

**SHENANDOAH  
ASSET  
MANAGEMENT, L.L.C.**  
*alternative investment strategies*

**Research Brief: April, 2006**  
First Quarter, 2006 Stock Returns  
*Low Quality Leadership*

# Analysis of Returns: First Quarter, 2006

## Average Returns: First Quarter, 2006 (universe = Russell 3000)

High  
↑  
↓  
Low

Decile	MktCap	LIQ	Technical	P/E
10	5.5%	5.6%	13.7%	12.5%
9	7.0%	9.2%	15.6%	10.3%
8	8.6%	11.9%	15.9%	12.2%
7	11.1%	12.7%	9.9%	12.7%
6	12.7%	11.1%	10.5%	11.1%
5	13.7%	10.2%	9.0%	9.7%
4	13.6%	13.8%	9.9%	8.6%
3	13.9%	11.2%	6.9%	8.5%
2	12.6%	12.7%	10.4%	8.2%
1	11.3%	11.6%	8.2%	8.3%
negative EPS	na	na	na	14.6%

Note: Returns in this analysis are equally weighted.


## Commentary:

- **Size matters:** Clearly, small stocks dramatically outperformed large stocks during the quarter, as evidenced by the “MktCap” decile return distribution above. The smallest 70% (bottom seven deciles) posted double-digit gains, doubling the return of the mega-caps (decile 10).
- **Liquidity:** Less liquid stocks clearly outperformed more liquid stocks. This is consistent with the market cap stratification (small stocks are typically less liquid).  
**Both the size and liquidity analyses are consistent with the strong capital inflows for small caps (Russell 2000) reported during the period.**
- **Price Momentum (“Technical”):** Stocks with the strongest price momentum as of 12/31/2005 continued to lead during the first quarter.
- **Low Quality rally:** The worst stocks generated the best returns. We use trailing 12 month P/E in the analysis above.
  - The highest return came from stocks that actually lost money over the past twelve months (+14.6%);
  - *Interestingly, stocks with negative consensus earnings FORECASTS actually did even better, rising 16.4% on average!*
  - Ultra-high P/E stocks (decile 10) outperformed (+12.5%);
  - This perverse performance was likely driven by extreme short covering.

The following pages illustrate this “low quality” effect on various market indices. As expected, the impact is much larger when we analyze small and midcap benchmarks.

# Russell 3000 Index

## Return Stratification: First Quarter, 2006

	P/E Tr12m Decile	Q1 Rtn	Contribution to Index Rtn
High P/E  Low P/E	10	12.5%	0.0%
	9	10.3%	0.5%
	8	12.2%	0.3%
	7	12.7%	0.4%
	6	11.1%	0.6%
	5	9.7%	0.7%
	4	8.6%	0.6%
	3	8.5%	0.4%
	2	8.2%	0.5%
	1	8.3%	1.0%
	negative EPS	14.6%	0.3%
	<b>Russell 3000 Rtn</b>		<b>5.2%</b>

← No P/E (Null)

### Commentary:

We are focusing on Price-to-Earnings ratios for the index constituents.

- Companies with negative earnings are generally assumed to have a “null” or “not meaningful” P/E ratio; therefore, we analyze this group of stocks separately (“negative EPS”);
- The remaining Index constituents (after excluding those with negative earnings) are divided into ten deciles by trailing 12 month P/E ratio. Each decile contains ten percent of the number of stocks in the index with positive earnings (not 10% of the capitalization); returns are equally weighted within deciles;
- The “Contribution to Index Rtn” column above illustrates the additive performance contribution within the index. The sum of these eleven “buckets” (ten deciles plus the “negative EPS” category) totals to the index return for the quarter.

Clearly, stocks with negative earnings and those with very high P/E ratios outperformed dramatically during the first quarter.

- **Stocks in this index with negative earnings returned 14.6% on average!**
- These stocks contributed approximately 30 bps to the total index return;
- The highest P/E quintile (top two deciles, or highest 20% of P/E ratios) added approximately 50 bps to the total return of the index;
- **Any fundamental manager who did not own the highest P/E quintile or stocks with negative earnings faced a –80 bps headwind versus this index.**

# Russell 2000 Index

## Return Stratification: First Quarter, 2006

	P/E Tr12m		Contribution to Index Rtn
	Decile	Q1 Rtn	
High P/E	10	14.8%	1.2%
	9	12.4%	1.0%
	8	12.8%	1.1%
	7	14.5%	1.4%
	6	14.6%	1.2%
	5	11.8%	1.1%
	4	11.3%	1.2%
	3	9.4%	0.8%
	2	10.3%	0.7%
Low P/E	1	10.8%	1.1%
	negative EPS	15.5%	2.8%
	<b>Russell 2000 Rtn</b>		<b>13.6%</b>

← No P/E (Null)

### Commentary:

The “Low Quality” character of the first quarter rally is most evident when analyzing the return of the small cap. Russell 2000 index. We use trailing 12 month P/E in this study.

- Returns were strong across the P/E spectrum within this small cap. index, with all but one decile posting double-digit average returns;
- The highest return came from stocks that actually lost money over the past twelve months (+15.5%). These stocks contributed 280 basis points of the total return of the index.
- Ultra-high P/E stocks (decile 10) outperformed (+14.8%). These stocks contributed 120 bps to the total return of the index.
- **Any active fundamental manager faced a headwind of –400 bps relative to this benchmark if he did not own the most overvalued decile and stocks with negative earnings!**
- An analysis by Steven DeSanctis of the Prudential Equity Group, LLC, attributes much of this perverse performance to the significant capital inflows into the Russell 2000 ETF (ticker: IWM) during the quarter.
  - “Year-to-date inflow for the IWM has reached \$1.2 billion, which easily surpasses the full-year flow of \$110.7 in 2005.”
  - “We, however, foresee a reversal of the ...trend, as tougher earnings comparisons...should be felt by small caps owing to issues such as options expense and the economy slowing in the second half of the year. This should prompt a decrease in small cap fund flows and even a reversal of fortunes.”
  - “Only 17.5% of [core Russell 2000 mutual] funds topped the index.”

# Russell 2500 Index (SMID)

## Return Stratification: First Quarter, 2006

	P/E Tr12m		Contribution to Index Rtn
	Decile	Q1 Rtn	
High P/E	10	13.3%	0.7%
	9	11.0%	0.9%
	8	13.5%	1.2%
	7	13.4%	1.2%
	6	12.9%	1.1%
	5	11.4%	1.0%
	4	9.9%	0.9%
	3	8.8%	0.7%
	2	9.8%	0.9%
	1	8.9%	0.7%
Low P/E	negative EPS	15.2%	1.7%
	<b>Russell 2500 Rtn</b>		<b>11.0%</b>

← No P/E (Null)

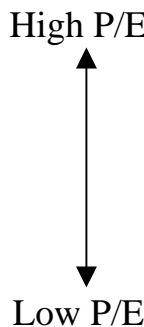
### Commentary:

The “Low Quality” character of the first quarter rally is also evident when analyzing the return of the “smid” cap. Russell 2500 index. We use trailing 12 month P/E in this study.

- The highest return came from stocks that actually lost money over the past twelve months (+15.2%). These stocks contributed 170 basis points of the total return of the index.
- Ultra-high P/E stocks (decile 10) outperformed (+13.3%). These stocks contributed 70 bps to the total return of the index.
- **Any active fundamental manager faced a headwind of –240 bps relative to this benchmark if he did not own the most overvalued decile and stocks with negative earnings!**
- An analysis by Steven DeSanctis of the Prudential Equity Group, LLC, attributes much of this perverse performance to the significant capital inflows into the Russell 2000 ETF (ticker: IWM) during the quarter, as discussed on the prior page.
  - “In the Russell 2500, stocks priced under \$5 had the best performance at 30.1%.”
  - “Another ‘quality’ measure we use is ROE. In the first quarter, stocks ranked in the lowest quintile based on ROE turned in the best performance in...the Russell 2500...with gains of 12.4%.”
  - “In the Russell 2500 stocks in Q5, or those with the highest betas, gained 17.3%.”

# S&P 400 Midcap Index

## Return Stratification: First Quarter, 2006



P/E Tr12m Decile	Q1 Rtn	Contribution to Index Rtn
10	4.7%	0.4%
9	15.3%	1.5%
8	12.1%	0.9%
7	13.0%	0.7%
6	11.0%	0.9%
5	9.6%	0.9%
4	5.4%	0.5%
3	5.3%	0.5%
2	5.7%	0.5%
1	5.8%	0.4%
negative EPS	20.3%	0.5%
<b>S&amp;P 400 Rtn</b>		<b>7.7%</b>

← No P/E (Null)

### Commentary:

The “Low Quality” character of the first quarter rally is also evident when analyzing the return of the S&P 400 Midcap Index. We use trailing 12 month P/E in this study.

- The highest return came from stocks that actually lost money over the past twelve months (+20.3%). These stocks contributed 50 basis points of the total return of the index.
- Ultra-high P/E stocks (decile 10) underperformed (+4.7%). These stocks contributed 40 bps to the total return of the index.
- Stocks in the second highest P/E decile (9) outperformed dramatically (+15.3%), contributing 150 bps to the total index return.
- **Any active fundamental manager faced a headwind of –240 bps relative to this benchmark if he did not own the most overvalued quintile and stocks with negative earnings!**
- S&P 400 stocks under \$5 rose 31.6% during the quarter.

# Russell Midcap Index

## Return Stratification: First Quarter, 2006

	P/E Tr12m Decile	Q1 Rtn	Contribution to Index Rtn
High P/E	10	7.4%	0.8%
	9	8.4%	0.9%
	8	11.6%	0.9%
	7	8.6%	0.6%
	6	10.7%	0.8%
	5	7.4%	0.9%
	4	5.5%	0.7%
	3	5.6%	0.4%
	2	7.9%	0.7%
	1	3.2%	0.5%
Low P/E	negative EPS	8.9%	0.4%
	<b>Russell Midcap Rtn</b>		<b>7.6%</b>

← No P/E (Null)

### Commentary:

The “Low Quality” character of the first quarter rally is also evident when analyzing the return of the Russell Midcap index, but the impact was more muted. We use trailing 12 month P/E in this study.

- Ultra-high P/E stocks (decile 10) rose 7.4%. These stocks contributed 80 bps to the total return of the index.
- Index stocks with negative earnings rose 8.9% during the quarter, contributing 40 bps to the total return of the benchmark.
- **Any active fundamental manager faced a headwind of –120 bps relative to this benchmark if he did not own the most overvalued decile and stocks with negative earnings!**

# Sources and Acknowledgments

“Russell 2500 Performance Recap”, Steven G. DeSanctis, Prudential Equity Group, LLC, April 3, 2006.

“Small-Cap Performance Recap”, Steven G. DeSanctis, Prudential Equity Group, LLC, April 4, 2006.

“Small Cap Study”, Steven G. DeSanctis, Prudential Equity Group, LLC, March 27, 2006.

Data:

Russell Index data: Frank Russell Company

Returns: Northfield Information Services

Fundamental Data: Market Profile Theorems, Inc.