THE DARDEN CAPITAL MANAGEMENT ADVISOR

February/March 2006

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Darden School Foundation Boosts DCM's Funds Under Management to $5 Million

By James Fessel, CFA ('06)

DCM Expands With Cash Infusion of $1.36 Million and Creation of a Fourth Fund

During its January meeting, the Investment Committee of the Darden School Foundation voted to increase its allocation of endowment capital to Darden Capital Management by approximately $1.36 million, bringing total student-run endowments under management to approximately $5.0 million. The capital infusion will be used to create a fourth fund with $1.25 million of capital at the end of March, 2006. The creation of this new fund will allow DCM to add four new portfolio managers, increasing the total number of fund managers to 16 when the Class of '07 DCM team officially takes over management on April 1, 2006. In addition, the Foundation authorized the creation of a Chief Investment Officer (CIO) position. The CIO will have risk management oversight responsibility for the four funds and will be the lead liaison with the Faculty Advisor and Foundation. The capital infusion and creation of a new fund confirm the continued commitment of the Trustees to strengthen the development of the program, create a stronger network of communication and interaction, increase awareness, and broaden membership and involvement in the Darden Capital Management Club.

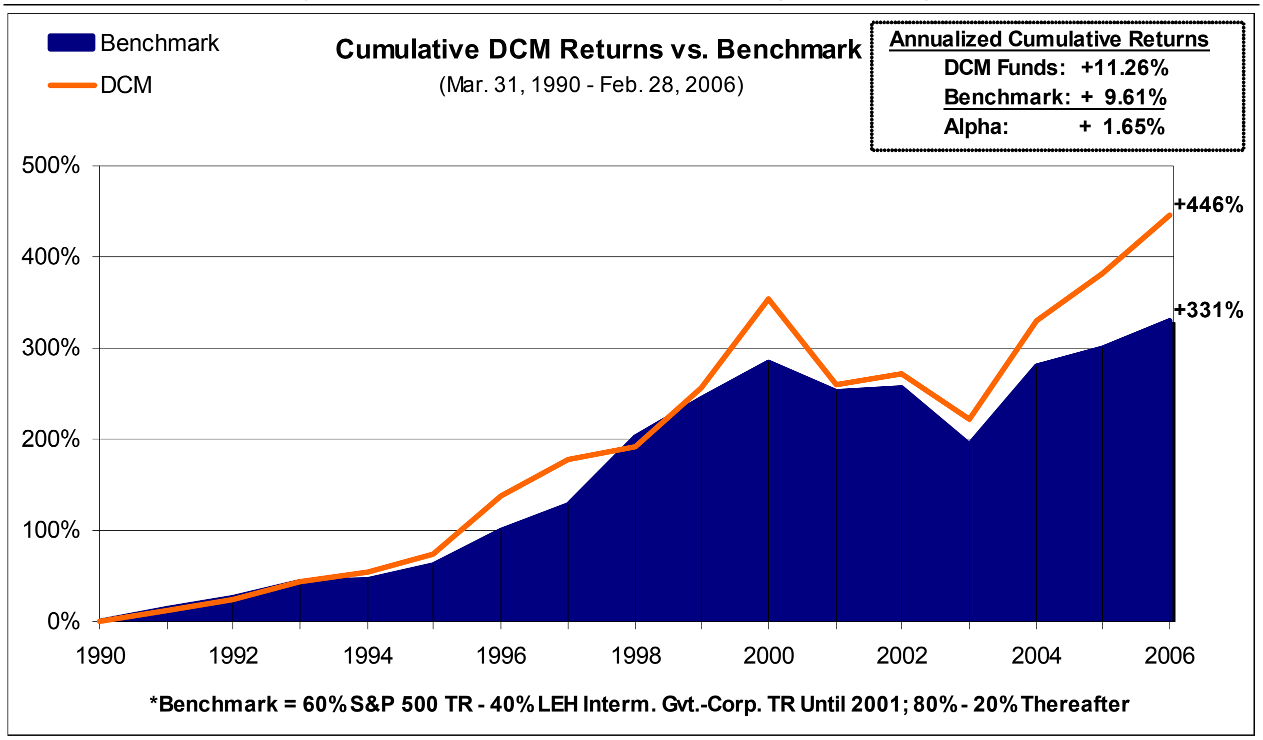
DCM Funds Perform Well Despite Headwinds

The fund managers of the Darden, Jefferson, and Monticello Funds generated solid returns during 2005 despite skyrocketing energy prices, natural disasters, rising interest rates, and a number of high-profile corporate bankruptcies. In aggregate, DCM's three funds returned 8.4% during the nine months ending December 31, 2005, exceeding the S&P 500 return of 5.7% by over 250 basis points.

January was a great month for the small capitalization stocks, as the S&P Small Cap 600 Index climbed 8.3%, potentially benefiting from the often cited January Effect. The S&P 500 and Russell 1000 Indexes posted relatively solid returns of 2.5% and 2.7%, respectively. The New Year brought in a wave of strong earnings reports and economic data. All three funds performed well in January, boosting the total return during the ten month period to approximately 12% versus the S&P 500 return of 8.4% during this period.

February market returns were lackluster, reflecting sluggish residential real estate markets and concerns in consumer sentiment surveys. The inverted yield curve also caused concern, as some economists suggest it is a warning sign of an impending recession. The market indexes remained flat in February; the DCM funds were mixed, generating an aggregate gain of 1.3%, with the Darden Fund expanding its lead over the benchmark, and the Jefferson and Monticello Funds keeping pace with the overall market.

Darden Capital Management Total Cumulative Returns (1990-2006)



The Darden Foundation and Darden Capital Management: A Symbiosis

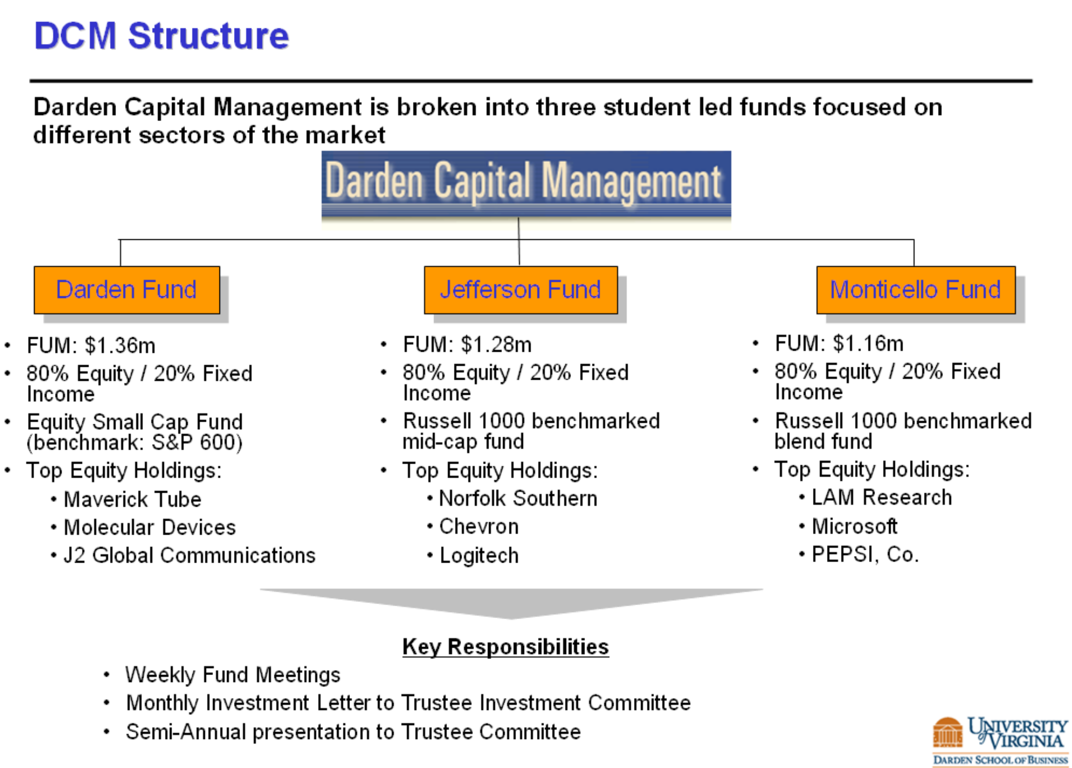
The relationship between the Darden School Foundation and Darden Capital Management has been mutually beneficial for more than 15 years. DCM student fund managers have generated returns above the S&P 500 on a relatively consistent basis since the Trustees first contributed $250,000 from the Foundation's endowment in 1990. With this gracious gift, Darden Capital Management has provided superior investment returns to the Darden School Foundation, while offering students hands-on experience in the practice of asset valuation and portfolio management. With support from the Darden School Foundation, DCM strives to offer practical preparation for future careers in investment management and research as well as other functions within the financial markets.

DCM Fund Managers Give Presentation To Wall Street Journal MBA Rankings Editor Ron Alsop

The DCM fund managers presented the history, structure, and accomplishments of the Darden Capital Management Club to Ron Alsop of the Wall Street Journal on February 16, 2006. The presentation provided a broad overview of Darden Capital Management's success as a strong and growing student-run organization that has driven integration with other areas of the school, including career services and networking, speaker forums, company visits and conferences. The presentation also highlighted DCM's focus on bridging the gap between theoretical classroom learning with real-world investment experience, which has certainly helped increase the size and depth of the Darden Capital Management Club.

Building The Brand & Passing The Torch

Although our tenure as DCM fund managers is not yet over, it is clear that the current managers have contributed additional alpha to the long-term track record of superior returns established over the past 16 years. Since the core group of 12 fund managers was selected last year, we have also been working actively to build the reputation, recognition, and visibility of the club both inside and outside Darden. Over the years, the DCM fund managers have enhanced the club through integrating skills learned in the classroom, and knowledge from guest speakers, including portfolio managers, Chief Investment Officers, and other investment professionals. This year's fund managers have not only generated strong investment returns, but have made significant strides in increasing the visibility of the club through participating in stock pitch competitions versus other top MBA programs, improving the content and distribution of the Darden Capital Management Advisor, and passing along valuable lessons and best practices to the new class of fund managers. Looking forward, both the student fund managers and the Trustees have a strong belief that Darden Capital Management clearly provides a unique learning experience that differentiates Darden to prospective students and employers.



Breakfast With Legendary Vanguard Founder Jack Bogle

By Baily Dent ('06)

In February, Darden Capital Managers enjoyed a lively hour long breakfast with legendary investor John "Jack" Bogle, who pioneered the concept of index investing as a cost-efficient method of providing ordinary investors with exceptional diversification and superior investment returns relative to the majority of available mutual funds. By minimizing turnover and trading costs through a passive investment in a portfolio of the stocks that make up a market index, Bogle revolutionized the investment management industry, and challenged the high costs associated with active management.

Mr. Bogle founded the Vanguard Group in 1974, and under his leadership, the company grew to be the second largest mutual fund company in the world. Bogle institutionalized the pursuit of lower costs at Vanguard by creating a structure in which the company is actually owned by the funds themselves, aligning the interests of fund managers with investors. At the age of 78, Jack continues to be actively involved with various for-profit and non-profit organizations as well as with the Vanguard Group. He has also written a number of influential books on the subject of investing.

Jack regaled the DCM fund managers with many stories of when he started in the industry as well as his current views on the investment markets. In a world where high profile fund managers and high-fee structures have become the norm, Jack offered a unique perspective espousing the benefits of indexing over active management. At first glance, the indexing argument seemed to be another argument in favor of efficient markets. However, Jack's view is that markets do not have to be efficient for indexing to work. Indexing works because it maintains the lowest fee structure in the industry. With the added layer of fees, even talented managers that beat their benchmark often underperform low-fee index funds. He noted that while most think of relative investment performance as a zero sum game, once fees are included less than 10% of managers actually outperform their benchmark. Interestingly, Jack's son is a successful hedge fund manager, a sector of the investment market not known for particularly low fees. Jack keenly noted that there are indeed talented active managers that earn their fees like his son, for example.

The legendary crusader of low-cost investing for the individual investor also provided interesting viewpoints on important issues facing the markets, including social security and underfunded pensions. Bogle is against privatizing social security because the government would represent another layer of management expenses. On the other hand, he is an advocate of stricter rules surrounding 401k and IRA distributions. He advised us to challenge pension fund return assumptions used by major corporations, and focus on the importance of a solid foundation in accounting, corporate governance, and ethics.

Taking Stock: Darden First-Years in Boston

By Brian Pratt ('07)

Five Darden first-year students visited several asset management companies in Boston in early January, in an effort to reach out to prospective employers and learn more about the industry. Chris Eastman, Brian Pratt, John Spears, Charles Seidman, and Brad Sullivan spent January 5th and 6th in Boston, meeting with MFS Investment Management, Wellington Management, Sirios Capital Management, Fidelity Management & Research, and GMO. The companies represented a range of investment philosophies and product offerings. For example, Sirios is a long-short equity hedge fund, while Fidelity, MFS, and Wellington all manage a broad range of mutual funds. In contrast to other companies, GMO relies more on quantitative models to select securities.

During these informational sessions, the students had an opportunity to meet with a variety of company representatives, including several Darden alums - Garrick Bauer, a high-yield analyst at Wellington, Camille Humphries, a portfolio manager at MFS, and Drew Tamoney, who is responsible for new business development and client service at GMO. "The trip was an amazing opportunity to interact with some of the top firms in the asset management world. The Darden alumni were very helpful and offered great advice. It was a great experience that I hope will be continued by future Darden students," said John Spears.

It wasn't all business, however. On Thursday night, the extended Darden community gathered for an alumni reception in the Back Bay area. Also in attendance were other first-year students in Boston to meet with companies offering general management opportunities. During the reception, the students had the chance to meet with alumni and others from State Street Global Advisors and Putnam Investments.

"The Boston finance trek was a tremendous success in my mind. I am optimistic about Darden's future with these firms, all of which were enthusiastic about the possibility of adding Darden to their core group of schools at which they recruit," said Charles Seidman, reflecting the shared sentiment that the visit strengthened Darden's relationships with these firms.

The visits proved fruitful, as several students garnered the opportunity to interview for summer internships, and as of this writing, at least two offers have been made. More importantly, the students had the opportunity to learn more about what it takes to succeed in the highly competitive asset management industry.

INTRODUCING THE NEWLY SELECTED DCM CLASS OF '07 PORTFOLIO MANAGEMENT TEAM

On March 1, 2006, seventeen First-Year students were informed that they had been selected as members of the incoming DCM Portfolio Management Team. The new DCM team (see below) was selected by the current fund managers in cooperation with the DCM Faculty Advisor, Katy Sherrerd, based on each candidate's overall participation in the club as a First-Year, a formal application process and interview, and the quality of investment ideas presented at the 1st Annual DCM Stock Pitch Competition, subsequent "Super Friday" stock-pitching events, and/or individual fund meetings.

DARDEN CAPITAL MANAGEMENT NEWLY SELECTED PORTFOLIO MANAGERS			
Faculty Advisor: Katy Sherrerd, PhD, CFA		Chief Investment Officer: Jennifer Mandeville	
Darden Fund	**Jefferson Fund**	**Monticello Fund**	**"New Fund"**
Brian Pratt ('07)	Chris Eastman ('07)	Brian Carney ('07)	Ellen Lee ('07)
Glenn Miller, CFA ('07)	Ben Mackovjak ('07)	Josh Ayers ('07)	Will Snellings, CFA ('07)
Charles Seidman, CFA ('07)	Will Cohen ('07)	Chris Pond ('07)	Brian Duff ('07)
Luke Semple ('07)	Manuel Artime ('07)	John Spears ('07)	Bradley Sullivan ('07)

S&P Index Changes: Free Money On The Table?

By James Fessel, CFA ('06) and Raymond Chung, CFA ('06)

The Standard & Poor's Index Committee meets monthly to evaluate candidates for addition to S&P indexes. Changes to an index are decided on during this meeting, usually in response to mergers, acquisitions, and restructurings that result in natural deletions. Since 2001, 108 stocks have been added to the S&P 500 Index, replacing an equal number of deletions. With an estimated $1 Trillion in S&P 500 Index Funds, a tremendous volume of trading occurs when changes are announced. While it is well known that a stock typically jumps when it is added to the S&P 500 Index, there are conflicting opinions on (1) whether or not the increase in the stock price is instantaneous, and (2) whether or not arbitrage profits can be generated through a trading strategy that exploits what appears to be a market inefficiency.

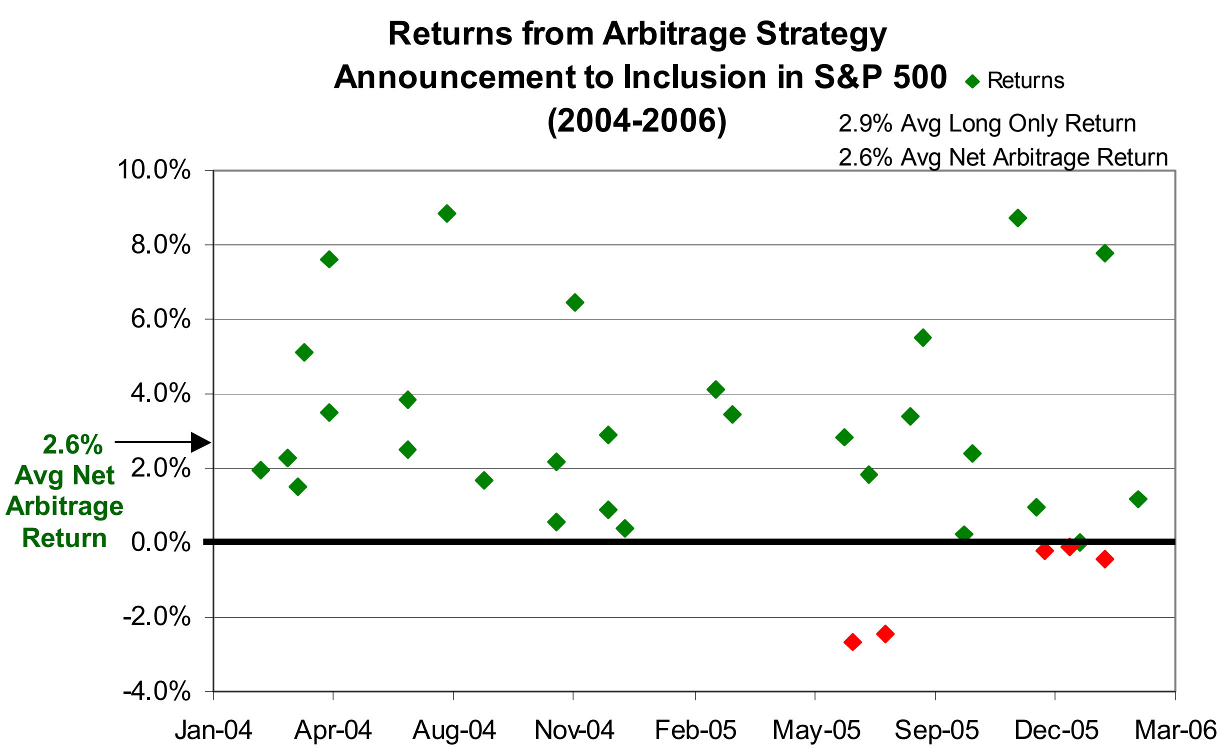
Our study and simulated trading strategy suggest that abnormal short-term returns can be captured by exploiting inelastic demand from index funds. While traditional finance theory asserts that stocks adjust instantaneously, our simulated trading results suggest that index fund purchases push the stock up through the 3 to 5 day period from announcement to inclusion.

As indicated in Figure 1, we found that stocks added to the S&P 500 during the past two years jumped an average of 3%, consistent with previous studies[1] over different time periods. Since some critics suggest that most of the increase occurs at the opening price following the announcement, we assumed we could only buy and sell the stock at the average daily price. Our simulation indicated that abnormal returns were earned even after the initial spike. Further research indicated that the stock typically rises over a period of days because indexers often build positions during the 3 to 5 days before inclusion, and then buy large blocks of shares near the market close on the inclusion date to boost the price at which the stock is included the S&P 500 higher than the average price at which index fund managers accumulated the shares. We implemented the following trading strategy to exploit the inelastic demand from index funds:

Trading Strategy: Long-Short (Market Neutral) Arbitrage Trade

- *Establish a Long Position in the Selected Stock Upon Announcement;*
- *Fund The Purchase by Short Selling the S&P 500 Index;*
- *On Inclusion Date, Sell the Selected Stock & Close Out the Short Position in the S&P 500 Index*

FIGURE 1: RETURNS FROM ARBITRAGE STRATEGY EXPLOITING "S&P INDEX CHANGES"



[1] Messod D. Beneish and Robert E. Whaley, "An Anatomy of the S&P Game: The Effects of Changing the Rules" *Journal of Finance,* December 1996.

The Efficient Market Hypothesis (EMH) asserts that since markets are efficient, investors are rational, and prices reflect all available information, attempts by investors to obtain abnormal returns through either trading strategies or fundamental analysis will prove to be futile after including trading costs and adjusting for risks. Practitioners often find that empirical phenomena are difficult to reconcile with the framework of traditional finance theory. Our study and simulated trading results suggest that there is indeed "free money" left on the table during the time period from announcement to inclusion. The disconnect can be explained by evaluating the assumptions of traditional finance theory. In textbook theory, demand curves for stocks are kept flat by riskless arbitrage between perfect substitutes. In reality, individual stocks do not have perfect substitutes. As a result, arbitrageurs and computerized trading programs that instantaneously capture risk-free arbitrage opportunities face market frictions that inhibit the ability to exploit many inefficiencies, such as inelastic demand from index funds in this study.

Because computerized trading programs seek risk-free arbitrage opportunities, certain inefficiencies in the market are left unexploited. In our study, the "arbitrage risk" inherent in imperfect substitutes is avoided by arbitrageurs or computerized trading programs that seek only riskless arbitrage. In other words, the lack of a perfect hedge results in exposure to price volatility, which can be extremely dangerous when engaged in heavily leveraged arbitrage trades, even if the trade is only partially unhedged. Therefore, the lack of a perfect hedge inhibits arbitrageurs or computerized trading programs from exploiting many inefficiencies in the market. This "arbitrage risk" provides investors or traders that are willing to accept calculated risks an opportunity to gain abnormal excess returns.

Our study and simulated results support the case that traditional finance theory (i.e. EMH) does not adequately explain the idiosyncrasies of the real world. However, the identification of behavior that violates efficient market assumptions may indeed indicate opportunities to exploit market inefficiencies and generate consistent abnormal returns with minimal risk. The following framework identifies exactly how the assumptions of EMH are violated by the anomaly of inelastic demand from index funds that occurs when additions are made to the index. Identifying violations in EMH provides an indication that opportunities may exist to gain abnormal returns through arbitrage strategies that exploit the market inefficiencies created by behavioral or technical anomalies.

I. <u>Evidence of Violations of Efficient Market Hypothesis (EMH):</u>

Assumptions of EMH:

i.) Homogeneous expectations. *Violation*: Participants have heterogeneous beliefs.
- *ex:* Arbitrageurs and indexers rationale for trading is inconsistent and biased.

ii.) Frictionless markets. *Violation*: Imperfect substitutes inhibit a riskless hedge.
- ex: Trading costs, short sale restrictions, and imperfect hedges are frictions that inhibit arbitrageurs from exploiting inefficiencies because they avoid unhedged risks.

iii.) Perfect competition. *Violation:* Large players impact market prices more than other players.
- ex: Index Fund managers tend to divide up large orders and accumulate shares during the period between announcement and inclusion. At the very end of trading on the day of inclusion, some index managers engage in rapid, large trades which push shares upward to close at an inclusion price in the S&P 500 higher than the average price shares were accumulated during the period from announcement to inclusion.

Results and Conclusions: Our study and simulated trading results suggest that abnormal returns can be achieved by implementing a long-short arbitrage trading strategy that exploits the necessity of index funds to purchase and hold the shares of any company that is added to the index. We implemented our simulated trading strategy on all additions to the S&P 500 from January 2004 until February 2006. The net gain from individual arbitrage trades was 2.6%, which translated into a total compounded annual return from the trading strategy of 46.6%. Our largest loss was (2.7%) in Constellation Brands, while our biggest gain was +8.9% in Fisher Scientific, indicating a bias or positive skewness in the standard deviation of returns. Of the 34 arbitrage trades, 29 of the trades, or 85%, were profitable. As demonstrated by this example in which violations of efficient market assumptions are identified and exploited, the ability to recognize and understand violations of traditional finance theory and EMH can reveal unidentified market inefficiencies that can be exploited.

Candidates For Addition To The S&P 500 Index: In order of Market Capitalization, likely candidates include: Legg Mason (LM), Peabody Energy (BTU), SanDisk (SNDK), Boston Properties (BXP), Expeditors International (EXPD), Smith International (SII), Cognizant Technology Solutions Corporation (CTSH), Precision Castparts Corp. (PCP), and Chico's FAS, Inc. (CHS).

February 2006 Investment Ideas

AirTran Holdings, Inc. (AAI - $17.69)
Jason Sinnarajah ('07)
Sinnarajahj07@darden.virginia.edu

Target Price: $20
Market Capitalization: $1.58 Billion

Description: AirTran is a low-fare airline based out of the Atlanta Hartsfield International Airport. The airline primarily services markets along the Eastern seaboard and Midwestern United States. AirTran serves 40 destinations with more than 500 flights daily. It has the youngest Boeing fleet of any U.S. airline, and is the only airline in the country that offers Business Class on every flight. The AirTran fleet consists of only Boeing 717 and 737-700 aircraft, which are larger and more fuel efficient than most aircrafts.

Positive Considerations: AirTran is gaining market share, as it continues to grow in terms of Capacity and Revenue per Available Seat Mile. The airline is adding capacity on existing routes and expanding its network with additional routes. AirTran has significant revenue overlap with Delta, Northwest, and Independence Air. None of these airlines have been able to sustain passenger load factors above break even. Amidst higher fuel prices in 2005, AirTran was able to add capacity, maintain its low cost structure, and still surpass its breakeven load factor, resulting in a pattern of positive operating income and free cash flow growth. The airline has a great opportunity to gain share in key markets where services are being reduced by bankrupt airlines (Washington Dulles – Independence Air, Chicago Midway - ATA).

Risks: Price competition may intensify as Delta and Northwest, both flying under Chapter 11, come out of bankruptcy with significant liquidity to sustain price wars in overlapping markets. A further rise in fuel prices is the biggest risk to Airtran's cost structure. While non-fuel unit costs continue to be the lowest in the industry, fuel is still 33% of Cost per Available Seat Mile. AirTran is properly aligned to manage through oil prices at $60-65/barrel.

Valuation: Revenue passenger miles should see 20-25% annual growth through 2009, when the airline will be a full grown low-cost carrier. With competitors showing a TEV/EBITDA multiple 7x-9x, I used a conservative 6.0x terminal multiple in 2010 when growth for the airline should slow down.

American Science & Engineering Inc (ASEI-$88.32)
James Fessel, CFA ('06)
Fesselj06@darden.virginia.edu

Target Price: $100
Market Capitalization: $722 Million

Description: American Science & Engineering, Inc. develops, manufactures, markets and sells proprietary X-ray inspection and screening systems used by seaport and border authorities, the military, and airports. The firm offers Z® Backscatter Systems, CargoSearch™, ParcelSearch™, and SmartCheck inspection systems that search trucks, cargo, and people for plastic explosives, weapons, illegal drugs, nuclear devices, and other contraband.

Positive Considerations: Recent concerns over U.S. port security will likely translate into greater government spending on inspection and screening systems at ports and borders. While over 95% of US overseas trade is conducted at the nation's 361 seaports, only 2% of total cargo is inspected. The proposed FY2007 federal budget includes a 35% increase in spending on border security, with $2 billion for port security. The Dept of Homeland Security will soon award a multi-billion dollar procurement contract for border security under the Secure Border Initiative. AS&E's core X-ray inspection technology, Z® Backscatter, is protected by more than 20 patents, and is integrated in most product offerings. Catalysts include new contracts from the TSA, new military orders in Iraq have doubled, and rising international orders. The high-margin parts and service business has risen to 35% of sales. The balance sheet is solid, with cash of $75M, no debt, and stable inventory.

Risks: Government orders (75% of sales) can be lumpy, and order size compared to total sales is high. AS&E does not provide guidance, resulting in low visibility. While sales and EBIT should rise more than 10% next year, EPS may decline due to both a higher tax rate and diluted shares outstanding.

Valuation: The stock has had a strong run lately, so wait to buy on a pull-back, or when visibility improves after the March quarter. Current valuation multiples of 11.5x CY2007E EBIT and 25x CY2007E EPS remain attractive. AS&E has exceeded expectations by a large margin during each of the past four quarters, and the earnings revision trends remain positive.

Books-A-Million, Inc. (BAMM - $11.27)
Glenn Miller, CFA ('07)
MillerG07@darden.virginia.edu

Target Price: $12.50
Market Capitalization: $186 Million

Description: Books-A-Million is the country's third largest bricks-and-mortar book retail chain. The company operates 210 stores throughout the Southeast, including 168 superstores. The company pays a quarterly dividend of $.08 per share. Management currently owns approximately 42% of the company's 16.5 million outstanding shares.

Positive Considerations: The company reported strong holiday sales and has consistently improved operating margins over the last several years through renovations of existing stores. Thus far, it has renovated 60% of its stores. With only 210 stores in the Southeast, there is room for expansion. Recently, the company announced its first store opening in Kansas, reflecting management's strategy to grow revenue and earnings through geographic expansion. The company's attempted Dutch auction in the summer of 2005 for 4 million shares up to $10 per share (stock was less than $8.50 at the time) may imply that management is interested in taking the company private. Only 54,000 shares were tendered, indicating that shareholders are unwilling to sell at an undervalued price.

Risks: Liquidity risk (~$100M float, 27K shares traded daily). High insider ownership can also be seen as a downside risk. In the event management is motivated to acquire the company, it has incentive to lowball earnings guidance and/or acquire control of the firm via share repurchases.

Valuation: BAMM shares have traded up over last month (to a fairly rich P/E of 13.3x), ostensibly due to heavy buying by hedge fund Hawkeye Capital, which disclosed a 6.3% stake on Jan. 25. Additionally, the retail sector has been surprisingly strong. With downside likely in the $9-$10 range, the risk/reward profile remains attractive assuming reasonable chance (20-25%) of a takeout in the next 12-18 months. On a private party transaction basis, the firm is worth $15-$18. This range reflects a 20-30% IRR in an LBO situation, under conservative assumptions (growth at pace of inflation, 8-9% EBITDA margin, no benefit from interest tax shield from leveraged financing, exit multiple of 4.5-6X EBITDA, and only 50% management rollover).

Clean Harbors, Inc. (CLHB - $30.03)
Chris Kenny (JD/MBA '07)
KennyC07@darden.virginia.edu

Target Price: $40
Market Capitalization: $584 Million

Description: Clean Harbors is leading provider of environmental services and the largest hazardous waste disposal company in North America. CLHB services approximately 55% of North America's commercial hazardous incineration and 20% of hazardous landfill volume. Technical services (waste collection, transport, treatment, disposal, etc.) account for 70% of revenue, while Site services (emergency response, spill cleanup, demolition, decontamination, wastewater treatment, and industrial services, etc.) account for 30% of revenue.

Positive Considerations: The clean-up and reconstruction efforts in the aftermath of Hurricane Katrina have resulted in significant need for environmental clean-up and remediation projects. The company recently raised revenue and EBITDA guidance 10% and 15%, respectively, due to greater-than-expected level of work in the Gulf coast regions.

High Barriers to Entry – Regulations, licensing, and capital investments make this a difficult business to enter. No new hazardous waste incinerators or landfills have commenced operations in the last decade. CLHB's large size allows it to handle waste streams internally, resulting in economies of scale.

Stable & Recurring Revenue Base – The average relationship with top ten customers is 15 years. More than 45,000 customers (175 of Fortune 500) in different industries, provides a diverse client base, with no customer accounting for >5% of revenue.

Risks: CLHB must book environmental liabilities for "repairing" the hazardous materials sites to meet government regulations. This liability is fairly certain (within $20mm), but the timing is uncertain. Also, changes in federal and state environmental law could require capital expenditures for compliance.

Valuation: CLBH is trading at a 2006E EV/EBITDA multiple of 6.4x. Median historical valuation multiples and a comparable company analysis suggest a fair value EV/EBITDA multiple of 8.5x, yielding a price target of $40. For every $100mm of Katrina cleanup dollars, CLHB should increase EBITDA by $18mm. Given constant EV/EBITDA multiples, this equates to an increase of roughly $10/share on an undiluted basis (~$5/share diluted basis).

Constellation Energy Group, Inc. (CEG - $54.88)
Erik Zalenski ('07)
Zalenskie07@darden.virginia.edu

Target Price: $64.50
Market Capitalization: $9.8 Billion

Description: Constellation Energy and FPL Group, Inc (NYSE: FPL) announced a definitive merger agreement on December 19, 2005, where FPL will acquire CEG to create the largest competitive energy supplier and the second largest electric utility portfolio in the United States. Constellation Energy Group, Inc., a holding company, supplies electricity to commercial and industrial customers in North America. CEG has a regulated gas and electric segment, Baltimore Gas and Electric, as well as a non-regulated merchant energy business. FPL Group, Inc., through its principal subsidiary, Florida Power & Light, engages in the generation, transmission, distribution, and sale of electric energy principally in the state of Florida.

Positive Considerations: The merger creates a new Fortune 100 company and U.S. market leader in competitive energy with combined 2005 annual revenues of $29 billion and $54 billion in total assets. The regulated segments of the business provide consistent cash flows but little growth. However, the merchant energy segment should provide substantial growth in revenue and earnings in the future; approximately 55% of earnings are expected to come from the unregulated energy businesses. In addition, both CEG and FPL have large nuclear and coal power generation capability, which is a much more stable cost basis then natural gas generation. The transaction is an all stock deal worth approximately $11 billion. The purchase price offers 1.444 shares of the new company (which will be called Constellation Energy) for each current CEG share. The merger is expected to close in the first half of 2007.

Risks: Failure to obtain approval for the merger; merchant power earnings subject to energy prices.

Valuation: Current shares of CEG are trading at approximately a 6% discount given a conversion of 1.444 shares of FPL stock for each CEG stock, representing a merger arbitrage opportunity, in addition to a dividend yield is 2.7%. An FPL target price of $44.70 is based on a comparable company median forward P/E of 15.8x estimated 2006 EPS of $2.83. The CEG target price of $60 is based on a conversion @ 1.444 shares of FPL at $44.70.

EMC Corporation (EMC - $13.60)
John (JT) Hardy ('07)
HardyJ07@darden.virginia.edu

Target Price: $18
Market Capitalization: $32.3 Billion

Description: EMC Corporation offers systems, software, and services for information lifecycle management worldwide. It operates in four segments: Information Storage Products, Software Group Products & Services, Information Storage and Management Services, and VMware Software Products and Services.

Positive Considerations: EMC recently issued a 2006 sales forecast that exceeded analysts' expectations. The company has now delivered ten consecutive quarters of double-digit sales growth, but the stock has remained flat due to declining profitability in storage hardware, an increasingly low-cost commodity. Management is making moves to try to increase the share price, allocating more than $1B for share repurchases. The company has also sought to diversify recently through acquisitions of data services and software companies, including VMware, Dantz, Documentum, Legato, Rainfinity, and Captiva, which should provide opportunities for synergies, improving growth, and higher margins.

Risks: Nearly half of EMC's sales come from the low-margin hardware component of data storage solutions, which continues to experience pricing pressure and margin erosion. However, EMC is expanding into complementary segments including software solutions and "information lifecycle management" technology. In addition, EMC is betting on future growth from international markets, particularly Western Europe, a market full of big organizations likely to buy high-end data storage solutions. Management believes that these customers have large cash piles and are "ready to open their wallets." If international demand does not materialize as planned, results may not meet expectations.

Valuation: EMC's recent purchases will allow it to upsell clients through a full product offering, driving 25% EPS growth in 2006. At a P/E multiple of 21x 2006 consensus EPS of $0.66 and 18x 2007 consensus EPS of $0.77, EMC is trading near the low end of its historical P/E range. As the storage market leader positioned to benefit from improving IT spending and a solid balance sheet with net cash of $3.00 per share, the stock appears undervalued.

GILEAD

Gilead Sciences, Inc. (GILD - $62.34)
Raymond Chung, CFA ('06)
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Purchased by Monticello Fund: $47.40
Target Price: $70 (updated 2/27/06)
Market Capitalization: $28.9 Billion

Description: Gilead Sciences is biotech company specializing in antiviral therapies. Its HIV franchise, Truvada, Viread and Emtriva is #1 worldwide and gaining share. GILD also has Hepsera, a leading Hepatitis B drug, and holds the patents for Macugen, the #1 treatment for wet macular degeneration, marketed by Eyetech/Pfizer and Tamiflu, the #1 flu antiviral marketed by Roche.

Positive Considerations: Gilead is positioned for 25%+ EPS growth in 2006 and 2007. Truvada, a combination pill of Viread and Emtriva has low market penetration; 34% penetration of existing HIV patients and even less of total worldwide paying patients. Truvada should gain more share as more efficacy data is presented in early 2006.

GILD also represents a call option on Tamiflu. GILD is currently suing Roche for negligence in producing Tamiflu. The most likely resolutions include GILD receiving higher future royalties or taking control of Tamiflu production at a future date.

Risks: The primary risk is failure to continually gain HIV market share. Other major risks include investor perception of a limited pipeline and the company's dependence on its HIV franchise which represents 71% of revenues. Truvada is in its early stages of growth and no new drugs are necessary for the company to achieve 25%+ EPS growth in 2006 and 2007. Truvada is also recommended by the FDA for first line HIV treatment. Market emphasis on three drug combination pill development is misguided. Management has also shown an ability to acquire key technologies to enhance the pipeline.

Valuation: GILD is undervalued relative to its expected future growth rate and other leading biopharmaceutical companies. The low end of its peer group PEG is 1.3x. Given 20% expected CAGR through 2007, a 28x P/E yields a $70 stock price.

Alliance Imaging, Inc.

Alliance Imaging, Inc. (AIQ - $5.88) *(03/05/06)*
James Fessel, CFA ('06)
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Target Price: $10
Market Capitalization: $294 Million

Description: Alliance Imaging is a leading national provider of diagnostic imaging services. AIQ offers hospitals and clinics a comprehensive outsourcing solution, which includes use of its imaging systems, technologist staff, equipment maintenance and upgrades, and management of day-to-day operations. AIQ derives 58% of revenue from MRI scans, 26% from PET & PET/CT scans, and 16% from other modalities. The company has 507 diagnostic imaging systems, and serves over 1,000 clients in 44 states.

Positive Considerations: The diagnostic imaging industry in the U.S. is a $66 billion market, with MRI at $12bn, growing at 11%, and PET at $2bn, growing at 14%. Several trends support long-term market growth, including an aging population, a focus on cost-efficient technology, and a greater emphasis on early detection and monitoring of medical conditions. The diagnostic imaging industry is highly fragmented, with AIQ positioned as either a consolidator or an acquisition target. AIQ focuses on small-to-mid size hospitals, offering a cost-effective outsourcing solution for imaging services. No single client accounts for >3% of revenue. Also, AIQ is insulated from risks associated with reimbursement and collections, since 87% of revenues are generated from exclusive, long-term contracts with hospitals and clinics that are obligated to pay regardless of reimbursement from third-party payors. These contracts average 3-5 years, supporting high visibility and strong stable cash flows.

Risks: Contract renegotiations hurt profits for past two years and fuel prices hit mobile transport costs. Soft hospital volumes, overcapacity of imaging equipment, pricing pressure, higher co-pays/deductibles, and labor costs may impact profitability. High debt load of $580M (113% LT debt/cap) after an LBO in 1999. KKR owns 70% of shares at a cost basis of $5.60. S-3 filing to sell 18m shares provides overhang.

Valuation: P/E of 31x 2006E and 18x 2007E implies investors must believe in turnaround story. With 2/3rds of contracts recently renegotiated for 3-5 years, stabilizing MRI, 43% growth in PET, < 4% exposure to Medicare crunch that faces troubled competitors, and no near-term debt maturity, EV/EBITDA of 5.8x 2006E and 5.0x 2007E reveals compelling value.

K-Swiss, Inc. (KSWS—$30.08)
John Spears ('07)
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Target Price: $35
Market Capitalization: $1.0 Billion

Description: K-Swiss, Inc. engages in the design, development, and marketing of athletic footwear for sport, fitness activities, and casual wear in the United States and internationally.

Positive Considerations: KSWS has positioned itself as a niche player that remains focused on their classic athletic shoe line for steady cash flow and consistent profit margins that are among the highest in the industry. In addition, KSWS has an experienced management team that has produced a 5-year ROIC of 23.2% and has instituted a share buyback program and annual dividend increases. Finally, their balance sheet is very strong with no long term debt.

The resulting stability provides a platform to expand into new areas of the world and into new products. KSWS has a strong relationship with Foot Locker, which it is using to leverage its European operations. Asia represents another growth opportunity. The company has seen 33% growth in Japan is a result of a new distributor acquisition. In addition, new basketball performance lines will boost revenue and earnings if successful.

Risks: There is always a substitution threat for shoes. The KSWS business model has relied on the classic shoe line for many years. Because it is so basic, the substitution threat is somewhat mitigated. In addition, the threat of new entry from other competitors is always possible. However, KSWS has taken more of a niche role that results in lower volumes and higher margins. The major players in the industry aren't willing to change their business model and new players have not been able to capture the same reputation and demand that the classic line has commanded.

Valuation: KSWS is undervalued, considering its steady cash flow and growth opportunities. The company's growth prospects are at a value price of 14x TTM P/E vs. an industry median TTM P/E of 16x.

LSI Logic Corporation (LSI - $9.15) *(02/22/06)*
Raymond Chung, CFA ('06)
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Target Price: $12
Market Capitalization: $3.6 Billion

Description: LSI Logic, founded in 1980, is a semiconductor company specializing in designing integrated circuits for the storage (67%), consumer (18%) and communications (15%) markets. The storage division also includes a storage systems subsidiary, formerly known as Engenio Storage Systems, a leading provider of modular, disk storage systems, sub-assemblies, and storage management software to server and storage OEMs. Customers include: Brocade, Dell, EMC, Fujitsu, HP, IBM, Motorola, Seagate, and Sun Microsystems.

Positive Considerations: LSI has shown significant financial improvements with respect to sales, margins, ROE and ROA since Abhi Talwalkar, from Intel, became CEO in May 2005. He has been effective at rationalizing products and R&D, and further progress should continue. The company is also transitioning from a fab to fabless model which should lead to significant gross margin improvements in the long run. In addition, LSI has leading market share in markets capable of growing 10-20% for the next few years: SCSI and SAS controllers (50-80%), fibre channel (80%), DVRs (45%), set-top boxes and digital audio/video chips (iPod nano through Portal Player).

Risks: The main risk is a dramatic slowdown in IT spending. Fortunately, enterprises have been slow to spend on storage in the last couple years. There is pent up demand and key technological transitions are taking place. Other risks include slower than expected turnaround and inability to continue to capture design wins. Customer concentration risks include IBM, which accounts for 15% sales.

Valuation: LSI is trading at a discount relative to its peers and forecasted earnings CAGR of 20% through 2007. A peer group 2006 PEG of 1.6 implies a $12 stock price and a 20x P/E multiple on 2007E EPS.

Lucent Technologies, Inc. (LU - $3.06)
Bradley Sullivan ('07)
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Target Price: $4
Market Capitalization: $13.8 Billion

Description: Lucent Technologies is a leading provider of communications networks for the world's largest communications providers. The company's systems, services, and software allow its customers to deploy and better manage networks in a timely manner. Backed by Bell Labs research & development, Lucent uses its strengths in mobility, optical, software, data and voice networking technologies, as well as services, to create new products and services for its customers.

Positive Considerations: Lucent is well positioned to benefit from a turnaround in the telecom industry, the emergence VOIP, and significant operating leverage. Telecom industry prospects have improved from early in the decade as many major suppliers announced capital budget increases. Lucent will directly benefit from the increased spending from key clients such as Sprint. Lucent has grown revenue 6.8% over last year and stabilized operating margins, as unprofitable product lines were dropped. Lucent also recorded a sizeable backlog of $2.1 billion. Not only have Lucent's operations improved but its financial condition has strengthened, evidenced by improving balance sheet ratios that measure liquidity and leverage. In addition, Lucent will receive a one-time tax refund which will provide additional liquidity for investment and debt repayment.

Risks: Primary risks include a consolidating customer base, increasing market competition, customer concentration and a sizeable debt level ($5.9 Billion). Lucent is also subject to fluctuations in the global telecommunications industry such as those occurring from 2001 through 2003.

Valuation: Lucent is relatively undervalued when compared to its peer group. Compared to the average peer group earnings ratio of 20x, Lucent is undervalued as it trades at only 16x. Taking into consideration company specific issues such as total debt, our price target for Lucent Technologies is $4.00. We feel the upside potential for stock price appreciation outweighs the downside risk exposure as the company has refocused its product offering and looks to benefit from positive industry factors in telecommunications capital spending.

Motient Corporation (MNCP.PK - $16.90) (*10/19/05*)
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Target Price: $42
Market Capitalization: $1.06 Billion

Description: Motient provides two-way wireless mobile data services and wireless Internet services throughout the United States. The company emerged from bankruptcy on May 1, 2002 with all its debt cleaned from its books. The common stock currently trades on the pink sheets.

Positive Considerations: Motient is an asset play based on its ownership of valuable wireless L and S-band spectrum, which is well positioned for use by all domestic wireless carriers. The company owns a this valuable wireless spectrum through its 49% stake in Mobile Satellite Ventures LP. In 2004, the FCC issued MSV the first ATC license granted by the Commission. Motient also owns 8 MHz of S-Band spectrum (2.0 GHz) in the U.S. and Canada through its 61% equity interest in TerreStar. In total, the company currently owns 8.2 billion MHz-POPs, which is expected to be used by domestic wireless carriers. The two primary near-term catalysts for the stock include: NASDAQ listing in the next six months, which will help the market better understand the company story; and a likely partnership or acquisition by a large telecom company over the next 6 – 12 months.

Risks: Motient has posted consistent EBITDA losses and continues to burn roughly $5–$15 million of cash per quarter. Despite this cash burn, it has a $240m cash balance that provides adequate near-term liquidity, and has shown confidence in its liquidity situation by its announcing a $50m cash buyback program in November. Motient could require additional financing to fund future losses and investments. Motient has increased its stake in MSV from 29% to 49% and has engaged in a number of dilutive financings. The company has also announced plans to issue a further 93 million shares to finance the 100% acquisitions of MSV and TerreStar.

Valuation: The market currently values Motient's proportionate L- and S-Band spectrum position (8.2 billion proportionate MHz-POPs) at $0.18 per MHz-POP. This is a significant discount to recent spectrum transactions that have taken place at a weighted average of $1.76 MHz-POP. Motient's $42 price target is based on a conservative valuation of $0.50 per MHZ-POP.

SFBC International, Inc. (SFCC - $24.58)
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Target Price: $29
Market Capitalization: $450 Million

Description: SFBC is a Contract Research Organization that provides drug development services (primarily clinical testing) to pharmaceutical, biotech and medical device companies. SFBC historically focused on early phase testing, but through a roll-up acquisition strategy, has expanded its service offerings to include lab testing and later phase trials.

Positive Considerations: In early November, Bloomberg Magazine ran an article that accused CROs in general, and SFBC in particular, of a variety of practices that threatened patient safety. This touched off a series of events & revelations that rattled investor confidence in the management team, and the stock lost over 60% of its value by mid-December. Finally, in January, SFBC's key executives stepped down and PharmaNet's management team (SFBC 2004 acquisition) took the reins and is now taking steps to get past these issues. It currently appears that the threat of customer defections has been contained to its Miami facility, the site of most documented problems.

The industry is growing rapidly, spurred by the FDA's desire for greater drug safety data, an increase in the number of molecules available for in-human testing (due to scientific advances), and the drug-makers' increased desire to outsource.

Risks: The emergence of more skeletons from the closet could drive customers away (biggest risk); regulatory scrutiny could increase; SFBC has higher than average debt (recent downgrade by Moody's); integration risk; management distraction.

Valuation: Although much of the low-hanging fruit has been picked, opportunities remain. SFBC is trading at a substantial discount to peer multiples (Fwd PE, Fwd PEG, EV/EBITDA, P/B, P/S), though it has historically traded in-line. Taking a weighted average of valuations under a variety of headline-risk scenarios, I value the stock at $29 a share.

Tempur-Pedic International (TPX-$11.99)*(01//09/06)*
Tony Costello ('06)
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Target Price: $15
Market Capitalization: $1.24 Billion

Description: TPX is a market leading, vertically-integrated provider of premium mattresses and pillows that are sold in 60 countries. TPX sells their premium mattresses and pillows through multiple channels at full prices: Retail (71%); Direct (15%); Healthcare (7%); and Third party distributors (7%). TPX has three product segments: Mattresses (63% of sales); Pillows, (20% of sales); and Other Products (17% of sales). TA Associates, a large private equity firm based in Boston, currently owns 22% of the shares.

Positive Considerations: TPX is the leading player in the specialty bedding industry, with 48% market share. From 2001 through 2004, specialty bedding has nearly tripled its percentage market share within the wholesale mattress industry. An aging population of baby boomers with more money in their pockets and an increased awareness of the health benefits of a specialty mattress should allow the specialty segment to gain market share from the innerspring market. Further, the healthcare industry, which TPX has not significantly entered, provides a tremendous opportunity for the company. While Tempur Pedic's superior branding and marketing alone give it a sustainable advantage over its competitors, several studies have found that its product is superior to its competitors' as well.

Risks: Competition in the specialty bedding industry has increased as Sealy and Serta have introduced memory foam products at lower price points. Higher petrochemical costs, which increased in 2005 despite locked in price terms, could hinder TPX's ability to maintain operating margins above 20%.

Valuation: The stock has declined over 50% since early July due to a lower priced product introduction coupled with slightly slower earnings growth. However, the problems experienced in 2005 were short-term, and the long-term prospects for TPX and the outlook for the specialty bedding niche remain positive. Based on a discounted cash flow and comparable company analysis, the stock appears undervalued by approximately 25%. As management continues to execute its strategy, the market will likely take notice and stock price should appreciate.

Teva Pharmaceutical Industries (TEVA-$41.57)
Manuel Artime ('07)
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Target Price: $51.00
Market Capitalization: $25.8 Billion

Description: Teva Pharmaceutical Industries Ltd. is a global pharmaceutical company producing drugs in all major treatment categories. Through aggressive acquisitions and product development programs, the company has become a leader in the global generic drug industry. Teva USA markets approximately 140 generic products representing more than 400 dosage strengths and packaging sizes, which are distributed and sold in the US. In Europe, the company has approximately 450 generic products representing over 1,700 dosage strengths and packaging sizes.

Positive Considerations: The $7.4 billion acquisition of Ivax, a large US generic drug company, was recently completed. This acquisition has further bolstered Teva's already strong pipeline and is expected to result in $150 million in synergies during the next two years. Teva has very strong product launch prospects for the next several years. The company has 204 ANDAs (generic filings) pending, 103 of which are in Phase IV. Eighty of these ANDAs, targeting branded annual sales of $40 billion, are expected to be launched in 2006 & 2007, and 30 of these launches may have 6 month exclusivity rights.

Teva's profit margins are significantly higher than its peers due to economies of scale and its successful recent entry into the branded drug market. Copaxone, which has become the leading drug treatment for multiple sclerosis in the US, is Teva's first blockbuster drug in the proprietary drug segment and is under patent until 2014. The near term growth prospects for the generic drug industry are particularly strong due to the implementation of the new Medicare Part D Plan and the continued wave of patent expirations affecting many current blockbuster branded drugs.

Risks: Regulatory delays, competition and legal challenges from proprietary drug companies.

Valuation: Trading at 18.2 times expected FY07 EPS with estimated annual earnings growth of 22% for the next two years, Teva is a very compelling GARP investment. Estimated annual earnings growth for the next five years is 20%.

TXU Corp. (TXU - $46.43)
Chris Eastman ('07)
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Target Price: $60.00
Market Capitalization: $21.5 Billion

Description: TXU Corp., a holding company, through its subsidiaries, manages a portfolio of regulated energy businesses in North America, primarily in Texas. The company, through its subsidiary, TXU Energy Holdings engages in electricity generation and retail and wholesale energy sales; and through TXU Electric Delivery engages in regulated electricity transmission and distribution operations. TXU provided electricity and related services to approximately 2.5 million retail electricity customers in Texas, as of December 31, 2004. The company also produced approximately 18,300 megawatt (MW) of electricity, including 2,300 MW of nuclear, 5,837 MW of lignite, and 10,228 MW of gas/oil fired electricity.

Positive Considerations: TXU has been a wonderful turnaround story and can continue to be going forward. It has divested itself of unprofitable businesses, achieved substantial cost savings and is planning to open two new lignite coal plants that give it a substantial cost advantage over competitors. Currently it is producing $2-3 billion a year in FCFs from operations that will allow corporate expansion. TXU has also locked in a price to beat on natural gas prices at over $11. With gas trading in the $7 range this gives them superior margins.

Risks: Management has made it no secret that it would like to expand its coal generation business through an acquisition. Such a merger would be via an equity deal due to TXU's highly leveraged balance sheet and would almost certainly be dilutive to the stock.

Valuation: TXU is trading at a large discount to peers. With a forward P/E multiple around 8.4x 2006 earnings, it is trading at a 40% discount to comparable companies. While its significant natural gas exposure causes it to trade at a discount, I believe this discount is overstated and the company should trade closer to 11x-12x, translating to a target value of $60.

Darden Fund	Jefferson Fund	Monticello Fund
Equity Holdings	**Equity Holdings**	**Equity Holdings**
Avid Technology Inc	Anheuser-Busch Companies Inc	B J Services Co.
Clean Harbors Inc	Bank of America Corp	Berkshire Hathaway Inc Class B
ConocoPhillips	Berkshire Hathaway Inc Class B	Capital One Financial Corp
Corrections Corporation of America	Chevron Corp	Chevron Corp
Curtiss-Wright Corp	Education Management Corp	China Mobile Hong Kong Ltd ADR
Delphi Financial Group Inc	FPIC Insurance Group Inc	Endo Pharmaceuticals Holdings Inc
Emcor Group Inc	General Dynamics Corp	Gilead Sciences Inc
Equity One Inc	Hospira Inc	Home Depot Inc
FTI Consulting Inc	Intel Corp	iShares Russell 1000 Index
Gardner Denver Inc	JP MorganChase	Kellogg Company
Headwaters Inc	JP MorganChase & Co	Lam Research Corp
iShares S&P Small Cap 600 Index	Logitech International SA ADR	LSI Logic Corp
J2 Global Comm Inc	Monro Muffler Brake Inc	Microsoft Corp
Kanbay International Inc	Nokia Corp ADR	Norfolk Southern Corp
Maverick Tube Corp	Norfolk Southern Corp	Pepsico Inc
Molecular Devices Corp	Pfizer Inc	Symantec Corp
NCO Group Inc	Royal Caribbean Cruises Ltd	Target Corp
Piedmont Natural Gas Co.	Satyam Computer Services ADR	Tempur-Pedic International Inc
Steak N Shake Co.	Sovran Self Storage Inc	
Texas Capital Bancshares Inc	Verizon Communications	
Thor Industries Inc		
Timberland Co.		
THQ Inc		
Thomas Nelson Inc		
Fixed Income Holdings	**Fixed Income Holdings**	**Fixed Income Holdings**
3.250% UST Notes due 8/15/07	6.125% UST Notes due 08/15/07	3.500% UST Notes due 11/15/06
6.125% UST Bonds due 11/15/27	4.250% UST Notes due 08/15/14	4.375% UST Notes due 05/15/07
6.875% Wal-Mart Bonds due 8/10/09	2.750% UST Notes due 08/15/07	4.125% FHLB Cllbl due 09/30/08
6.250% SBC Bonds due 3/15/11	3.250% UST Notes due 08/15/07	1.875% USTII Notes due 07/15/13
5.000% GNMA MBS due 7/20/34	4.375% UST Notes due 08/15/12	2.000% USTII Notes due 07/15/14

RECENT BUYS	RECENT BUYS	RECENT BUYS
Kanbay International Inc	Intel Corp	B J Services Co
NCO Group Inc	Bank of America Corp	China Mobile Hong Kong Ltd ADR
Timberland Co		LSI Logic Corp
		Tempur-Pedic International Inc
RECENT SELLS	**RECENT SELLS**	**RECENT SELLS**
Diebold Inc		Chicago Bridge & Iron Co NV
Harman International Industries Inc		Johnson & Johnson
Jos. A Bank Clothiers Inc		Thor Industries Inc
Titanium Metals Corp		Titanium Metals Corp

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