THE TANDEM REPORT

Volume XIII, Issue 4 October, 2012

"It requires a great deal of boldness and a great deal of caution to make a great fortune, and when you have it, it requires ten times as much skill to keep it."

~ Ralph Waldo Emerson

Dear Clients,

Tandem is committed to the preservation of your wealth by minimizing risk while adding value through superior investment performance. This issue of *The TANDEM Report* provides a summary of our views pertaining to the investment landscape and subjects that influence our decision making. More information about our firm, including our investment style and process, is available at www.tandemadvisors.com or upon request. We hope you find this report useful.

Respectfully,

John B. Carew
President,
Chief Investment Officer

In This Issue

MARKET COMMENTARY:

STOCKS SURGE HIGHER WITH MORE HELP FROM THE FED

The Federal Reserve announced its latest round of Quantitative Easing and the market ripped higher. The S&P 500 was up over 16% year to date and over 6% for the quarter through September. By this measure, the Fed's policies have been a success.

While the market seems fairly valued to us at this point, one critical trend is emerging that bears watching. Since the market and the economy bottomed in early 2009, the stock market has been playing catch-up to corporate earnings growth. In the quarter just ended, we believe this trend may have reversed itself and now stock prices could be ahead of earnings. We will be paying close attention to earnings growth as companies report third quarter results to monitor this situation.

It is neither an unusual nor troubling occurrence for stock prices to anticipate good news that has yet to materialize. There is no predictable outcome when this happens. In some instances, prices pause in their ascent allowing time for earnings to rise to the anticipated level. Other times, markets correct to reflect the current reality. In still other instances, prices keep going up. The first two outcomes do not trouble us. Stock prices do not rise in a straight line. They move in fits and starts,

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COMMENTARY:

THE DANGER OF "FOOL ME ONCE, SHAME ON YOU. FOOL ME TWICE, SHAME ON ME."

For every government action, rule or policy, no matter how well intended each may be, there are unintended consequences. Some are predictable, some are not. We would like to believe that in most cases, the benefit of the intended outweighs the harm of the unintended. But this is not always the case.

The Federal Reserve has announced another round of Quantitative Easing, dubbed QE Perpetual because there is no end date (if confused, please see our comments on QE in previous editions). The Fed deems this necessary and warranted because unemployment remains high and economic activity slow. We would like to take a look at some of the unintended consequences of further Fed action. Before we do, an example may be helpful. Or not. Either way, it will certainly be less eye-glazing than a discussion of Fed policy and economic activity.

In an effort to remain far-removed from the politics of the day, let us contemplate a hypothetical example of government action and its unintended consequences. Suppose the government decided to enact a lawn beautification program *(thankfully, we are unaware of any government contemplation of such a policy)*. The property owners with the most beautiful lawns will be rewarded with recognition within their communities and tax credits to incent them to participate. Funding and loan guarantees will be made available for the purchase of lawn equipment in an effort to provide the latest technology to the lawn beautification providers. In the end, our communities will be more beautiful and economic growth will be stimulated through increased equipment and lawn service sales. What's not to like?

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In this example, it is not hard to identify the winners. The community wins, the local John Deere dealer wins, Home Depot and Lowes win and the landscape companies providing the services win. But who loses? How about the kid next door that used to mow your lawn? You can't use him any more because he only accepts cash. You can't get the tax credits you deserve for your beautiful lawn if you are not paying a real business. Plus, are you going to trust the kid when everyone else is using professionals? What will the neighbors think? How about the small landscapers that don't have the resources to compete against the bigger firms? They were doing fine before the policy, competing on price and personal service. Now, their larger competitors have all the fanciest gadgets. And what about the people that mowed their lawns and weeded their gardens themselves? Don't they deserve tax credits? Not to mention the renters! They don't even own a lawn. The kid, the small landscaper, the do-it-yourselfer and the renter all lose. They lose jobs or money or opportunity. And their tax dollars go to pay for a program that pushes them out of the way.

While this particular example may seem a bit ridiculous, it serves its purpose. Too often government can only see the potential benefits of its actions because the consequences are harder to quantify. Everyone can see and appreciate the beautiful lawns. The lost wages are harder to notice. In the case of the Federal Reserve, perhaps they should know better.

The Federal Reserve wants to put more people back to work and stimulate a disturbingly lethargic economy. A noble and just cause, to be sure. They have been active participants in stimulus since the depths of the financial crisis, much as they were after the last recession following the tech bubble and 9/11. And this is why they should perhaps know better. Fed policies are not enjoying the success they experienced last time around. We believe it is because of the unintended consequences of their past actions.

Fed policy has brought interest rates to historic lows, yet borrowing is anemic. Why? Perhaps banks won't lend. Perhaps too few of us wish to borrow more money. Perhaps both and more. But why? Fed policy also aims to get savers and investors to take more risk in an effort to stimulate the economy. Few take the bait, as evidenced by the accumulation of cash in money market accounts paying 0% interest and the continued exodus of the individual investor from stock mutual funds. Why are more and more people satisfied with earning nothing? Why aren't they piling into stocks, or real estate, or starting their own businesses, or *something*?

Why is this massive dose of Fed action being met with such resistance? Because we have been here before. We learned the unintended consequences the hard way. Until recently, we believed that our home was our best and safest investment, that buying stocks on dips was a winning strategy and that banks were safe. We believed that the Federal Reserve's response to the previous recession was masterful. They held interest rates artificially low for an extended period of time and the economy responded with a real estate boom, stock market growth and widespread economic activity that brought unemployment rates to extreme lows. Everything worked just as planned!

Until it didn't. And we all lived that nightmare. So now, no matter how hard the Fed tries, we aren't taking the bait this time around. Some do, but not as many as needed to get things moving again. Some are willing to take on risk and so far they are winning. But those on the sidelines, the majority in fact, don't trust the ending, even if they see others winning for the moment.

The Fed has pumped trillions (with a T) of dollars into the economy and much of that cash sits idle. The stock market certainly rallies each time another round of stimulus is put in place. But is the market strong enough to stand on its own when the stimulus goes away? Will the economy survive without its life support? And will small businesses risk hiring if they are afraid they will just have to fire those people eventually? Firing is painful. No one wants to do that. So small business remains stagnant.

Now to be clear and fair, we do not blame the Federal Reserve for trying to do something. They certainly get no help from the federal government (that is not political, that is fact). However, their actions are now viewed by many as extreme. Their intentions are noble. They are mandated by law to try to realize full employment and stable economic growth. Yet our own experiences have taught us that artificial stimulus leads to bubbles and bubbles burst. Many are now resigned to wait out the bubble and not get hurt this time around.

There is an old saying in the south - *Fool me once, shame on you, fool me twice, shame on me.* You don't have to be a Southerner to appreciate the sentiment. We've been down this road before. You got me last time. It won't happen again. No one wants to get fooled twice.

What if we are in danger of fooling ourselves, not of being fooled by the Fed? The *Market Commentary in* this issue speaks to the current valuation of the stock market. It is not expensive. It is not a bubble. Corporate earnings are real and more than 50% higher than they were the last time the stock market reached these levels. We may have a recession

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COMMENTARY (CONTINUED)

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or a market correction in our future, but fundamentals this time around are real. Perhaps a bit overstated by Fed policy, but real nonetheless. What if we are too concerned about *imagined* consequences?

If investors have become too clever, there is a risk, an unintended consequence, that is not being adequately contemplated. Investors are missing out on a rising stock market. Perhaps that is a cost worth incurring in exchange for peace of mind. However, by foregoing stocks, too many are losing out not on only potential opportunity. They are losing current income they could be earning from stock dividends. The S&P 500 has a dividend yield of 2.1%. Perhaps not an enticing rate. But have you checked CD rates lately? Stocks come with certain risks, and twice this century we have been painfully reminded of these risks. Rarely do such risks manifest themselves when anticipated by so many.

Our clients have survived the market's ups and downs and their portfolios are better for it. Our clients have made money over the last one, three, five, seven, ten, fifteen and twenty years. All the while, they have experienced dividend *growth*. The income from bonds and CDs doesn't grow and pales in comparison to the dividend yield of good stocks today. Sometimes we have to take the bait and manage for the unintended. Our clients have history on their side.

Fool me once, shame on you. Fool me twice, shame on me. Isn't fooling yourself once as bad as being fooled twice by someone else? We understand the hesitancy on the part of investors. We understand why they are afraid of being fooled. But too many are being fooled anyway. Stay the course.

MARKET COMMENTARY (CONTINUED)

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but ultimately higher when earnings and dividends continue to grow. Only the last outcome is troubling because it creates an unsustainable situation. Eventually, fundamentals will matter. If the fundamentals fail to keep pace with extended share price increases, prices will fall. The greater the disconnect between optimism and reality, the greater the price adjustment. We do not foresee this situation, as we will discuss shortly.

As we enter the heart of the third quarter earnings reporting season, we have noticed a general slowing in the rate of growth of corporate earnings. In many cases, companies are earning less this year than at the same point last year. Stock prices have not yet reflected a slowdown. There may be good reason. Perhaps companies and consumers are holding back, awaiting the outcome of the Presidential election and the resolution of the fiscal cliff. Once resolved, it is reasonable to expect more certainty and therefore more economic activity. Stocks are likely pricing in some anticipation of resolution, rather than what may be perceived as a temporary slowing of growth.

Tandem's research process follows over 1,200 different companies on a daily basis. We generate a lot of data, and some of it is actually useful. While we invest on a stock-by-stock basis, our process gains us insight into a broader view of the market. Most of the disappointing earnings announcements to date occurred in September, making the two charts below generated from our research informative.

Every stock in our universe receives a ranking of Buy, Accumulate, Hold or Sell. When earnings growth exceeds share price appreciation, more stocks would show up as Buys. Conversely, when share prices get ahead of earnings, we would expect to see more Sell rankings. Over the last month there is virtually no change in our overall rankings. There are a few less Buys, but a few less Sells as well. Most

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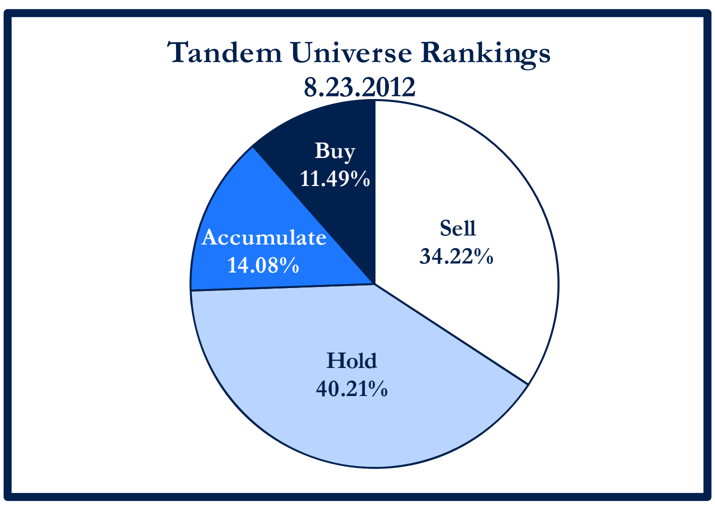

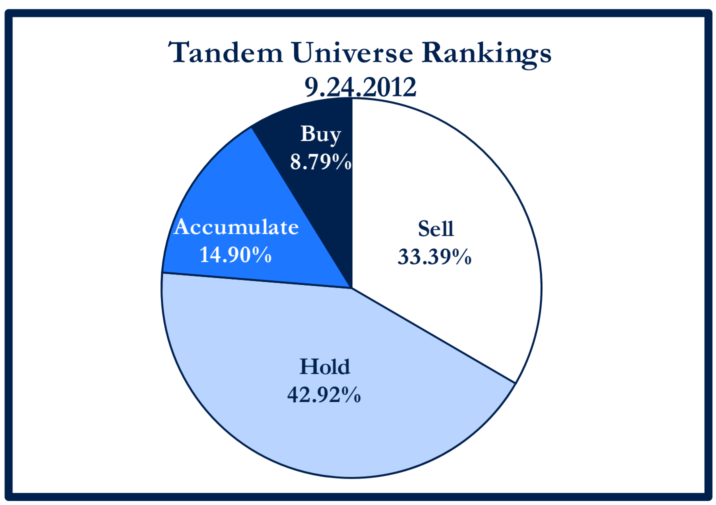

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are ranked as fairly priced. So even with the slowdown in earnings we have seen to date, optimism does not outpace reality. If the trend of slower growth continues, our rankings will reflect that and more stocks will become expensive based on fundamentals.

When stocks are fairly priced, as they are now in our universe, share price movement is hard to justify. However, when we look at specific sectors of the economy through the prism of our universe, we get a more complete picture. The three tables below drill deeper into the data we shared in the charts on page 3. Those charts reflected our entire universe. These tables account for the ten broad economic sectors of the market. The results are quite different. While the change from August to September (bottom table) is relatively limited as predicted by the previous charts, not all economic sectors are equally valued by the stock market.

Our Telecommunications sector shows massive overvaluation (72.2% of the companies are ranked Sell), as one might expect. A popular strategy in this environment has been to invest in companies that make large dividend payments like AT&T and Verizon. You will recall that this is not part of Tandem's strategy. We favor dividend *growth* justified by earnings growth. We do not favor high dividend payments, as evidenced by our lack of Telecomm holdings in client portfolios. Energy is also overvalued in our work, with over half of the companies ranked Sell. Again, this is to be expected. Investors fear inflation and a devaluation of the dollar. If this materializes, the price of oil will go up. But Energy fundamentals have failed to keep pace with share price increases, and thus they show up as overvalued.

It is not a negative signal that more companies are ranked Sell than Buy. Investors tend by nature to be optimistic. They drive prices higher than fundamentals justify. Most great companies that generate consistent results are fairly priced. Buys in our world are rare because we demand a lot of companies before we are willing to invest our clients' money in them.

That said, there are still attractive sectors in our universe. Consumer Discretionary (things consumers want but don't need) and Industrials look very attractive to us. Many have been left behind in this market either because they do not pay large dividends or are not perceived to be beneficiaries of QE. Regardless, they show good value.

The lesson here is that while the market as a whole appears to be fairly valued, pockets are not. You can look at your portfolio holdings and see this data reflected in what you own, what we have bought for you and what we have sold. In a market such as this, we

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8.23.2012	Sell	Hold	Accumulate	Buy
CONSUMER DISCRETIONARY	28.32%	41.62%	14.45%	15.61%
CONSUMER STAPLES	33.33%	48.15%	9.26%	9.26%
ENERGY	52.92%	29.57%	9.34%	8.17%
FINANCIALS	34.69%	42.35%	12.76%	10.20%
HEALTH CARE	24.11%	50.89%	17.86%	7.14%
INDUSTRIAL	17.45%	32.89%	22.15%	27.52%
INFORMATION TECHNOLOGY	34.38%	42.50%	16.25%	6.88%
MATERIALS	23.44%	53.13%	15.63%	7.81%
TELECOMMUNICATION	72.22%	16.67%	5.56%	5.56%
UTILITIES	30.19%	54.72%	9.43%	5.66%

9.24.2012	Sell	Hold	Accumulate	Buy
CONSUMER DISCRETIONARY	28.90%	43.35%	16.76%	10.98%
CONSUMER STAPLES	25.93%	53.70%	16.67%	3.70%
ENERGY	51.18%	31.89%	10.24%	6.69%
FINANCIALS	34.69%	42.35%	14.29%	8.67%
HEALTH CARE	24.07%	52.78%	16.67%	6.48%
INDUSTRIAL	16.89%	39.86%	23.65%	19.59%
INFORMATION TECHNOLOGY	35.00%	45.00%	13.75%	6.25%
MATERIALS	23.44%	56.25%	14.06%	6.25%
TELECOMMUNICATION	72.22%	16.67%	11.11%	0.00%
UTILITIES	24.53%	60.38%	9.43%	5.66%

One Month Change	Sell	Hold	Accumulate	Buy
CONSUMER DISCRETIONARY	0.58%	1.73%	2.31%	-4.62%
CONSUMER STAPLES	-7.41%	5.56%	7.41%	-5.56%
ENERGY	-1.74%	2.32%	0.90%	-1.48%
FINANCIALS	0.00%	0.00%	1.53%	-1.53%
HEALTH CARE	-0.03%	1.88%	-1.19%	-0.66%
INDUSTRIAL	-0.56%	6.98%	1.50%	-7.92%
INFORMATION TECHNOLOGY	0.62%	2.50%	-2.50%	-0.63%
MATERIALS	0.00%	3.13%	-1.56%	-1.56%
TELECOMMUNICATION	0.00%	0.00%	5.56%	-5.56%
UTILITIES	-5.66%	5.66%	0.00%	0.00%
UNIVERSE RANKINGS CHANGE	-0.84%	2.70%	0.82%	-2.69%

Market Commentary (Continued)

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expect a lot of choppiness and perhaps a pull-back. The future earnings picture needs to solidify before much more forward progress (or backward) can be justified. However, our research clearly indicates pockets of opportunity within the broader market.

While the latest round of QE has buoyed the market, the next couple of quarters will tell a lot about where we go from here. Are corporate earnings on hold awaiting a resolution or are they sending a warning? Stay tuned.

The Fed Hopes Quantitative Easing Increases Inflation:

It Appears to be Working in Financial Assets

Portfolio Characteristics:	Tandem Large Cap Core		Tandem Equity	
	9.30.2012	9.30.2011	9.30.2012	9.30.2011
Portfolio Yield	2.3%	2.4%	1.7%	1.8%
Weighted Current PE	18.85	12.58	19.49	13.33
Weighted Forward PE	17.57	11.36	17.95	11.80
5 YR Historical EPS Growth	10.00%	8.86%	13.00%	10.99%
Weighted Price /Book	4.56	2.80	6.37	3.01
Weighted Price/Cash Flow	13.58	8.88	14.60	9.74
Weighted Price/Sales	2.68	1.78	2.73	2.48
Weighted Return on Equity	26.29%	20.92%	33.13%	21.70%
Weighted Debt as % of Total Capital	33.83%	25.43%	40.07%	21.75%

We certainly do not expect the statistics in the table above to make a lot of sense to the average reader. Some of our readers prefer visual data, some prefer written, so we provide both.

The Federal Reserve is on record as saying they would like to see a higher rate of inflation. Quantitative Easing is the policy of choice to achieve this purpose. The traditional measure of inflation is the CPI, or Consumer Price Index. CPI is growing slower than desired. Yet that doesn't mean Fed policy is ineffective. It just might not be working everywhere they had hoped.

QE is certainly achieving some measure of inflation in the price of financial assets. A quick look at the table at the bottom right of page 6 informs us that the prices of gold, oil and commodities have risen since the Fed embarked on stimulus. It also shows rising stock prices around the globe, excluding China.

The table above illustrates the inflationary effects on the portfolios we manage. Increased share price is not in and of itself a measure of price inflation. The data above provide valuation measures that shed light on whether price appreciation is driven by fundamentals or other things. It appears other things are winning.

We manage several styles of portfolios for our clients. We have chosen to highlight the two most popular, Tandem Large Cap Core and Tandem Equity. Each style's portfolio characteristics are given for today and one year ago to study change in valuation measure.

Historical earnings growth for each style has increased over the last year, as we would hope. As a result, a share price increase is warranted. Other positive fundamental changes have occurred as well. Our companies are experiencing a higher rate of return on Equity (assets) and have taken advantage of low interest rates to borrow inexpensively to fuel growth.

However, other measures indicate that these positive changes account for only a portion of price gains. No matter if you understand the terms, they are measures of valuation. PEs, or price/earnings ratios, are up 50%. Price/book value, price/cash flow and price/sales are also higher. Higher numbers in 2012 than in 2011 mean stocks have gotten more expensive, not just higher in price.

These data points are not red flags. But they are to be noticed. QE has forced people into stocks because interest rates are too low in more traditional alternatives. The law of supply and demand dictates that prices rise when there is increased demand for the same amount of stuff. This is inflation. QE has increased demand, causing prices to rise. That said, fundamentals need to catch up at some point.

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Market Report Card

Yield table

	Current	3 months ago	1 year ago
3-month Treasury Bill	0.11%	0.09%	0.01%
5-year Treasury Note	0.67%	0.71%	0.95%
10-year Treasury Bond	1.72%	1.62%	1.92%
30-year Treasury Bond	2.88%	2.70%	2.91%
Prime Rate	3.25%	3.25%	3.25%
Federal Funds Rate	0.14%	0.16%	0.08%
Discount Rate	0.75%	0.75%	0.75%
3-Month LIBOR	0.36%	0.43%	0.37%

The data used to compile the above tables come from publicly available sources. Tandem believes it to be reliable, but makes no such assertions. Such data is not meant to imply past or future performance for Tandem or any securities market.

Key Market Data

	9/30/12 Close	% Change 1 Year	% Change 3 Years	% Change 5 Years
S&P 500	1,40.67	27.33%	36.29%	-5.64%
Dow Jones Industrial	13,437.13	23.13%	38.35%	-3.30%
NASDAQ	3,116,23	29.02%	46.82%	15.35%
Russell 2000	837.45	30.00%	38.59%	3.97%
German Xetra DAX	7,216.15	31.15%	27.15%	-8.21%
London FTSE 100	5,742.07	11.96%	11.45%	-11.21%
Shanghai Composite	2,806.17	-11.57%	-24.94%	-49.46%
Crude Oil	$92.19	16.40%	30.56%	12.88%
Gold	1,776.00	9.63%	78.37%	139.03%
CRB Index	309.30	3.74%	19.24%	-7.30%
U.S. Dollar Index	79.93	1.45%	4.20%	2.87%
Euro/Dollar*	128.54	-3.96%	-12.17%	-9.90%

** Negative return represents dollar strength, positive return represents dollar weakness. Returns are cumulative, not annualized.*

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