

## Market Data & Commentary:

Source: Vestek & Frank Russell

Index	Month	Q3'06	1 Yr
S&P 500	2.6%	5.7%	10.8%
Dow Jones Industrials	2.7%	5.4%	13.2%
NASDAQ	3.4%	4.0%	5.0%
S&P/Citigroup Value	2.7%	5.3%	15.5%
S&P/Citigroup Growth	2.5%	6.1%	6.4%
S&P 500 Equal-Weighted	2.6%	4.2%	11.2%
S&P 400 Midcap	0.7%	-1.1%	6.5%
Russell 2000	0.8%	0.4%	9.9%

	Q3'06	YTD '06
Energy	-11.2%	3.4%
Materials	-3.2%	7.8%
Industrials	-4.5%	7.3%
Consumer Discretionary	4.0%	4.7%
Consumer Staples	4.2%	10.3%
Health Care	4.8%	3.9%
Financials	3.7%	7.3%
Information Technology	3.0%	3.6%
Telecommunications	7.1%	20.9%
Utilities	4.6%	9.6%

After a sluggish July, the equity markets moved steadily higher throughout August and September. Helping to drive the stock market rally was the removal, at least for now, of a number of factors that had been dampening investor enthusiasm including; a sharp reduction in the price of oil from its \$78+ barrel high, a halt to rising interest rates, subdued inflation reports and easing tensions in the Middle East. Although market momentum ebbed and flowed throughout the quarter, the bias was to the upside. By quarter-end many of the major equity indices traded at or near multi-year highs. Major equity index returns: DJIA +5.4%, S&P 500 +5.7% and the NASDAQ 4.0%. More specifically, a number of underlying factors drove the market's performance during the quarter:

•**The Fed takes a breather, finally.** After 17 consecutive increases, the FOMC chose to leave the Funds rate unchanged (5.25%) when it met in August and maintained this stance at its September meeting. The FOMC's post meeting press statements expressed the belief that previous interest rate increases along with a cooling housing market have worked to moderate economic growth sufficiently to reduce the risk of rapid inflation (although recognizing that some inflation risks remain) while avoiding slipping into recession, the so called "soft landing." Given the lag between interest rates increases and their economic impact, generally 6 to 9 months, juggling the "soft landing" of an \$11 trillion plus economy is no easy task. With this in mind and given the recent batch of weaker than expected economic reports it is unlikely, in our opinion, that interest rates will move above current levels prior to year-end.

•**Value was generally the place to be.** Excluding the large cap segment, where Growth narrowly outperformed, Value was the winning style this quarter. Sector weighting, especially in extreme performing sectors, i.e. Energy, Industrials and Materials, continue to be likely drivers of style performance. For the quarter, the S&P/Citigroup Growth index outperformed Value, returning +6.1% vs. +5.3%, S&P/Citigroup Mid-cap Value outperformed Mid-cap Growth -0.6% vs. -1.7, and S&P/Citigroup Small-cap Value outperformed Growth +0.6% vs. -2.5%. Note: Value outperformed Growth in all capitalization ranges of the Russell Indices that we monitor.

▪**Large-cap wins again.** After lagging small cap consistently during the past few years, large-cap equities outperformed for the second consecutive quarter. Driving the performance gap was the significant underperformance of small-cap Energy, Materials and Industrial stocks vs. their large-cap counterparts. The equal-weighted S&P 500 index underperformed the cap-weighted version by -150 bps in the quarter (+4.2% vs. +5.7%). However, the equal weighted index is still slightly ahead (+40 bps) of the cap-weighted index over the past 12 months (+11.2% vs. +10.8%) and 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) outperformed the Russell 2000 (small-cap index) by +190 bps.

▪**Q3 EPS season – how much is the slowing economy impacting corporate profit growth?** As we suspected, Q2'06 operating earnings growth (y/y) for the S&P 500 (+13.0%) handily beat the +9.1% pre-reporting season estimate. Heading into Q3 EPS reporting season corporations face a much tougher growth hurdle (+14%). The slowdown in economic activity, along with sharply lower commodity prices will likely dampen future profitability in the sectors that are forecast to post the strongest Q3 growth (20%+), Consumer Discretionary, Energy and Materials. Excluding these sectors, average forecast EPS growth drops to the mid single digits. As we have noted previously, the heavy reliance on a few economically sensitive sectors raises the risk of a significant reduction in future S&P 500 earnings growth expectations should economic growth continue to track below average (as expected). With this in mind, Q3 earnings growth and more importantly Q4 guidance could disappoint.

Sector performance was dispersed. The Telecom sector, up +7.1%, benefited from improved profitability and an increase in merger and acquisition activity. The Energy sector, down -11.2% was negatively impacted by the sharp sell-off in the price of oil. Year to date, Telecom, up +20.9% is the best performing sector while Energy, +3.4% is now the laggard.

## Model Attribution: *Third Quarter 2006*

Quint	Opt E/I	Earnings	Insider	DDM	Cashflow
5 (high)	-2.0%	-2.7%	2.1%	4.6%	0.2%
4	1.1%	0.6%	2.7%	3.3%	2.5%
3	2.1%	2.8%	1.7%	3.5%	4.1%
2	3.2%	3.0%	2.8%	1.1%	1.5%
1 (low)	2.9%	3.7%	-1.9%	-0.1%	-1.0%
<b>Spread</b>	<b>-4.9%</b>	<b>-6.3%</b>	<b>3.9%</b>	<b>4.7%</b>	<b>1.2%</b>

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

The Shenandoah models posted mixed results for the quarter. The OPT E/I and Earnings models struggled, down, -4.9%, and -6.3%. A sharp sell-off in commodities negatively impacted the performance of the Energy, Materials and Industrials sectors. Many companies in these underperforming sectors were ranked strongest (quintile 5) by the Earnings model. The remaining models logged low to mid-single digit gains up +1.2%, 3.9% and 4.7% for the Cashflow, Insider and DDM, respectively.

None of the Shenandoah models exhibited a clear positive monotonic pattern this quarter. The spread pattern of Earnings and OPT E/I, which combines our Earning and Insider models, while monotonic, was unfortunately upside down (stronger performance by lower ranked stocks). The other model spreads were "lumpy" due, in part, to the divergent performance of the economic sectors this quarter, i.e. Energy (-11.2%) vs. an average performance of +4.5% for non-commodity related sectors. The following is an overview of factors that influenced the performance of our models during the quarter.

▪ **The Earnings model spread was -6.3%.** The negative spreads were driven, in part, by the under-performance of Energy, Materials and Industrial stocks ranked strongest (quintile 5) by this model combined with the out-performance of Technology and Healthcare stocks ranked weakest (quintile 1). The model continued its strong performance predicting the direction of quarterly EPS reports. Approximately 75% of our Long holdings that reported EPS during the quarter reported better than expected results, slightly above the models historical average and well ahead of the market average of 60% to 65%.

▪ **The Insider Transactions model spread was +3.9%.** Stocks ranked weakest (quintile 1) significantly underperformed, especially Energy, Materials and Industrial stocks. **Note:** After reaching a more **neutral** level by the end of Q2, we saw a **pickup in Insider selling** during the quarter. It is not unusual for Insiders to increase their selling during a period of market strength, however; later in the quarter insiders continued to sell their company stock during periods of market weakness. We believe that this is a Bearish indicator of near-term equity market performance.

▪ **The OPT E/I model (Earnings and Insider Transactions) spread was -4.9%.** The negative performance of the Earnings model, which is the most heavily weighted model in our process, was partly offset by the positive performance of the Insider model.

▪ **Our Valuation models both recorded positive results: DDM +4.7% and Cashflow +1.2%.** Both models benefited from the significant under-performance of stocks ranked weakest (quintile 1) during the quarter. The under-performance of the Cashflow model vs. the DDM model was due, in part, to a greater number of Energy stocks, which was the weakest performing sector during the quarter, ranked strongest (quintile 5) by the Cashflow model vs. the DDM model.

Year to date all of the Shenandoah model spreads are positive. The Earnings model, +2.1% (the most heavily weighted factor in our process), and the Insider Transaction model, 3.9% combined to provide an OPT E/I model spread of +2.9%. The DDM model is the best performer YTD, +4.7% primarily due to the underperformance of the stocks ranked weakest (quintile 1) by this model. The Cashflow model spread, +0.5% is dampened by a concentration of under-performing Energy stocks ranked strongest (quintile 5). None of the models exhibit a clear inter-quintile spread pattern (monotonic). Year to date, investor sentiment toward sectors and industries has shifted rapidly based on changes in oil prices, interest rates and the outlook for the economy. However, on average, stocks with the strongest fundamentals have outperformed their weaker counterparts during this period.

## Model Attribution: *Year to Date*

Quint	Opt E/I	Earnings	Insider	DDM	Cashflow
5 (high)	7.8%	8.3%	7.5%	7.5%	6.0%
4	6.7%	6.0%	8.7%	9.7%	8.0%
3	7.7%	7.4%	6.3%	9.8%	7.5%
2	7.1%	6.1%	8.2%	6.0%	7.3%
1 (low)	4.9%	6.2%	3.6%	2.9%	5.5%
<b>Spread</b>	<b>2.9%</b>	<b>2.1%</b>	<b>3.9%</b>	<b>4.7%</b>	<b>0.5%</b>