will be as much about the strength of corporate performance during the latest quarter as it will be about the tone of 2005 guidance.

For the quarter, the retreat in the price of oil was a key driver in the best and worst performing sectors. Transportation, up +18.8%, was the best performing sector. While Energy, up +5.3% was the laggard. For the year, Energy up +37.6% was the clear beneficiary of the surge in oil prices during 2004. Technology, up +5.4% was the worst performing sector. Throughout the year, investors grappled with the outlook for growth, which is expected to slow significantly in 2005 vs. valuation levels. The result was volatile sector performance.

Model Attribution: *Fourth Quarter, 2004*

Quint	Opt E/I	Earnings	Insider	DDM	Cashflow
5 (high)	13.6%	13.9%	11.9%	15.9%	15.7%
4	11.6%	11.3%	14.1%	12.9%	12.3%
3	12.2%	11.9%	12.6%	12.4%	11.7%
2	14.2%	14.2%	13.1%	12.4%	12.0%
1 (low)	12.5%	12.7%	12.4%	11.6%	13.1%
Spread	***1.1%***	***1.2%***	***-0.5%***	***4.3%***	***2.6%***

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 Insider model, which was down slightly. The DDM model was the only model that exhibited a monotonic inter-quartile pattern. The breadth of the equity market rally is evidenced by the double-digit returns of all model quartiles. Even the stocks ranked weakest by our models (quintile 1) managed to record an average return of +12.5% during the quarter.

Although the rising tide tended to raise all ships this quarter, sector and industry moves were once again a key determinate of model performance at the extremes. This was especially the case for our valuation models that saw the performance of stocks ranked strongest by these models (quintile 5) out-perform the universe by an average of 300+ bps. The following is an overview of factors that influenced the performance of our models during the quarter.

- The Earnings model spread was +1.2%. Positive model performance in October and November was partly offset by negative performance in December. The more speculative nature of the December rally saw stocks with the weakest current earnings outlook (quintile 1) outperform.
- The Insider Transactions model spread was –0.5%. The Insider model failed to gain any traction during the quarter. Interestingly, we noticed a pickup in the level of Insider selling during this period of market strength. **In fact, 2004 closed out with Insider selling at one of its most bearish levels of the year. 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 +1.1%. The positive performance of the Earnings model, which is the most heavily weighted model in our process, was partly offset by the negative Insider model performance.
- Our Value models both recorded positive results: DDM +4.3% and Cashflow +2.6%. The models moved in opposite directions in October and November driven by underlying differences in sector and industry rankings. However, in December both models recorded positive results due in part to the relatively strong performance of stocks ranked highest (quintile 5) especially in the Medical Services and Homebuilding industries.

All of the Shenandoah models added value in 2004. The Insider, DDM and Cashflow models exhibited a clear intra-quartile spread pattern (monotonic). While the Earnings model's intra-quartile spreads were lumpy (non-monotonic). The Earnings model, +4.1% (the most heavily weighted factor in our process), and the Insider Transaction model, +8.0% combined to provide an OPT E/I model spread of +7.9%. The valuation models were the best performers; DDM spread of +13.2% and Cashflow model spread +8.8%.

Model Attribution: *YTD 2004*

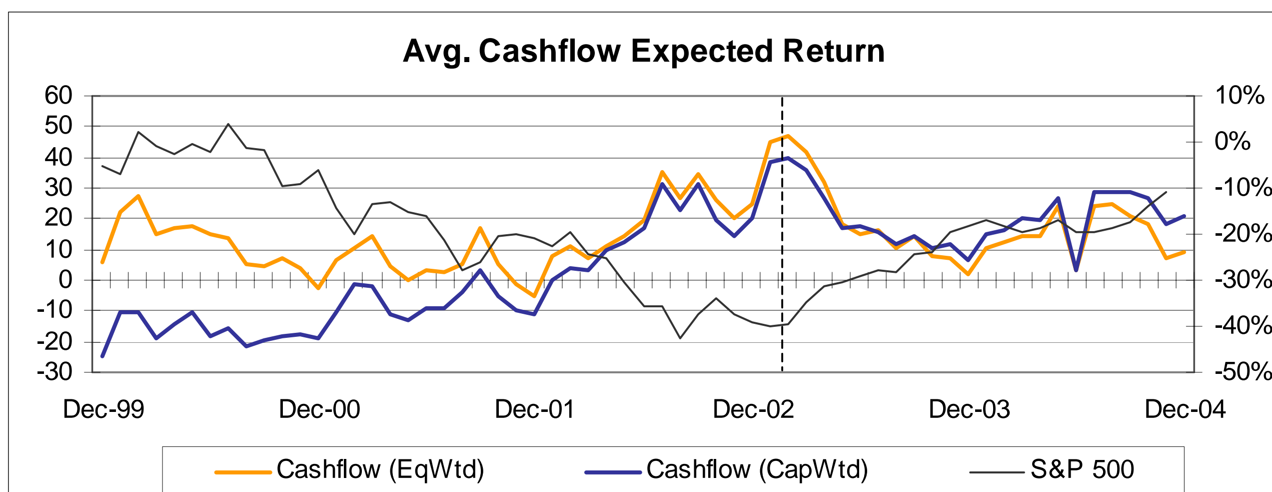
Quint	Opt E/I	Earnings	Insider	DDM	Cashflow
5 (high)	22.7%	23.1%	22.0%	25.2%	23.2%
4	23.2%	20.6%	22.8%	21.6%	19.7%
3	19.5%	16.3%	20.2%	20.0%	19.1%
2	16.3%	17.2%	17.4%	15.7%	18.8%
1 (low)	14.8%	19.1%	14.0%	12.0%	14.4%
Spread	***7.9%***	***4.1%***	***8.0%***	***13.2%***	***8.8%***

Current Market Perspective

CASHFLOW MODEL:

Calendar year-end always offers an interesting moment to step back and seek perspective regarding the longer term trends and outlook for the market and the various fundamental factors we follow. While the Shenandoah process is entirely bottom-up (disciplined growth-at-a-reasonable price process), it may be instructive or helpful to take a look at what our models, in aggregate, are telling us right now about the stock market.

We begin with our discounted cashflow model (DCF). As a reminder, the DCF is driven by forecast corporate cashflows; economic margins, leverage and current Zacks earnings estimates are primary drivers of the DCF forecasts in the near term. The following graph outlines expected stock returns for our research universe based on the DCF model. The expected returns (left axis) are presented on a capitalization-weighted and equal-weighted basis. The cumulative return of the S&P 500 (right axis) is provided for reference.



OBSERVATIONS:

- The DCF model is predictive; the graph above shows a high degree of predictive accuracy:
  - Expected returns (DCF) were the lowest at the beginning of this five-year period (1/1/2000), and the S&P 500 clearly declined precipitously for a period of three years after that date.
  - Expected returns (DCF) peaked in January, 2003 (dotted vertical line). The S&P 500 posted strong returns for the ensuing two years.

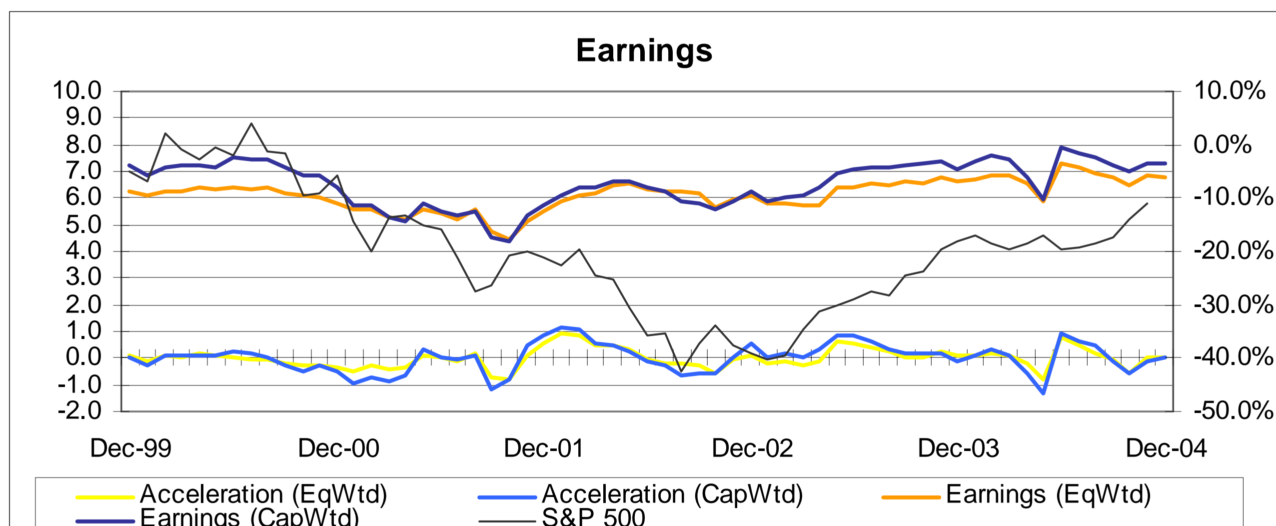
- Capitalization trends: In early 2000, the DCF model clearly indicated that the expected returns were far greater for small stocks than large-cap stocks: In January, 2000, the equally-weighted average of the DCF expected returns for stocks in our universe was +22% (orange line) while the capitalization-weighted expected returns for that same universe was –11% (blue line). As we all have seen, small and mid-cap stocks out-performed their large-cap counterparts dramatically over the entire five-year period. It is interesting to note that that relationship has now reversed, and the DCF model now prefers large-cap stocks.

- **Where are we now?**
  - **The DCF model is bullish, predicting positive returns for the market (10-20%).**
  - **Large-cap stocks are now more attractive than small stocks.**
  - **Note: If earnings expectations decline significantly from current levels, the DCF expected returns will decline commensurately.**

EARNINGS MODEL:

We now turn our attention to the Shenandoah earnings model. As a reminder, the earnings model is driven by Wall Street analysts' earnings revisions (current and next two fiscal years) and quarterly earnings surpises. The following graph outlines aggregate earnings scores for our research universe. A score of 10 is best, indicating rapidly rising estimates; a score of 1 is the worst, indicating rapidly falling estimates; a score of 5.5 is neutral. The earnings scores (left axis) are presented on a capitalization-weighted (dark blue) and equal-weighted (orange) basis. The cumulative return of the S&P 500 (right axis) is provided for reference.

We have also included an earnings acceleration score (the rate of change of the aggregate earnings scores) for reference. The cap-weighted acceleration is in light blue, and the equally-weighted measure is in yellow. A score of zero is neutral.



OBSERVATIONS:

- Earnings estimate were clearly declining in aggregate during the 2000-2001 period. Estimates began to stabilize, and even rise, in October, 2001.

- The rising estimate trend peaked in June, 2004, and estimates have declined somewhat since that time.

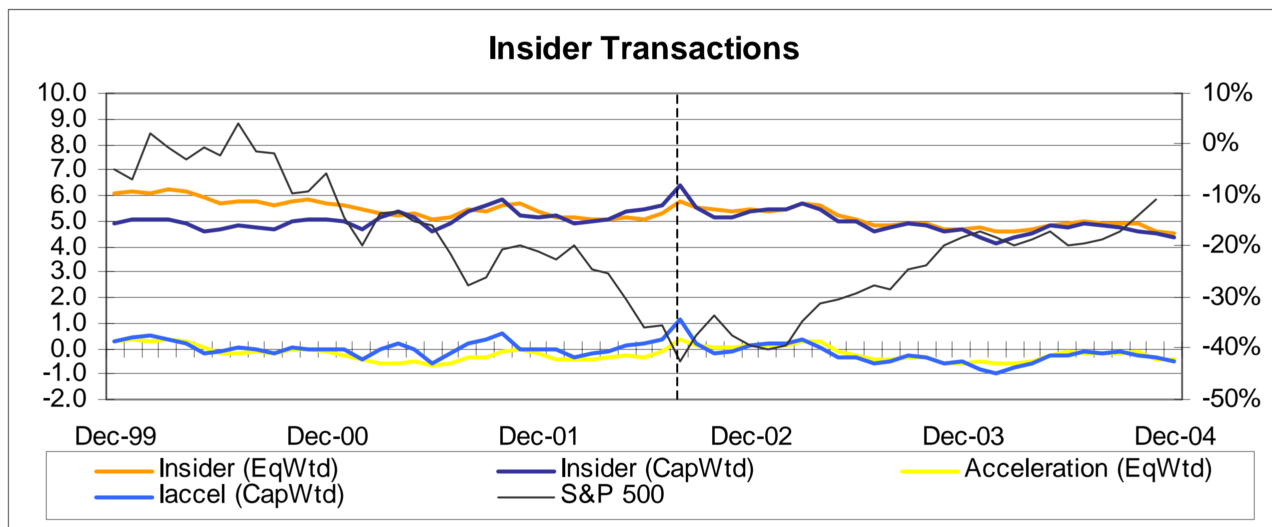
- Capitalization trends: Large stocks have enjoyed stronger earnings expectations (relative to small stocks) for the duration of this five year period. Large stocks continue to have a slight advantage now.

- **Where are we now?**
  - **The earnings model is neutral.**
  - **Large-cap stocks are slightly more attractive than small stocks from an earnings perspective.**
  - **Estimates have come down over the past few months, as indicated by the negative trend in the acceleration measures.**
  - **Earnings momentum is clearly slowing: Year-over-year growth rates have declined from very high levels (28%) in the first quarter of 2004 to approximately 15% today. This is normal in that peak growth rates generally appear at the trough of the economy, then growth rates must slow to a more sustainable pace. We would remind readers that the bull market of the 1990s was fueled by 10-15% earnings growth p.a.**

INSIDER TRANSACTIONS MODEL:

We now turn our attention to the Shenandoah Insider Transactions model. As a reminder, this model is a stock-specific measure based on the purchases and sales by corporate officers and directors as they trade their own firms' stocks. The following graph outlines aggregate Insider scores for our research universe. A score of 10 is best, indicating aggressive insider buying; a score of 1 is the worst, indicating aggressive insider selling; a score of 5.5 is neutral. The Insider scores (left axis) are presented on a capitalization-weighted (dark blue) and equal-weighted (orange) basis. The cumulative return of the S&P 500 (right axis) is provided for reference.

We have also included an Insider acceleration score (the rate of change of the aggregate Insider scores) for reference. The cap-weighted acceleration is in light blue, and the equally-weighted measure is in yellow. A score of zero is neutral.



OBSERVATIONS:

- Insiders have been net sellers for most of the five-year period in this study.
- Insiders did turn bullish in late 2002, and insider buying peaked at almost exactly the same time that the stock market bottomed in August/September, 2002 (vertical dotted line above).
- Capitalization trends: Insider selling has been equally prevalent in both large and small stocks.
- **Where are we now?**
  - **The Insider model is bearish. Insider selling is almost at an all time high.**
  - **Insider transactions are negatively correlated with investor sentiment; as insiders continue to sell stock aggressively, investor sentiment remains very high. Who is right? The insiders or the outsiders? Only time will tell.**

SUMMARY: Mixed Signals

Our models are sending mixed signal regarding the prospects for the market:

- •Discounted Cashflow: Bullish
- •Earnings: Neutral
- •Insider Transactions: Bearish

From a discounted cashflow valuation perspective, the market is still very attractive, but earnings growth rates have declined significantly. Meanwhile, corporate insiders are selling stock hand over fist. Our models are, therefore, neutral on the market currently. One thing is clear, however: Our models indicate that large-cap. stocks are now more attractive than small-caps from the perspective of earnings and valuation.

The current quarter's earnings reporting season will most likely clear things up. If forward guidance is better than expectations, the market will rise. However, if guidance does not meet expectations, look out below!

Sources and Acknowledgments

Source:	Data:
Applied Finance Group, Ltd.	Discounted Cashflow and Market Data
Aronson + Partners	Stock Market Returns Data
Market Profile Theorems, Inc.	Earnings and Insider Transactions Data
Vestek	Stock Market Returns Data

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