Shenandoah Asset Management, LLC

Quarterly Review: June 30, 2006

121 Shockoe Slip
Richmond, VA 23219
(804) 343-1400
e-mail: bhill@samllc.com

Market Data & Commentary:

Source: Vestek & Frank Russell

Index	Month	Q2'06	1 Yr
S&P 500	0.1%	-1.4%	8.6%
Dow Jones Industrials	0.2%	1.3%	11.2%
NASDAQ	-0.3%	-7.2%	5.6%
S&P/Citigroup Value	0.3%	0.6%	14.9%
S&P/Citigroup Growth	-0.1%	-3.5%	2.7%
S&P 500 Equal-Weighted	-0.2%	-2.1%	11.8%
S&P 400 Midcap	0.0%	-3.1%	13.0%
Russell 2000	0.6%	-5.0%	14.5%

Sector	Q2'06	YTD '06
Energy	5.5%	16.4%
Materials	-3.7%	11.3%
Industrials	-2.4%	12.4%
Consumer Discretionary	-6.6%	0.7%
Consumer Staples	0.5%	5.9%
Health Care	-5.9%	-0.9%
Financials	-2.6%	3.4%
Information Technology	-9.0%	0.6%
Telecommunications	-2.7%	12.8%
Utilities	3.2%	4.8%

Generally better than expected Q1 EPS results were more than offset by concern that high oil prices, rising interest rates and a slowdown in the housing market will combine to dampen economic growth and corporate earnings as we move into the second half of the year. In addition, a number of volatile situations abroad, i.e. the nuclear ambitions of Iran and North Korea added to the negative sentiment and kept buyers on the sidelines. That said, a late June rally, following a less "hawkish" statement from the FOMC essentially wiped out what had been low single digit losses month to date. The June rally moderated quarterly losses and propelled some indices into positive territory. Major equity index returns: DJIA +1.3%, S&P 500 -1.4% and the NASDAQ -7.2%. More specifically, a number of underlying factors drove the market's performance during the quarter:

•***The Fed makes a point regarding inflation.*** The Fed added a further +0.50% (two +0.25% increases) to the Funds rate, which ended the quarter at 5.25%. Initially viewed by some as soft on inflation, Mr. Bernanke was outspoken regarding his view that further interest rate increases were likely given the inflationary pressure building in the economy. The market, which had been expecting at least a pause in interest rate increases at the June meeting, reacted negatively to this more "hawkish" stance. That said, the more moderate tone of the statement released following the FOMC's late June meeting gave investors hope that at least a pause in the interest rate tightening cycle is close at hand. The most recent +25 bps increase and any subsequent increases are expected to have a more significant dampening impact on the economy than the previous increases (given the historically low starting point). With this in mind, the FOMC will likely move ahead cautiously, i.e. pause sooner rather than later vs. risk pushing the economy into recession, in our opinion.

•***Value beats Growth across the board.*** Not too surprisingly, given the downward bias of the markets, Value was the winning style this quarter outperforming Growth across all cap ranges. Sector weighting, especially in extreme performing sectors, i.e. Energy, Utilities, Consumer Staples and Technology, continue to be likely drivers of style performance. For the quarter, the S&P/Citigroup Value index out-performed Growth, returning +0.6% vs. -3.5%, S&P/Citigroup Mid-cap Value out-performed Mid-cap Growth -2.0% vs. -4.4%, and S&P/Citigroup Small-cap Value out-performed Growth -4.0% vs. -5.1%. Note: Value also out-performed Growth in all capitalization ranges of the Russell Indices that we monitor.

▪***Large-cap gains favor as investors turn defensive.*** The equal-weighted S&P 500 index under-performed the cap-weighted version by -70 bps in the quarter (-2.1% vs. -1.4%). However, the equal weighted index still leads the cap-weighted index by +320 bps over the past 12 months (+11.8% vs. +8.6%) and also dominates over the 2, 3, 4, 5 and 10-year time periods. The relative strength of large-cap stocks was also apparent in the Russell indices, i.e. the Russell 200 (large-cap) out-performed the Russell 2000 (small-cap index) by +370 bps.

▪***Q2 S&P 500 year over year (y/y) earnings growth is expected to drop below 10% for the first time in 17 quarters.*** Q2'06 operating earnings for the S&P 500 are forecast to grow at +9.1% (y/y). However, given that the pre EPS reporting season estimates have been beaten of late, it is likely that when the dust has settled Q2 growth will top 10%. That said, the soft underbelly of this relatively strong performance is the small number of sectors that are driving the aggregate growth. The Energy, Materials and Industrial sectors are all expected to log EPS gains of 10%+. Excluding these sectors, average forecast EPS growth is in the mid single digits. The heavy reliance on a few economically sensitive sectors raises the risk of a significant drop in earnings growth should we see (as expected) a slowdown in economic growth in the US and abroad.

For the quarter, the Energy sector, up +5.5%, benefited from higher oil prices. The Technology sector, down -9.0% was negatively impacted by expectations that economic growth will slow in the second half of 2006 and into 2007. Year to date, Energy, up +16.4% is the best performing sector while Healthcare,-0.9% is the laggard.

Model Attribution: *Second Quarter, 2006*

Quint	Opt E/I	Earnings	Insider	DDM	Cashflow
5 (high)	-0.9%	-1.6%	-1.6%	-3.5%	-2.2%
4	-3.0%	-3.4%	-2.8%	-2.0%	-2.9%
3	-3.0%	-2.6%	-4.2%	-3.2%	-3.8%
2	-4.9%	-4.4%	-3.6%	-4.6%	-4.1%
1 (low)	-5.9%	-5.7%	-5.5%	-5.1%	-4.6%
Spread	***5.0%***	***4.1%***	***4.0%***	***1.6%***	***2.4%***

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. The OPT E/I, Earnings, Insider models all reported strong performance up, +5.0%, +4.1% and +4.0%, respectively. Although positive, the Cashflow (+2.4%) and DDM (+1.6%) model spreads were more modest. During this period of market weakness, investors appear to have focused their selling on stocks with the weakest fundamental Earnings, Insider and valuation characteristics.

Cashflow was the only individual model that exhibited a clear monotonic pattern during the quarter. However, the spread pattern of the OPT E/I model, which combines our Earning and Insider models, was also monotonic. Although there was some "lumpy" performance in quintiles 4 through 2 (likely due to the impact of sector and industry weightings) there was a clear performance distinction between companies with the strongest fundamental characteristics vs. their weakest counterparts. The following is an overview of factors that influenced the performance of our models during the quarter.

- ***The Earnings model spread was +4.1%.*** Monthly spreads were driven, in part, by the under-performance of stocks with the weakest earnings characteristics (quintile 1) especially in the Technology sector combined with the out-performance of Energy stocks ranked strongest (quintile 5). This model continued its strong performance predicting the direction of quarterly EPS reports. Approximately 82% of our Long holdings that reported EPS during the quarter reported better than expected results, well ahead of the market average of 65%.
- ***The Insider Transactions model spread was +4.0%.*** Stocks ranked strongest (quintiles 5 and 4) held up better during the market sell-off vs. their weaker counterparts (quintiles 3 through 1). **Note: Insider selling** moved to a **more neutral** level during the quarter. This shift in model sentiment is not unusual as insiders generally sell into market strength and reduce their selling during market declines. Although improving, the slowdown in insider selling has **not reached** a level that would be considered **bullish.**
- ***The OPT E/I model (Earnings and Insider Transactions) spread was +5.0%.*** The positive performance of the Earnings model, which is the most heavily weighted model in our process, was compounded by the positive Insider model performance.
- ***Our Valuation models recorded positive results: Cashflow +2.4% and DDM +1.6%.*** Both models benefited from the significant under-performance of stocks ranked weakest (quintile 1) especially in the Technology and Consumer Discretionary sectors. However, the Cashflow model outperformed the DDM due, in part, to the larger number of Energy stocks, which was the best performing sector during the quarter, ranked strongest (quintile 5) by the Cashflow model vs. the DDM model.

The year to date performance of the Shenandoah models is mixed. The Earnings model, +8.8% (the most heavily weighted factor in our process), and the Insider Transaction model, -0.3% combined to provide an OPT E/I model spread of +8.1%. The valuation model spreads are both slightly negative; DDM -0.2% and Cashflow -0.8%. The Earnings model has exhibited the clearest inter-quintile spread pattern (monotonic) of the individual models. Investors have clearly been focused on earnings, rewarding companies with the strongest earnings profile vs. those with weaker earnings profiles. The Earnings model is also driving the monotonic spread pattern of the OPT E/I model. The Insider, Cashflow and DDM model spread patterns are less clear. As we have noted previously, such non-monotonic spread patterns are indicative of factors outside of the model variable, i.e. sector and industry weightings within quintiles, being important drivers of performance.

Model Attribution: *Year to Date*

Quint	Opt E/I	Earnings	Insider	DDM	Cashflow
5 (high)	10.1%	11.2%	5.3%	2.8%	5.7%
4	5.6%	5.4%	5.8%	6.2%	5.3%
3	5.4%	4.5%	4.5%	6.1%	3.3%
2	3.7%	3.1%	5.3%	4.8%	5.7%
1 (low)	1.9%	2.4%	5.6%	3.0%	6.5%
Spread	***8.1%***	***8.8%***	***-0.3%***	***-0.2%***	***-0.8%***