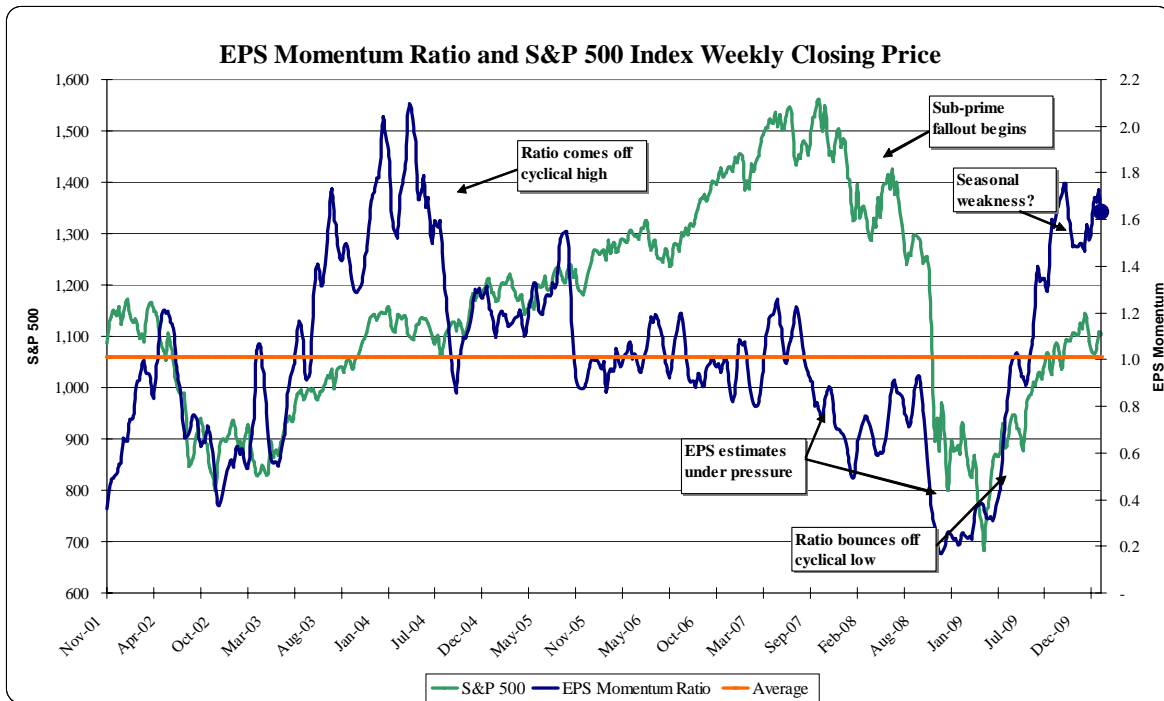




Shenandoah Asset Management, LLC
EPS Momentum Ratio
(02/28/10)

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Against a backdrop of an above average percentage of companies reporting better than expected (BTE) Q4'09 EPS results, we saw little movement in the EPS Momentum ratio this month. The EPS Momentum Ratio now stands at 1.6 vs. 1.6 (01/31); still well above the historical average (1.0) but only modestly above its pre EPS reporting period level of 1.5.

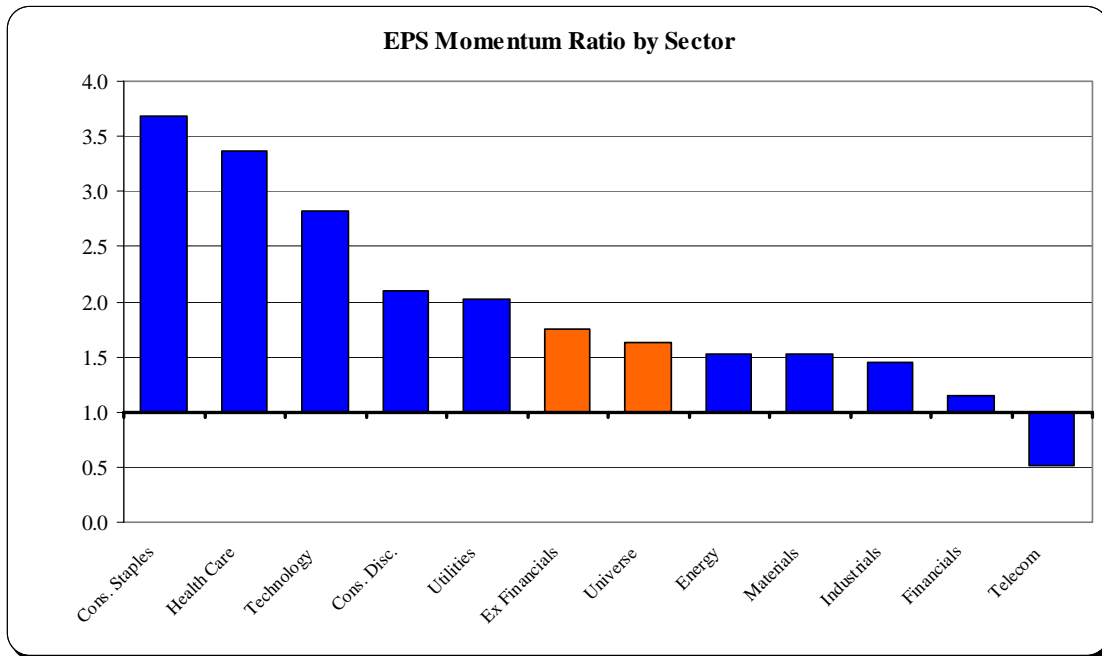


We believe that an EPS Momentum Ratio of the current magnitude is unsustainable. It is not unusual to see a considerable increase in the Momentum Ratio following a period of earnings/economic weakness. The initial move higher is driven by a number of factors including: company cost cutting efforts and the unwillingness of analysts to “get ahead” of the earnings improvement in case it proves short lived. As the operating recovery lengthens in time, 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 expect to see a decrease in the seasonal peak Momentum Ratio as we move further into 2010. 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).

As we suspected, the lack of Momentum Ratio weakness ahead of the Q4 EPS reporting season indicated that EPS results would be better than expected. We estimate that 70% of the companies have reported BTE Q4 EPS results vs. the 60% to 65% historical average. When the Financial sector is excluded the percentage moves to 74%. The negative EPS results recorded by many indices and sectors makes year/year growth comparisons less useful than they may otherwise be. That said, it appears that Q4'09 aggregate results will continue the recent trend of being sequentially higher than the previous quarter.

We are entering what should be a seasonally weak period for EPS momentum. Companies beat the consensus estimate 60% to 65% (average) of the time (70%+ this quarter). 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 13% higher than its level just prior to the Q4'09 EPS reporting period getting under way, slightly below the seasonal high reached during Q3'09 EPS reporting period. With the bulk of the Q4'09 reports behind us, we expect to see some “seasonal” deterioration in the ratio as we move further into February. This weakness will likely continue until the beginning of the Q1'10 EPS reporting period, which should get underway in mid-April. The level at which the ratio “bottoms out” just prior to the upcoming quarterly EPS reporting season provides an indication of the level of optimism/pessimism regarding companies ability to beat the consensus earnings expectations.

At the sector level, inline with the aggregate results, there was some improvement in EPS momentum during the most recent period. **Improving: Healthcare** — a relatively positive EPS reporting season combined with a more optimistic outlook for the sector have combined to move the EPS Momentum Ratio sharply higher. **Deteriorating:** a moderate pullback in the EPS Momentum Ratio for a number of the more economically sensitive sectors, i.e. Materials, Industrials and Energy, was evident.



Where to from here? We have seen a **considerable improvement in EPS momentum** since late March. However, so far there has been only a **modest increase in index level EPS expectations for 2009 and 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, recently we have seen a modest increase in growth expectations for large and mega cap companies. The result has been that index level EPS estimates have moved higher, albeit slightly. In addition, as we have moved further away from the EPS nadir of early 2009, expectations have become increasingly difficult for companies to beat (see following paragraph) or to beat significantly enough to move the needle on overall index level expectations.

Current 2010 earnings expectations assume a significant improvement (38% 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 operating EPS in 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, the risk of lower than expected EPS growth is more likely, in our opinion.

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.