THE TANDEM REPORT

Volume XIV, Issue 4 October, 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:

SUPPLY & DEMAND TRUMPS GOVERNMENT CHAOS

Government chaos has dominated the headlines. The list of concerns befuddling investors includes a Federal shutdown, Obamacare, political polarization, an over-accommodative Federal Reserve, budget deficits, debt ceilings and so on. You would think the stock market would reflect the country's consternation. Yet the 3rd quarter ended with most major market indices at or near all-time highs.

The bull market of the 1980's was fueled in some respects by the advent of the leveraged buyout, or LBO. Believing that stocks were extremely undervalued, corporations and corporate raiders borrowed substantial sums of money and acquired major American companies. The stock market responded favorably to this, as you might expect.

Today we have what we are dubbing here the "Fed Buyout", or FBO. Once again, the market is responding favorably. Sometimes history repeats itself, though rarely in obvious ways.

Then, as now, many factors contributed to historic highs in all the major stock indices. Many perceived significant value after prolonged periods of sub-normal market returns. However, the basic law of supply & demand must be recognized for its significant contribution to rising stock prices in both instances.

In September 2012, the Federal Reserve embarked on its 3rd round of Quantitative Easing, or QE. During the prior two rounds of QE the Fed purchased approximately \$1.9 Trillion (with a T) of U.S. Treasury and mortgage-backed securities

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COMMENTARY:

LIKE CORPORATE AMERICA, OUR CASH LEVELS ARE RISING.
THE BEST TIMES TO BUY AND SELL RARELY COINCIDE.

We think buying low and selling high makes good sense. Who doesn't, really? The challenge is in knowing what is low and what is high. Too many people assume that when the stock market makes new highs it is expensive. Maybe it is, but maybe it's not. Similarly, a market selloff doesn't guarantee that stocks are worth buying.

Rarely do the best times to buy and the best times to sell coincide. Yet most investors instinctively buy something whenever they have cash. If they sell something, they want to buy something with the proceeds. That just doesn't make sense to us.

We would rather buy and sell when our process dictates, not because we have cash. We are confident enough in our discipline to exercise patience. That is the best way we know to buy low and sell high.

The amount of cash we hold in accounts has been gradually increasing since the Federal Reserve embarked on its latest round of QE (see *Market Commentary*). This is not a reaction by us to Fed policy, the fact that the market is at historic highs or any other external factor. Rather, we simply have more stocks that need to be sold than bought. As a result, cash levels have risen. At some point, this trend will reverse itself and we will have more to buy than sell. Until then, patience seems in order.

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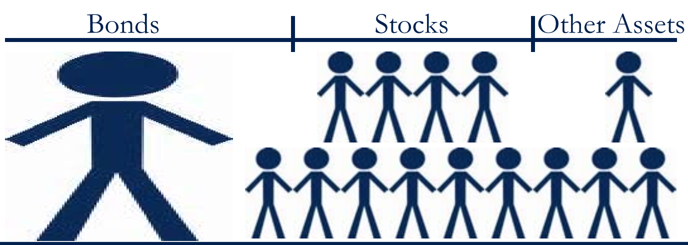
over a finite period of time. Round 3 began with $40 Billion per month of the same securities, only this time QE would be indefinite. After 3 months, the Fed upped their purchase amount to $85 Billion per month. As we write this, the QE3 has now purchased roughly $1.05 Trillion worth of securities with no fixed end date. You may wonder how these sizable purchases of bonds can drive stock prices higher.

Equilibrium

Picture 1: Equilibrium describes the state of a 'normal' market, where the number of investors present is sufficient to absorb the supply of investments and prices reflect the balance of supply and demand.

Disequilibrium With the Federal Reserve



Picture 2: Disequilibrium occurs as the Fed absorbs most of the supply of bonds, crowding out other investors and forcing them into new investments. The increased demand for the new investments without an increase in supply causes prices to rise.

The pictures above attempt to illustrate the effect of the Fed's purchases on asset prices. The first picture we call Equilibrium. In a "normal" market, the number of investors is satisfactory to absorb the supply of all investments. Investments in these pictures are represented by Bonds, Stocks and Other Assets. The 2nd picture illustrates disequilibrium as the Fed crowds out would-be bond buyers, forcing them into other investments. This increases demand for stocks and other assets. Increased demand leads to increased prices.

If you ever took an Economics class you may recognize the chart at the bottom of the page. This is the classic Supply/Demand chart and it depicts how prices are determined. At equilibrium, price occurs where demand and supply intersect. When demand is increased, prices must increase if supply is constant. And this is precisely the situation in which we find ourselves.

The Federal Reserve has disrupted equilibrium. With the same supply of investments and now greater demand, prices must rise. The dashed line below indicates the increase in demand resulting in increased price.

Some people learn best with pictures, others by examples. Let's use some examples to try to quantify the impact of the Fed's purchases. Ignoring rounds 1 and 2 of QE and only focusing on the Fed purchases since last September, the Fed has spent enough money to purchase 153 of the 500 companies that comprise the S&P 500. Should we call it the S&P 347? Or, they have spent enough money to buy 13 of the 30 components of the Dow. Or, they have spent enough money to buy Apple, Google and Microsoft. Or, they have spent enough money to buy Wells Fargo, J.P. Morgan, Bank of America, Citigroup, American Express, AIG, Goldman Sachs and Morgan Stanley. Or...you get the picture. It is a remarkable sum of money that the Federal Reserve has pumped into the financial markets. And they continue to do so at a rate of $85 Billion/month.

Clearly the Fed has not bought common stock. By absorb-

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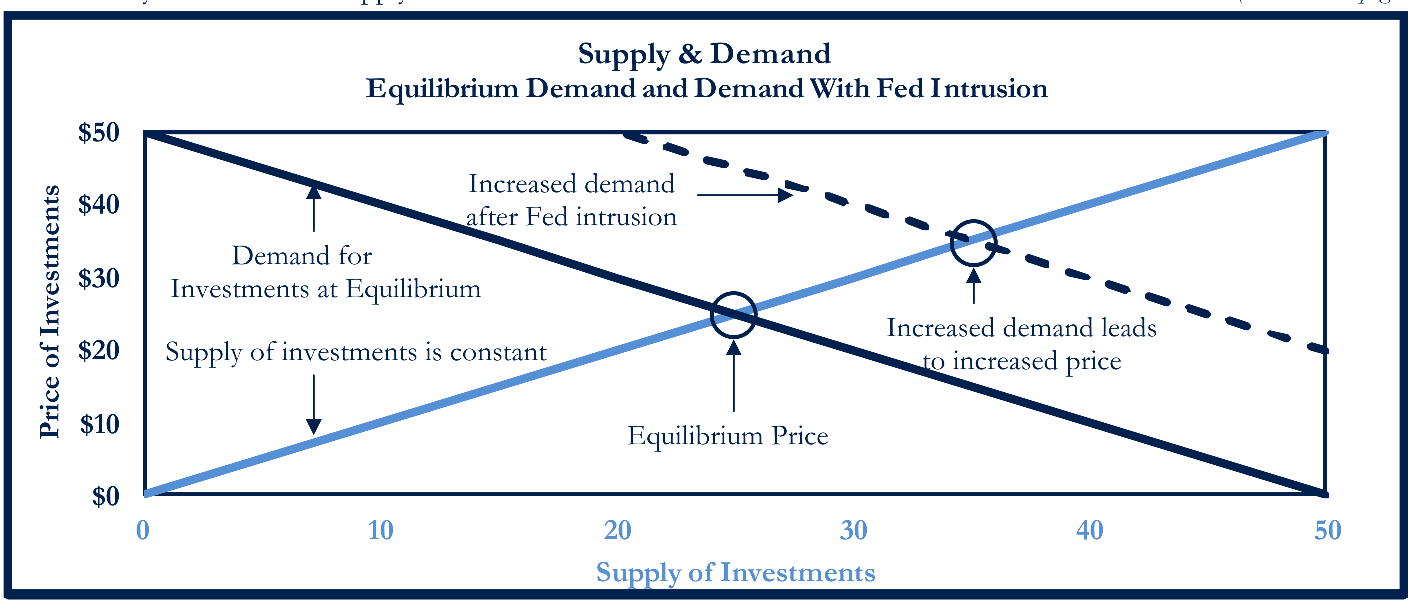

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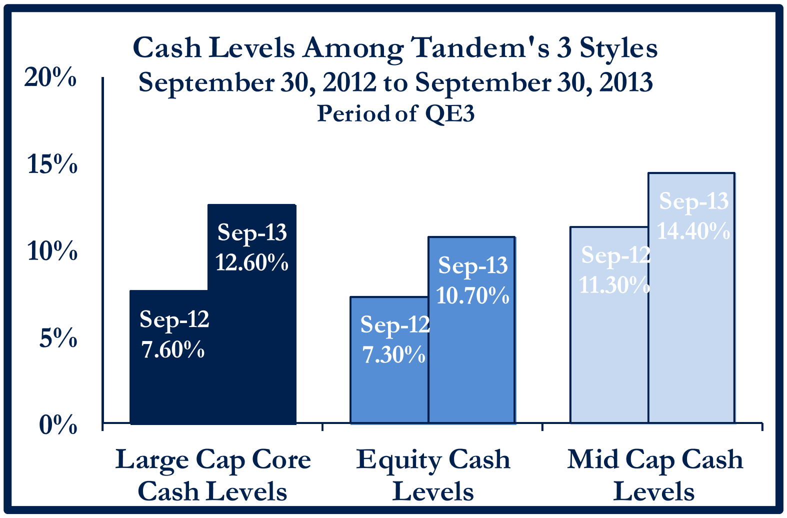
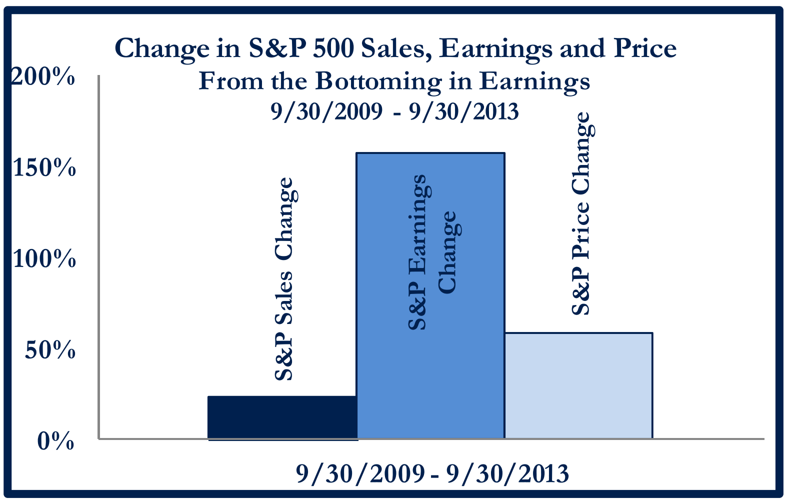
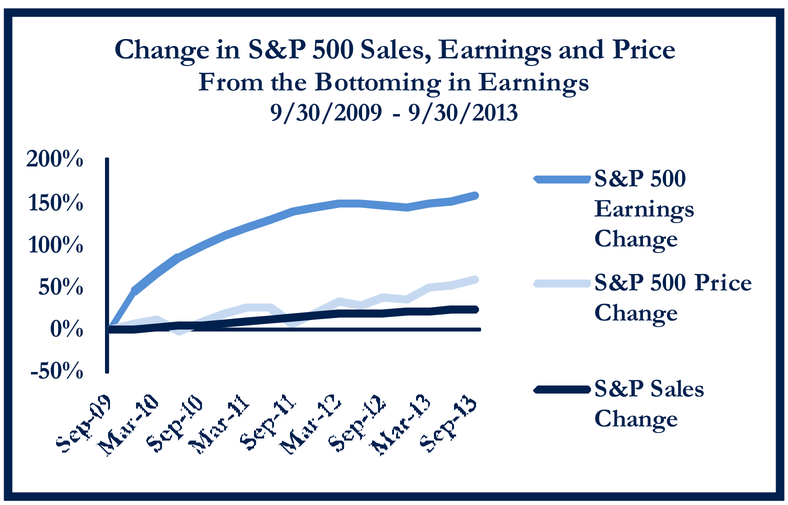
The vast majority of our stocks have performed exceedingly well and continue to do so. Our 3 portfolio styles (Large Cap Core, Equity and Mid Cap) are up quite nicely this year. However, a few of our stocks have run out of steam and they have accordingly been pared back.



Our sell discipline is what limits the volatility of our accounts. When companies fail to grow their businesses and their dividends through any economic environment, they must be sold. When companies deliver the growth we demand but their price levels exceed their implied value, we sell 25% of our holdings in that company. And we execute these sales by placing a protective stop underneath the price. If a stock marked for sale continues to rise in value, our clients benefit because we haven't sold it. We move our stop up along with the price increase. Then when the stock rolls over and begins to fall, our stop is hit and we sell.



Some stocks have reversed course and hit our stops. Others are attractively priced and worth buying. There are simply fewer of them at the moment. This does not send a warning of any kind to us. It is simply the way our process works.



What is interesting to us is the fundamental breakdown we see across much of the broader market. When the S&P 500 price bottomed in 2009, it had clearly reached levels far too low to be justified by fundamentals. Essentially fundamentals, although bad, were better than prices indicated. This is normal at market bottoms. Accordingly, stock prices ricocheted back to more "normal" levels in fairly short order. Anyone out of the market missed it because it happened so quickly. Similarly, earnings rebounded robustly as it became apparent that the world was not ending and that business could get back to normal.

What hasn't responded with the same vigor is sales. There are essentially two ways a business can grow its earnings. One is by growing sales. The other is by cutting expenses. Clearly a lot of the earnings growth displayed since 2009 has been attributable to cost cutting.

The two charts to the left show the same information in different ways. The top chart expresses total change in S&P sales, earnings and price since S&P 500 earnings bottomed in September, 2009. Earnings growth has been robust while sales growth has been lagging.

The lower chart tracks the rate of change for the same data. Early in the recovery earnings exploded. Since the initial leg up, growth in earnings has been rather modest.

This second chart illustrates the fundamental issue challenging the market today. How much higher can prices go if earnings don't keep pace? And how much higher can earnings go if sales continue to be challenging? Companies cannot grow earnings through cost cutting indefinitely. At some point they need more customers if they are to continue to grow. If they can't grow sales,

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earnings and price will have to adjust to reflect this.

For a moment we will borrow the chart on the next page in *Market Commentary*. It clearly illustrates that stock prices are closely correlated with earnings growth. A closer examination also shows that earnings growth has moderated in recent months while stock prices have continued to climb. Our *Market Commentary* addresses one aspect of this. Now we would like to address another.

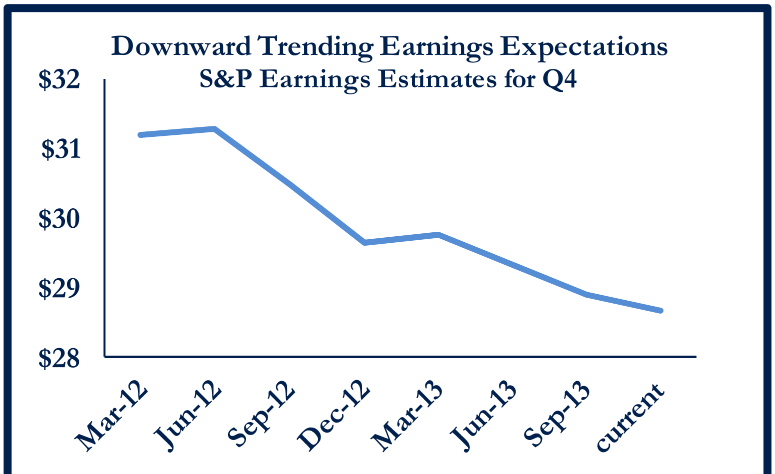
We do not by any means forecast earnings trouble for corporations. Both sales and earnings growth are positive and we expect those trends to continue. This is not about an impending economic downturn. Rather, it is about buying low and selling high.

We would argue that regardless of price, if the S&P's earnings were growing faster than its price, stocks would be relatively cheap. Conceivably, the market could be at all-time highs with earnings even higher. That scenario would make stocks generally attractive. It is not about the price alone. It is about what that price represents.

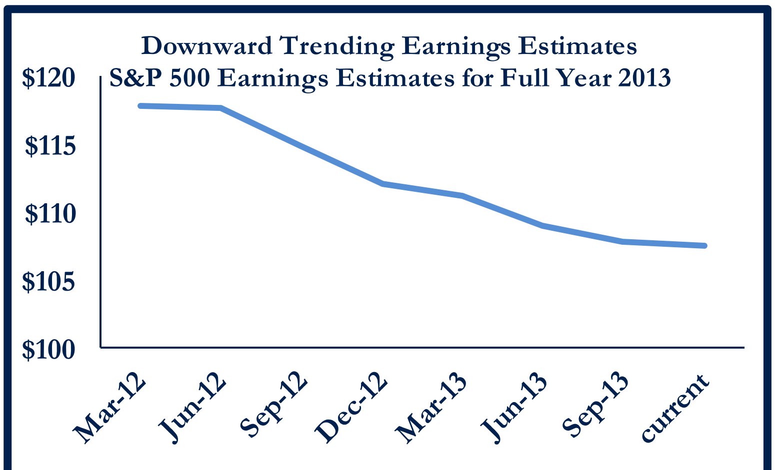
For many stocks, today's price represents a set of expectations that may be too lofty. That makes them expensive. Even as earnings growth has slowed, prices have continued to rise. This does not make every stock expensive. But it does make some stocks expensive.

The two charts in the middle of this page reflect Wall Street expectations over time for S&P 500 earnings for the 4th quarter and full year of 2013. The charts begin with estimates made in March, 2012. At that time, analysts were forecasting Q4 estimates of $31.18 and full year estimates of $117.91. With the passage of time and a dose of reality, those expectations ratcheted lower. Q4 estimates have fallen 8.05% to $28.16 and full year estimates are down 8.80% to $107.53. These are meaningful decreases.

Think about it this way. If there were no stock market to confuse and confound us and a company were to grow its business by 8%, its value would logically follow suit. Similarly if a company were to contract by 8% we would expect its value to similarly decline.



Earnings estimates for the 4th quarter have steadily come down since last March. Analysts are not as optimistic as they once were.



Much like Q4 estimates, expectations for full year earnings have been lowered from $117.91 in March, 2012 to only $107.53 currently.

In 18 months, earning expectations have declined by more than 8%. What has the market done? It has risen over the same period by 23.05%. There are good reasons that stock prices have risen as earnings expectations have fallen. However, this disconnect is not sustainable. At some point, earnings growth needs to accelerate to justify prices.

Earnings growth is not likely to accelerate in the absence of sales growth. Some companies continue to grow their businesses quite nicely and their share prices are justifiable. But more and more companies are falling short.

Standard and Poor's reports that, as of this writing, 99 companies in the S&P 500 have reported earnings for the 3rd quarter. Of those 99, 58 exceeded expectations, 15 met expectations and 26 came up short. These numbers in isolation are somewhat encouraging. Nearly 59% of companies reporting beat their estimates. But they are beating lowered estimates. Much like the charts above illustrate lowered expectations for the S&P as a whole, many companies are beating (or even missing) lowered expectations. And this makes them expensive.

Rarely do the best times to buy coincide with the best times to sell. Cash does not reflect concern. It demonstrates patience, and a process.

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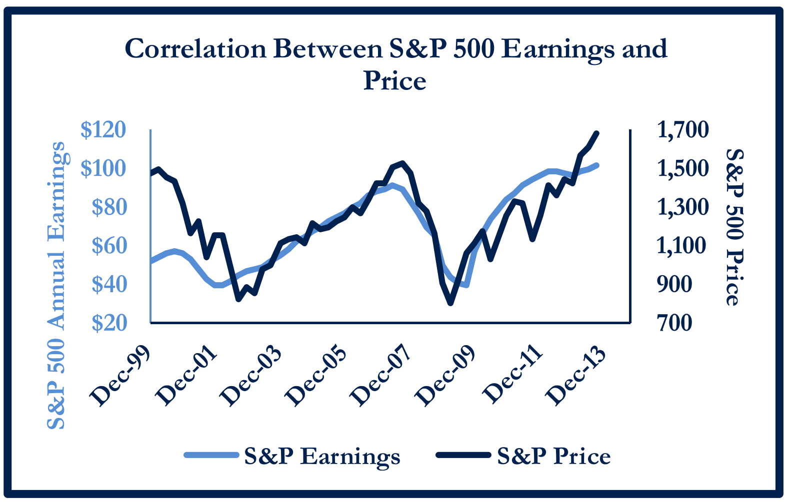
ing the supply of bonds, however, they have forced others to buy stocks and other assets. And prices have risen to reflect this.

Many are concerned that the Fed has created inflation in the price of investments. While it is certainly true that the Fed has caused prices to rise, it is less clear that this is necessarily a bad thing. The 1980's were slightly different, but they did not end badly. Instead of experiencing a shock to demand, LBOs created a shock to supply by reducing the number of public companies available to investors. This then lead to an increase in demand as investors saw stock prices continuing to rise, leading many to put more money to work.

Herein lies the scenario for this not ending badly. Rising stock prices have a way of attracting new investor dollars. Perhaps enough new money will flow into the market to negate the removal of the Fed money. Time will tell.

If the Fed's demand were to suddenly go away, prices would certainly fall initially. But if the Fed's demand can be replaced by an increase in investor demand, the impact could be mitigated. The 1980's may in fact be a good example of how this resolves itself.



In the meantime, investors are not likely to match the Fed's demand because of all the problems we see around us. The chaos our Government has created is a real drag on investor demand and the economy as a whole. Investors hate uncertainty, and there is plenty of it.

For the Fed to exit, they will need to see a real and sustainable uptick in the economy and the markets. In the 1980's, the improvement in economic and market data was the direct result of the Federal Government getting it right. The economy was stimulated by what the Government took away, not what it added. Today, our politicians can't agree whether to add or subtract but a fair amount of adding has already been done even without the Fed.

In the short run stock prices rise and fall on external influences. Most still expect prices to fall given the general state of affairs in this country. Prices continue to rise however because of the meaningful increase in demand brought about by Fed policy.

In the long run, stock prices rise and fall with corporate earnings. Earnings for the S&P 500 bottomed in the 3rd quarter of 2009. Since then, S&P earnings have grown 158%, from $39.61 to $102.00. During the same time period stock prices have risen only 59%. One could reasonably argue that the Fed's simulative policy is merely forcing us to more fairly value stock prices, much as the LBO's did in the 1980s.

History tells us that there is a strong correlation between corporate earnings and share prices. The chart to the left tracks both for the S&P since the end of 1999. As earnings grow, so too do stock prices. When earnings contract, stock prices follow. Interestingly, earnings have proven to be a better leading indicator than prices. Even as earnings begin to descend, stock prices generally continue to rise for a time.

Combinations of companies the Fed could have theoretically purchased outright thus far with QE3		
Tech Titans	Banking Industry	Corporate America
Apple Google Microsoft	Wells Fargo J.P. Morgan Bank of America Citigroup American Express AIG Goldman Sachs Morgan Stanley	Disney Home Depot McDonalds Boeing 3M Bristol-Myers Squibb Union Pacific Ford Nike Starbucks Colgate Palmolive Caterpillar General Motors Deere

As long as earnings continue to grow, stock prices will likely continue to rise. If the Fed decides to withdraw its support, stocks can still offer reasonable value if their earnings continue to improve.

The temptation for many is to focus on the chaos. Until now, one would have been better served to heed the laws of supply and demand. When so many wait for the next shoe to drop, it rarely does. But as long as QE3 is around, stocks will probably remain the only game in town. Don't fight LBOs or FBOs.

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MARKET REPORT CARD

Yield table	Current	3 months ago	1 year ago
3-month Treasury Bill	0.01%	0.03%	0.09%
5-year Treasury Note	1.38%	1.40%	0.63%
10-year Treasury Bond	2.61%	2.49%	1.63%
30-year Treasury Bond	3.69%	3.50%	2.82%
Prime Rate	3.25%	3.25%	3.25%
Federal Funds Rate	0.01%	0.03%	0.08%
Discount Rate	0.75%	0.75%	0.75%
FNMA 30 yr Mortgage	3.86%	3.92%	2.72%

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

	9/30/13 Close	% Change 1 Year	% Change 3 Years	% Change 5 Years
S&P 500	1,681.55	16.72%	47.35%	44.17%
Dow Jones Industrial	15,129.67	12.60%	40.24%	39.44%
NASDAQ	3,771.48	21.03%	59.23%	81.12%
Russell 2000	1,073.79	28.22%	58.81%	58.01%
German Xetra DAX	8,594.40	19.10%	37.97%	47.39%
London FTSE 100	6,462.22	12.54%	16.47%	31.82%
Shanghai Composite	2,098.38	0.59%	-20.98%	-8.52%
Crude Oil	102.33	11.00%	27.96%	1.68%
Gold	1,326.50	-25.31%	1.49%	49.97%
CRB Index	285.54	-7.68%	-0.46%	-17.36%
U.S. Dollar Index	80.22	0.36%	1.78%	1.05%
Euro/Dollar*	135.25	5.22%	-0.72%	-3.98%

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

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