

THE TANDEM REPORT

Volume X, Issue 3 July, 2009



"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. 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.

COMMENTARY:

DIVERSIFICATION ACROSS ASSET CLASSES DOES NOT EQUAL DIVERSIFICATION OF RISK.

"Nobody goes there anymore. It's too crowded."

~Yogi Berra

Imagine a fire on a Friday night at your local Multiplex. For those fleeing the premier of the latest blockbuster movie, escape is a harrowing experience. For the three people leaving the British documentary, the event is a bit less chaotic.

Humans find comfort in numbers. Investors, being human, prefer crowds as well. Most like to go where others have already found success. Diversification has proven to be such a lure.

Prevailing wisdom holds that diversification across multiple asset classes (foreign stocks and bonds, real estate, natural resources, hedge funds and private equity) reduces risk. As this notion became common practice, something unanticipated happened. There was little difference in performance between the new assets and the old during the precipitous decline experienced by global markets.

We decided to try to understand why diversification failed investors. It appears

that this crowding into new asset classes has brought an increase in the associated risk. A broader group of owners makes the investments behave more similarly. When investors panic, as many did in 2008, they sell indiscriminately. As a result, nearly all asset classes suffered - not what asset class diversification practitioners would have predicted.

The correct notion of diversification is that portfolio stability is best achieved by selecting investments with little correlation (price movement relationship) to one another. Put another way, one should not create a portfolio of similarly behaving instruments if one wishes to avoid similarly bad results.

Until recently, different asset classes displayed little correlation. This lack of correlation was precisely what made this type of diversification attractive. An Asian recession would be of little consequence to U.S. Real Estate, for example.

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MARKET COMMENTARY

Holy Cow, what a great quarter. Finally! And just in time, too. When we last left you, we hoped the market had put in a bottom on March 6th, when the S&P 500 touched an intraday low of 666.97 (down 57% from the record close on October 9, 2007). At the end of last quarter, the S&P had rallied almost 20% from its low.

And that was only the beginning. April and May exploded upward, and June managed to eke out a gain as well. By the end of this

quarter, the S&P stood nearly 38% higher than the 666.97 level. For the quarter, the advance measured 15.22%.

The rally was led by financials, which is some cause for concern. As we pointed out in the last edition of *The TANDEM Report*, we can't find a time in history when the sector that led the decline led the next advance as well. To sustain this advance, new leadership must emerge.

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ARE WE HEADED FOR A BEAR MARKET IN BONDS?

A long-term trend is much like a pendulum. The path of a trend is not nearly as smooth as that of a pendulum, but the trend keeps it pushing in one direction until fully extending. Once it can go no further, it must reverse course, beginning a new trend.

In 1980, the Federal Funds Rate stood above 17%. Today it is targeted between 0% and 0.25%. Unless the Federal Reserve is contemplating a negative interest rate, this trend would appear to have reached its maximum extension.

Prematurely raising rates would potentially choke off any economic recovery. Thus, it is unlikely the Fed will raise rates soon. However, after recovery is firmly established, failure to raise rates could be equally damaging. Timing the reverse of a trend is far less important than being aware that a reversal is imminent. We believe the days of rates going lower will give way to a sustained, long-term uptrend in interest rates. We just don't know when.

The chart below tracks the yield on the 10-Year Treasury for the last 56 years. Rates peaked at 15.32% in September, 1980. Prior to that, rates steadily rose from a very modest level of 2.83% in 1953. There were bumps along the way, but the long-term trend is unmistakable. The downward ascent from the peak through today has been equally steep. As of June 30, the yield on the 10-Year was a mere 3.72%, up from 2.42% in December. Was this low the pivot point

for the pendulum? We can't say for sure, but we feel comfortable believing we are near an inflection point.

World events such as war, recession, inflation and prosperity influence the short-term direction of interest rates. Both sides of the mountain depicted below experienced all of these. Yet the larger trends are clear, in spite of external events. Trends always reverse themselves as they revert back to the mean. The 56-year average yield for the 10-Year Treasury is 6.38%. We have a heck of a long way to go just to get back to normal. And of course, we have learned repeatedly this decade that markets always overshoot, meaning that once established, a trend goes beyond the mean.

So is a bear market ahead for bonds? We say yes, at some point. Remember that rising yields are actually bad for bond investors, because prices go in the opposite direction of rates. Thus, bond prices are likely to fall in the future.

To navigate this looming landmine, we are being extremely selective for our bond investors. Earlier this year, we saw value in the bonds of certain financial institutions and seized the opportunity. That door has closed, and we are once again focused on the Treasury market. Keeping bond maturities short is paramount. The greater the length to maturity, the greater the risk to principal. We are confident our strategy will pay off at some point. It appears to us this pendulum has reached its maximum extension.

The Yield on the 10 Year U.S. Treasury Note from April, 1953 - June, 2009



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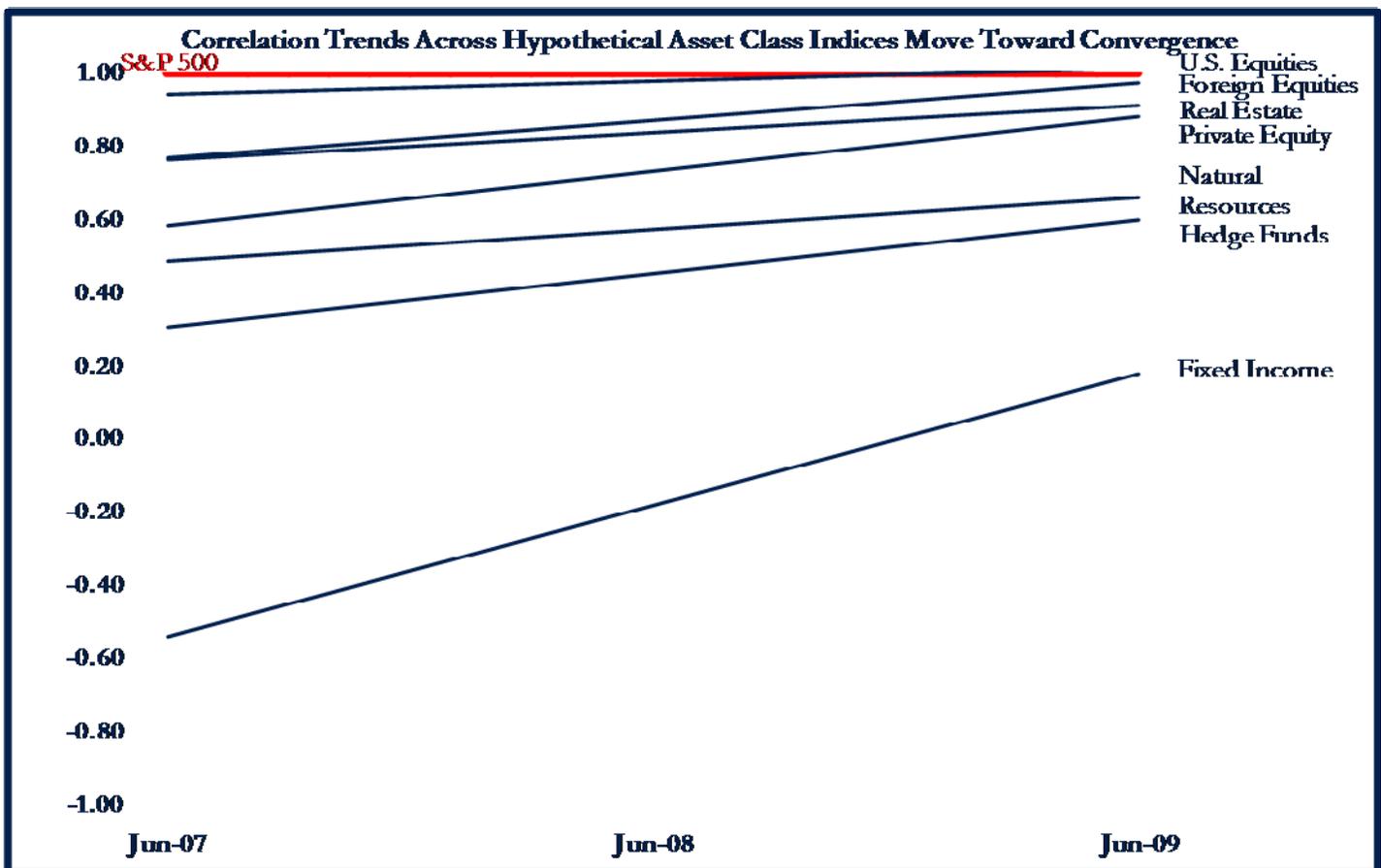
Lack of correlation began to quietly disappear this decade as staggering amounts of money flowed into these seemingly varied assets. A great deal of that money came from U.S. markets (stocks and bonds, or equities and fixed income). Assets became more closely linked once diversification was broadly achieved.

In the chart below, we have created a graphic depiction of this convergence. We calculated the correlation for each asset class relative to the S&P 500 for the last 3 years and then plotted the trend lines of the data points. In June of 2007, correlations were fairly diverse. By the end of June, 2009, differences had narrowed substantially¹. A correlation of 1 indicates perfect correlation. The S&P 500, denoted by the red line, has a correlation to itself of 1. A correlation of -1 is perfectly negative (meaning a move by the S&P would predict the opposite move from anything with a correlation of -1). A correlation of 0 means there is no correlation. We

should note that the Private Equity index we created is not statistically significant because we could only find one Private Equity ETF (see footnote below). We should also note that we did not have enough data to calculate perfectly accurate correlations, yet we felt strongly that the trend lines our data uncovered were worth sharing.

There is much anecdotal evidence to corroborate our findings that correlation increased with popularity. Mutual fund flow data over the past decade show a substantially greater inflow of money into funds that invest in foreign instruments than of money into funds investing in the U.S. The growth of both Hedge and Private Equity funds has been cited here many times. But the National Association of College and University Business Officers (NACUBO) is perhaps our favorite source of data, simply because University endowments have been among the leading proponents of asset class diversification. Each year, NACUBO surveys endowments and publishes their portfolio allocations. The accompanying table at the top of next page shows the dra-

(Continued on page 4)



¹ Tandem compiled and calculated the asset class data by creating indices of equally-weighted publically traded ETFs from the representative styles with at least 3 years of performance data. "U.S. Equities" used 57 ETFs, "Foreign Equities" used 56 ETFs, "Real Estate" used 4 ETFs, Natural Resources used 10 ETFs investing in Natural Resources, Commodities and/or Precious Metals, Fixed Income used 5 U.S. Fixed Income ETFs (we could find no foreign examples with at least 3 years worth of data), "Private Equity" used 1 ETF and "Hedge Funds" used 7 different indices compiled by HedgeFund Intelligence and found at www.hedgefundintelligence.com. All ETF data was found on the Yahoo finance web site, and only U.S. Core styles and short and ultra-short styles were omitted.

COMMENTARY (CONTINUED)

	Equity	Fixed Income	Hedge Funds	Real Estate	Cash	Private Equity	Venture Capital	Natural Resources	Other
1998	63.5%	25.6%	2.8%	2.1%	4.3%	0.4%	0.7%	0.2%	0.4%
2008	51.9%	19.2%	12.9%	4.1%	3.9%	3.3%	1.0%	2.2%	1.5%
% Change	-18.3%	-25.0%	+360.7%	+95.2%	-7.1%	+725.0%	+42.9%	+1,000.0%	+275.0%

Data taken from the NACUBO compilation of Equal-Weighted Asset Allocations for all reporting institutions, and can be found at www.nacubo.org.

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matic changes that have taken place. Equities, Fixed Income and Cash holdings have all decreased while every other asset class identified has increased. What we cannot tabulate with available data is the breakdown between U.S. and foreign equities. We know from other sources that there has been a significant allocation to foreign and away from U.S. equities over this time.

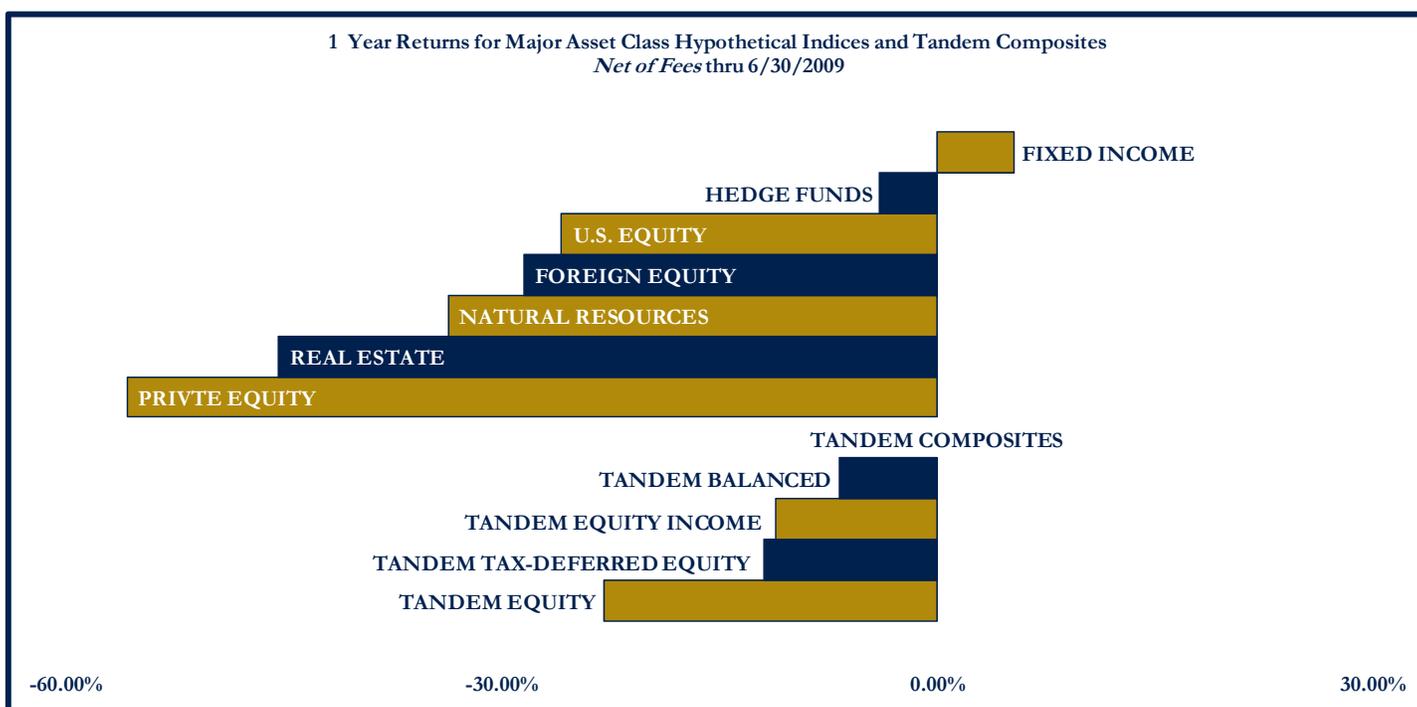
The data shows that investors spent the greater part of this decade “diversifying”, when reality now shows us that they would have been at least as safe had they relied on more traditional investments. The returns for asset classes indicated below confirm that over the past year, asset classes have indeed behaved quite similarly. And this is precisely what we would expect. Similar ownership yields similar results.

Our findings are clear - in a worst case scenario like the past year, asset class diversification does not reduce risk. So what does?

Influenced by NACUBO, we decided to back-test various hypothetical portfolio allocations. The endowment study inspired two, one that represents endowment allocations weighted equally, regardless of endowment size, and one that is dollar weighted, taking endowment size into account (neither includes cash or “other”). To these we added some traditional mixes as well. And just for fun, we decided to see how our own composites fared against the study. The results are reflected in the chart on the opposite page.

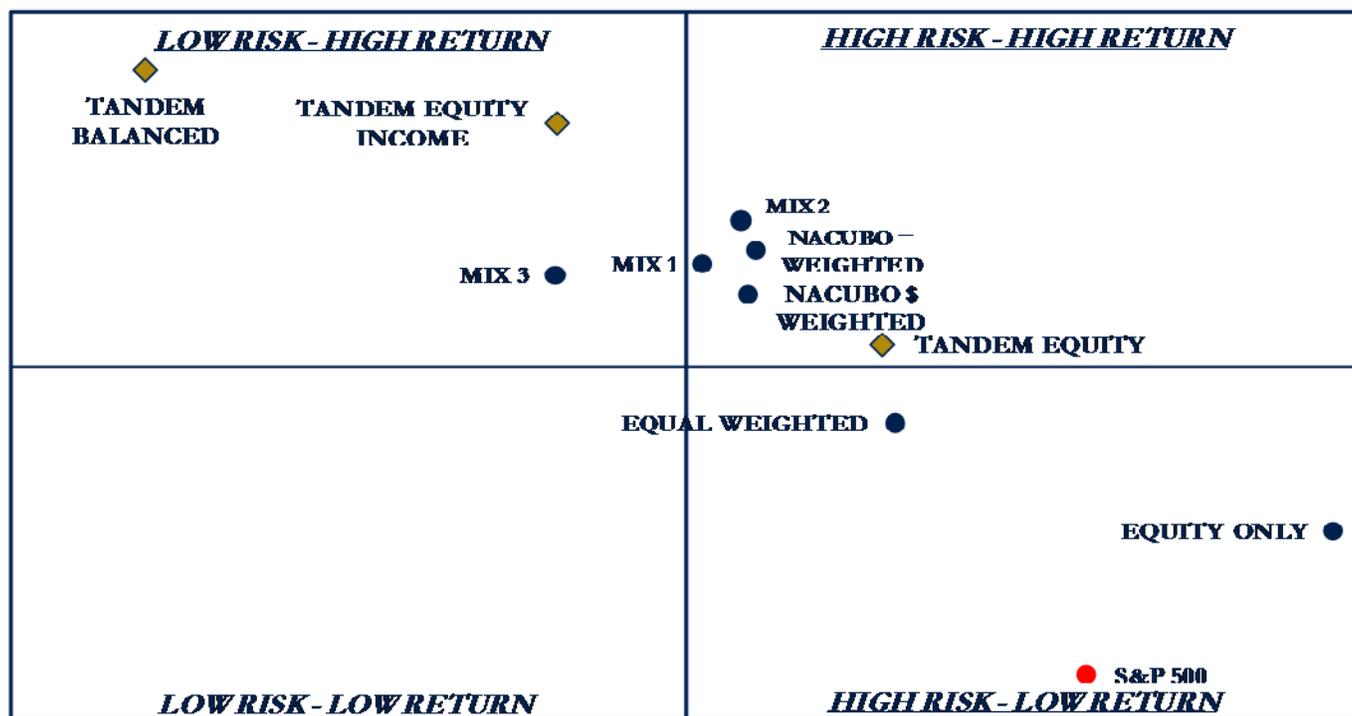
Plotting risk and return together can yield eye-opening results. Risk is measured by standard deviation (a calculation of the volatility of monthly returns over a three-year period) and is plotted horizontally on the chart. The annualized three-year return for each portfolio is plotted along the vertical axis.

The chart is broken down into four quadrants, with Low Risk - High Return being the most desirable. As the results of our study would indicate, most portfolios yielded similar results with similar risk. The negative outliers are the ones



COMMENTARY (CONTINUED)

Risk (Standard Deviation) and Return (3 Year Annualized) Quadrants for 7 Allocation Strategies, Tandem Composites and the S&P 500 thru 6/30/2009



Sample Portfolio Weightings	U.S. Equities	Foreign Equities	Fixed Income	Real Estate	Hedge Funds	Private Equity	Natural Resources
Equal Weighted	14.29%	14.29%	14.29%	14.29%	14.29%	14.29%	14.29%
NACUBO = Weighted	55.45%		20.51%	4.38%	13.78%	3.53%	2.35%
NACUBO \$ Weighted	41.88%		13.72%	6.81%	21.99%	8.80%	6.81%
Traditional Mix 1	30.00%	20.00%	25.00%	5.00%	10.00%	5.00%	5.00%
Traditional Mix 2	40.00%	25.00%	30.00%	0.00%	0.00%	0.00%	5.00%
Traditional Mix 3	65.00%	0.00%	35.00%	0.00%	0.00%	0.00%	0.00%
Equity Only	70.00%	30.00%	0.00%	0.00%	0.00%	0.00%	0.00%
S&P 500	100.00%	0.00%	0.00%	0.00%	0.00%	0.00%	0.00%

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with no allocation to Fixed Income (the one asset class with little correlation to the stock market as shown in the chart on page 3). The positive outliers are two of Tandem's three Composites with at least a 3-year track record.

At Tandem, we have never practiced asset class diversification. The potential pitfalls have always appeared to us to be too great to justify the potential returns. Instead, we strive to avoid the crowds and stay with what we understand. We rely on investment discipline to protect our gains and limit our losses. We recognize that strong market moves in a particular direction will influence all stocks, yet the events that

impact a utility company have little effect on a medical device manufacturer. This is how we seek diversification. In short, we want to diversify risk, not asset classes.

Many smart investors were hurt by this bear market. It turns out that risk can result from crowds. Sometimes a stampede tramples bystanders as well. Nonetheless, we hold a soft spot for a good British documentary.

Past performance cannot guarantee future results. Any Tandem performance data is reported net of fees and must be accompanied by the appropriate disclosures found on page 6. Other than the risk and returns attributed to Tandem, all risk and performance data presented in this report is for hypothetical portfolios comprised of hypothetical indices created by the authors.

COMPOSITE DISCLOSURES

TANDEM COMPOSITES

Tandem Investment Advisors, Inc. (“The firm”) is a Registered Investment Advisor with the U.S. Securities and Exchange Commission (SEC), and, where required, with all state government securities agencies. Tandem’s Equity Income Composite has an inception date of March 31, 1991, and consisted of fewer than five accounts prior to March 31, 2000. The Equity Income Composite includes all appropriate actual fee-paying, discretionary accounts with a minimum client contribution of \$100,000. Tandem’s Equity Composite has an inception date of March 31, 1992, and consisted of fewer than five accounts prior to September 30, 1997. The Equity Composite includes all appropriate actual fee-paying, discretionary accounts with a minimum client contribution of \$100,000. Tandem’s Tax-Deferred Equity Composite has an inception date of May 31, 2007, and never consisted of fewer than five accounts. The Tax-Deferred Equity Composite includes all appropriate actual fee-paying, discretionary accounts with a minimum client contribution of \$100,000. Tandem’s Balanced Composite has an inception date of March 31, 1992, and consisted of fewer than five accounts prior to September 30, 2005. The Balanced Composite includes all appropriate actual fee-paying, discretionary accounts with a minimum client contribution of \$100,000.

Accounts eligible for a composite are included after one complete calendar quarter under management. Performance results are calculated on a time-weighted basis using a minimum of monthly valuation and are geometrically linked. Total return calculations are used with the inclusion of cash and cash equivalents and the reinvestment of dividends. Tandem uses accrual and trade date accounting for performance calculations. No leverage has been used by Tandem to obtain these returns, and no model results are represented. A complete list and description of the composite is available upon request. All returns in this report are calculated net of fees and inclusive of brokerage commissions. Client returns will be reduced by the advisory fees incurred in the management of an investment advisory account. For example, assume that a client places \$1,000 under management and Tandem achieves for that client a 10% compound annual total return on a gross basis for a period of ten years. If a management fee of 1% of average assets under management per year for the ten year period were charged to the account and deducted from the returns, the resulting compound annual total return would be reduced from 10% per year to 9% per year, and the ending dollar value of the account would be reduced from \$2,593.74 to \$2,367.36. Typical fees for equity accounts are 1% per annum of the value of assets under management. A complete description of the investment advisory fees can be found in Form ADV Part II on file with the SEC and is available upon request.

These performance results are not to be shown without the

proper accompanying disclosures. Past performance is no guarantee of future results. The S&P 500 is used as the primary benchmark for performance comparisons for Tandem’s equity composites. The Balanced Index is used as the primary benchmark for performance comparisons for Tandem’s Balanced Composite. The Balanced Index is a constant ratio of 65% S&P 500 and 35% 1-5 year Treasury Index. The Tandem Composite Risk statistics are based on monthly returns.

HYPOTHETICAL ASSET CLASS INDICES

For the purpose of this issue of *The TANDEM Report*, Tandem created hypothetical indices for each asset class studied. The Indices were constructed from an equal-weighting of all like-style publically traded ETFs with at least 3 years of performance data reported on the Yahoo Finance website. U.S. Equities included 57 ETFs, excluding only those with a style defined as Core or Short. Foreign Equities includes 56 ETFs. Real Estate used 4 ETFs. Natural Resources used 10 ETFs investing in Natural Resources, Commodities and/or Precious Metals. Fixed Income used 5 U.S. Fixed Income ETFs (we could find no foreign examples with at least 3 years worth of data). Private Equity used 1 ETF and Hedge Funds used 7 different indices compiled by HedgeFund Intelligence and found on the firm’s web site at www.hedgefundintelligence.com. No index constructed here should be construed as publically available.

HYPOTHETICAL PORTFOLIOS

The Hypothetical Portfolios used in this report should in no way be construed to represent any real portfolio. NACUBO provides asset allocation mixes that include cash, venture capital and an asset class called “other”. Tandem allocated these portions of the NACUBO-inspired portfolios equally among all other asset classes. The performance of the NACUBO portfolios in this report do not reflect the actual experience of portfolio returns available at www.nacubo.org. Rather, they are a result of the performance of the indices Tandem created for this report.

BEST EFFORTS

Tandem put forth its best effort to fairly depict the performance and risk characteristics of the asset classes used in the issue. By electing to create indices comprised of ETFs, we endeavored to reflect the options available to most investors. Public data for many of the asset classes used is limited, leading us to construct our own. The ETF indices reflect share price appreciation adjusted for dividends, but do not include dividend reinvestment. The hypothetical portfolio returns and risk profiles do not include cash. The information obtained to compile this data is from publicly available sources and is 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 (CONTINUED)

(Continued from page 1)

Nearly every sector turned in a respectable performance for the quarter. The Technology, Industrial, Consumer Discretionary and Materials sectors posted mid- to high-teen percentage gains, and some believe tech may be emerging as the much-needed new leader.

Now in the midst of corporate earnings season, all eyes will be focused on profit and revenue growth to see if the market's gains are sustainable. At press-time, approximately 75% of S&P 500 companies reporting earnings thus far have exceeded analyst estimates. The market has interpreted these results positively, yet there is some concern that much of the profit gains can be attributed to corporate cost-cutting. The market will need to see revenue gains as well to carry this rally much further. Sentiment indicators imply that the disaster we feared is behind us, but a clear picture of the future for profits has yet to emerge.

Earnings will be the driver for the stock market going forward and earnings will largely depend upon the economy's ability to grow. If corporate earnings show improvement, the market should continue to rise. However, if earnings begin to deteriorate again, we could revisit levels we had hoped to be done with. The recession will probably reduce corporate earnings by about 40% from the 2007 peak. In the last bear market, the S&P took three years to recover to its previous earnings level. If history repeats itself and 2009 is the trough, we are looking at something close to a 75% increase in S&P earnings by 2012. For this rally to be sustained, some of that growth must materialize soon.

Many point to the housing market as the key for sustainable economic recovery, as it drives the consumer. There are some signs of improvement, as the last few months have brought upticks in both existing and new home sales. Excess inventory remains a problem due to foreclosures and overbuilding, but sales seem to be taking place at a greater rate. Perhaps more important to homeowners, housing prices continue to decline on a year-over-year basis, but the rate of decline is lessening. In all, housing is firmly in the "less-bad" category.

The unemployment rate, near 10%, is on the minds of many. This is a real and painful reminder of the severity of this recession. However, unemployment is a lagging indicator. Coming out of past recessions, employment has always been one of the last things to pick up. While unfortunate, the reasons are somewhat logical. Employers, generally speaking, do not like to lay off workers. Therefore, they tend to hold off hiring until they are confident that they can keep their new hires. Companies will first attempt to increase productivity and hours worked by existing employees before bringing on new hires.

Improvement in other areas will be seen before employment rises. Corporate investment and consumer spending will rise first. The stock market will then buoy a rosier outlook. When these elements are in place, unemployment will drop. For those focusing on this unfortunate statistic as a stock market barometer, the market will anticipate increased economic activity before it actually arrives.

There has been much hand-wringing about monetary and fiscal policy. Monetary policy is the domain of the Federal Reserve, while fiscal policy is dictated by the Administration and Congress. We will tackle monetary policy first. The Federal Reserve, under the Leadership of Ben Bernanke, has been very aggressive in extending credit and liquidity to the markets. Recall that last fall we faced a global financial meltdown as credit markets froze. While not yet completely thawed, the improvement in these markets has been nothing short of remarkable. As with all government action, there will be unintended consequences. In this case, those consequences will likely lead to higher interest rates and inflation down the road. Bernanke is confident that the Fed stands ready to reverse their fixes when the time is right, although he says current policies will remain in place for the foreseeable future.

Fiscal policy is the hot topic of the day. The Obama Administration's Stimulus and Health Care plans are debated nightly on cable TV, and the division is clearly along party lines. We avoid taking political stands in *The TANDEM Report*, so we will simply elaborate on the ramifications to the stock market. Increased government spending comes with consequences - chiefly among them higher interest rates. When the government increases the amount it borrows, there is a crowding out effect for other borrowers, meaning corporations, states and municipalities must pay higher interest rates to borrow. Higher interest rates can squeeze corporate profits, slow economic growth and attract more investors to fixed rate investments and away from stocks. When coupled with the Fed's aggressive monetary policy, the long-term ramifications could be substantial. Yet for all the debate, the market seems to have shrugged off these worries. At least for now. The S&P 500 at the end of this quarter was roughly at the same level on Election Day. We have made quite a trip from there to here, but we are here nonetheless.

Forecasting this market is challenging. There is a tug-of-war going on between bulls and bears, and both sides make persuasive arguments. We remain optimistic that the market is returning to a more normal level now that it appears a depression is off the table. After attaining this level of sustainability, however, the market will then move based on expectations of the future. We feel it prudent to remain cautious while staying in the game.

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MARKET REPORT CARD

YIELD TABLE				STOCK MARKET INDEX DATA				
	Current	3 months ago	1 year ago	Stock Market Indices	06/30/09 Close	% Change 1 Year	% Change 5 Years	% Change 10 Years
3-month Treasury Bill	0.18%	0.21%	1.86%	S&P 500	919.32	-28.18%	-19.42%	-33.03%
5-year Treasury Note	2.71%	1.82%	3.35%	Dow Jones Industrial	8,447.00	-25.58%	-19.05%	-23.00%
10-year Treasury Note	3.72%	2.82%	4.00%	Russell 1000	502.27	-28.58%	-17.57%	-29.62%
30-year Treasury Bond	4.52%	3.64%	4.55%	Russell 3000	535.62	-28.40%	-17.28%	-27.22%
Prime Rate	3.25%	3.25%	5.00%	Russell 2000	508.28	-26.30%	-14.07%	11.06%
Federal Funds Rate	0-0.25%	0-0.25%	2.00%	GLOBAL MARKET INDEX DATA				
Discount Rate	0.50%	0.50%	2.25%	Hang Seng	18,378.73	-16.85%	49.59%	35.82%
3-Month LIBOR	0.62%	1.27%	2.77%	Shanghai	2,959.36	8.16%	111.51%	NA
				Nikkei 225	9,958.44	-35.38%	-16.03%	-43.19%
				Brazilian Bovespa	51,465.00	-20.84%	143.34%	342.63%
				London FTSE 100	4,249.20	-24.47%	-4.81%	-32.75%
				German Xetra DAX	4,808.64	-25.08%	18.65%	-10.60%

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.