THE TANDEM REPORT

Volume XIV, Issue 2 April, 2013

"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:
STRONG MARKET LEADS TO RECORD HIGH

The S&P 500 ended the first quarter of 2013 at an all-time high. The index spent the latter half of March flirting with the record but was unable to eclipse the previous mark established in October, 2007 until the last trading day of the quarter.

Some observers suggest that the struggle to break through the old high could indicate a near-term top in the market. We see a trend emerging that could potentially sustain the market's rise for some time, although this trend paints a more concerning longer-term picture.

For the past few years the market has rallied in the first quarter. This year's rally has been the strongest. There were 60 trading days during the quarter. The S&P was down for only 23 of them. It was down 2 consecutive days only 4 times and 3 consecutive days only once. In other words, there were no real pullbacks. This is strong stuff.

While the S&P index rose a remarkable 10.0% in the quarter just ended, the advance was not uniform across all industry sectors. Health Care (up 15.2%), Consumer Staples (up 13.8%), Utilities (up 11.8%) and Consumer Discretionary (up 11.8%) were the clear winners. These sectors are typically favored by individual investors for their name recognition, perceived safety and enticing dividend yields.

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COMMENTARY: STOCKS WITH BIG DIVIDENDS CARRY MORE RISK THAN INVESTORS MAY REALIZE

We begin this commentary with a brief reminder. We do not invest for dividend yield. We invest for dividend growth. There is a big difference and we will discuss it in this commentary as well as in our analysis on page 4.

Federal Reserve policy has forced interest rates to historic lows, penalizing savers and retirees while rewarding borrowers. For those investors that seek current income, certain types of stocks have become better income vehicles than traditional fixed income investments likes bonds and CDs. A review of these types of stocks is in order.

There are three basic corporate structures for what we typically refer to as "stocks": Corporation (common stock), Real Estate Investment Trust (REIT) and Master Limited Partnership (MLP). Common stock is by far the most common. Under the present tax code REITs and MLPs are penalized for retaining earnings and thus pass through to investors most of their net cash flow. REITs typically invest in real estate and pay as dividends what essentially amounts to their net rental income. MLPs typically are in the energy industry and own transmission networks like pipelines. They pass through to investors the net income collected from transmission fees. Both REITs and MLPs also pass through any capital gains and losses the entity may incur. When they need capital to expand or fund growth, they borrow or sell new shares to the public. In recent years REITs and MLPs have become popular vehicles for income investors because their corporate structure lends itself to high dividend

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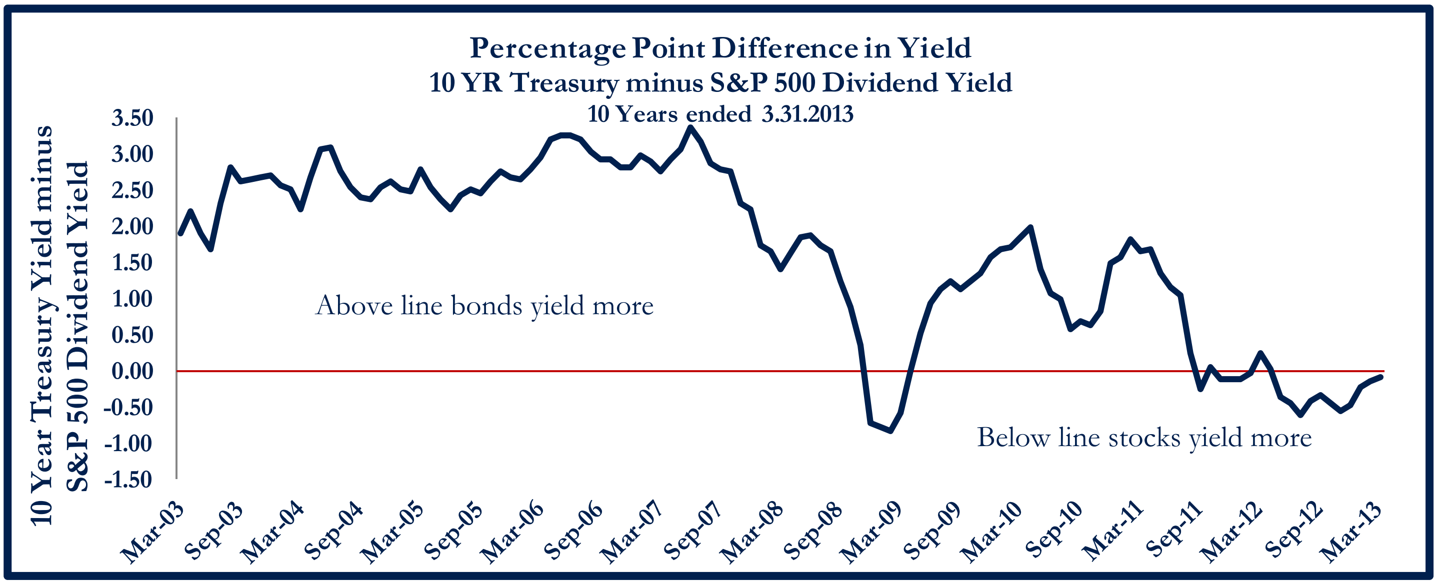
What appears different about this rally is that for the first time in years we may be seeing the market driven by the individual investor. It is certainly a possibility that institutional investors rotated out of the more aggressive sectors favored in quarters past and into these more defensive ones. But the fact that these sectors powered the market higher indicates to us that individuals more than institutions are behind this move. If this is so, the rally could prove more sustainable than most suspect.

Many folks over the years have preferred to avoid stocks in favor of CDs and bonds - instruments that pay fixed rates of return with a promise of a return of principal. As fixed rates have fallen to historically low levels, more investors have been forced to choose higher dividend paying stocks to replace the income lost from lower fixed rate investments. In fact, the chart below illustrates that stock dividend yields now exceed the fixed rate of the 10 year U.S. Treasury. Investors needing income are being forced into stocks will trend higher.

However, the long-term concern for us is that many of these folks finding their way into the market are not stock investors by choice. If and when rates rise, some of these investors will undoubtedly revert to their preferred fixed rate vehicles and take their money out of the stock market. When enough people reach the point where they believe that fixed rates are again satisfactory for their needs, stocks will come under selling pressure.

Think about the real estate market from 2003 - 2006. Most homeowners took advantage of low mortgage rates and refinanced their mortgages. Others realized they could buy more expensive homes because lower rates meant lower payments. This was not particularly harmful to the real estate market because it was essentially the same group of players in the market. However, low rates combined with rising real estate prices attracted new people to the marketplace, creating an increase in the number of buyers without substantially changing the supply of housing. People be-



The above chart illustrates the percentage point difference in yield on the 10 year U.S. Treasury and the dividend yield of the S&P 500. For most periods, the Treasury yield is higher. The financial meltdown and artificially low interest rates have turned this relationship upside down, making stocks more attractive for income than bonds.

the stock market and this will likely be sustained at some level until interest rates rise enough to make fixed rate investments appealing once again.

Because we believe that fixed rates will remain low for some time, we also believe that a rally fueled by the individual investor is sustainable. Many consumer companies, utilities and pharmaceuticals sport 3% - 4% dividend yields. A 6 – month CD yields about 0.27%. Fixed rates have considerable room to rise before they are once again competitive. As long as investors seeking yield turn to the stock market,

came "investors". As long as these new "investors" continued to participate prices continued to rise. But when the "investors" got shaken out of the market, the number of potential buyers was reduced once again to just the number of people looking for a primary residence. Prices plunged.

Today we may be confronting a similar situation in certain types of stocks - high dividend yielders like the ones presently driving the market higher. When these new investors leave, prices will fall. Our conclusion is that this market rally is sustainable, for awhile at least. But be careful out there.

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yields.

REITs and MLPs pay corporate income tax on earnings *after* dividends are paid. Companies that issue common stock pay taxes on their earnings *before* dividends are paid. Dividends for all three types of entities are taxable to the shareholder. Common stock dividends are essentially taxed twice, once at the corporate level and once at the shareholder level.

Unlike REITs and MLPs, common stock entities have the ability to retain all or a portion of their earnings to fund future corporate growth. How much of its earnings a company decides to retain versus pay out to shareholders as dividends helps determine its appeal to different groups of investors. For this discussion we will divide common stock into 3 broad groups based upon how much they retain versus pay as dividends:

1. No Dividend - retain all or nearly all of their earnings for corporate purposes and pay little or no dividends.
2. Modest Dividend - pay out a sustainable percentage of earnings in the form of dividends while retaining a significant portion of earnings for corporate purposes.
3. High Dividend - pay out a majority of earnings in the form of dividends and retain only modest amounts for corporate purposes.

Right now, the stock market run up is largely being fueled by investor demand for High Dividend stocks. In the recent past, MLPs and REITs have also experienced heady share price gains. Given the need to replace fixed rate income, this should come as little surprise. In fact, the surprise to us it that it has taken this long for these stocks to lead the way.

The S&P 500 made its most recent low on November 16th. Since that time the index has rallied 15.39% through the end of the quarter in price alone, not including dividends. Income stocks have performed even better.

On November 16th the S&P had a dividend yield (dividend amount divided by share price) of 2.30%. We looked at every stock in the S&P with a dividend yield between 2.30% and 3.50% as of the same date. There were 121 of them (out of 500 in the index). The average share price increase for this group was 19.35%, 4 full percentage points higher than the S&P as a whole. Clearly demand for these stocks exceeded demand for ones with smaller or no dividends.

The chart below illustrates a hypothetical 10% total return (including dividends) for the 3 types of stocks we are discussing. For a company that pays no dividend, 100% of its 10% return comes from share price appreciation. For a modest dividend payer, most of its return comes from share price appreciation. For a high dividend payer, a lot of its return comes from the dividend and the stock is less reliant than the others on share price appreciation.

When a group of dividend payers exhibit share price appreciation greater than the market, as we are presently experiencing, investors should take note. While this occurrence is not necessarily alarming, it likely isn't sustainable either. If this trend continues for very long, investors in high dividend payers may unwittingly be setting themselves up for

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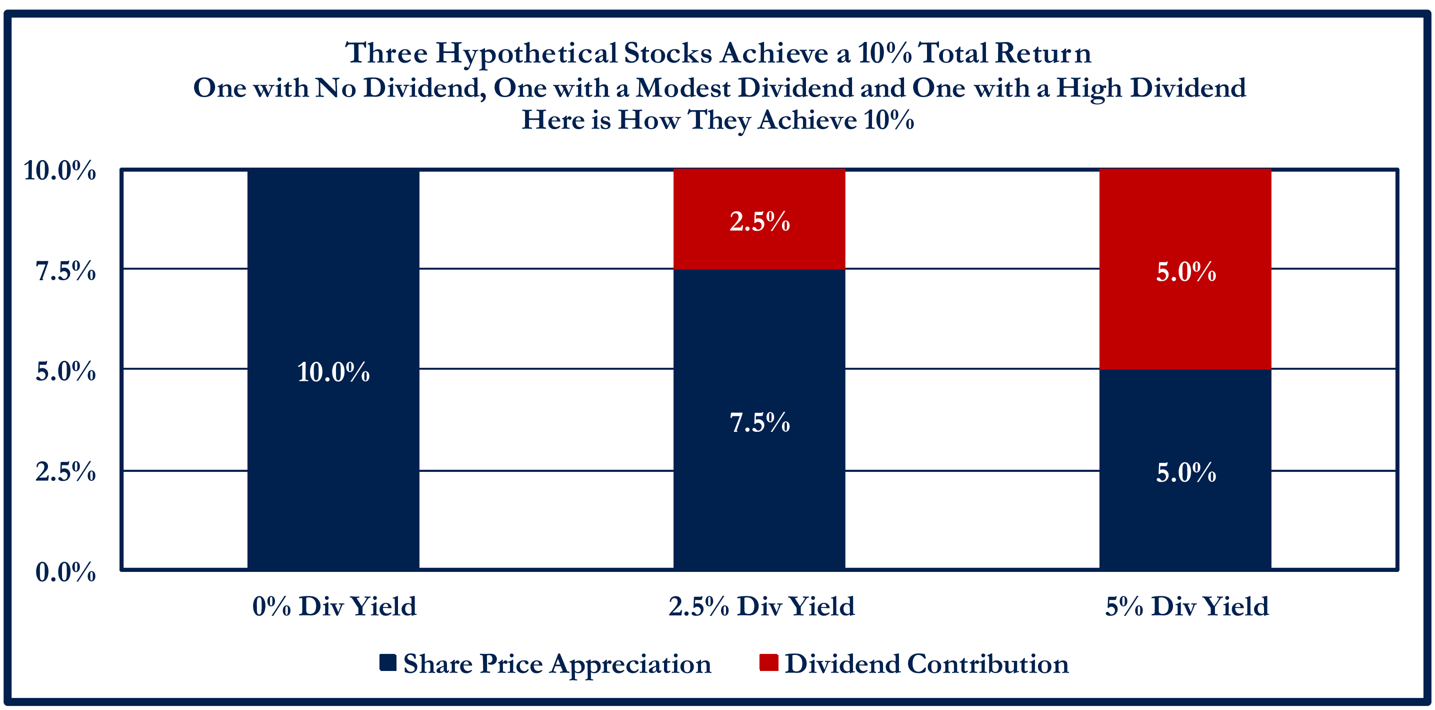

Analysis: The Importance of Dividend Growth, Not Dividend Yield

Since our founding over 22 years ago we have followed one basic investment tenet: companies that deliver consistent earnings and dividend growth through any economic environment will reward patient shareholders. The reward is not always immediate. To be sure, some markets over the years have been kinder to us than others. But over time, our clients have been rewarded by the companies we invest in on their behalf.

Much of this newsletter has been devoted to high dividend paying stocks and the hidden risks they pose to investors forced to seek income. Now we would like to focus on our belief that dividend growth trumps dividend income.

To help us make this point we have provided three scenarios involving two hypothetical companies, Company A and Company B. In all three scenarios, Company A is able to grow its dividend by 15% annually while Company B only grows its by 5% annually. You may ask why one would grow dividends faster than another. If you refer back to our Commentary on page 3, you will recall that some companies pay out a large percentage of their earning to shareholders in the form of dividends, leaving less capital available to invest for future growth. Without investment, corporate growth is likely to be moderate at best, sporadic more likely. So with less corporate growth there is less earnings growth and therefore less dividend growth. Other companies pay out a smaller portion of their earnings and retain enough to fuel future growth, thereby insuring future dividend growth as well. In our examples, Company A retains more for future growth while Company B pays out more of its earnings as dividends.

The scenarios we paint involve interest rates. Stock prices are generally sensitive to interest rates. Think about it. If

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Scenario 1: Prevailing interest rates rise from 2.5% to 5.0% over a 5 year period.

Rising Interest Rates		Company A 15% per Yr Dividend Growth		Company B 5% per Yr Dividend Growth	
	Prevailing Interest Rate	**Dividend**	**Implied Price**	**Dividend**	**Implied Price**
Initial	2.50%	$0.25	$10.00	$0.25	$10.00
Year 1	3.00%	$0.29	$9.58	$0.26	$8.75
Year 2	3.50%	$0.33	$9.45	$0.28	$7.88
Year 3	4.00%	$0.38	$9.51	$0.29	$7.24
Year 4	4.50%	$0.44	$9.72	$0.30	$6.75
Year 5	5.00%	$0.50	$10.06	$0.31	$6.20

Scenario 2: Prevailing interest rates remain constant at 2.5% over a 5 year period.

Stable Interest Rates		Company A 15% per Yr Dividend Growth		Company B 5% per Yr Dividend Growth	
	Prevailing Interest Rate	**Dividend**	**Implied Price**	**Dividend**	**Implied Price**
Initial	2.50%	$0.25	$10.00	$0.25	$10.00
Year 1	2.50%	$0.29	$11.50	$0.26	$10.50
Year 2	2.50%	$0.33	$13.23	$0.28	$11.03
Year 3	2.50%	$0.38	$15.21	$0.29	$11.58
Year 4	2.50%	$0.44	$17.49	$0.30	$12.16
Year 5	2.50%	$0.50	$20.11	$0.32	$12.76

Scenario 3: Prevailing interest rates decline from 5.0% to 2.5% over a 5 year period.

Falling Interest Rates		Company A 15% per Yr Dividend Growth		Company B 5% per Yr Dividend Growth	
	Prevailing Interest Rate	**Dividend**	**Implied Price**	**Dividend**	**Implied Price**
Initial	5.00%	$0.25	$5.00	$0.25	$5.00
Year 1	4.50%	$0.29	$6.39	$0.26	$5.83
Year 2	4.00%	$0.33	$8.27	$0.28	$6.89
Year 3	3.50%	$0.38	$10.86	$0.29	$8.27
Year 4	3.00%	$0.44	$14.58	$0.30	$10.13
Year 5	2.50%	$0.50	$20.11	$0.32	$12.76

COMMENTARY (CONTINUED)

(Continued from page 3)

more risk than they contemplate. Another example may prove helpful.

Dividend per Share	Price per Share	Dividend Yield
$0.50	$10.00	5.00%
$0.50	$11.00	4.55%
$0.50	$12.00	4.17%
$0.50	$13.00	3.85%
$0.50	$14.00	3.57%
$0.50	$15.00	3.33%
$0.50	$16.00	3.13%
$0.50	$17.00	2.94%
$0.50	$18.00	2.78%
$0.50	$19.00	2.63%
$0.50	$20.00	2.50%

The table to the right illustrates what happens to dividend yield as share price appreciates. If the stock price were to double from $10 to $20 and the $0.50 dividend were to remain constant, the dividend yield would be halved to 2.50%. Too much appreciation without a similar dividend increase can be problematic for high dividend stocks. If competing interest rates rise, these stock prices are too high and must go lower in order to bring the yield back in line with higher prevailing rates.

Have a look at the table from bottom to top to imagine what might happen if rates were to rise from 2.50% to 5.00%. In this example, the stock price would be cut in half. Too many investors seeking income fail to realize that the more dividend yield contributes to total return (think back to the chart on page 3) the more excessive share price gains add risk for the investor when rates rise.

For the last 30 years, rates have generally moved in only one direction - lower. Eventually, that trend will reverse itself. Income stocks have attracted a group of investors that typically do not prefer stocks but have been forced into them by low interest rates. If interest rates rise to more appealing levels, this group of investors will bear fully the risk of stocks that rely heavily on dividend yield for total return. As the table on the left indicates, prices rise when yields fall but prices fall when yields rise.

Remember that by nature these high dividend payers are reinvesting only a fraction of their earnings to fund corporate growth. Most of their earnings go to shareholders in the form of dividends. When companies neglect growth, their earnings don't grow and thus their dividends don't grow. At least not enough to compensate for rising interest rates.

We discuss the importance of dividend growth in our Analysis on the preceding page. Investors that need current income may be relying too much on immediate gratification at the expense of future capital preservation.

ANALYSIS (CONTINUED)

(Continued from page 4)

you could receive 100% on a federally insured CD, why would you ever bother to own a stock? Conversely, if CDs offered a 0% return and were not guaranteed, why would you ever own a CD? Reality lies somewhere between these two extremes and therefore investors must decide between the certainty of fixed rates and the variability of the stock market. Higher fixed rates attract more investors than do lower rates. And stock prices adjust accordingly.

The first scenario we create on the preceding page is in our view the most likely. We contemplate a steady rise in interest rates from 2.5% to 5.0% over a five year period. The stock prices and dividends of Company A and Company B start out the same and reflect a 2.5% dividend yield. As rates begin to rise, both companies experience an initial stock price decline. However, Company A's dividend growth catches up to the rise in rates and results in a modest share price gain. Company B cannot grow its dividend enough to stabilize its stock price as rates rise, resulting in a nearly 40% price decline in our example. Healthy dividend increases clearly provide a better investment when interest rates rise.

The second scenario considers an environment in which interest rates do not change. Assuming no change in dividend yield as a result, Company A wins again because its higher dividend over time justifies a significantly higher stock price.

In the final scenario we contemplate rates declining from 5.0% to 2.5% over a five year period. The stock prices both increase, but Company A experiences a 4 fold gain while Company B experiences little better than half of that. Again, healthy dividend increases prove a better investment.

While we recognize that these examples and scenarios are imperfect in that they only contemplate changes in interest rates, the math is correct. All things being equal, dividend growth in modest dividend payers (page 3) trumps high dividends that do not grow as much over time.

It is tempting in today's environment to seek high dividends. Immediate income gratification is not without its consequences. Although the dividend amounts started out the same in our examples, the greater dividend growth resulted in greater *future* income and more price stability.

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MARKET REPORT CARD

Yield Table			
	Current	3 months ago	1 year ago
3-month Treasury Bill	0.09%	0.07%	0.07%
5-year Treasury Note	0.82%	0.70%	1.04%
10-year Treasury Bond	1.96%	1.72%	2.21%
30-year Treasury Bond	3.16%	2.88%	3.34%
Prime Rate	3.25%	3.25%	3.25%
Federal Funds Rate	0.14%	0.16%	0.10%
Discount Rate	0.75%	0.75%	0.75%
3-Month LIBOR	0.28%	0.31%	0.47%

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				
	3/31/13 Close	% Change 1 Year	% Change 3 Years	% Change 5 Years
S&P 500	1,569.19	11.41%	34.18%	18.64%
Dow Jones Industrial	14,578.54	10.34%	34.28%	18.88%
NASDAQ	3,267.52	5.69%	36.26%	43.37%
Russell 2000	951.54	14.60%	40.21%	38.31%
German Xetra DAX	7,795.31	12.21%	26.68%	19.29%
London FTSE 100	6,411.74	11.15%	12.89%	12.45%
Shanghai Composite	2,236.30	-1.17%	-28.07%	-35.60%
Crude Oil	$97.23	-5.60%	16.08%	-4.28%
Gold	$1,598.20	-3.87%	43.27%	71.21%
CRB Index	296.39	-3.91%	8.43%	-23.39%
U.S. Dollar Index	83.00	5.13%	2.34%	15.47%
Euro/Dollar*	128.11	-3.99%	-5.13%	-18.67%

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

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