THE TANDEM REPORT

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TANDEM Investment Advisors

"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.

MARKET COMMENTARY:

WITH THE WORST SEEMINGLY BEHIND US, WHAT WILL PROVIDE THE GROWTH THAT LEADS US FORWARD?

Although the New Year began much as the old one ended, there are signs that we may have survived the worst. The S&P 500 reached a new bear market low of 666.79 (a level not seen since September, 1996) on March 6th and has rallied smartly since then. By quarter's end, the market was down only 13% for the year but up nearly 20% from the low.

Economic data continues to be troublesome, yet the rapid decline in activity we saw in the fourth quarter has abated. While unemployment is worrisome, this is a lagging indicator, meaning it confirms what has already happened more than it predicts what lies ahead. Housing prices continue to decline, but sales activity has risen. Many banks are still in perilous states, although their stock prices have rallied. It appears as though the economy is indeed significantly weakened but not headed over a cliff.

Predictably, the stock market is in the process of re-pricing itself. In September, with the failure of Lehman and the government takeovers of AIG, Fannie and Freddie, the market panicked and priced in a depression. As time has passed and panic has subsided, most now believe that a depression scenario is not likely. Therefore, the market must revalue from a worst case level to a deep recession level. Hardly good news, but better than feared to be sure.

It is our view that the market will continue to rally to a new level reflecting a less dire reality. That said, we see little evidence that a new bull market is just around the corner. Positive economic growth will have to come from quarters we cannot as yet identify.

The perceived lack of bank lending makes for great (and frustrating) political theater. Congress doesn't let facts get in the way of good public spectacle. Demand for bank loans among consumers is *down*, and understandably so. We have all been told we have borrowed too much. Who among us would dare borrow more? Banks are not the only culprits here. Rather, the disappearance of what is known as the shadow-banking industry has led to the tight credit environment.

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HOW WILL INCREASED GOVERNEMNT SPENDING IMPACT THE STOCK MARKET?

The U.S. Government has embarked on a massive spending spree. We shall leave the political debate about the merits of the government's fiscal policy to others, and instead turn our attention to the effects of government stimulus on our stock market.

In 1936, John Maynard Keynes published <u>The General Theory of Employment, Interest and Money</u>, revolutionizing the way most governments view economic policy. In short, Keynesian theory supports a temporary increase in government spending when normal economic activity contracts (a recession), thereby allowing government to fill the void created by a weakened consumer and business environment. What is often misunderstood about Keynesian the-

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The Perils of Indirect Ownership of Investments

Wall Street is nothing if not innovative. Our industry has consistently developed ingenious ways to entice investors with new products.

Before we begin the rant we promised in the last issue of ***The TANDEM Report***, let us clarify what we mean by "indirect ownership". Most investors own a portfolio of stocks that they selected themselves or hired a manager to select for them (a money manager like Tandem or an actively managed mutual fund). We consider this direct ownership. It is direct because *someone* in this process has responsibility for selection and oversight of each investment. Indirect ownership, by our definition, comes in the form of investing by *proxy* in stocks—a basket of stocks that is not actively managed or watched over.

In the 1920's, the inventive financiers discovered a sizable market among small investors for something known then as Unit Trusts. Unit Trusts were initially developed as passively held baskets of stocks allowing the small investor instant diversification. Later, they became baskets of Unit Trusts, and they could be margined. Soon, the investor had no clue what he actually owned, only that he had a piece of the action. Some historians now point to the use of these vehicles as having promoted excessive speculation that led to the bubble that finally burst in the Crash of '29.

Fast forward to the 1990's and the proliferation of index funds. We warned at the time that index funds would become a self-fulfilling prophesy. As they gained in popularity, the stocks that comprised index funds grew in value. The market's advance became narrower as more investors shunned the notion of a portfolio in favor of an index. And when the party ended, the indices did worse than the broader market. Why, you ask? Because when it came time to sell, there was no selectivity involved. Investors simply sold the index. If an investor owned a NASDAQ index fund, that entire basket of stocks was indiscriminately sold. The good were thrown out with the bad.

This decade has given us such things as hedge funds and private equity, but the most egregious development (and this is an unpopular view we take) is the ETF, or exchange-traded fund. At least with a hedge fund, there is direct oversight of the underlying assets by the fund's manager. An ETF is by definition a basket of stocks selected at the time of the ETF's creation, and then held without regard to the quality of the individual stocks in the basket.

Originally touted as cheaper alternatives to index mutual funds, ETFs have become popular with traders, hedge funds and even money managers. The small investor in an ETF is swimming with the sharks. And now some ETFs offer leverage. Those wishing to bet that a particular index will decline can buy an ETF that is double or even triple short that index. Only the most sophisticated understand why one can lose money in this strategy even when right. Needless to say, the small, long-term investor gets killed while the professionals use these as day-trading strategies.

Our issue with indirect ownership generally and ETFs specifically is far less noble than concern for the unwitting small investor. We have no empirical evidence to support our case, so we must rely on intuitive reasoning. That said, we posture that when investors own stocks directly, there is liquidity and fair pricing in the marketplace, and decision making is based on pure self-interest. As ETFs proliferate, the nature of the marketplace changes from one that invests in individual stories to one that speculates on broader themes. This increases volatility for the market as a whole, as entire groups of stocks are bought and sold. The number of buyers and sellers of individual stocks decline, leaving behind a less efficient market.

Every great market decline in the last century has been accompanied by the presence of these speculative vehicles. From atop our soapbox we implore the investing public to shun these vehicles and know what they own. If the day comes when others share our view, investing in stocks will be safer for sure, and likely more profitable as well.

More Accolades (and Other Stuff)

We reported in the last issue that Tandem's Equity Income style was honored after the 3rd quarter of 2008 by PSN, the large database of money managers. PSN has again notified us that our performance in our Equity Income style places us among the 10 best Large Cap Core managers in their database for the quarter, one-year and three-year time periods ended 12/31/2008. While we are pleased with this acknowledgement (and it certainly isn't bad for business), we again feel compelled to stress that performance alone does not measure who we are as portfolio managers. Our job is to provide superior performance ***and*** less risk for the money you entrust us to manage. One without the other is not satisfactory. Accordingly, we were pleased to learn recently that a database that measures both performance and risk (Zephyr) confirms that our risk results are at least as lofty as our returns.

We humbly add that our success navigating this market has not gone unnoticed by many of you. We have recently earned new business that comes to us through referrals by our existing clients. We thank you for your support in these challenging times.

Please note a complete description of all our composites, including results, is available upon request. We make no performance claims other than the acknowledgements noted, and we further caution that past performance cannot predict future results.

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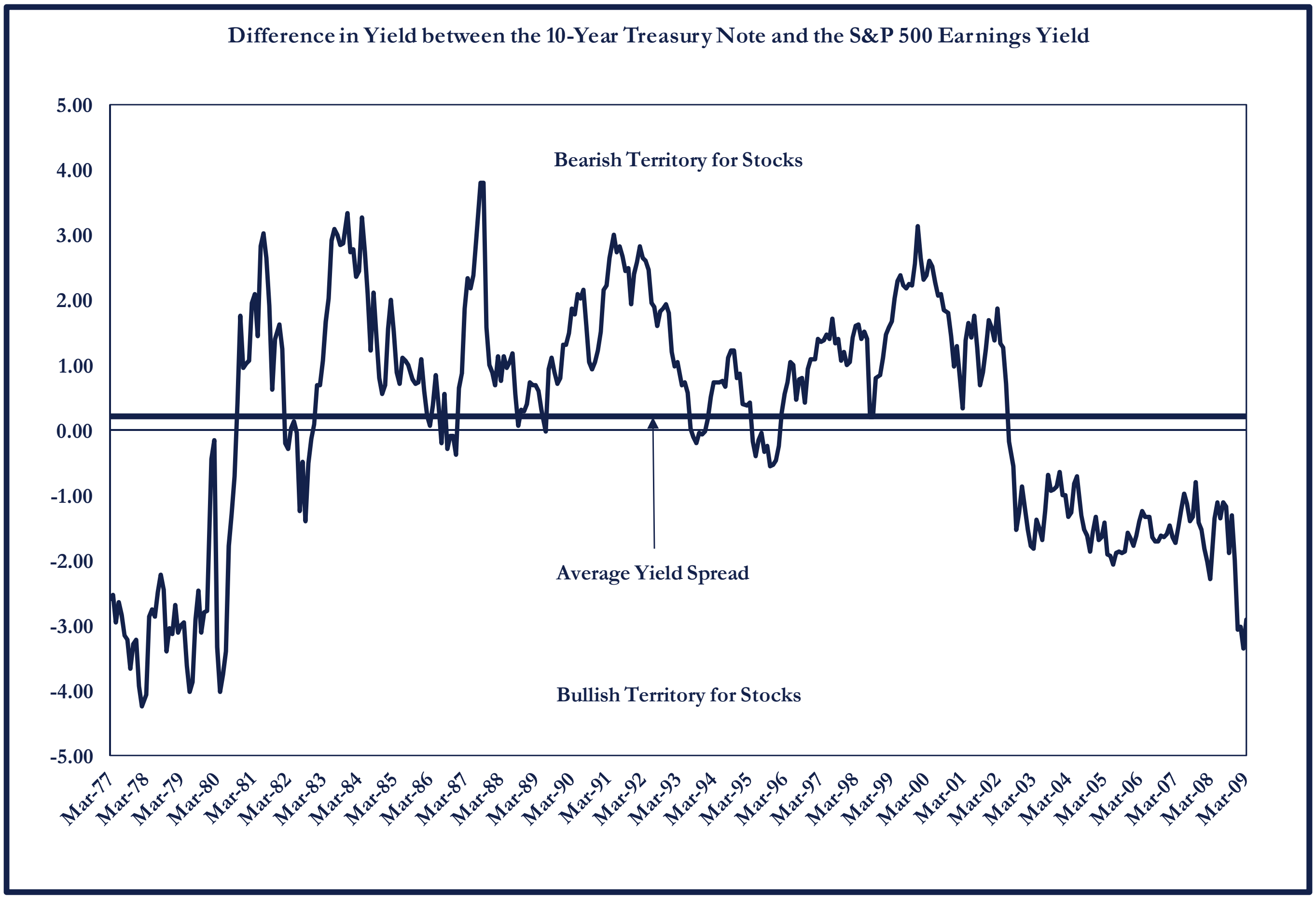
Gone are many of the finance companies that allowed us to buy flat screen TVs, laptops, refrigerators, granite counter tops and even cars on a whim. These were not traditional banking companies. Compounding matters is the collapse of the securitization market. Few of us realized at the time that when we financed our new TVs, our loans were packaged with similar loans and sold to surprisingly naïve investors around the globe. When investor demand for these "products" went away, there was no more money available to finance our whimsical purchases. Such purchases helped fuel the last economic expansion, and without easy financing, this type of consumer demand will not lead us out of this mess. This is not the fault of banks.

No, the banks can't be blamed for the failure of the shadow-banking market. But they can rightfully be blamed for making ill-advised traditional banking loans that now shackle them. Banks themselves borrowed more money than prudent and loaned it to perhaps sympathetic but nonetheless undeserving borrowers. As a result, banks find their capital impaired. One result of less bank capital is less bank lending. Coupled with more stringent requirements being imposed on the sector by both government and the marketplace, bank earnings will be under pressure for the foreseeable future. Banks will struggle to provide enough lending and profit to fuel future economic expansion.

Banks and shadow-banks in many ways are more a symptom than a cause. They are in the business of making profits (hopefully the government won't change this) and we are confident that when opportunity arises, those that have survived will find new and creative ways to help us finance our consumption. It is our new consumption patterns that lie at the very heart of the problem. If we, the immediate-gratification-seeking consumers, no longer desire to live beyond our means, it will take time for our financial condition to improve enough to consume without debt. And if we don't consume, the economy won't grow. The consumer traditionally makes up more than 2/3 of GDP, and our consumption has come to a grinding halt. Even the government can't fill this void, which bodes ill for future economic growth.



An improvement in the housing market will no doubt make consumers feel better about their financial health. We doubt, however, that a housing boom will emerge from this housing bust. Rather, much like our expectations for the stock market, we anticipate a stabilization, and perhaps even some modest price appreciation. In many ways, housing led

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ory, however, is that it does not advocate for or against a particular permanent size of government, only for a temporary expansion beyond the norm.

A temporary increase in government spending during recession can provide a much-needed boost. Recall from the previous issue of ***The TANDEM Report*** that GDP (Gross Domestic Product, the common measure of economic growth) is defined as the sum of consumption, investment, government spending and net exports. In a recession, consumption and investment typically lag. Increased government spending can be a valuable tool to promote GDP growth until the economy regains its footing.

However, skeptics tell us that increased government spending is never temporary. Our data analysis leads us to conclude that the stock market should be counted among the skeptics. The collection of dots in the chart below confirms that the stock market typically greets expanding government with negative returns and vice versa.

Since the accompanying chart is *not* self-explanatory, allow us to elaborate. First, we assume that the stock market (represented by the S&P 500) is forward looking. Second, we assume that the absolute size of government spending as a percentage of GDP is less relevant than the *change* in size. Thus, for every year since 1950, we computed the calendar year return for the S&P and plotted that return with the change in government spending for the *following* year (forward looking). Each such year is represented by a blue dot. The big red dot in the middle represents the average annual change. Government spending moves from left to right across the bottom of the chart, and the calendar year S&P returns move from bottom to top on the left.

Of the 59 years observed, government spending as a percentage of GDP was *less* than the average annual increase 37 times. Of those 37 times, the S&P gained more than average in the preceding year 65% of the time. More importantly, government spending increased at an above average rate 22 times, with the preceding year's market return less than average 73% of the time. From this data, we conclude that the market does not like increased government spending and rallies in anticipation of government contraction.

Some may argue that economic circumstances causing government expansion also lead to market declines. We acknowledge this may be so, yet we are inclined to accept the evidence at face value. There have been 9 recessions since 1950, which would not account for all 22 periods of government expansion. Further, of the 6 times the market responded positively to government expansion, 3 came during recession, while the other 3 came just prior to recession. We think the market has it right.

The market's reaction aside, there are other issues investors must contend with. First, how does the government pay for its increased spending? The government typically has two sources of money: revenues (taxes) and borrowing. During a recession such as the present one, revenues decline, leaving borrowed money as the only viable source of funds for increased expenditures. Increased borrowing leads to higher interest rates. If we assume that there is presently perfect equilibrium between the amount of money sought to be borrowed and the amount of money available to lend, inter-

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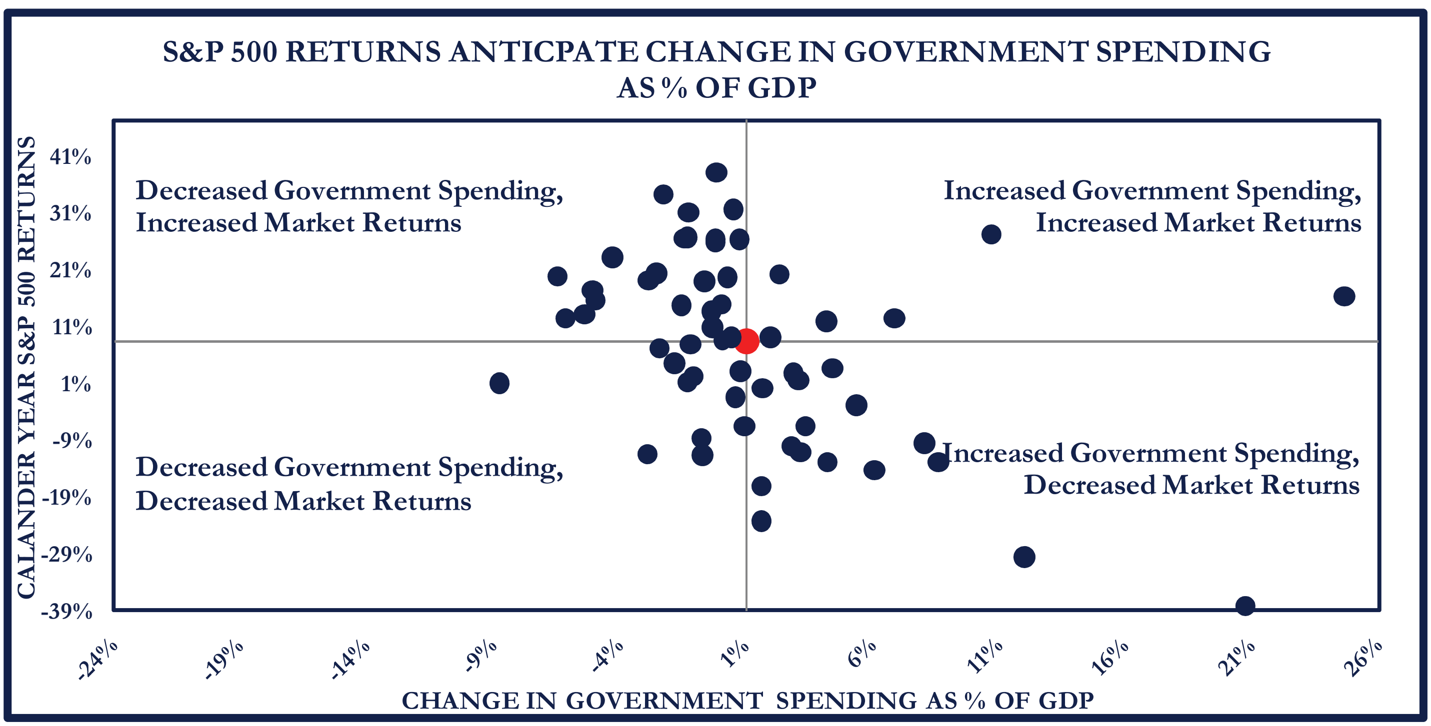

MARKET COMMENTARY (CONTINUED)

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us out of the last recession. With tighter lending standards and fewer qualified buyers in this new environment, housing is not likely to lead the way again.

We do not look for investors to lead us out of the doldrums either. As we have written many times, too many investors never contemplated the risks they were undertaking in search of creating wealth. It bears repeating that we do not believe that investing should be about wealth creation. It should be about wealth preservation. Wealth is best created by situations that permit us to influence the outcome. We cannot influence the outcome of the price of copper, gold or IBM. As the market recovers, many will be looking to "get out whole" and sell their holdings as the price approaches their cost. This selling pressure makes it difficult for rallies to sustain themselves.

For the economy to return to positive growth and the stock market to begin a new bull market, something new must lead us. In both our experience and our education, we cannot recall the emergence of a new bull market led by the same sectors that fueled the previous bull. Thus, we conclude that government policies, financials, energy and commodities will not lead us forward anymore than real estate will.

The 1990 recession gave way to a technology boom that revolutionized the world. The 2001-2002 recession brought us a recovery led by consumer demand and investor speculation as a result of historically low interest rates. What will lead the next bull market? That is anyone's guess, so here is ours.

We see a market that will not enjoy the same level of participation among investors that previous markets experienced. Many have been so burned by their experiences that they will not soon return. We expect that many past participants will be less willing to allocate assets to areas they do not fully understand or that do not provide adequate liquidity, creating new demand for more traditional investments like stocks.

Speculators will gravitate toward what has fared the worst, but we believe real opportunity lies in what has held up the best. Manufacturing will again attract talent as the rich rewards offered by Wall Street fade into history and the best and brightest rethink their career strategies. The global economy will resume its growth, and we anticipate that quality, not just cheap, will again be rewarded. We expect that, with the dollar likely headed for a prolonged period of weakness, U.S. produced goods will be more competitive around the world.

Some may say that our perspective is wishful or even nostalgic. Perhaps so. Yet the U.S. stock market was not in a bubble. Everything else was, but not U.S. stocks. As the chart on page 3 indicates, stocks are at levels of valuation relative to fixed interest investments not seen since the 1970's. And when the 70's ended, the market experienced the same type of growth we expect to see again.

There are many parallels between that decade and this, and we suspect the recovery will be similar as well. Massive government intervention brought higher interest rates and large deficits. Recessions were separated by short bursts of growth before the economy finally found footing as interest and tax rates declined. We anticipate this recession will not be our last before the market returns to a more sustainable bullish posture. While the current recession may be nearing its natural end, government involvement has the potential to choke off the economy's resurgence.

Finally, it is our opinion that the stock market has become an unloved and undervalued asset class that in time will attract investors the world over with this plain, simple maxim - growing earnings and growing dividends will bring growing share price. Keep the faith.

INCREASED GOVERNMENT SPENDING (CONTINUED)

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est rates will be stable. If demand for borrowed money increases while the supply available to lend remains unchanged, interest rates must rise to entice new lenders. This scenario is typically harmful to the stock market as some investors leave stocks when enticed by higher interest rates.

A second complication for stock (and bond) investors is that increased government spending is often inflationary. When the government spends money, it consumes goods and services. When the economy emerges from recession, the public sector wants to consume goods and services as well, but may find itself in competition with the government. Increased demand without a corresponding increase in supply causes prices to rise. Can the government curtail its spending before inflation emerges?

Keynesian theory prescribes temporary government stimulus to boost demand. Reality tells us that once expanded, government rarely contracts. Thus, we face a conundrum. Do we want the economy to run its own course, or do we want medicine to cure the ills in spite of the side-effects? This debate may never be resolved, yet it is part of the world we face. The market has reason to be cautious. The cure may be worse than the cause.

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Market Report Card

Yield table	Current	3 months ago	1 year ago
3-month Treasury Bill	**0.22%**	**0.51%**	**1.37%**
5-year Treasury Note	**1.82%**	**1.50%**	**2.74%**
10-year Treasury Note	**2.82%**	**2.18%**	**3.60%**
30-year Treasury Bond	**3.64%**	**2.87%**	**4.41%**
Prime Rate	**3.25%**	**3.25%**	**5.25%**
Federal Funds Rate	**0-0.25%**	**0.25%**	**2.25%**
Discount Rate	**0.50%**	**0.50%**	**2.50%**
3-Month LIBOR	**1.19%**	**1.41%**	**2.70%**

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.

Stock Market Index Data				
Stock Market Indices	03/31/08 Close	% Change 1 Year	% Change 5 Years	% Change 10 Years
S&P 500	**768.54**	**-41.90%**	**-31.76%**	**-37.98%**
Dow Jones Industrial	**7,608.92**	**-37.95%**	**-26.54%**	**-22.25%**
Russell 1000	**433.67**	**-39.79%**	**-28.13%**	**-35.03%**
Russell 3000	**461.14**	**-39.69%**	**-28.14%**	**-32.66%**
Russell 2000	**422.75**	**-38.55%**	**-28.39%**	**6.32%**
Global Market Index Data				
Hang Seng	**13,576.02**	**-40.58%**	**7.05%**	**24.07%**
Shanghai	**2,373.21**	**-31.66%**	**36.26%**	**NA**
Nikkei 225	**8,109.53**	**-35.26%**	**-30.78%**	**-48.79%**
Brazilian Bovespa	**40,926.00**	**-32.87%**	**84.83%**	**282.63%**
London FTSE 100	**3,926.10**	**-31.15%**	**-10.48%**	**-37.63%**
German Xetra DAX	**4,084.76**	**-37.49%**	**5.91%**	**-16.37%**