

The **TANDEM** Report



Volume 5, Issue 2, April, 2004

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MARKET SCORECARD:

S&P 500:

<i>Annualized returns:</i>	
1 year ended 3/31/04	32.78%
3 years ended 3/31/04	-0.99%
5 years ended 3/31/04	-2.62%
7 years ended 3/31/04	5.84%
10 years ended 3/31/04	9.71%

MARKET COMMENTARY:

The market began the new year like it finished the old. After a 5.08% advance in December, the S&P 500 recorded gains of 1.73% and 1.22% in January and February. But the optimism was curtailed in March by geopolitical uncertainties, and the S&P lost 1.64% of its value. Nonetheless, the market managed to stay positive for the quarter, recording a gain of 1.29%.

Even though the market was up over 32% for the last twelve months, investors ended the quarter concerned about the future of the economy and Iraq. While the situation in Iraq remains a concern for some, the news on the homefront is looking up. March job creation numbers, combined with upward revisions of the January and February reports, were three times greater than anticipated, and the mar-

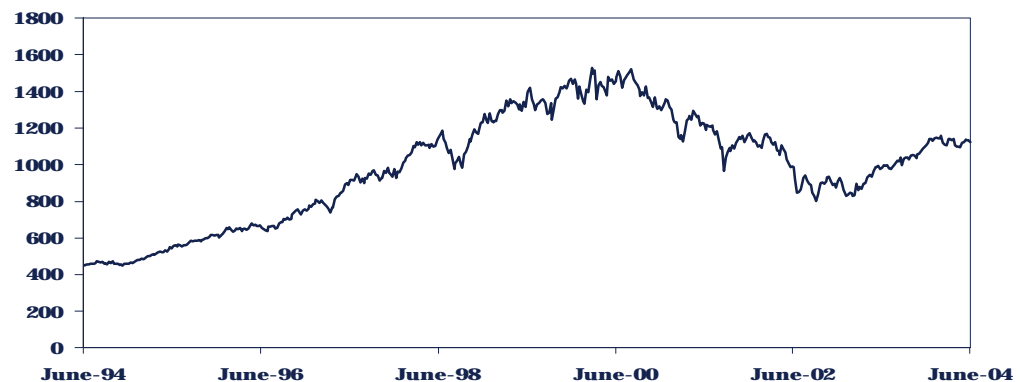
ket has since rallied accordingly. Further good news arrived when Standard & Poor's announced increased earnings growth expectations for the companies in its benchmark index to more than 20% for the coming year.

Of course, not everyone sees the glass as half full. Concerns over economic growth have caused interest rates to spike. But we'll take a growing economy any day.

Last year, some of the biggest gains were in small caps and technology stocks. They had fallen the most during the three year decline, so their rally was not a surprise. So far this year, there is new leadership. Consumer goods and related businesses, financial services and energy are the best per-

(Continued on page 3)

Ten Year Chart of the S&P 500



TOP TEN HOLDINGS IN THE TANDEM EQUITY COMPOSITE

AS OF MARCH 31, 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.

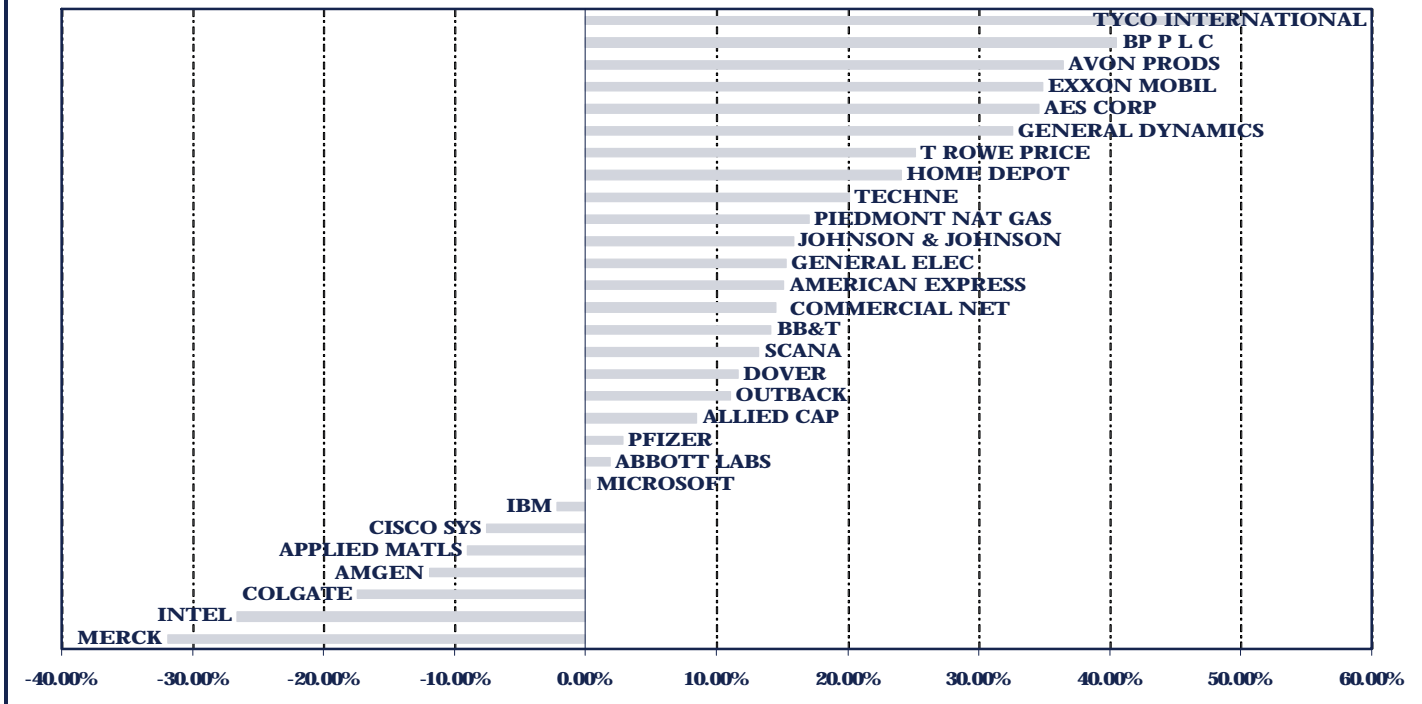
Rank by Performance of the Top Ten Holdings in the Equity Composite for the Period 12/31/2003 - 3/31/2004

Rank by Market Value Original Purchase

1. Home Depot	06/03/99
2. Johnson & Johnson	06/03/97
3. Microsoft Corp.	12/06/96
4. Pfizer, Inc.	12/18/96
5. General Electric	07/08/94
6. Amgen	10/31/96
7. Allied Capital	12/21/01
8. General Dynamics	11/13/01
9. Exxon Mobil	11/08/94
10. Colgate Palmolive	10/31/00

Company	Appreciation	Dividend	Total Return
Allied Capital	8.64%	.57	10.69%
Colgate Palmolive	10.09%	.24	10.57%
Home Depot	5.27%	.07	5.47%
Exxon Mobil	1.44%	.25	2.05%
Pfizer	-0.79%	.17	-0.31%
General Dynamics	-1.17%	.20	-0.82%
General Electric	-1.48%	.32	-0.84%
Johnson & Johnson	-1.82%	.24	-1.36%
Amgen	-5.89%	0	-5.89%
Microsoft	-8.91%	0	-8.91%

Total Return of all Stocks Held in Composite for 9/30/03 - 9/30/04



ANALYSIS OF THE COMPOSITE

A quick study of the chart on the lower left of the quarterly returns for all stocks in the equity composite shows the big winner was T. Rowe Price, and the big loser was Intel. A more in-depth look shows there is a bigger message. The best performers were largely consumer goods and finance (healthy dividends didn't hurt), while the underperformers were pharmaceuticals and technology.

We have recently added to our holdings in many of the better performing companies. Depending on a specific account's needs, we have been buyers of T. Rowe Price, Allied Capital, Colgate, Fortune Brands, Home Depot, Conagra and others in recent months. No two accounts are the same, so purchases may vary by individual. However, we believe these sectors are likely to continue their strong performance for the near future.

Of some concern is the performance of the laggards. We believe that, as the economy continues to

pick up steam, increased business capital spending will boost the shares of tech stocks.

More frustrating is the environment in which drug stocks find themselves. The industry is a political hot-potato, and will most likely continue to underperform the general market until the uncertainties about its future become more settled. We recognize these stocks are likely to be a drag on performance for awhile, but we remain confident in their long-term prospects, and are willing to endure their unloved status for now. However, if their ability to compete is impaired by political promises, we will have to revisit our commitment to these stocks.

One other lesson to be learned from the chart to the left is the importance of portfolio building, rather than stock-picking. Not every stock will beat the market each quarter. A good portfolio will contain an array of stocks that do well in differing environments. We work hard to achieve this delicate balance.

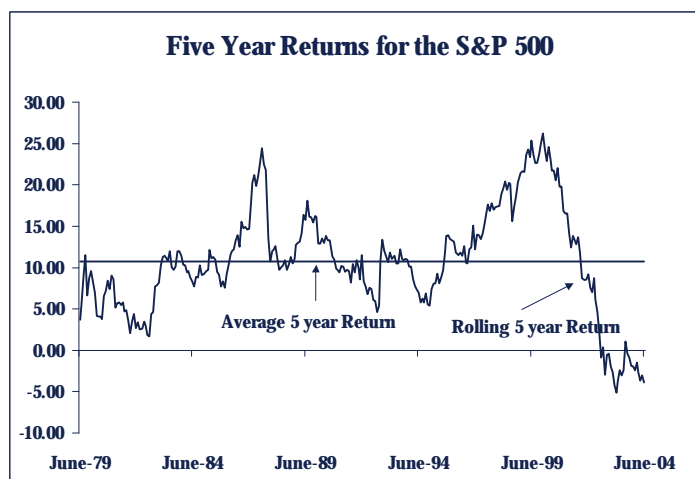
MARKET COMMENTARY (CONTINUED)

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forming sectors. While we see this trend continuing for the near future, we also look for investors to take refuge in dividend-paying stocks as interest rates rise.

return for the last twenty-five years is better than 10% annually. From this viewpoint, the market still has some catching up to do. That said, we offer no predictions as to when we will again see an average of 10% a year.

The market has been in what many describe as a trading range, unable to go to new highs, but not threatening to make new lows either. For perspective, we like to look at history. The five year return on the S&P 500 is still negative, but the chart to the right tells us that the average five year



But the news is encouraging. In addition to the positive jobs report, a recent CEO survey indicated more optimism than at any time in the last two decades. This ought to translate to further hiring, and as importantly, increased capital expenditure by businesses. This has been

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THE INCOME INVESTOR'S DILEMMA

FINDING YIELD IN A LOW-BUT-RISING RATE ENVIRONMENT

We manage accounts for many clients who rely on their investments to supplement their income. Given that current interest rates are near historic lows, the challenge we face is an obvious one - how do we build a portfolio that provides for current income needs without disregarding future income needs, growth needs and risk tolerance. Choices for an investor seeking current income are limited, and often unappealing. Our solution for our clients, while perhaps out of the mainstream of typical investment thought, is to create a portfolio that provides for a combination of principal and income growth in addition to current income. Before we delve into a discussion of our solution, it is helpful to have a complete understanding of the predicament investors face.

Have a look at the table below. The 10-year Treasury bond yields in the neighborhood of 4%. An investor requiring \$50,000/year of income from investments needs a \$1,250,000 portfolio to attain the necessary income. CD's and money market are worse. Maybe the investor might be willing to invest in corporate bonds. A little riskier than Treasuries no doubt, but corporate bonds can yield more. The same investor, at today's rates, would need a portfolio of \$833,333 in low-grade corporate bonds at 6% to produce \$50,000/year.

For many investors, a fixed income portfolio now often fails to produce enough income. To make matters worse, interest rates are likely to rise. While that

may sound good, it is bad news for bondholders. As bond yields rise, their prices fall. Worse still, if inflation rears its ugly head again, that \$1,250,000 bond portfolio will see its relative value decline, because things will cost more in the future. In other words, a dollar buys less in the future than it does today. Bonds promise to pay back your principal, but the principal won't buy as many goods and services in the future if it doesn't grow. Bonds also promise that your principal doesn't grow.

So how about some high dividend paying stocks, like utilities and REITs? At current levels, a portfolio of utility stocks might yield 4.5%. That requires a portfolio value of \$1,111,111 to generate the same \$50,000 in income. A REIT portfolio might yield 6.5%. That requires a portfolio of \$769,231. The good news about REITs and utilities is that, if business is good, their dividends will likely rise over time. The bad news is, in the short-run, they trade in the market similarly to bonds. So, if rates rise, the stock prices will likely fall.

For the income investor with a portfolio large enough to produce the necessary income at today's interest rates, the situation is not too bleak. Keep your maturities short so that rising rates will have a minimal impact on principal, and as the bonds mature, re-invest your principal at higher rates.

For the rest of us, what do we do? You can use the

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	<u>2.00%</u>	<u>4.00%</u>	<u>6.00%</u>	<u>8.00%</u>	<u>10.00%</u>	<u>12.00%</u>
\$100,000	\$2,000.00	\$4,000.00	\$6,000.00	\$8,000.00	\$10,000.00	\$12,000.00
\$250,000	\$5,000.00	\$10,000.00	\$15,000.00	\$20,000.00	\$25,000.00	\$30,000.00
\$500,000	\$10,000.00	\$20,000.00	\$30,000.00	\$40,000.00	\$50,000.00	\$60,000.00
\$750,000	\$15,000.00	\$30,000.00	\$45,000.00	\$60,000.00	\$75,000.00	\$90,000.00
\$1,000,000	\$20,000.00	\$40,000.00	\$60,000.00	\$80,000.00	\$100,000.00	\$120,000.00
\$1,250,000	\$25,000.00	\$50,000.00	\$75,000.00	\$100,000.00	\$125,000.00	\$150,000.00
\$1,500,000	\$30,000.00	\$60,000.00	\$90,000.00	\$120,000.00	\$150,000.00	\$180,000.00
\$1,750,000	\$35,000.00	\$70,000.00	\$105,000.00	\$140,000.00	\$175,000.00	\$210,000.00
\$2,000,000	\$40,000.00	\$80,000.00	\$120,000.00	\$160,000.00	\$200,000.00	\$240,000.00
\$3,000,000	\$60,000.00	\$120,000.00	\$180,000.00	\$240,000.00	\$300,000.00	\$360,000.00
\$5,000,000	\$100,000.00	\$200,000.00	\$300,000.00	\$400,000.00	\$500,000.00	\$600,000.00



MARKET COMMENTARY (CONTINUED)

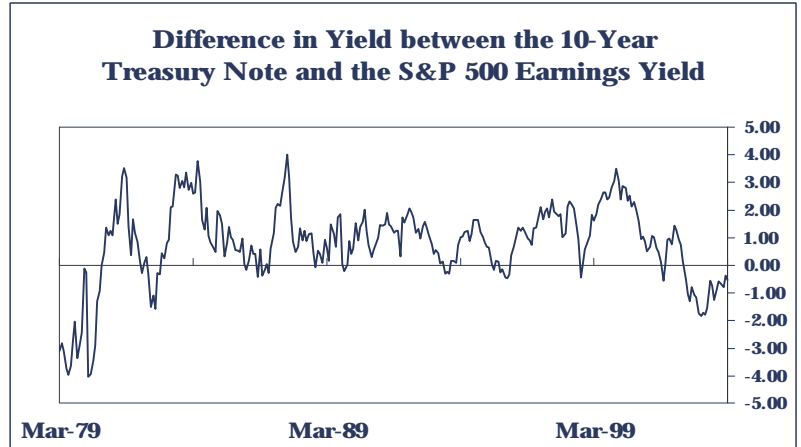
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the missing ingredient in the recovery to date. Businesses have been hesitant to invest, even with an historically low cost of borrowing. As evidence mounts that the economy is on solid footing, rates will inevitably rise. This should spur business investment before the cost of borrowing increases too much.

Another consequence of potentially rising rates is that bonds become relatively less attractive. As a result, many investors will likely allocate more of their assets to the stock market. One of our favorite valuation measurements is the "earnings yield" of stocks relative to the yield on the 10-year U.S. Treasury Bond. Earnings yield is earnings divided by price, or the inverse of the PE ratio. It reflects the earnings return one can expect to realize on a share of stock, and gives a means of comparing that value to a virtually riskless rate of return. The graph to the right explores this relationship for the last twenty-five years, and the conclusion we draw from this is the

same we have drawn for awhile now.

Historically, the market's earnings yield has been less than the treasury yield. For the last few years,



the opposite has been true, meaning, relative to bonds, stocks are cheap. Thus, eventually, stock prices will rise, bond prices will fall, or both. Given our fondness of history, we like the message.

THE INCOME INVESTOR'S DILEMMA (CONTINUED)

(Continued from page 4)

chart at the left to determine the rate of return your investments require to produce the income you need. If you are like most, you find yourself needing a rate beyond current bond yields. In the past, bonds afforded investors two benefits: current income and capital preservation. Capital preservation may be a primary concern. If you can't lose what you have, bonds are a solution. But if income is the motivator, we need look elsewhere.

Many publications have advised their readers to cut expenses, live a simpler life, and wait for higher rates. That may be sound advice. But hardly helpful to those who already have reigned in spending and still need more income. Our solution is to rely on stocks - the amount depends on the needs of the particular investor. But good stocks pay dividends that increase regularly. If you buy a stock today with a dividend yield of 2.5%, and the dividend

increases by 10% next year, your effective yield becomes 2.75%. Bonds can't do that. Another 10% increase the following year makes your yield on your original investment 3%. Not every company increases its dividend by 10% each year, but more do today than ever before due to the favorable change in dividend taxation. In the meantime, a stock that raises its dividend every year will likely see its price increase as well. Portfolio gains can be used to supplement income until the portfolio generates enough dividend and interest income on its own.

The solution to the income investor's dilemma is to build a portfolio that blends current income, rising dividends and principal growth. Combinations vary according to a client's needs, but the principal is the same. We build a portfolio for life. No matter what stage of life a client may be in, we find this to be an attractive alternative to today's low interest rates.





www.tandemadvisors.com

In Charlottesville:

117 4th Street NE
Suite A
P.O. Box 2259
Charlottesville, VA 22902

Phone: (434) 979-4300 or
(800) 527-0101

(This section intentionally left blank)

In Charleston:

901 Daniel Island Park Drive
Suite 201
Daniel Island
Charleston, SC 29492

Phone: (843) 216-3791 or
(800) 303-8316

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.

John B. Carew

Phone: (434) 979-4300

e-mail: jcarew@tandemadvisors.com

Andres Gonzalez

Phone: (434) 979-4300

e-mail: agonzalez@tandemadvisors.com

Allen Ouzts

Phone: (843) 216-3791

e-mail: caotandem@email.msn.com

