

# The TANDEM Report



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## MARKET HEADLINES

### S&P 500:

#### Annualized returns:

1 year ended 3/31/07	9.73%
3 years ended 3/31/07	8.05%
5 years ended 3/31/07	4.37%
7 years ended 3/31/07	-0.76%
10 years ended 3/31/07	6.50%

### Russell 3000 Growth:

#### Annualized returns:

1 year ended 3/31/07	6.53%
3 years ended 3/31/07	7.22%
5 years ended 3/31/07	3.81%
7 years ended 3/31/07	-5.30%
10 years ended 3/31/07	5.54%

## MARKET COMMENTARY:

### EXCESSIVE BORROWING THREATENS STOCKS

For seven years now we have suffered poor performance of growth stocks relative to the rest of the market. We have put forth numerous articles, charts and graphs supporting our assertion that growth stocks are attractive relative to virtually all other investment alternatives. Just as it appears that the investing public has *finally* come around to our way of thinking, we find ourselves more concerned about the near-term health of the overall market than we have been in years. And the reason has nothing to do with stocks.

Leverage, or borrowing, has been on the rise for several years now, with no apparent abatement in sight. The principal reason is low interest rates around the globe. A secondary reason is the poor performance of the stock market for most of this decade. Leverage in and of itself is not a bad thing. Most of us used leverage when we bought our house. Let

us explore how leverage can magnify returns.

Assume you buy a house for \$1,000,000 and pay cash. Your house appreciates in value to \$1,200,000. Your gain on your million dollar purchase is 20% (\$200,000 in appreciation divided by the amount of cash you invested). Now assume you bought the same house, but you only put down \$100,000 and borrowed the difference. In this scenario, the \$200,000 of appreciation represents a return of 200% on the money you invested, not the 20% return you would have experienced had you paid all cash. This is a significant improvement on return.

But leverage works both ways. If the same house decreased in value by \$200,000, you would lose 20% on your investment had you paid all cash, but you would lose

*(Continued on page 4)*

## COMMENTARY:

### SOME SERIOUS SOUL SEARCHING

In June of 2006, completely frustrated by the prolonged underperformance of growth stocks, I personally embarked on a complete review of our investment process, questioning absolutely everything we do as researchers and portfolio managers. In the ensuing 10 months and counting, I have learned a great deal, installed some new systems, tweaked a few others, and have begun to implement what we have re-

ferred to previously as the Tandem Valuation Model. TVM will be a subject of a future article in *The TANDEM Report*, but some of my findings are worth sharing here.

In no particular order, I have either discovered or reaffirmed that:

1. Growth stocks provide superior re-

*(Continued on page 5)*

# TOP TEN HOLDINGS

AS OF MARCH 31, 2007

As always, the list that follows represents our ten largest holdings ranked by total market value in the accounts that make up our Tandem Equity and Equity Income Composites. These are not recommendations for purchase. Rather, the list is simply intended to provide some insight into how we manage accounts.

Market value is determined by the number of shares of a

	E	T	M	TE
	M			
1.	BB&T			7.62%
2.	FMC Technologies			6.21%
3.	Altria Group			5.80%
4.	BP, plc			5.03%
5.	Exxon Mobil			4.74%
6.	FMC Corp			4.41%
7.	T. Rowe Price			4.14%
8.	Home Depot			3.54%
9.	Johnson & Johnson			3.35%
10.	Microsoft			2.67%

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company we own in a composite multiplied by the share price. Percentage of composite is a holding's value divided by the value of the composite. A composite is a group of accounts with similar investment strategies over which we exercise complete discretion.

For more detailed information on Tandem's composites, please visit our website at [www.tandemadvisors.com](http://www.tandemadvisors.com).

	E	T	N	ME	M	TE
	M					
1.	Exxon Mobil					5.27%
2.	General Electric					4.88%
3.	T. Rowe Price					4.29%
4.	Johnson & Johnson					3.85%
5.	Home Depot					3.84%
6.	Microsoft					3.54%
7.	General Dynamics					3.40%
8.	Abbott Labs					3.38%
9.	BP, plc					3.24%
10.	Enterprise Products Partners					3.19%

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## COMPOSITE UPDATES

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**Important Note:** During our annual internal compliance review, we discovered that 6 of the 22 accounts that now comprise this composite were either omitted or not entered on the appropriate date. We have rectified this situation, and the effect on composite performance by this correction is negligible. Nonetheless, if you have received information from Tandem regarding The Tandem Equity Composite since June 30, 2002, we would like to correct the information provided. Please notify Billy Little at (800) 303-8316.

During the quarter, we sold Allied Capital for a nice profit because they were under SEC investigation. We also sold Biomet, Constellation Brands, Fortune Brands and MultiFineline outright, while taking some profits in Amgen, General Dynamics, General Electric and Home Depot. We bought Advisory Board, Brown Forman, Canadian National Railway (before Mr. Buffet), Praxair, Republic Services Group, Walgreen and Watts Water, while adding to our holdings in BP and Genentech. Fortunately, we began selling before the February decline.

E T N ME M TE

**Important Note:** During our annual internal compliance review, we discovered that 2 of the 9 accounts that now comprise this composite were either omitted or not entered on the appropriate date. We have rectified this situation, and the effect on composite performance by this correction is negligible. Nonetheless, if you have received information from Tandem regarding The Tandem Equity/Income Composite since September 30, 2002, we would like to correct the information provided. Please notify Billy Little at (800) 303-8316.

During the quarter, we added Brown Forman, Praxair, Walgreens and some BP, while selling Allied Capital, Biomet, and Fortune Brands and taking some profits in Amgen and Home Depot.

The accounts that comprise a composite are not necessarily identical. Some contain positions that Tandem did not buy. The Equity Composite is designed to produce principal growth, while the Equity Income Composite is designed for principal and income growth. For more information, please visit [www.tandemadvisors.com](http://www.tandemadvisors.com).



# MARKET STATISTICS AS OF MARCH 31, 2007

T M A E T N D E DATA						
M			TD			
D A						
NA DA						

E D T A E				
T				
T				
T				

## PERFORMANCE BY SECTOR WITHIN THE S&P 500

THROUGH MARCH 31, 2007

(SOURCE: S&P 500 GICS SECTOR SCORECARD)

		M	TD		A
	100.00%	0.2%	0.2%	13.6%	4.4%
	48.36%	-0.4%	-0.4%	9.4%	1.4%
	51.64%	0.8%	0.8%	18.0%	7.2%
D	10.49%	-1.0%	-1.0%	17.2%	4.0%
	9.57%	1.6%	1.6%	11.8%	2.8%
E	10.09%	1.7%	1.7%	22.2%	15.1%
	21.63%	-3.4%	-3.4%	16.2%	5.5%
	11.90%	0.6%	0.6%	5.8%	0.4%
	10.91%	0.6%	0.6%	11.0%	4.4%
T	14.87%	-1.1%	-1.1%	7.7%	1.5%
M	3.08%	8.4%	8.4%	15.7%	9.8%
T	3.73%	6.4%	6.4%	32.1%	3.1%
	3.73%	8.4%	8.4%	16.9%	6.3%



## MARKET COMMENTARY (CONTINUED)

(Continued from page 1)

200% had you only put down \$100,000. You still owe the bank \$900,000, but your investment is now worth only \$800,000. Where do you get the extra \$100,000 to make the bank whole?

Might you have to sell stocks to cover your borrowing shortfall? It is a good source for cash, isn't it? Leverage works great for the borrower when investment returns are positive. But when investor returns are negative, leverage can force investors to liquidate investments in order to pay off debts.

More and more, investors are relying on leverage, or margin, as it is referred to in stock market parlance. As the table below outlines, borrowing has increased 60% since 2002, and now stands at levels never seen before.

The worrisome thing about this set of circumstances is

	NET	TOTAL	LEVERAGE	
ENDING	\$1.8 TRILLION	\$4.9 TRILLION	172.22%	Bridgewater Associates, Inc.
ESTIMATE	\$51.5 BILLION	\$317.3 BILLION	516.12%	Reuters Loan Pricing Corp.
DATA NET	\$134.58 BILLION	\$293.2 BILLION	117.86%	New York Stock Exchange
TOTAL	\$1.99 TRILLION	\$5.51 TRILLION	177.46%	
ESTIMATE TAND N	\$11.91 TRILLION	\$20.6 TRILLION	73.00%	Federal Reserve estimates
DETAILED	16.71%	26.75%	60.08%	

All sources referenced were cited in a *Wall Street Journal* article entitled "As Funds Leverage Up, Fears of Reckoning Rise" published April 30, 2007 on page A1.

not that the stock market looks bad. In fact, earnings are good and stocks are up nicely. No, what troubles us is the likely fallout if this global liquidity bubble bursts and investors have to sell to cover their debts.

Consider the case of Hedge Funds, the largest borrower of the groups cited in the table. Hedge Funds have exploded in popularity in recent years as investors have sought higher rates of return during a lackluster stock

market. One popular trade among them is to borrow money in Japan (where interest rates are low) and buy U.S. Treasuries. This is referred to in the press as the Yen Carry Trade and has been very profitable. Borrowing costs in Japan are about 0.5% and U.S. Treasuries yield about 4.5%. Considering these funds are using massive amounts of leverage, the 4% spread amounts to substantial percentage gains. If, however, anything changes (as happened in February, helping to trigger a one-day 500 point decline in the U.S. stock market), the Hedge Funds could stand to lose a lot of money very quickly. They would have to sell assets to cover their losses. Stocks are easy to sell, and as stock prices fall, more selling is triggered, and the effect becomes extremely exaggerated because of the massive amount of borrowing investors have used to finance investments.

Some say we are in a global bubble, much like the one we saw in real estate. When borrowing is easy and cheap, assets like stocks, bonds, commodities and real estate get

bid up in price. This is asset inflation. When and if interest rates rise, the unwinding can be very ugly. So even though we think the market, particularly the growth sector, is very attractive fundamentally, we are concerned about external circumstances. As a result, we believe it is now appropriate to be cautious. While we remain long-term growth investors, having plenty of cash will be helpful when (not if, in our view) stocks are sold to unravel this leveraged mess.



## COMMENTARY (CONTINUED)

(Continued from page 1)

- turns over the long-term.
2. We are not crazy to be growth investors (although we must have some deep-seeded need to suffer for our beliefs).
  3. Growth's 7-year underperformance is absolutely unprecedented.
  4. The market, from time-to-time, misprices securities. Identifying these situations when they occur leads to profitable investments, although there is no guarantee the market corrects a mispricing quickly.
  5. Our process identifies these securities very well.
  6. Growth is likely to have an equally long period of outperformance just to get back to the norm.
  7. We became too cautious in the types of stocks we bought.
  8. Large growth companies provide stable returns over time, while smaller growth companies often provide stellar (but less stable) returns overtime. A blend provides the best chance for stability and performance.
  9. Developing an automated system that removes the human element from the process creates a repeatable investment process.

All of these findings have proven themselves valuable to me, and I believe they will prove valuable to you as well. Outperforming a growth benchmark this decade is somewhat akin to kissing your sister. While nice, it hasn't proven to be terribly rewarding. Laboring to keep pace with the S&P in the face of such strong headwinds has been trying. But I learned early in my career that, at the end of the day, the best investor is the one that stays true to his or her style. We will undoubtedly again outperform value and other styles, and chasing the latest hot returns is a prescription for failure. We know growth, and we do it well. Seven years is a long time to wait for the sun to shine, but it will.

Johnson & Johnson is a terrific company, but owning it has hurt our performance. The same is true for General Electric, Wells Fargo, Amgen, Microsoft, BB&T and even BP. Investors have greeted multiple years of double digit earnings growth from these titans with a resounding yawn.

The TVM has provided us with several names worthy of

owning and the confidence to buy them. Some began showing up in your portfolios the two past quarters. Walgreens, Watts Water, Praxair, Brown Forman, Genentech, Hershey, Advisory Board, Canadian National Railway and Republic Services Group are all additions that have remarkable records of growth, but heretofore might have gone undetected by us. Our new systems permits us to be well-versed and current on nearly 3,000 companies!

As you have read in our market commentary, we are troubled by the investment landscape. Our research efforts are producing results we haven't seen since the late '90's when most stocks we screened seemed more worthy of selling than buying. While it is not that extreme today, it is close. Because of our trepidation, we have elected to own more companies in smaller amounts, as opposed to larger concentrations in fewer names.

As a result, we began to scale back in some holdings in January. The market correction in February put that effort on hold, but as the market rallied back to new highs, we resumed the process. With the market at its current levels, we have not yet put all of our cash to work. Again, the last time we held this much cash was at the end of the last decade, and that worked out pretty well.

If we get the pullback we expect, we will be adding more names that we like, and we will have the cash to do it without having to sell. In the meantime, the stocks we own are doing well, growth appears to be back in the limelight, and we expect to profit from this development.

The past ten months have reaffirmed my confidence that we are very good at what we do, but that what we do has not been adequately appreciated by the market. Frustration cannot be permitted to lead us astray. I look forward to sharing the story of TVM with you when it is completely ready for its grand unveiling. Until then, please know that we are working hard for you. We believe that our first and most important job is to preserve what you have entrusted to us. After ensuring that, we must provide you with competitive returns. Our stated purpose is to provide superior returns with less risk. Our efforts since last June have confirmed to me that we are doing the right things the right way, and we thank you for your support.

JBC





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*All performance figures, charts and graphs contained in this report are derived from publicly available sources believed to be reliable. Tandem makes no representation as to the accuracy of these numbers, nor should they be construed as any representation of past or future performance.*



*Because Working in Tandem  
is a Better Solution*

*Portfolio Management Since 1991*

*Equity*

*Equity/Income*

*Balanced*

*Fixed Income*

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