

# THE TANDEM REPORT

Volume IX, Issue 3 July, 2008



*“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 on our web-site. Please visit [www.tandemadvisors.com](http://www.tandemadvisors.com). We hope you find this report informative.

Respectfully,

John B. Carew  
President,  
Chief Investment Officer

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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.*

## MARKET COMMENTARY

What began as a perfectly pleasant quarter for the stock market ended badly. After rallying smartly in April and May, the rug was pulled out from under the bulls in June. As banks reported further write-downs and Fannie Mae and Freddie Mac looked as if they might require a Federal bailout, enthusiasm quickly turned to pessimism. Shortly after quarter's end, the market entered bear-market territory for the second time this decade.

As of June 30, the S&P 500 is down 12.88% since December 31, 1999. Over that time, fundamentals have improved dramatically. Operating earnings for the S&P 500 have increased 43.94%, the dividend yield has risen from 1.12% to 2.22%, and the interest rate of the 10-year Treasury Bond has fallen from 6.44% to 3.97%. All of these things in isolation would seem to point to higher stock prices.

Yet a sustained upward movement in stock prices that would reflect these positive trends has proven illusive. We have discussed our reasoning for this numerous times in these pages, and the situation has not changed. As our stock market suffered from the hangover of the tech bubble, speculative borrowing spurred inflation in the prices of other assets - real estate, commodities, currencies, emerging markets and debt securities. Now that the culprits are being forced to de-lever their balance sheets (reduce borrowing), stocks are easy assets to sell.

In addition to the headwinds stocks have confronted from this unwinding of debt, they now face the possibility of a recession, as the spillover threatens to contaminate the broader economy. And as if the threat of recession were not enough to challenge

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## IS BUY AND HOLD STILL A USEFUL STRATEGY?

If the stock market only goes up, as it did throughout most of the 1980's and 1990's, buying stocks and holding them indefinitely makes sense. After all, a rising tide lifts all boats. At least all boats that are seaworthy. Even if you don't own the best stocks, you are still likely to make money.

But what about when the market doesn't go up all the time, like this decade? Does it make sense to use buy and hold as an investment strategy? We were curious about this, and researched it in some depth. Our groundbreaking, stop-the-presses conclusion is that it depends.

The one thing that we found strikingly different about this decade from the previous two (aside from overall performance) is the volatility of individual stocks. Investors

have far less patience with companies that disappoint, and excessive exuberance for companies alleged to have great promise. The reaction time for stock prices moving on such news is much faster today than it once was, and the herd mentality is much more prevalent. We can guess at the reason for this, but we have no empirical evidence to support our case.

It is our opinion that today's volatility is brought about as a result of investors' efforts to achieve returns the market as a whole isn't providing. When individual stocks start to exhibit some positive price momentum, the herd piles in, sending stocks to levels so lofty as to be unjustifiable by most reasonable measures. But the prices keep going up as long as more investors keep buying. Many stocks just keep

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## BUY AND HOLD (CONTINUED)

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climbing to extremes that are sustained much longer than we would think logical.

To analyze the price movement of one stock is hardly scientific, but it can provide a dramatic illustration. We offer you Mosaic, a fertilizer company we have never owned but that has been a Wall Street darling of late. In June of 2005, Mosaic traded at a price of \$15.56. A year later, the stock traded at \$15.65, a gain of \$0.09 in one year. By June of 2007, the price was up to \$39.02. As of June of this year, the stock was trading at \$144.70, an increase of 830% in just three years. To be sure, we wish we owned this stock. But at what price? And how much gain is enough? Has the world really changed that much since 2005 that fertilizer companies are now the high-flyers? Whatever happened to internet grocery stores? Our sense is that the *perception* of the world has changed that much, but like all previous fads, the fall back to earth will be painful. We foolishly thought Mosaic was expensive \$100 ago. Such euphoria about unlimited prospects for a company serving the new world is very reminiscent to us of internet companies that were going to revolutionize the world ten years ago. In truth, they did. But their stocks still came plummeting back to earth.

The other end of the spectrum is just as crazy. Short-selling (selling stock you don't own) has proliferated this decade.

Just as the momentum crowd drives the prices of selected stocks ever higher, so too does the short crowd pile in driving the prices of the stocks worthy of their disdain practically to zero. Some evidence suggests that the shorts killed Bear Stearns. Ultimately, whether the shorts were to blame or not, Bear Stearns did go away. So let's look at a different example.

Again selecting a stock we have not owned (thankfully), we will use AIG as an example. American International Group, or AIG, is the world's largest insurance company. Among the investments they carry on their balance sheet are some of the troubled debt instruments that have been both the cause and the victim of the credit crisis. AIG has suffered huge write-down's, and may indeed incur more. The troubled assets were obvious to us last summer, so we steered clear, as did most others. This left room for the short-sellers to have a field day. In one year, the shares of AIG have fallen from \$68.88 to \$26.46, a decline of 62%. Is this justified? Who knows? But it is dramatic for a company that remains profitable and still holds onto to its perch as a giant in the insurance industry.

Back to the original question of buy and hold. There are many reasons to buy a stock. There are only two rational ones to sell. First, the stock ceases to be the company you bought. Years ago, there was a sleepy little utility company

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## TANDEM NEWS

Tandem is pleased to welcome **John W. Highfield, III** and **Warren R. Dempsey, III** to our team. Both add considerable experience and insight, and our clients will surely benefit from their presence.

John comes to Tandem after a distinguished career on Wall Street. He spent twenty-one years on the floor of the New York Stock Exchange, ascending from floor clerk to trader and Member. He worked for Kidder Peabody, Inc., Tucker Anthony, Inc. and most recently, Morgan Keegan. In 2007, John and his family decided to leave the big city and relocate to the Charleston, South Carolina area. Continuing his career with Morgan Keegan in his new location, Tandem became his client. We knew we were working with a quality individual, and began our efforts to convince him to join us. In May, we succeeded.

John and his wife live in Mount Pleasant, South Carolina with their three beautiful daughters. John graduated from the College of Wooster, where he played attack on the men's lacrosse team.

With over twenty-two years of experience in the financial industry, John will be instrumental in expanding our brokerage relationships and our trading platform.

Warren Dempsey has spent the past twenty-four years running his own international hedge fund - Inter Ocean Capital. After spending three years at the United States Military Academy, where he played both football and lacrosse, Warren served with distinction in Viet Nam. When he returned home, he received his B.S. in Finance from the Wharton School of Finance at the University of Pennsylvania and headed to Wall Street. He began his career in 1971 in Institutional Equity Sales and Trading.

After spending twelve years in this role for various firms including Kidder Peabody, Inc., Donaldson, Lufkin & Jenrette, Inc. and Bear Stearns, Inc., he founded Inter Ocean in 1984.

In 2005, Warren and his wife relocated to Aiken, South Carolina, where he continued to run Inter Ocean. With over thirty-seven years of experience in the investment industry, Warren adds talent and insight to our investment process.

We feel very fortunate to be able to announce the addition of these two gentlemen to our team. We continue to make every effort to provide our clients superior returns *and* less risk. John and Warren are valuable additions.

## *MARKET COMMENTARY (CONTINUED)*

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future earnings growth for U.S. companies, we now are faced with the very real threat of inflation. Suffice it to say that the environment for stocks has been challenging.

Fortunately, we anticipated much of this. Beginning in the spring of last year, we started to scale back in our holdings of financial companies, particularly banks. We also limited our exposure to the consumer. These moves have proven beneficial. We have used the market's volatility to our benefit, selling stocks of companies exposed to economic weakness as prices rise, and buying stocks we like for the new environment as prices decline. Today, we are far more heavily invested in industry (companies like United Technologies and Republic Services Group, to name two) and materials (Praxair and Aptar), and far less exposed to the more economically sensitive sectors than we were a year ago. We believe this is the appropriate strategy to both weather the present market and prosper when things turn around. So far, our strategy has worked.

Bear markets are not fun. And no two are alike. Defined as a decline of at least 20%, they typically range from declines of 20% - 50%, with an average drop of about 31%. The good news is that we are two-thirds of the way to the average. What makes this one different from any others we can identify is that stocks were not expensive when the sell-off began. The fundamentals we have pointed to make this a rather unusual bear. Because we believe that the factors precipitating this sell-off are not stock-centric, we remain optimistic that the decline will be fairly short in depth and duration.

While a recession is a possibility, we view the greater concern to be the likelihood of inflation if interest rates remain this low. Once the Federal Reserve believes that the threat to the financial sector has satisfactorily diminished, we expect them to begin raising interest rates to a more normalized and healthy level. Interest rate hikes are the Fed's strongest weapon to combat inflation. Interestingly, we have studied previous rate hike cycles and discovered that growth stocks typically do quite well, while bonds, stocks of companies with heavy borrowing needs, real estate, commodities and international investments often suffer.

Without getting too technical, let us explore this in a bit more depth. First bonds. A bond, be it a U.S. Treasury, a municipal bond, a corporate bond or even a CD, is a loan. When you buy one of these, you are lending money to the issuer. They promise to pay you back, and to pay you interest every year for the life of the bond (loan). This may not be obvious, but when interest rates rise, bond prices fall. Think of it this way. You pay (loan) \$10,000 for a bond with an interest rate of 3%. A year from now, interest rates have

risen to 4%. But your bond pays you 3% because that is the term of the loan you agreed to. If you wanted to sell your bond to another investor, would it be worth the \$10,000 you paid? No. The investor can get 4% somewhere else, so why would he pay you \$10,000 to get only 3%. He wouldn't. He would pay you something less than \$10,000. Thus, as interest rates rise, bond prices fall.

Stocks of companies with heavy borrowing needs also struggle when interest rates rise. As rates go up, the cost to borrow goes up, and this has an adverse effect on earnings. Real estate can suffer for the same reason. Most real estate is purchased with borrowed money. Rising borrowing costs make real estate more expensive.

The effect of rising interest rates on commodity prices is not as obvious as there is less of a direct correlation. Traditionally, rising commodity prices cause inflation. The Fed raises rates to combat inflation, causing the economy to slow by increasing the cost of borrowing. As the economy slows, demand for commodities decreases, and prices fall. In today's bubble environment, the prices of commodities are rising because of increased global demand for the actual commodities, but prices are also rising because of increased investor demand for commodity futures contracts. This has become a very popular asset class recently, with substantial sums of investment (or speculative) money pouring into commodity futures contracts. This spike in demand for contracts has also caused commodity prices to rise. It is important to note that these futures contracts are bought on margin (that is to say, with borrowed money). If the Fed hikes interest rates, borrowing costs rise, creating less demand for the contracts.

International investments will face challenges if rates rise because higher interest rates will strengthen the dollar. To explain why a stronger dollar hurts, another example may help. Let us assume that €1 buys \$1. So you convert your dollar to a euro and buy 1 share of stock for €1. After one year, your stock is still worth €1, so you decide to sell it and turn your money back into dollars. During the year, the dollar strengthened against the euro, and now a euro only buys \$0.75. You lost \$0.25, or 25% of your investment, even though the price of the stock you bought didn't change. A strengthening dollar will make it harder to find positive results investing overseas.

Growth stocks can do well when rates rise in an inflationary environment because stocks can be somewhat inflation proof. Stock prices can rise, minimizing the erosion of principal that inflation causes. Dividend payments also rise, providing further insulation. Lastly, growth companies typically have much smaller borrowing demands, so higher borrowing costs have less impact on their bottom lines.

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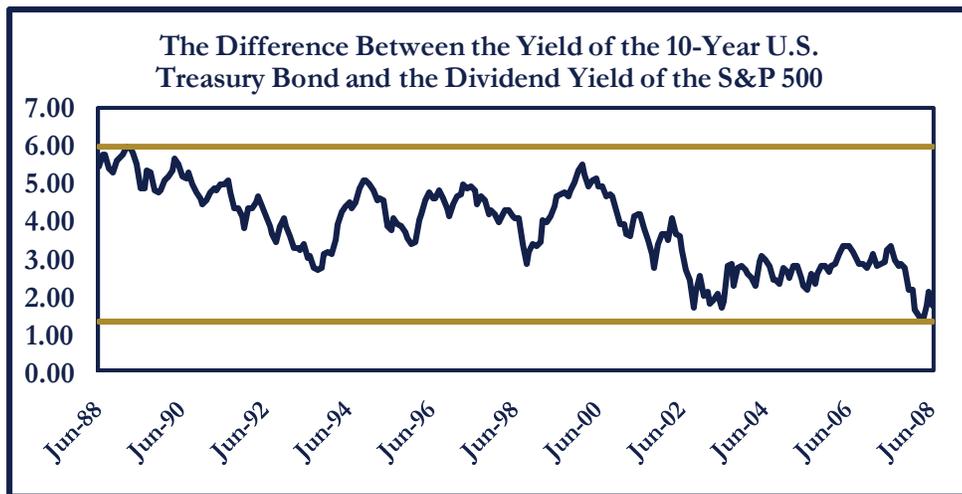
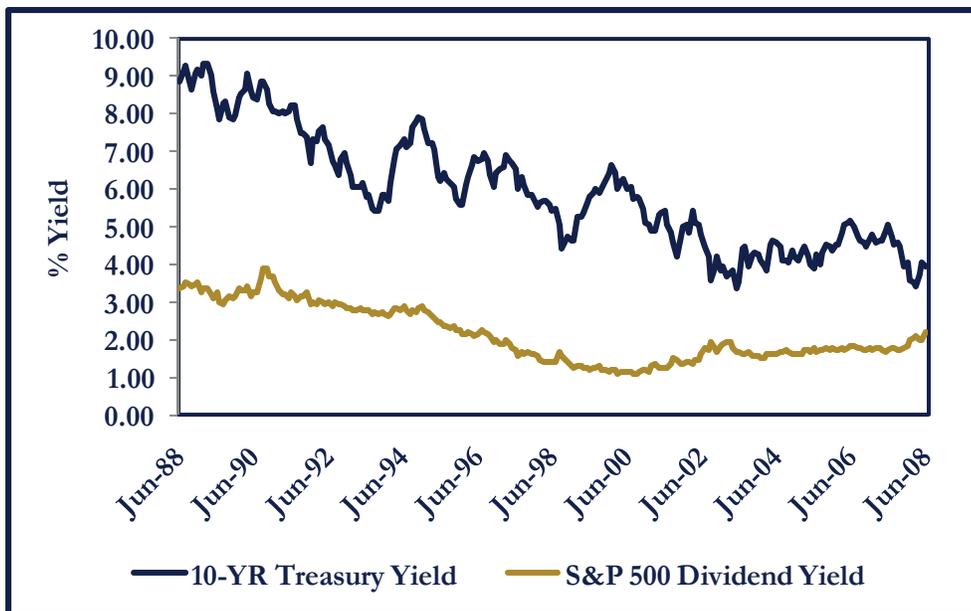
Of course, we still have to get through the current credit crisis before the Fed can start raising rates. And that could get uglier before it gets better. Until the housing market bottoms, banks will continue to struggle, as will the consumer. We need a healthier, or at least more stable, residential real estate market before we can become too enthusiastic. We have no idea when that bottom will form. Some say it isn't far away. Apparently, new housing starts data has historically been a reasonable indicator. In the past, when new starts dipped below 1,000,000, the bottom was at hand. We dipped below that level last quarter. Additionally, the threat of higher mortgage rates may spur some buyers to action. We are not qualified to make this determination. We can only watch and wait.

In the meantime, we continue to position ourselves to endure and then prosper as the market presents opportunities. Our conviction that stocks are cheap relative to almost any other asset remains strong, and the biggest reason is interest rates.

The charts to the left offer a fresh look at the history of interest rates and where they are now. For reference, we use the 10-Year U.S. Treasury Bond and compare its yield to the dividend yield of the S&P 500. As you can observe in the top chart, interest rates twenty years ago on the 10-Year were around 9%, compared to less than 4% today. Dividend yields haven't changed nearly as much, going from not quite 3.5% then to about 2.3% now. In fact, you may notice that dividend yields began to rise in 2000, even as Treasury yields have continued to fall.

The bottom chart shows the difference in yield, and this is the more important chart. Everyday, whether they are consciously doing so or not, investors must choose between stocks and bonds. The difference between the two yields tells us the preferred investment. For instance, in 1988, the difference in yields was almost 6 percentage points. This means that stocks were the more preferred investment, as they were significantly more expensive (lower yielding) than bonds. Today, we have reached the opposite extreme. Bonds are now more expensive in rela-

tion to stocks than at any time in the last twenty years. There are only four things that can correct this, and three of them are good for stocks and bad for bonds. First, bond yields can rise, causing bond prices to fall (usually good for stocks). Second, stock prices can rise, causing dividend yields to fall (obviously good for stocks). Third, stock dividends can go down (rare), causing dividend yields to fall (bad for stocks). Fourth is some combination of these, which would likely be good for stocks relative to other things.



These are certainly turbulent times that try our patience and conviction. There are only 18 months left to what is shaping up to be the worst decade on record for stock investors since the Great Depression. Things just don't look that bad to us. We continue to plug away, finding opportunities where they present themselves and waiting for the good times.

## BUY AND HOLD (CONTINUED)

(Continued from page 2)

that for years had rewarded patient investors with steadily increasing earnings and dividends. Then came a change at the top. The new regime craved bigger, bolder things. They began a trading operation speculating in energy futures. They attempted to expand their circle of influence by selling energy in markets opening up to newly unregulated utilities. And they attracted lots of attention. They embarked on a national advertising campaign, even though they served only a small portion of the country. And their ambitions were handsomely rewarded through dramatic stock price appreciation. This company had truly emerged as a player on the national utility scene. Smart investors recognized that this was no longer the same company they originally invested in, and they got out. For the rest, well, you know how the story ended. The company was Enron. The point of this is that one good reason to sell a stock is if the company has morphed into something you didn't buy.

The second good reason to sell stock is because, no matter how sound the company may be, the price can no longer be justified. Beginning in 2002, Berkshire Hathaway (Warren Buffet's holding company) began investing in PetroChina.

They estimated the company was worth about \$100 billion, but the market price was only \$37 billion. They saw value. By 2007, the company had a total value of \$275 billion, well beyond what Berkshire thought reasonable. So they sold it. Period. They took their \$3.5 billion profit and left. Were they right? Not immediately, but ultimately.

Stocks are like merchandise, and investors are consumers. When a product represents quality at a reasonable value, we buy it. When we no longer perceive the benefit, we must stop buying it, or in the case of stocks, sell it. Owning a stock for ever is a nice, almost romantic notion. And occasionally we are fortunate enough to find the right company that we can sock away and forget about. But these days, the likelihood of finding such a stock is diminishing. Times may change, and buy and hold may once again become an easy strategy, but for now, it is difficult.

Holding a stock in today's environment requires as much vigilance as buying it. We must constantly monitor what we own. Not only the fundamentals of the business, but the price of the stock as well. Owning stock is no longer a question of just buying it right. It is also a question of owning it right. It sure was easier when stocks just went up.

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## EXAMING OUR SELL DISCIPLINE IN THE NEW WORLD OF BUY AND BE VIGILANT

**W**e have discussed many times our discipline for buying stocks. The regular reader may not be as familiar with our sell discipline. That is an oversight on our part, because having (and using) a rigorous methodology for selling stock is perhaps more important than having one to buy stocks. It is certainly more important to us.

Our sell discipline is clear, concise, and strictly followed. There are two reasons (stated in the article above) to sell. For us, if our TVM model ranks a stock as unusually overvalued (i.e., a sell), we must sell 25% of our holding in each quarter that the stock is so ranked, until the stock constitutes no more than 1.25% of a portfolio. In our view, overvaluation is never a reason to sell a stock completely. It just means it is time to scale back. Second, if a stock is no longer what we bought (like the Enron example above) we must sell it outright, regardless of its TVM ranking. There is a third event that causes us to review a stock to determine if it needs to be sold. When a stock underperforms the S&P 500 by 20 percentage points, our Investment Committee must subject the stock to a complete fundamental review to determine why the company has underperformed and what, if anything, must be done about it. Once a stock is determined to be a sell, we employ our proprietary technical analysis to determine the best exit strategy.

Any manager worth his or her salt has a sell discipline. Not

all adhere to it. We decided to analyze how well ours works. In the last twelve months, we have had 30 firmwide sales of stock. These sales represent calls made universally by us at the firm level, and do not include account specific sales. Of those 30 sales, 4 were liquidations because the stock was no longer what we bought. The majority were done because of valuation. Most were timely sales, meaning the price of the stock went down after we sold. Some proved unwise. But in total, the average price decline *after we sold* was 16.8%. That represents a lot of principal saved by not holding on. But this statistic only tells part of the story. While the stocks we sold declined 16.8% on average after we sold them, the S&P 500 only declined an average of only 10.3%. That means the stocks we sold performed *worse* after we sold them than the market did. Those are good sales.

To be clear, we have made mistakes. We thought oil had peaked last fall, and began selling ExxonMobil and BP prematurely. We sold Amgen, Johnson & Johnson, Canadian National, Applied Materials and Colgate too early as well. We would have performed better had we ignored these sell signals. But because we do not ignore sell signals, we were fortunate enough to scale back in or rid ourselves of Bank of America, BB&T, Home Depot, American Express, Capital One and Microsoft. All of these experienced double-digit percentage declines after we sold, and declines exceeding the markets decline. Clearly, knowing how to sell is as important as knowing how to buy.

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## MARKET REPORT CARD

YIELD TABLE				STOCK MARKET INDEX DATA				
	Current	3 months ago	1 year ago	Stock Market Indices	6/30/2008 Close	% Change 1 Year	% Change 5 Years	% Change 10 Years
3-month Treasury Bill	1.86%	1.37%	4.95%	S&P 500	1,280.00	-14.86%	31.35%	12.89%
5-year Treasury Note	3.35%	2.74%	4.94%	Russell 3000 Growth	2,466.19	-6.38%	43.93%	11.36%
10-year Treasury Note	4.00%	3.60%	5.04%	DJ Industrials	11,350.01	-15.35%	26.32%	26.79%
30-year Treasury Bond	4.55%	4.41%	5.14%	NASDAQ 100	1,837.09	-5.02%	52.88%	37.37%
Prime Rate	5.00%	5.25%	8.25%	Russell Mid-Cap	5,271.34	-11.19%	84.81%	117.93%
Federal Funds Rate	2.00%	2.25%	5.25%	Russell 2000	2,969.68	-16.19%	63.19%	71.22%
Discount Rate	2.25%	2.50%	6.25%	GLOBAL MARKET INDEX DATA				
3-Month LIBOR	2.79%	2.70%	5.36%	Hang Seng	22,102.01	1.51%	130.78%	158.71%
				Shanghai	2,736.10	-28.39%	84.12%	NA
				Nikkei 225	13,481.38	-25.67%	48.42%	-14.84%
				Brazilian Bovespa	65,018.00	20.00%	401.18%	571.81%
				London FTSE 100	5,265.90	-20.31%	30.63%	-9.71%
				German Xetra DAX	6,418.32	-19.84%	99.29%	8.83%

*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.*