THE TANDEM REPORT

Volume XIII, Issue 1 January, 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 informative.

Respectfully,

John B. Carew
President,
Chief Investment Officer

In This Issue

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.

MARKET COMMENTARY:

U.S. STOCKS ENDED THE YEAR UNCHANGED. REALLY? IT SURE FELT A LOT WORSE. WE WILL TRY TO ADD SOME PERSPECTIVE.

Hopefully you have been paying attention to your statements because we had a pretty good year. But if you didn't pay attention to the stock market as a whole in 2011, you didn't miss a darn thing. For those of you that followed the markets closely, the year was much like a roller coaster - a ride that begins and ends in the same place but both thrills and frightens along the way. The S&P 500 began the year at 1,257.64. It ended the year at 1,257.60.

In between, the S&P hit a post-crisis high of 1,363.61 on April 29th for a gain of 8.43% on the year. A good start to be sure. Yet much like the initial mild ascent of a roller coaster, the calm belied the thrills ahead. The market moved mostly downward from its high, falling 19.39% to 1,099.23 by October 3rd. The S&P went from up over 8% to down over 12.5% for the year within a span of 5 months. Then, it all turned on a dime, gaining more than 14% in the last 3 months to close the year flat. You were probably better off not paying attention.

Investors were asked to navigate a mine field in 2011. From the Arab Spring to the Debt Ceiling debacle and the ensuing U.S. credit downgrade to the Iranian challenge, trouble reared its head at every turn. Miraculously, the U.S. economy managed to muddle through better than most expected. Perhaps the U.S. was simply the best of a bad lot, but our economy and our markets managed to outperform most others around the globe.

In spite of the incessant volatility we experienced, the year could have been a lot worse. Ordinarily this is the time of year that we as portfolio managers look back to see what we learned, what we got wrong and what we got right. Frankly, we are not sure there is much to be learned from 2011. We think the picture is bigger than just one year.

As frequent readers know, the U.S. stock market has essentially done nothing since the bursting of the Tech Bubble. Many bright folks predict more troubling times ahead. Not convinced that two stock market declines of 50% within a decade have effectively priced in a poor global economy, they foresee a looming financial crisis triggered by the collapse of the Euro zone,

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COMMENTARY:

WHY FUNDAMENTALS MATTER WHEN ENTHUSIASM WANES

Imagine that you have been transported back to January, 2008. The names Bear Sterns, Lehman, Fannie Mae, Freddie Mac, AIG and Ben Bernanke mean nothing to you. You just refinanced your house again and have a little extra cash left over from the kitchen remodel and you are thinking about investing it. The stock market has been a little bumpy lately but maybe a few stocks are starting to look cheap to you.

You decide to do a little research and come across a company you know and see that the stock price is down about 15% from its recent high. It grew earnings 47% last year and everyone expects it to con-

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its currency, its governments and its banks. They tell us that such a catastrophe will surely spread to our shores, where our economy is still burdened by debts it cannot hope to repay. Perhaps. Other respected pontificators see the glass as half full, believing that U.S. markets are fairly or even cheaply valued and will attract capital because our troubles are behind us and our economy is once again a safe haven. Possibly.

It strikes us that this tug-of-war between despair and hope is symptomatic of a trendless market. The page to the right identifies 5 distinct periods of time of the Dow Jones Industrial Average going back to 1928. While certainly not scientific, this study is informative nonetheless. The original purpose of this exercise was to identify those extended periods of time in the Dow's history marked by steadily increasing prices with every pullback marking a higher low. We found two. The first was the post-war period from 1949 - 1965, which lasted 16 1/2 years and saw the Dow gain 452%. The second began at the end of 1981 and lasted 18 years with the Dow rising 1,214%. These two periods account for 34 1/2 years out of 83. The rest of the time was spent much like the market we find ourselves in presently.

While the remaining 3 periods have experienced varying durations and returns, they are marked by extreme volatility, steep declines followed by sharp increases with the index ultimately going nowhere. And they seem to last for quite some time. We are presently 12 years into the current malaise. The Depression understandably experienced the longest duration and greatest decline. We think there are more similarities between the present market and the one from 1965 - 1981, which lasted 16 years. If we are correct, our market today will likely remain trendless for a few more years. We may go up or down (or both), but it seems improbable that either direction will become a lasting trend until other trends begin to reverse themselves, clearing the decks for a prolonged and eagerly awaited Bull market.

What other trends need to reverse themselves you ask? Last quarter's report devoted attention to unemployment. A clear descending pattern of unemployment must emerge before the stock market can feel comfortable about the future. But there is another trend we haven't discussed lately that is also important. It is the most simple and elegant economic concept of all - supply and demand.

Each year, the National Association of College and University Business Officers (NACUBO) releases its study of U.S. and Canadian College and University endowments and foundations (www.nacubo.org). We have culled this data and observed that since 1999, endowments have consistently reduced their holdings in U.S. equities. In 1999, NACUBO reported that their member institutions allocated 53% of their investment portfolios to U.S. stocks. By 2010 (the most recent data), that allocation had declined to 30% (See chart below). At the same time, their allocations to non-U.S. stocks rose from 11% to 16% and their allocation to "alternatives" (mostly hedge funds) went from 5% to 26%. There is anecdotal evidence suggesting that other institutions and individual investors have behaved similarly.

A consequence of this move away from U.S. stocks by investors is a corresponding decline in the value of the U.S. dollar, as evidenced by the dollar index in the chart at the bottom of this page. As allocations to U.S. Equities have steadily decreased (gold diamonds on the chart), the value of the dollar Index (blue line) declined as well.

While we certainly do not correlate the dollar's decline exclusively with this investing trend, we do believe there is a relationship. In fact, the relationship is circular. The more the dollar declines, the more attractive non-U.S. investments become. The more attractive non-U.S. investments

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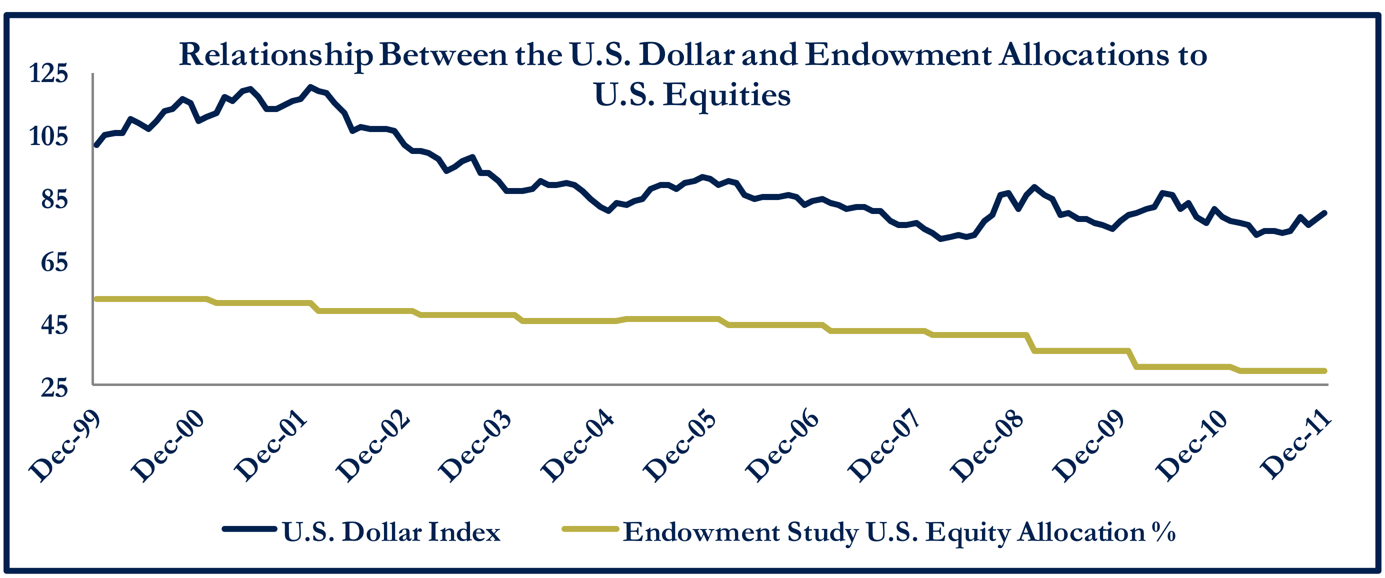


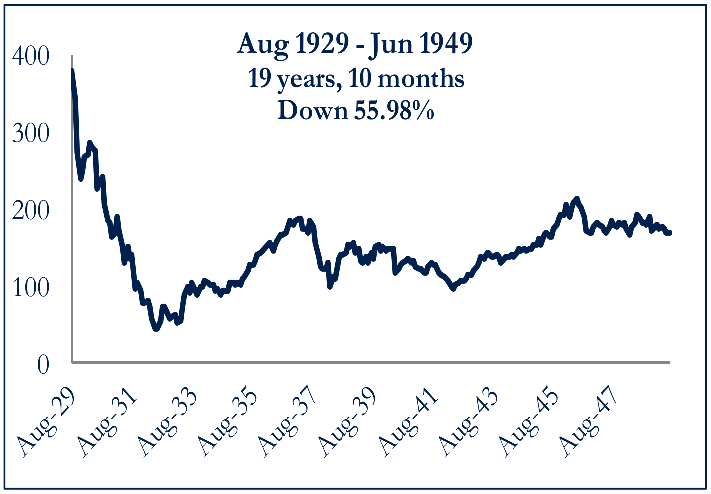
Dow Jones Industrial Average 1928 - 2011

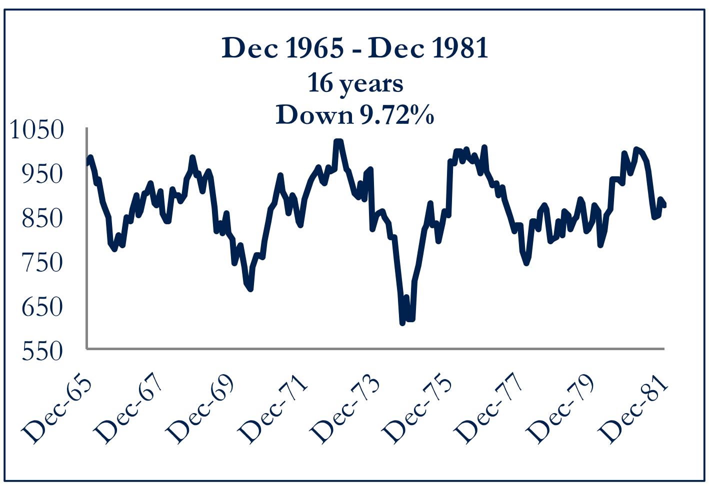
A look at the history of the Dow Jones Industrial Average since 1928 identifies five distinct periods. The three charts on the left side exhibit trendlessness. The nearly 20 years after 1929 suffered a substantial overall decline, yet nearly all of that came in the first 2 years. The second period lasted 16 years and experienced a modest decline over the full period. We find ourselves in the midst of the third trendless period with the outcome and duration yet to be determined.

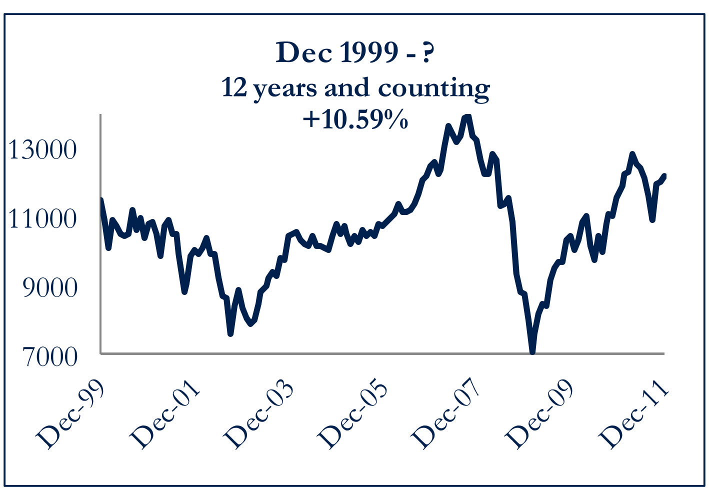
There are two extended periods of a steadily rising market covering 16 1/2 years and 18 years respectively. The chart at the bottom right covers all 83 years and clearly shows that, overtime, the stock market has an upward bias.

If history is to be a guide, we should expect a few more years of a trendless market. There will be ups and downs, but likely no real direction until the next uptrend begins.

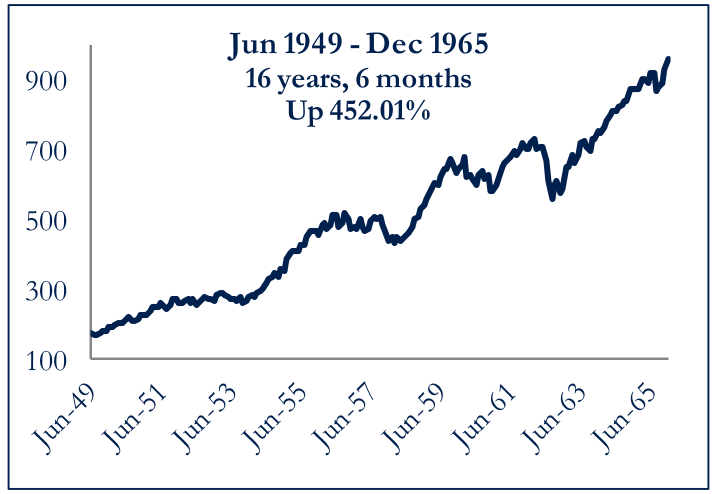
Trendless Markets

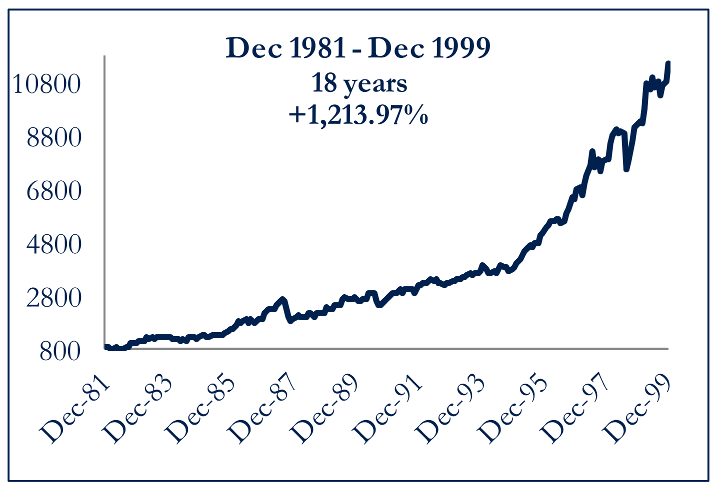


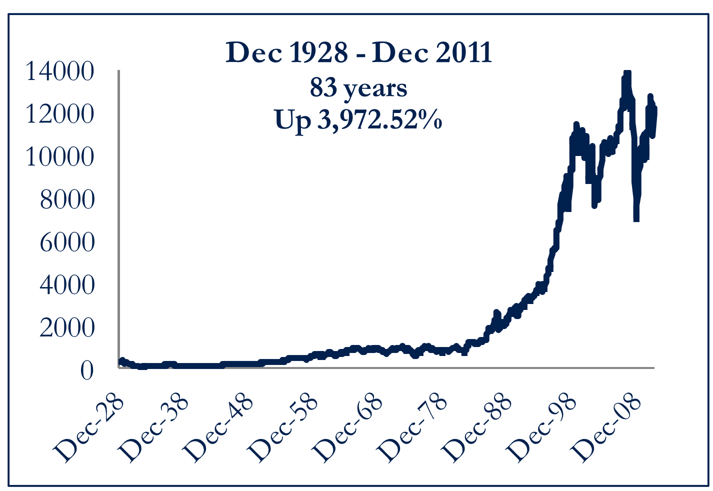




Upward Trending Markets







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tinue to grow spectacularly. So you take the plunge and pay $691/share for Google.

Now you are back to the present and decide to check on your investment. You discover that over the past four years, Google has managed to grow earnings by an eye-popping 137%. Because you know that fundamentals matter, you are quite pleased with your company's performance. So you check the stock price to calculate your wealth and you discover that you have lost money! Google is now trading for only $645/share. How could this happen to you when your company performed so well?

This happens to investors whenever we pay too much for an asset. None of us are immune and we certainly do not mean to pick on Google. But for perspective, just ask any homeowner that bought a house between 2003 and 2008 if price matters. Herein lies perhaps the most important lesson for investors - prices keep going up until they don't, and then they fall. Period. Pay a reasonable price for a good asset and your investment will fall less and recover sooner.

Investors should always try to buy good assets at sale prices because eventually the market will put everything on sale. Identifying a good asset is not hard. Google is clearly a good asset. Identifying a reasonable price is much harder. In the tables below, we take a look at the most popular valuation tool available to the average investor. The Price/Earnings Ratio, or PE, can provide a quick valuation for most stocks. Dividing a stocks price by its earnings per share gives you a ratio that tells you how much investors are willing to pay per share for $1 of corporate earnings. Different types of companies often have different PE's, but a quick rule of thumb is that the higher the PE, the more expensive the stock.

For the 3 years leading up to your hypothetical purchase of Google, the stock had traded in a PE range of 30 - 64. Your purchase price of $691 indicated a PE of about 44, right in the middle of the range. So perhaps this seemed reasonable at the time. But the stock had experienced impressive but slowing earnings growth. As a newly minted public company, Google experienced triple-digit annual earnings growth. The stock was priced to reflect that pace. However, as the company grew, earnings naturally slowed to a more sustainable level and the PE at 44 reflected continued optimism, not reality.

As you can see from the table on the left below, Google's PE fell from 44.38 at the end of 2007 to 17.52 at the end of 2011, even though earnings grew 136.65%. As investors' enthusiasm for Google's prospects dampened, the price fell 6.59%. The same thing happened to nearly every stock in both tables. PE's contracted universally because investor optimism has waned. As a result of the public valuing a $1 of corporate earnings less today than they did 4 years ago, all 20 companies experienced PE contraction. Only 2 of the

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10 Largest Stocks in the S&P 500 by Market Capitalization as of 12.31.2007

	2007 PE	2011 PE	PE Change	Earnings Growth	Price Change
Exxon Mobil	12.87	9.90	-23.06%	17.58%	-9.53%
GE	17.32	13.07	-24.53%	-35.98%	-51.69%
Microsoft	19.45	9.61	-50.58%	47.54%	-27.08%
AT&T	15.00	13.50	-10.02%	-19.13%	-27.24%
P & G	22.45	17.02	-24.21%	19.88%	-9.14%
Google	44.38	17.52	-60.53%	136.65%	-6.59%
Chevron	11.12	7.68	-30.94%	65.08%	14.00%
J & J	16.07	13.20	-17.90%	19.76%	-1.68%
Wal-Mart	15.19	13.31	-12.35%	43.45%	25.73%
Bank America	12.28	NA	NA	NA	-86.52%
Average	**18.61**	**12.76**	**-28.23%**	**19.60%**	**-17.97%**
S&P 500	**17.03**	**12.99**	**-23.74%**	**12.31%**	**-14.35%**

10 Largest Positions held by Tandem Accounts as of 12.31.2007 and still widely held as of 12.31.2011

	2007 PE	2011 PE	PE Change	Earnings Growth	Price Change
Exxon Mobil	12.87	9.90	-23.06%	17.58%	-9.53%
T. Rowe Price	25.37	19.71	-22.32%	20.42%	-6.46%
Microsoft	19.45	9.61	-50.58%	47.54%	-27.08%
Gen'l Dynam	17.45	9.19	-47.36%	41.76%	-25.37%
Repub Serv	18.89	14.65	-22.40%	13.25%	-12.12%
Praxair	24.51	19.65	-19.81%	50.28%	20.51%
Colgate	23.07	18.37	-20.37%	48.82%	18.51%
Coca Cola	22.73	18.27	-19.63%	41.85%	14.01%
Abbott Labs	19.91	12.09	-39.27%	64.89%	0.14%
ThermoFisher	21.77	10.89	-49.97%	55.85%	-22.04%
Average	**20.60**	**14.23**	**-31.48%**	40.22%	**-4.94%**
S&P 500	**17.03**	**12.99**	**-23.74%**	12.31%	**-14.35%**

MARKET COMMENTARY (CONTINUED)

(Continued from page 2)

become, the more the dollar declines. Such a trend decreases demand for U.S. stocks. According to economic theory, price must decline to offset a drop in demand. In some respects, it is remarkable that the U.S. stock market has held up in spite of this dramatic decrease in demand.

The Bull market of the 1980's and 1990's experienced the opposite. For many reasons, demand for U.S. stocks grew during this period, but a strengthening dollar certainly helped attract assets. Perhaps the biggest reason for increased demand was the acceptance of the IRA and 401(k) as common retirement vehicles. Prior to the 1980's, most workers had what are known as Defined Benefit plans. Employers promised a certain amount at retirement. IRAs and 401(k)s are Defined Contribution plans. Employers and employees are permitted to contribute a certain amount and invest as they see fit without a guaranteed outcome. Most participants invested in stocks through mutual funds.

As retirement account assets exploded from practically zero, the U.S. stock market benefitted from increased demand. Again according to economic theory, prices must rise when demand increases. And did they ever! See the chart on page 3 for the period 1981 - 1999. By 1999, new IRA and 401(k) contributions were no longer enough to drive prices higher. Demand began to taper off and the Tech Bubble caused many to invest elsewhere.

So it seems to us that no lasting period of stock market growth can occur until we see a noticeable pick up in demand for U.S. stocks. One clue to that might be the performance of the dollar. When the trend of investing offshore reverses, our market could be in for another extended run. Unfortunately, there is little on the horizon to give us hope that such a reversal is imminent. But it will surely come. It always does. Until then, look for more sideways action. In fact, if you don't pay attention for another few years, you might just think the market never moved. Those of us that watch every day will know differently.

Be assured that we are in no way pessimistic about investing. When stock markets go up, all investors look brilliant. When stock markets are trendless, we just have to work a little harder. Check your statements. It can be done.

COMMENTARY (CONTINUED)

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10 S&P stocks (Chevron and Wal-Mart) and 4 of the 10 Tandem stocks (Praxair, Colgate, Coke and Abbott) experienced price gains over this 4-year period. The S&P 500 had a 24% PE decline and a 14% price decline.

When PE's decline, prices usually fall. Think about it. A stock earns $1 and has a PE of 10. The price then is $10. If the same company still earns $1 but the PE falls to 5, the stock price falls to $5.

The best way to combat contracting PE's is to own companies that grow earnings substantially faster than their PE's contract. Using the example above, a company grows earnings from $1 to $2 while the PE falls from 10 to 5. That company would have a price of $10. Praxair was the best performing stock on either list to the left. While the company's PE contracted by 19.81%, its earnings grew by 50.20%. Colgate, Coke, Abbott, Wal-Mart and Chevron experienced similar results. The rest failed to deliver earnings growth that matched the optimism of four years earlier. It is not that they did not grow earnings, because most did (all Tandem stocks did). Rather, they were simply priced higher 4 years earlier than warranted.

There is another way to counter PE contraction - dividend growth. We have written previously on the importance of dividend growth and will limit that topic here to a reminder that growing income can offset declines in price and PE.

As we discuss in *Market Commentary* on page 1, we appear to be in a market characterized by prolonged investor indifference. In 2007, PE's were much higher than now. In 1999, PE's were even higher because investors had a greater level of enthusiasm for stocks. Today they are more skeptical and PE's are significantly lower.

We expect PE's to continue to contract for as long as we remain in this trendless market. This is not bad news. The "market" isn't likely to do much, but certain stocks are capable of performing quite well because expectations have become more modest. With PE's significantly lower, quality earnings growth is more likely to be reflected in future stock prices. While we are *not* recommending Google, it is clearly easier for the stock price to rise over the next 4 years with a PE of 17.52 than it was when its PE was 44.

In a stock market lacking investor enthusiasm and demand, fundamentals matter. In a Bull Market, we all buy "good" companies and let them run. In a trendless market, we need more. We need companies that can deliver to shareholders the things management can control - earnings growth and dividend growth. And we need to pay a reasonable price for them. PE's will trend lower, so companies really have to deliver in spite of the economic headwinds they face. These are the types of companies that can make this market worthy of investment.

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MARKET REPORT CARD

YIELD TABLE	Current	3 months ago	1 year ago
3-month Treasury Bill	0.01%	0.01%	0.13%
5-year Treasury Note	0.88%	0.95%	2.00%
10-year Treasury Bond	1.95%	1.92%	3.33%
30-year Treasury Bond	2.98%	2.91%	4.40%
Prime Rate	3.25%	3.25%	3.25%
Federal Funds Rate	0.07%	0.08%	0.20%
Discount Rate	0.75%	0.75%	0.75%
3-Month LIBOR	0.58%	0.37%	0.30%

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

	12/31/11 Close	% Change 1 Year	% Change 5 Years	% Change 10 Years
S&P 500	1,257.60	0.00%	-11.33%	9.54%
Dow Jones Industrial	12,217.56	5.53%	-1.97%	21.91%
NASDAQ	2,605.15	-1.80%	7.86%	33.57%
Russell 2000	740.92	-5.45%	-5.93%	51.67%
German Xetra DAX	5,898.35	-14.69%	-10.59%	14.31%
London FTSE 100	5,572.28	-5.55%	-10.43%	6.80%
Shanghai Composite	2,333.41	-16.90%	-12.79%	41.77%
Crude Oil	$98.83	8.15%	61.88%	399.90%
Gold	$1,570.00	11.70%	148.42%	467.81%
CRB Index	305.30	-8.26%	-0.64%	59.08%
U.S. Dollar Index	80.18	1.55%	-4.15%	-31.32%
Dollar/Euro*	129.55	-3.23%	-1.80%	45.50%

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

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