

# THE TANDEM REPORT

Volume XI, Issue 2 April, 2010



*“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: THE STEALTH BULL MARCHES ON

The market continued its bull run in the first quarter, even as many investors remained on the sidelines awaiting the ever-illusory pullback. The S&P 500 posted strong gains of 4.87% on the heels of last year’s dramatic bounce off the March lows in spite of fairly widespread investor apprehension. Although many believe a correction is long overdue, we have yet to experience a meaningful one since the rally began.

There remain many justified concerns for investors to contemplate: the sustainability of economic growth; high unemployment; mounting government debt; etc. Some-

how, issues such as these continued to be shrugged off as the market marched on.

Unlike last year, the first quarter didn’t “feel” like a real bull. However, market statistics (*see table below*) reveal a story of quiet strength. Advancing days outnumbered declining by nearly a two-to-one margin and volume in the S&P exceeded the five year average for all but 1 trading day. To be sure, there was evidence of a nervous investing public. Down days were far more dramatic. The biggest one-day decline was -3.11% with over 30% of down days declining more than 1%. The

*(Continued on page 3)*

Daily 1<sup>st</sup> Quarter Statistics for the S&P 500

	% of Days	Most Consecutive Days	Largest % Daily Move	Average % Daily Move	% Days Moving >1%/<-1%	% of Days S&P Volume > 5 yr. avg.
Market Up	62.3%	6 (twice)	1.80%	0.58%	18.42%	98.4%
Market Down	37.7%	3 (once)	-3.11%	-0.78%	30.43%	1.6%

## COMMENTARY:

### WHY INTEREST RATES WILL RISE REGARDLESS OF FED POLICY

The Law of Supply and Demand will trump Federal Reserve policy every time. The Federal Reserve clearly wishes to hold interest rates low for the foreseeable future in its effort to stimulate economic recovery and growth. Investors, frustrated by the resulting low yields in traditional savings vehicles, have poured unprecedented amounts of money into bond mutual funds. This, in effect, has aided the Fed’s efforts to hold rates low. After all, the Law of Supply and Demand informs us that increased demand leads to increased prices. But what happens when this massive investor demand for bonds

dissipates? We think it means that bond prices will fall and yields will rise. Here is why.

First, a quick bond review. Remember that when bond prices rise, bond yields fall and vice versa. Bond prices and interest rates are inversely correlated. If you own a 5% bond that you paid \$1,000 dollars for and hold it until rates drop to 3%, your bond is worth more than \$1,000 because it pays more income than the current rate of 3%.

Now, back to why rates will rise regardless

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## *THE LESSONS OF EXCESSIVE RISK APPEAR TO BE LOST ON THE “SMART MONEY”*

**I**t's simple math really. If you lose half your money, you need to double what's left just to get back to even. Rather than absorbing the lessons of the financial crisis, many investors are now swinging for the fences with their investment strategies in an effort to recoup their losses. Too often, risk is dismissed in pursuit of returns. If you can't afford to lose half your money, then don't lose half your money!

To be clear, this is not an argument for “conservative” investing, whatever that means. Taking on more risk than is appropriate can force investors into a position where they will take on ever more risk just to get back to where they started. In our opinion, most investors get this. In fact, it is clear that individual investors, like Tandem's clients, behaved rationally and responsibly leading up to and during the financial crisis. The “smart money” apparently did not.

Much of the so-called forward thinking about investing the past decade has come from the endowment funds of our colleges and universities. Their actions have been closely mirrored by pension funds. An article in the March 22<sup>nd</sup> edition of *Pensions & Investments* points out that, as a result of the recent financial crisis, both public and private funds find themselves under-funded for the obligations they have to their retirees. We would hasten to add that while the article did not specifically discuss endowments, they, too, are struggling to fund the operations they are supposed to support.

According to this article, public and private pension funds are opting for different paths to solvency. Private funds (corporations) will make up their shortfalls through increased contributions from profits. In our view, this is a

prudent response to recovering losses incurred by taking on excessive risk. Public funds (governments, municipalities, etc.), on the other hand, are reportedly considering taking on added risk to earn back what they lost. Isn't that what put them in this predicament in the first place?

We have long maintained that markets have failed to adequately price risk and that the majority of the stock market selloff in 2008 and 2009 was not a market event but rather one driven by a lack of liquidity for investors. Recent reports indicate that either others do not share our opinion or they have already forgotten what they should have learned.

Either way, public pensions funds (and certain large endowments as well) are beginning to take on riskier strategies in an effort to boost returns. These strategies rarely involve stocks. In fact, the latest strategy in vogue is called “Risk Parity”. Risk Parity is achieved by taking on leverage to increase bond holdings (*see our “Commentary” on page 1 in case you don't know how we view this*). This will increase the contribution of bonds to the portfolio, and the smart money deems this a good thing. While it is true that bonds were the only asset class that experienced positive performance during the bear market, it is also the asset class that most resembles a bubble formation now.

Excessive risk led to the economic turmoil we are struggling to emerge from. The dust has barely settled and already crazy strategies are emerging. There was a time when our largest institutions just held stocks and bonds in their portfolios. Maybe one day soon that can be the “new” strategy. Until then, it continues to work just fine for us. Some people seem to forget that they are managing other peoples' money.

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## *TANDEM IS PLEASED TO ANNOUNCE A MID CAP CORE STYLE*

**S**ince our firm's inception in 1990, Tandem has been considered a Large Cap manager. Until now. Large Cap is industry parlance for companies with a market value in excess of \$10 billion. Market value is determined by multiplying a company's share price by the number of shares outstanding. Mid Cap stocks have a market value between \$2 billion and \$10 billion, while Small Cap stocks have market values less than \$2 billion.

Mid Cap Core is a logical extension. Our research model, which we call TVM, is fed by a database of stocks that primarily come from the Russell 1000. Most of these stocks are actually Mid Cap. While our *style* has been correctly identified as Large Cap because of our overall portfolio characteristics, we have been managing Mid Cap stocks within our

portfolios for nearly twenty years. We have always offered two basic Large Cap Styles, now known as Large Cap Core and Equity. Large Cap Core requires that a dividend be paid while Equity does not. We also offer Balanced accounts that include a fixed income portfolio along with one of our equity styles.

Tandem's Mid Cap Core strategy is based on our Equity style. We use the same discipline, and process. We just use less than 100% of our database for research purposes. Mid Cap stocks are historically more volatile than Large Cap, but we believe it is an important option for our clients. While our Mid Cap Core is too new to offer a track record, our expectation is that we will continue to deliver *superior returns AND less risk* to our clients.

## MARKET COMMENTARY (CONTINUED)

(Continued from page 1)

up days were more tempered, but remarkably consistent. With only 18% of up days gaining more than 1%, the average daily advance was a measured 0.58%. Some called the first quarter a stealth bull because its advance was tepid on a daily basis while being impressive cumulatively.

There is evidence that those fortunate enough to be in the market are increasingly cautious. The 2009 rally was led largely by those stocks that had been crushed the most during the great Bear Market of 2008. For the year, only three of the ten S&P industry sectors outperformed the S&P 500: Information Technology, Materials and Consumer Discretionary, volatile industries all. In the first quarter of 2010, four sectors outperformed the broader average, with Consumer Discretionary the only repeat. Consumer Staples and Industrials (more defensive sectors) joined the ranks along with Financials. Perhaps this sector rotation away from the more volatile industries indicates the desire to remain invested while being protected.

Tandem clients are more fully invested now than at any time in the last two years. Some of this is due to greater confidence beginning in December of 2008 resulting in putting cash back to work. Some is due to the appreciation of the securities we hold, decreasing the percentage of cash we hold, if not the dollar amount. Yet we too are cautious. We continue to overweight the less economically sensitive sectors like Health Care, Consumer Staples and Industrials, while having limited holdings in Energy and Financials.

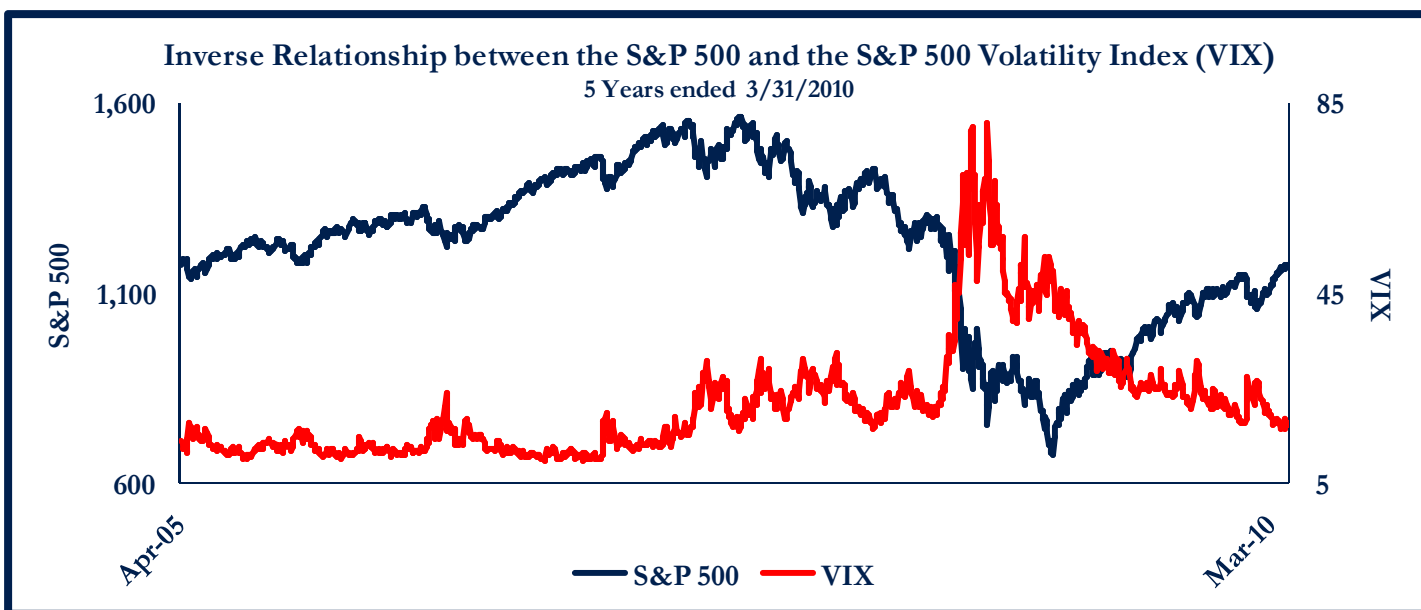
Confirmation of justified optimism may be displayed in the chart below. In the stable market of the period between 2005 and mid-2008, fear was very low. The VIX index is also known as the fear indicator, and levels were low until

Spring of 2008, when Bear Sterns had to be sold to J.P. Morgan on St. Patrick's Day. After that, the fear index spiked to unprecedented levels until the market began to stabilize. Now, as the market continues its recovery, we find the VIX back at more normal levels, indicating fear has gone, if not skepticism.

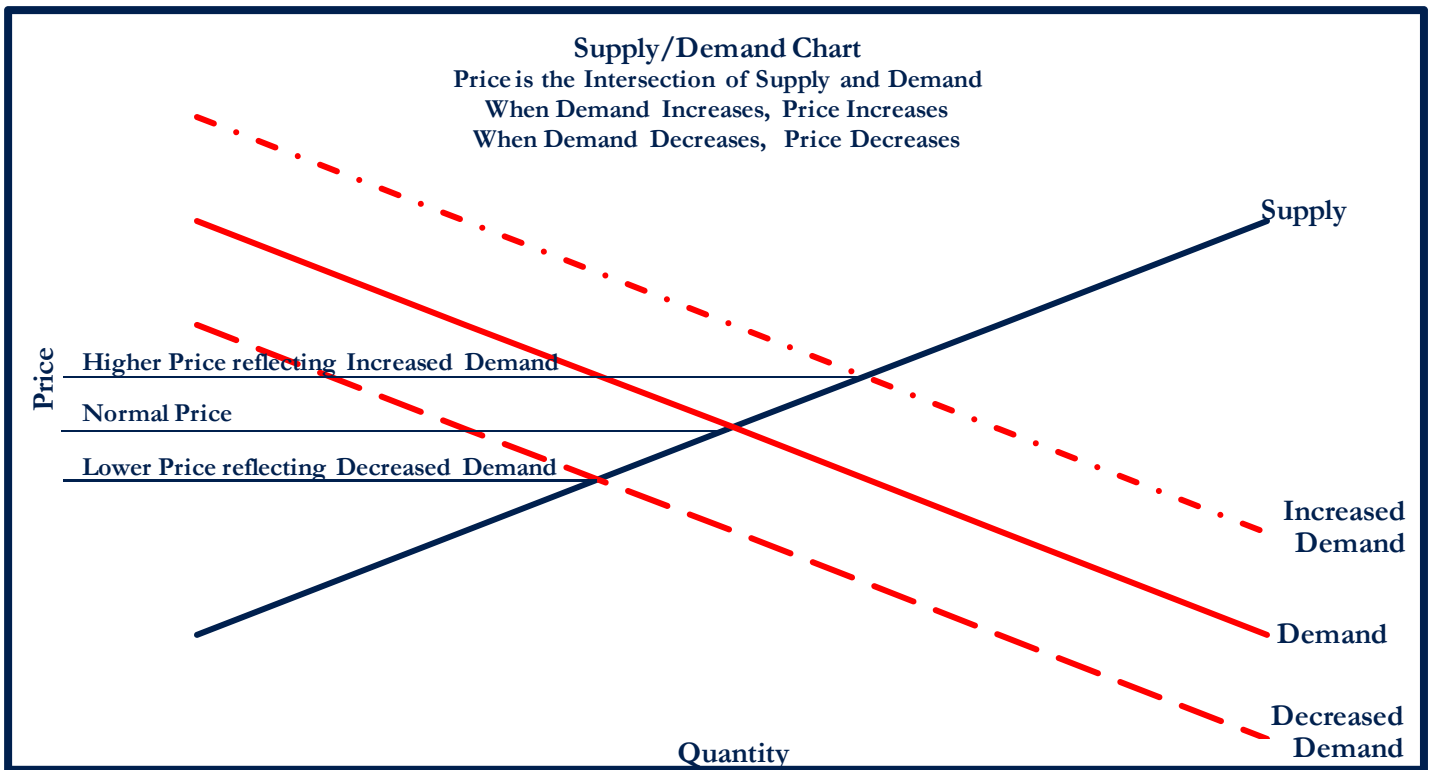
As you may recall, we said at the time that the stock market decline was less a stock market event than a liquidity event. As investors spent the majority of the decade loading up on less-liquid investments (like real estate), stocks were all that could be sold quickly as the bursting bubble created a liquidity crisis. Certainly the crisis created a different economic environment that does affect stocks, but, unlike most bear markets, this one punished stocks for the sins of other asset classes.

Thus, it makes sense to us that stocks would recover to a more normalized level and fear would abate. We do not know where that more normalized level may be. We may not be there yet, or we may have overshot it. So we proceed with caution, but we participate nonetheless.

We believe the prudent strategy to follow is to invest in businesses that grow their earnings (and dividends) in any economic environment. The stocks of these businesses tend to be less volatile, and we still find value in these areas. But we can never be too sure. We will continue to rely on our sell discipline, which places exit stops under the market price of certain portfolio holdings. By doing so, if our holdings begin to decline, we become sellers automatically. This approach has served us well over the years and affords us the opportunity to participate in a rising market (even one that makes many nervous) while having confidence that our risk is controlled. So, for now, *laissez les bon temps rouler!* But keep risk control on the front burner.



COMMENTARY (CONTINUED)

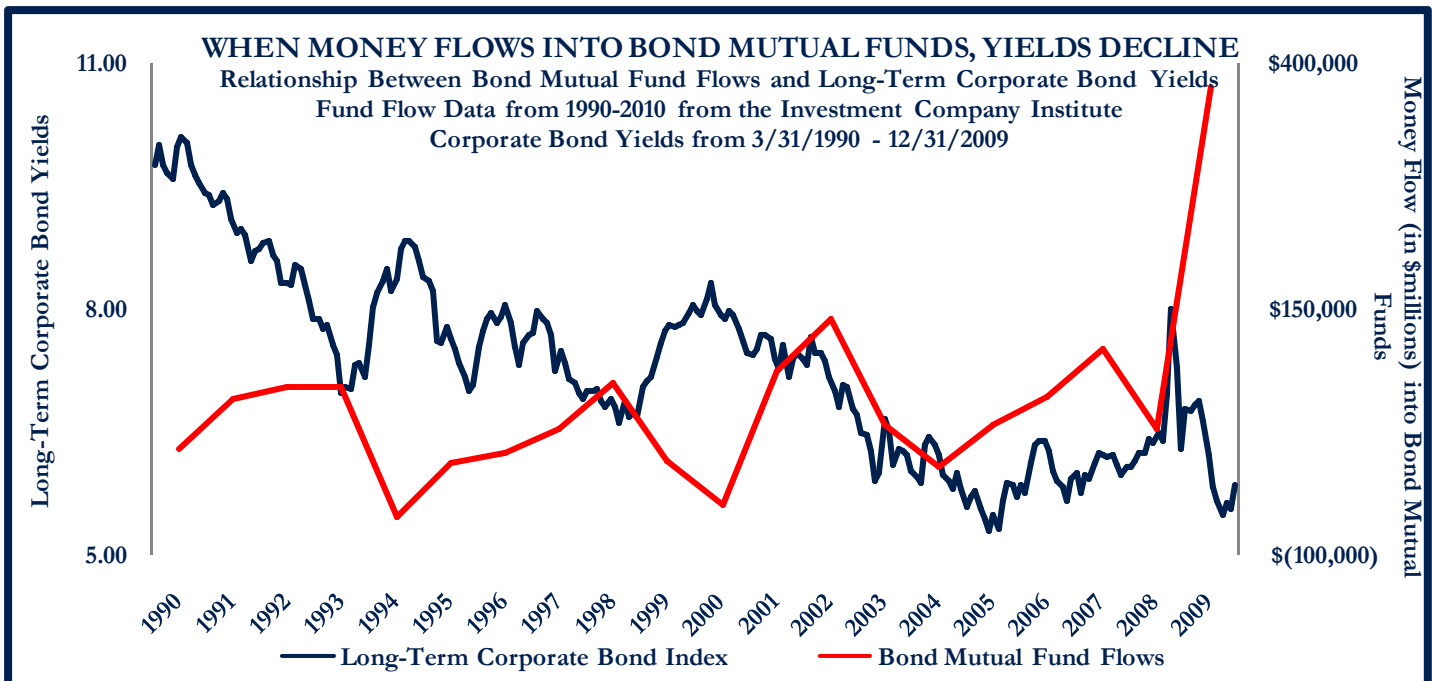


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of Fed policy. Simply put, the current level of investor demand for bond funds is unsustainable. According to the Investment Company Institute, investors added an average of \$33.9 billion to bond mutual funds annually between 1984 and 2008. The largest annual increase was \$140.6 billion in 2002, and 7 times investors took out more than they put in during this period. In 2009, investors added a net total of \$375.5 billion - 2.67 times the previous record amount. A look at the chart below shows a strong correla-

tion between fund flows and bond yields. Every spike in flows (demand, the red line) corresponds to a low in interest rates. Similarly, when flows decline, rates rise. One doesn't need to be a practicing forecaster to conclude that the dramatic spike in 2009 flows will likely be followed by a decline to more normal levels, resulting in higher interest rates.

We believe that the 2009 levels of new money going into bond funds is a bubble waiting to pop. From 1984 through 2008, money going into stock funds exceeded money going into bond funds by 2.5 to 1. The most ever added to stock



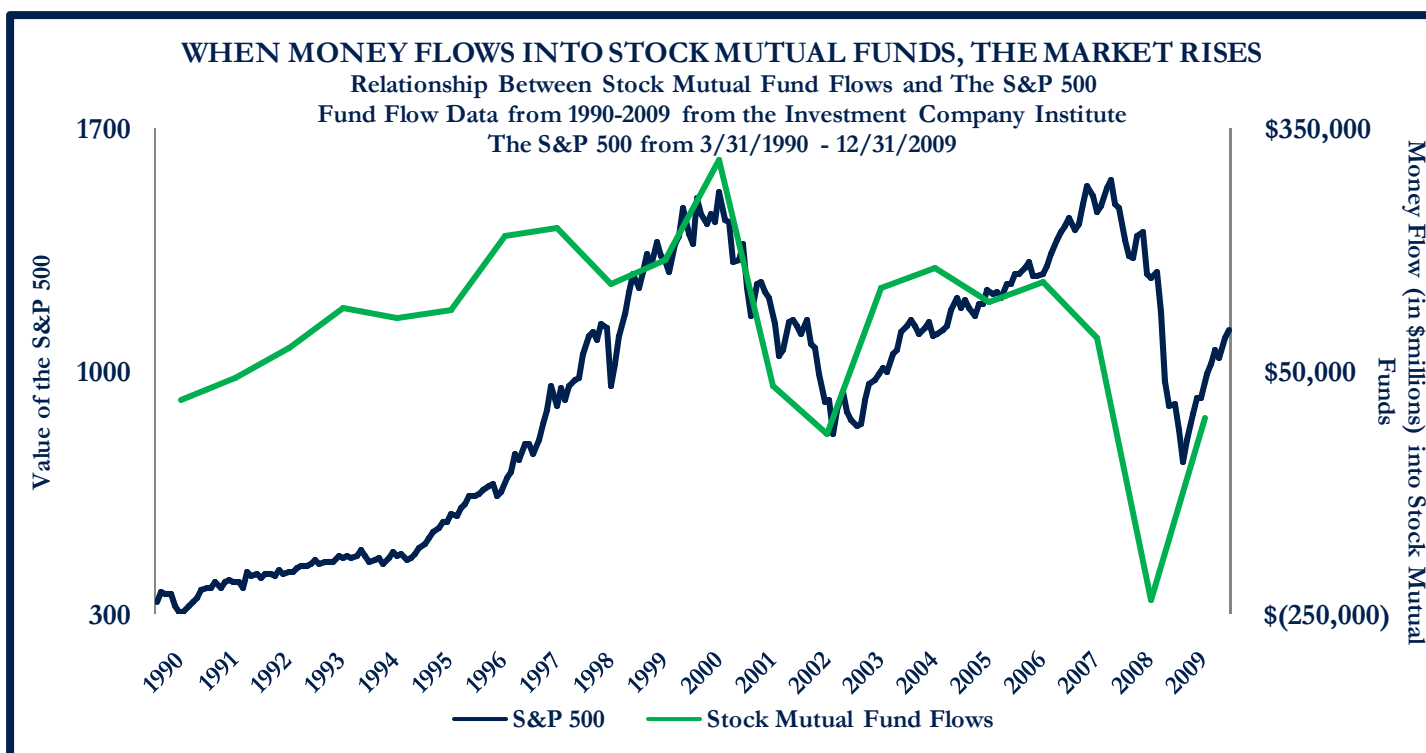
## COMMENTARY (CONTINUED)

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funds in one year was only \$309.4 billion (versus the \$375.5 billion into bonds in 2009). Much of the new money going into bond funds now has come at the expense of stock funds. Yet the chart below shows a bottoming and reversal in 2008 and 2009, just as the market was turning around. With history as our guide, we expect both bond and stock mutual fund flows to normalize as the stock market is more widely perceived to be on solid footing.

lation to the direction of markets. It is our contention that excessive demand for bond funds has created a bubble, and when demand dries up, the bond market will implode.

For investors seeking the principal protection bonds offer, we prefer direct ownership of bonds to participating in a bond fund. For investors seeking income, we prefer stocks with rising dividend streams. While the Fed desires to stimulate growth through low interest rates, current demand will eventually be curtailed, sending rates higher even if the



Unfortunately, many bond fund investors do not fully appreciate that they can lose money. When you own a bond, regardless of what interest rates do, you can get your principal back if you hold the bond to maturity. When you own a bond *fund*, you don't own bonds. You own shares of a fund. Those share prices not only rise and fall in value, but they do not mature. This means that return of principal is not a certainty by any means.

We fear that as these unsuspecting investors come to grips with the fact that they have lost money in their bond funds, many will sell their funds, sending bond prices lower and yields higher. Another bubble will pop.

Lest we be accused of cherry-picking data to suit our purpose, we have created the accompanying chart above to indicate the importance of fund flows to stock mutual funds as well. The evidence is clear. While there are certainly important external factors that influence the direction of both stock and bond prices, investor demand has a strong corre-

Fed has not raised the rates it directly influences.

Many have cautioned against Treasury bonds. We strongly disagree. The surge in demand has increased the price of all bonds - corporates, junk and municipals alike. In fact, the difference in interest rates between investment grade corporates, municipals (taxable-equivalent yield) and Treasuries is now so miniscule that we cannot justify taking on added risk for so little added return. Therefore, our bond strategy is chiefly to hold short-term treasuries and wait for the bubble to pop. When interest rates rise, we will be able to take advantage of the aftermath for our clients that want to hold bonds.

Of course, the bond market can influence the stock market as well. If we are correct, we expect stocks to become more favored by investors fleeing their bond funds. Bubbles can last a long time. Yet the charts that we have constructed for this article provide as clear a picture as we could have imagined. Excesses are not sustainable. The Law of Supply and Demand is constant.



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**MARKET REPORT CARD**

YIELD TABLE				STOCK MARKET INDEX DATA				
	Current	3 months ago	1 year ago	Stock Market Indices	3/31/10 Close	% Change 1 Year	% Change 5 Years	% Change 10 Years
3-month Treasury Bill	0.16%	0.05%	0.22%	S&P 500	1,169.43	46.57%	-0.95%	-21.96%
5-year Treasury Note	2.55%	2.34%	1.82%	Dow Jones Industrial	10,856.63	42.68%	3.36%	-0.60%
10-year Treasury Note	3.84%	3.59%	2.82%	Russell 1000	643.79	48.45%	1.26%	-19.32%
30-year Treasury Bond	4.72%	4.49%	3.64%	Russell 3000	688.74	49.36%	1.97%	-16.62%
Prime Rate	3.25%	3.25%	3.25%	Russell 2000	678.64	60.53%	10.34%	25.89%
Federal Funds Rate	0-2.25%	0-0.25%	0-0.25%	GLOBAL MARKET INDEX DATA				
Discount Rate	0.75%	0.50%	0.50%	Hang Seng	21,239.35	56.45%	57.13%	22.02%
3-Month LIBOR	0.29%	0.25%	1.19%	Shanghai	3,109.10	31.01%	163.21%	72.71%
				Nikkei 225	11,089.94	36.75%	-4.96%	-45.47%
				Brazilian Bovespa	2,373.71	110.82%	69.50%	317.00%
				London FTSE 100	5,679.60	44.66%	16.04%	-13.16%
				German Xetra DAX	6,153.55	50.65%	41.50%	-19.03%

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.

Returns are cumulative, not annualized.