

# The **TANDEM** Report



Volume 5, Issue 3, July, 2004

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## MARKET SCORECARD:

S&P 500:

Annualized returns:

1 year ended 6/30/04	17.07%
3 years ended 6/30/04	-2.33%
5 years ended 6/30/04	-3.64%
7 years ended 6/30/04	3.70%
10 years ended 6/30/04	9.91%

## MARKET COMMENTARY: DOES THE REWARD JUSTIFY THE RISK?

Investors are an illogical group. The only thing one can reasonably expect of their behavior is that which is least expected. How else can we explain the current goings on inside the mystery that is the market?

Positive news abounds. Job growth exceeds expectations, corporate profits are rising, and the economy is growing at better than a 4% clip. Ah, but lest we get too intoxicated by all this good fortune, we need only remind ourselves that we are at war (one with ever-decreasing popularity - if war is ever popular), that interest rates are rising, and that we are in the middle of an election cycle. At least the political uncertainty will be settled in November. Or will it?

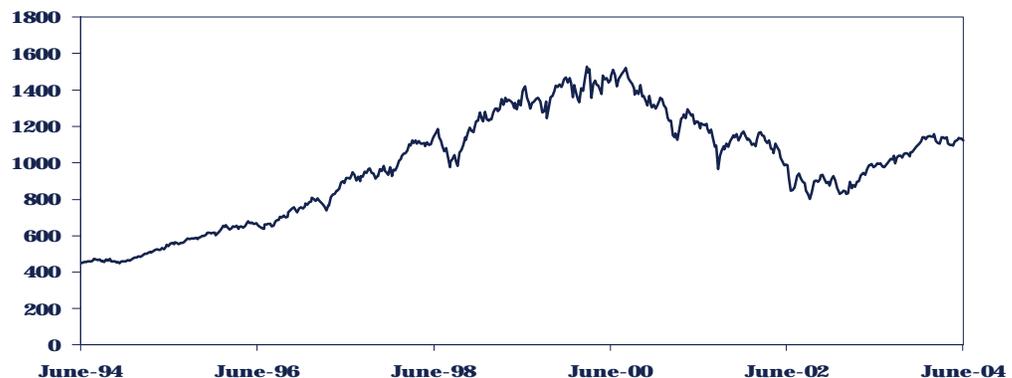
Historically, investors have gravitated toward blue chips in times such as

these. Historically, but not now. Quality issues remain unloved by most mutual fund portfolios. More speculative investments are reaping what rewards there are to be handed out. The old adage that the market climbs a wall of worry is tried and true. Yet it seems only to apply in this instance to shares of quality companies.

It is well documented by academic study that investors chase yesterday's best performance, only to be disappointed by arriving too late. A study of mutual fund investors found that while the average fund did quite well, the average investor realized less than half of any given fund's return. At first glance, this seems illogical. But the reason for this gross misfortune is simple. Investors pile in *after* the fund has achieved superior results, and flee

(Continued on page 5)

### Ten Year Chart of the S&P 500



# TOP TEN HOLDINGS IN THE TANDEM EQUITY COMPOSITE

AS OF JUNE 30, 2004

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 Composite. These are not recommendations for purchase. Rather, the list is simply intended to provide some insight into how we manage accounts.

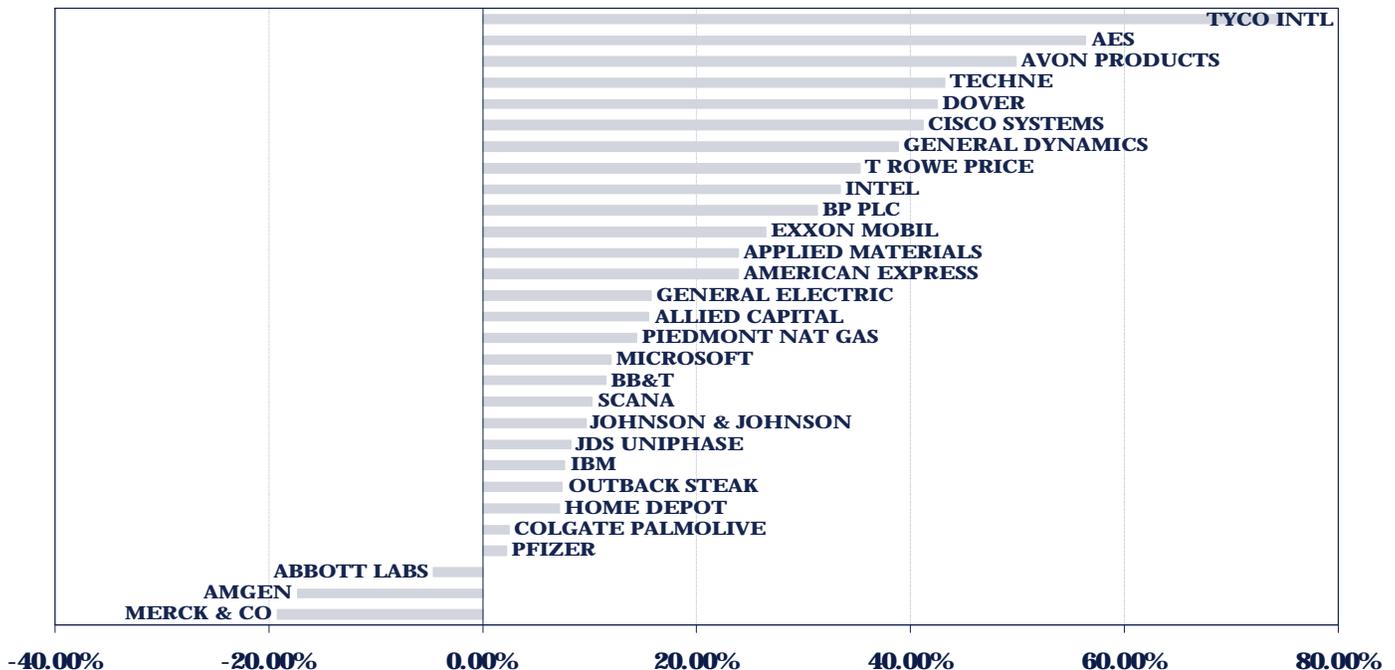
## Rank by Performance of the Top Ten Holdings in the Equity Composite for the Period 6/30/2003 - 6/30/2004

### Rank by Market Value      Original Purchase

1. Microsoft Corp.	12/06/96
2. Johnson & Johnson	06/03/97
3. General Electric	07/08/94
4. Home Depot	06/03/99
5. General Dynamics	11/13/01
6. Pfizer, Inc.	12/18/96
7. Amgen	10/31/96
8. Exxon Mobil	11/08/94
9. Colgate Palmolive	10/31/00
10. Cisco Systems	02/06/97

Company	Appreciation	Dividend	Total Return
Cisco Systems	41.16%	\$0.00	41.16%
General Dynamics	36.97%	\$1.32	38.79%
Exxon Mobil	23.67%	\$1.02	26.51%
General Electric	12.97%	\$0.79	15.73%
Microsoft	11.39%	\$0.16	12.01%
Johnson & Johnson	7.74%	\$1.005	9.68%
Home Depot	6.28%	\$0.295	7.17%
Colgate Palmolive	0.86%	\$0.96	2.52%
Pfizer	0.38%	\$0.64	2.25%
Amgen	-17.24%	\$0.00	-17.24%

## Total Return of all Stocks Held in Composite for 6/30/03 - 6/30/04



## REVIEW OF THE COMPOSITE

Observing the twelve month returns of the stocks held for at least one year in our composite sheds some light on what has been rewarded by the market, and what has not. We will begin with what has not.

Pharmaceutical stocks continue to struggle. The four worst performers in the composite illustrate this vividly. The environment is difficult, and likely to remain so for awhile. Frustratingly, the fundamental operations of our companies remain strong. In fact, their valuations seem as compelling as those of any group we follow. External influences are taking their toll on the prices of these stocks. With all the political chatter about price controls and importing drugs from foreign countries, investors have been frightened off. And understandably so.

While there are many reasoned arguments to be made about the high cost of prescription drugs, it occurs to us that prices across the entire health care

spectrum are absurdly high, yet no one, to our knowledge, is complaining loudly about the cost of a prosthetic hip or knee, or the obscene profits being made by medical supply companies. Could it be that Americans feel the sting of drug costs more, because most of us incur that cost, while our insurance pays for everything else? Without climbing up on a soap box, we are once again reminded that you can't fight Washington. Or is it City Hall?

To be sure, we still find these beleaguered stocks attractive, and remain committed to them. However, there are easier ways to make money right now, and we are actively pursuing them. We have been adding positions in companies not under the political microscope, names like Biomet or Techn. Without question, the most cost-effective way to treat illness is through medication - not procedure. But our health care system doesn't seem to perceive

that. So, without jettisoning the underperforming blue chips, we will continue to add names less likely to be impacted by new federal regulation.

So what is working, you ask? Interestingly, fallen angels finding their footing. The best performing stocks we own include Tyco, AES, Dover and Cisco. The common thread is that each fell on hard times, some of their own doing, some not. But business has recovered nicely, and investors have warmed to these shares again. Technology still has its detractors, but the shares of Cisco, Intel, Microsoft and Applied Materials have seemingly awoken.

Obviously, defense companies have had the wind at their backs of late. General Dynamics has achieved remarkable results, and we have added a new name to our portfolio, Engineered Support Systems, that

will likely benefit from increased military spending for years to come. Oil stocks have been solid as well, and we expect that trend to continue. BP

and Exxon Mobil are solid citizens in our portfolio, and have been for some time. And its nice to see our old friend T. Rowe Price benefiting from the market's recovery. One stock we expect great things from that has yet to fulfill its promise is Home Depot. More than half the stocks we own in the composite have outperformed the S&P 500 for the last twelve months, and that is why it is important to have a good portfolio. Not all do well at the same time, but they certainly should over time.

It has been a tricky market - one where good economic news has not always led to good stock performance. High quality, blue chip stocks are being ignored by investors in favor of more speculative, lower quality issues. We think it unlikely this trend can continue in the face of so much uncertainty. It will be interesting to see what the second half of the year brings.

<b>New Names to Watch:</b>	<b>Price</b>	<b>Comments</b>
Engineered Support Systems	\$58.51	High-tech military equipment
Fortune Brands	\$75.43	Cabinets, liquor and golf
Tyco International	\$33.14	Clean house, growth is back
Biomet	\$44.44	Prosthetics, bone growth



# THE YIELD CORNER

## TODAY'S RATES, AND SPECULATION ABOUT TOMORROW'S

In our last issue, we addressed the plight of today's income investor. The table that accompanied the discussion outlined the yield required to provide various income levels for a given portfolio value. From feedback received, the data proved to be quite an eye-opener.

Meeting current income needs in today's low interest rate environment is, to say the least, extremely challenging. Moreover, the task isn't likely to become easier any time soon. The table below indicates that most income rates (the S&P 500 being the notable exception) have risen modestly over the last twelve months, and we expect this trend to continue. That said, rates are still near historic lows, with little prospect of rising dramatically.

Rather than re-hash the income investor's dilemma in this issue, we will instead focus on the likely direction of interest rates. Remember, most interest rates reflect current expectations of future inflation. Infla-

tion occurs when too much money chases too few goods. A decrease in supply of and/or an increase in demand for goods and services is typically the culprit. The decade of the seventies was marked by dramatic price increases resulting largely from inadequate supply (principally oil). Prices and interest rates rose in order to curtail demand, bringing it back in line with the available supply. Free markets, when left to their own devices, naturally act to realign supply and demand.

Today's economy is showing signs of heating up. As more people go to work in a recovering economy, demand for goods and services increases. But this economy is vastly different from that of thirty years ago. For one, productivity continues to increase with demand. This means we are not likely to see shortages that lead to inflation. While fuel prices have risen dramatically recently, there is no evidence to suggest an imminent lack of oil. Other price increases have been modest, at best. Factory inventories remain at healthy levels, suggesting corporate America is keeping up with Main Street America's needs.

It is important to note that the Federal Reserve lowered interest rates to lessen the impact of a recession. It is imperative that rates return to more normal, sustainable levels, sooner rather than later. Accordingly, the Fed has raised rates by 1/4 of one percent, with a promise of similar increases to follow. This action is both healthy and necessary, but is not, in our opinion, a sign of growing inflation concerns. An orderly economic expansion like the current one can easily be choked out by overzealous rate hikes. At the same time, if rates remain artificially low, inflation will probably be the outcome.

We are left to conclude that modest rate increases by the Fed will continue for the near future, and that the market has already priced in those expectations. Therefore, income investors aren't likely get relief any time soon. Meeting current income needs will remain challenging.

	Recent	Year-Ago
<b>Bank Rates:</b>		
Fed Funds	1.25%	1.00%
Prime rate	4.25%	4.00%
<b>CD's:</b>		
1-year	1.36%	0.79%
5-year	3.68%	2.35%
<b>Treasury Obligations:</b>		
13-week	1.32%	0.88%
5-year	3.55%	2.83%
10-year	4.36%	3.97%
<b>Corporate Bonds:</b>		
Dow Jones Corp. 5-year	5.18%	4.06%
Dow Jones Corp. 10-year	5.58%	5.02%
<b>Equities:</b>		
S&P 500	1.63%	1.66%



## MARKET COMMENTARY (CONTINUED)

(Continued from page 1)

when returns are less robust.

So what can we take from this examination of confusion? Several points come to mind, but the one worth focusing on is the relationship between risk and reward. The gambler who repeatedly bets on the long shot, or a tip, will undoubtedly have some wild success stories. But do the few winnings make up for the many losses? Probably not, and thus the risk is not justified by the return.

Taking risk when investing is often appropriate. But the likelihood of return must justify the risk, or we are no longer investing - we are gambling. Through mathematical analysis of a portfolio, it is a comparatively simple exercise to determine the risk/reward characteristics of any portfolio. In fact, it is a tool we use regularly at Tandem.

Imagine, if you will, a square evenly divided into four quadrants. The top two quadrants offer the highest return, while the two on the left offer the least risk. Most investors (aside from Tandem clients, of course) typically find themselves in quadrants II and III, although they are most likely unaware of this. The unfortunate ones find themselves in quadrant IV.

<b>Low Risk - High Return</b>  I  <b>Ideal</b>	<b>High Risk - High Return</b>  III  <b>Less than Ideal</b>
<b>Less than Ideal</b>  II  <b>Low Risk - Low Return</b>	<b>Not Good</b>  IV  <b>High Risk- Low Return</b>

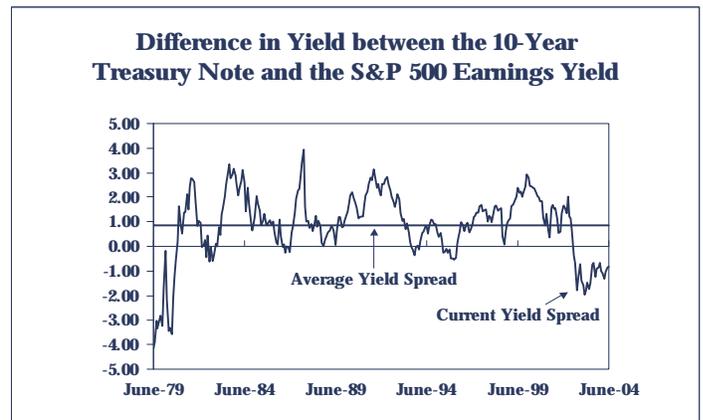
Quadrant I, where reward exceeds risk, is the ideal location for your portfolio. It seems, judging by the market's recent activity, that investors prefer Quadrant III. While this occurrence is not new (i.e., the late nineties), we view it as unsustainable. We are

not concerned that the market is ripe for a fall. In fact, we believe we are potentially in a very sweet spot. We simply suggest that, in light of the uncertainties surrounding us, the wise investor will be well served to take more appropriate risks.

## KEY MARKET INDICATORS

While limited space makes the accompanying charts difficult to read, they merit consideration. We use these tools as a means of determining the market's valuation. The

market's most recent 5 year return is well below its historical average. Further, relative to Treasuries, stock are significantly undervalued. Of course, this could mean that bonds are too expensive.





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Tandem Investment Advisors, Inc. was founded in 1990 to provide professional portfolio management with uncompromising service to investors. For more than a decade, we have worked in Tandem with our clients to attain their investment goals. If we can provide further assistance, please contact us.

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