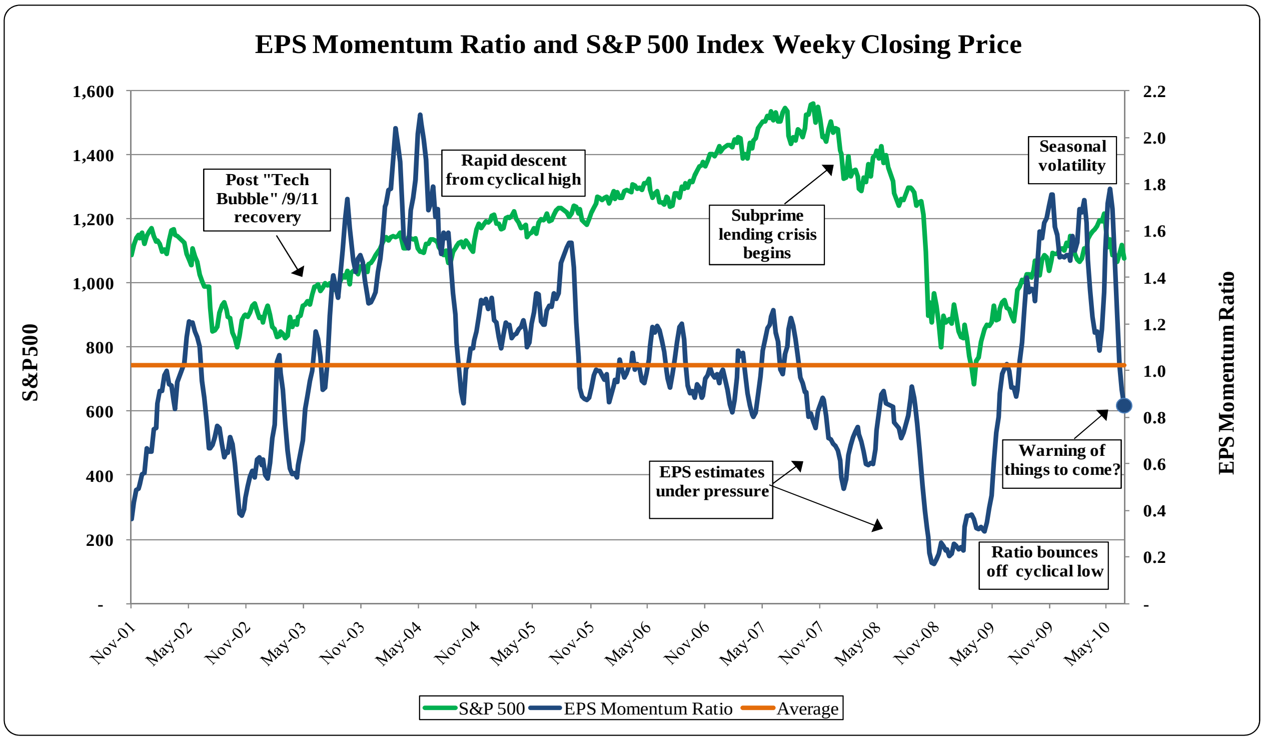
Shenandoah Asset Management, LLC

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

EPS Momentum Ratio

(06/25/10)

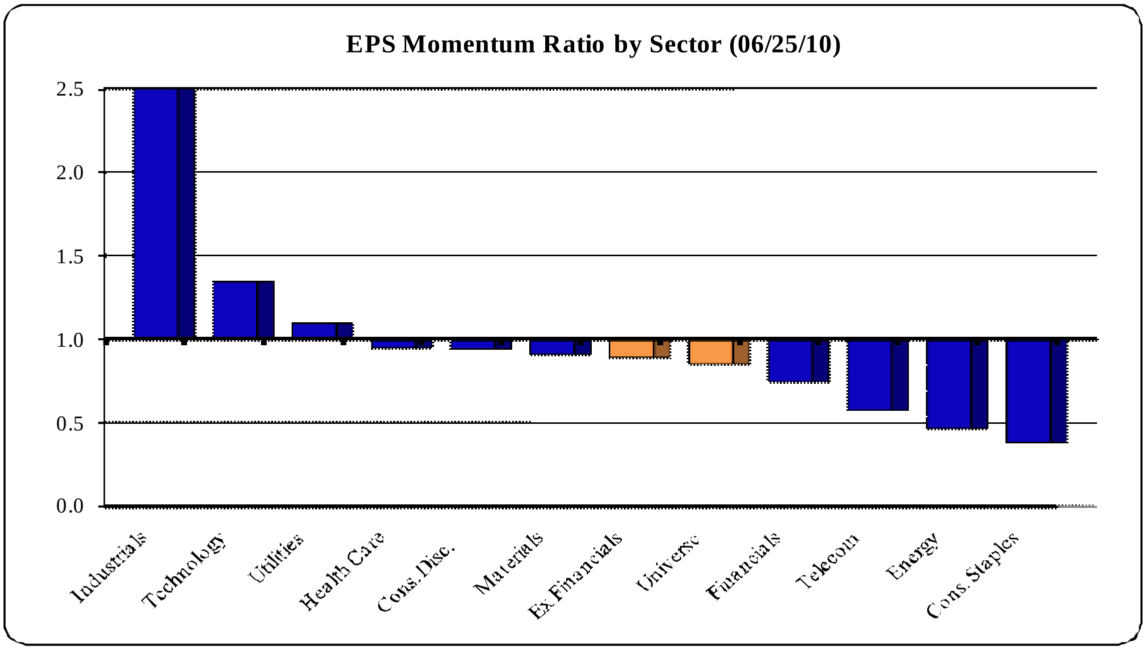
At just 0.8 (average 1), the EPS Momentum Ratio has been in a "free fall" since hitting a post Q1'10 EPS reporting season high of 1.8 (05/14/10). Analysts have grown increasingly cautious since our last update (05/31/10) when the ratio stood at 1.5. While we would expect to see some seasonal weakness ahead of a quarterly EPS reporting period, the ferocity of the Ratio's most recent downward move appears somewhat panicked. At its current level, the **Ratio indicates that more companies are having their annual EPS estimates lowered than raised**, a situation that we last saw over 12 months ago as the Ratio began to move off its cyclical lows.



As we have noted previously, we believed that the above average level of EPS momentum recorded during the past 12 months was unsustainable. It is not unusual to see a considerable increase in the EPS momentum following a period of earnings/economic weakness. The initial improvement is driven by a number of factors including: company cost cutting efforts and the unwillingness of analysts to "get ahead" of the earnings recovery in case it proves to be short lived. As the recovery in operating performance moves from early to late stage, companies find it increasingly difficult and in most cases impossible to deliver bottom line year over year (y/y) earnings improvement/surprise of the magnitude gained during the initial recovery phase. With this in mind, we expected to see a decrease in the Ratio's seasonal highs and lows as we moved further into 2010. This scenario has already begun to play out. The level of the Ratio heading into the Q1'10 EPS reporting season was approximately –20% below its level ahead of the Q3'09 and Q4'09 EPS reporting seasons. Assuming a generally positive Q1'10 EPS reporting environment we expected the ratio to move higher from its 04/02/10 low, which it did. However, for the reasons noted earlier, going forward it is unlikely that the Ratio will continue to "seasonally peak" at the relatively high levels recorded during the most recent 3 quarters (close to 2.0). The good news for investors is that a Momentum Ratio approaching 2.0 is not necessary to support an upward trending equity market, i.e., the S&P 500 moved steadily higher from 2005 through 2007 supported by an EPS momentum ratio that, ex seasonal weakness, ranged from 1.05 to 1.30 (see chart).

We are entering what should be a seasonally strong period for EPS momentum. Companies beat the consensus estimate 60% to 65% (average) of the time (70%+ more recently). Therefore, we expect to see an uptick in momentum as analysts raise their full year estimates to incorporate positive quarterly surprises. During this period the Momentum Ratio should trend upward from its pre EPS reporting season low. The level at which the ratio "tops out", post quarterly EPS reporting season and prior to the start of the next quarter's EPS pre-announcement season, provides an indication of how optimistic companies and analysts are regarding future earnings. The Momentum Ratio peaked at a level 65% higher than its reading just prior to the beginning of the Q1'10 EPS reporting period. On the flip side, the level at which the ratio "bottoms out" just prior to the next quarterly EPS reporting season provides an indication of the level of optimism/pessimism regarding companies ability to beat the consensus earnings expectations. The recent deterioration in the Ratio is an indication that analysts are concerned about the upcoming Q2'10 EPS reporting results and/or the companies ability to meet the considerably more difficult Q3 and Q4 y/y comparisons.

At the sector level, deterioration in EPS momentum has been widespread. Currently there are only 3 of the 10 GIC's sectors where more estimates are being raised than lowered, Industrials, Technology and Utilities. Improving: Utilities — the sector Ratio experienced a modest rebound following a difficult period for the sector. ***Deteriorating:*** along with the aggregate Ratio, most sectors experienced some deterioration in there EPS Momentum Ratios this month. That said, sectors more reliant on a strong economic outlook, i.e. ***Consumer Discretionary*** were more negatively impacted than less economically sensitive sectors, i.e. Healthcare.



Where to from here? We have seen a **considerable improvement in "seasonal peak" EPS momentum** since late March 2009. However, there has been only a **modest increase in index level EPS expectations for 2010.** Why is this so? The capitalization weighting of the index appears to be one reason why the improvement in the equally weighted Momentum Ratio has not flowed through to index level EPS growth expectations. Based on our analysis, the average estimate for the small and mid capitalization segments of a broad index had been moving higher. However, the average expectation for large to mega capitalization companies had shown little movement, up or down. The lack of estimate improvement in the large and mega capitalization segment, which accounts for the majority of a capitalization weighted index such as the S&P 500 or Russell 1000, overwhelmed the positive Mid and Small cap revisions. That said, prior to the recent weakness we had seen some improvement in the earnings outlook for large and mega cap companies. The result was a modest improvement in index level EPS estimates. In addition, as we have moved further away from the EPS nadir of early 2009, expectations have become more difficult for companies to beat (see following paragraph) or to beat significantly enough to have a considerable impact on index level expectations.

Current 2010 earnings expectations assume a significant improvement (44% y/y for the S&P 500 index) from 2009. Based on our analysis, the **highest level of y/y growth in S&P 500 index operating EPS during the past 20 years was just under 30% (1993/1992)**. Given the considerable amount of uncertainty surrounding the 2010 operating environment and the general inability of analysts (in aggregate) to accurately forecast earnings results 12 months in advance, it is likely that the level of earnings growth recorded in 2010 will differ from the current expectations. With that in mind, will the current growth estimates prove to be too high or too low? Given the current optimistic expectations and uncertain economic outlook, **we continue to believe that the risk of lower than expected EPS growth is more likely.**

Definitions:

EPS Momentum Ratio: Represents the number of companies (in the Shenandoah Asset Management (SAM) stock selection universe) that had a positive change in their mean EPS estimates (FY+1 and FY+2) during the prior week divided by the number of companies that had a negative change in their mean EPS estimates during the same period. An EPS Momentum Ratio of 1 indicates that there were an equal percentage of companies that had a positive or negative change in their mean EPS estimates. An EPS Momentum ratio greater than/less than 1 is an indication of a positive/negative bias to mean EPS changes for the period.

4 wk MA: 4 week moving average of the weekly EPS Momentum Ratio.

EPS FY +1: Zacks Mean EPS estimate for the current fiscal year. *EPS FY +2:* Zacks Mean EPS estimate for the next fiscal year.

Note: This analysis is provided for informational purposes only. Our research indicates that the momentum ratios have had mixed results when tested as a predictor of equity market performance.

Source: Earnings data from AFG and Zacks.