

THE TANDEM REPORT

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“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 informative.

Respectfully,

John B. Carew
President,
Chief Investment Officer

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MARKET COMMENTARY: THE RISK TRADE MARCHES ONWARD AND UPWARD. IS IT SUSTAINABLE?

Global markets continue to benefit from what has come to be known as *the risk trade*. Low U.S. interest rates and a weak dollar are driving investors into assets riskier than they might otherwise consider (hence, the “Risk Trade”). This is the design of the Federal Reserve as it attempts to bolster the U.S. economy through its purchase of U.S. Treasury securities. Investors are pouring money into riskier asset classes as they try to find returns greater than the almost 0% provided by more traditional savings vehicles.

Fed policies are sending commodity prices higher. Stocks related to commodities have outperformed most other categories of stocks. The table to the right illustrates this point. For the first quarter of 2011, the S&P 500 advanced 5.9%. Only the Energy and Industrial sectors outperformed. The other eight sectors all trailed the market,

S&P 500 Sectors <i>(Source: Standard and Poor's)</i>	% of S&P 500	1st QTR Return
S&P 500	100%	5.9%
Consumer Discretionary	10.46%	5.1%
Consumer Staples	10.22%	2.3%
Energy	13.25%	16.8%
Financials	15.82%	3.6%
Health Care	11.07%	5.6%
Industrials	11.30%	9.2%
Information Technology	17.98%	3.1%
Materials	3.69%	4.4%
Telecomm. Services	3.03%	3.4%
Utilities	3.19%	2.3%

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COMMENTARY:

POPULARITY IS NOT THE BEST PREDICTOR OF FUTURE SUCCESS

Think of the stock market as a high school senior class. Popularity is extremely important. However, when that senior class is viewed years later, popularity is not always the most reliable predictor of future success.

In the 1960's and early '70's, the stock market was dominated by the *Nifty Fifty*, a group of large cap stocks traded on the New York Stock Exchange that were widely regarded as solid buy and hold growth stocks. The group included such venerable names as American Express, Coca Cola, IBM and Johnson & Johnson, familiar and admired companies even to this day. It also included Digital Equip-

ment, Emery Air Freight, Polaroid and the Joseph Schlitz Brewing Company (companies with less glorious fates).

The *Nifty Fifty* became so beloved by investors that their prices soared to exorbitant valuations relative to the rest of the market. By the mid-'70's, as the economy stumbled, the group became viewed as overvalued and their fall from grace was more dramatic than the broader bear market that ensued. It took years for many of these companies to once again reach their previous high prices. Some failed to survive.

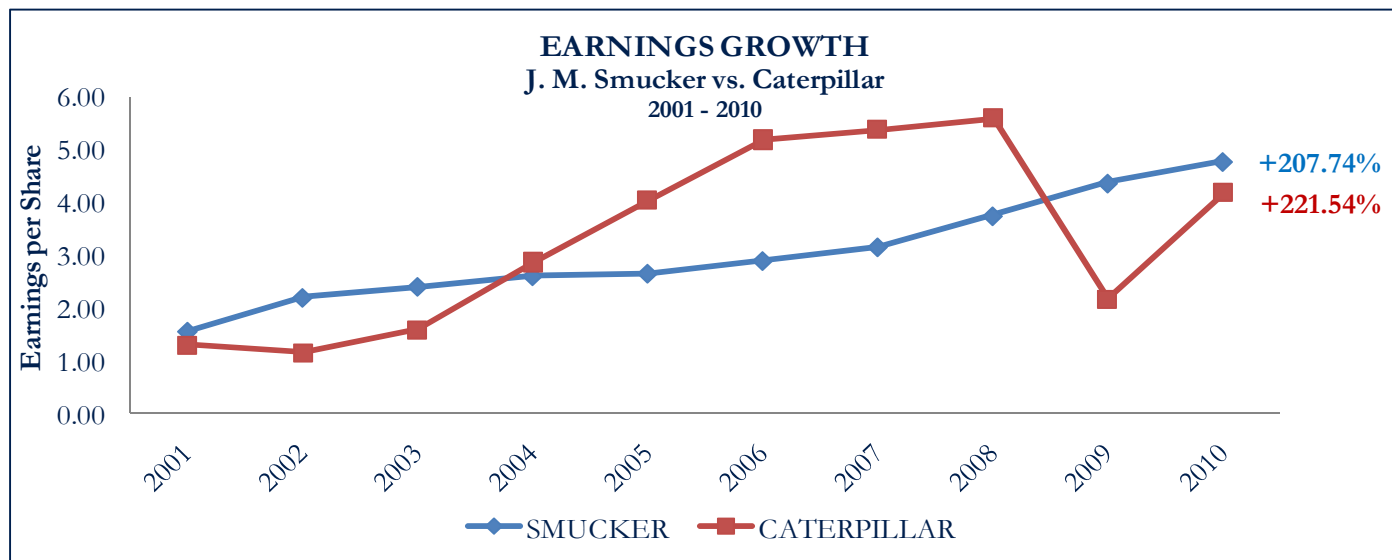
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THE TORTOISE AND THE HARE

J.M. SMUCKER AND CATERPILLAR

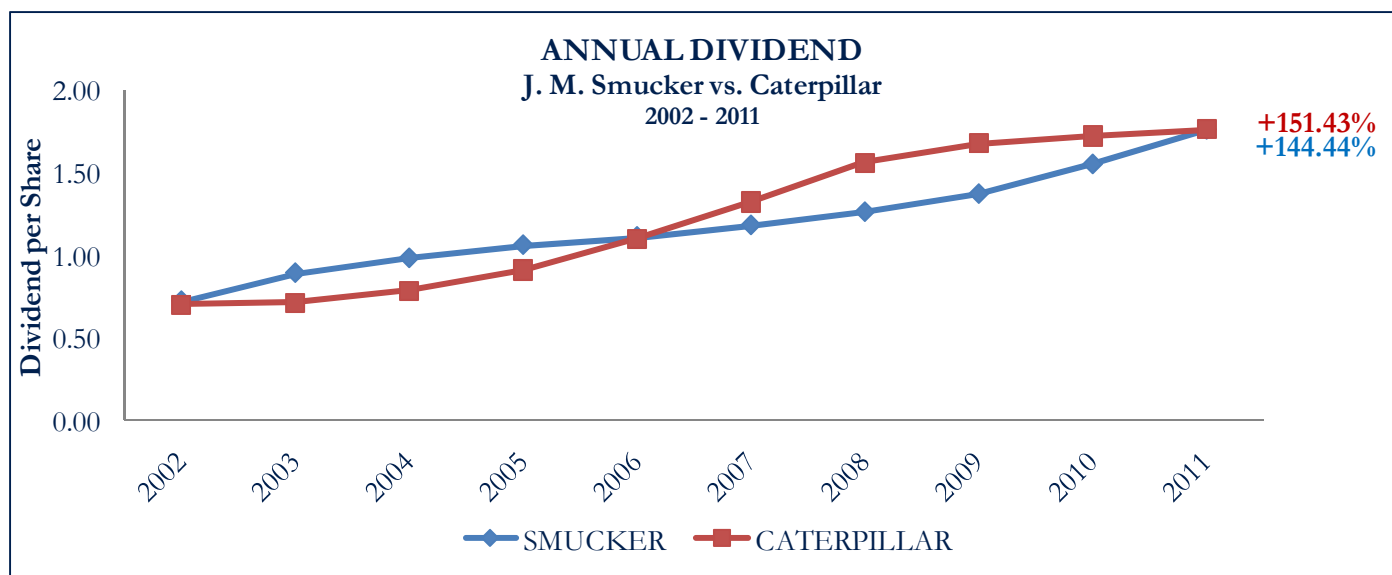
Asop's legendary fable of the tortoise and the hare provides a useful frame of reference as we examine two iconic American companies: J.M. Smucker (the tortoise) and Caterpillar (the hare). Both are outstanding corporations yet very different investments. Smucker is a relatively unexciting tortoise of a company that makes peanut butter, jelly and coffee. Demand for its products is influenced little by globalization, governments, interest rates or boom and bust economic cycles. The company keeps

recovery periods as the times the hare races ahead of the tortoise. Since 2000, we have had two recessions and two recoveries. The first chart below shows earnings growth for the pair over the last 10 years. Smucker steadily grows year after year while Caterpillar zooms ahead during economic recoveries and naps a bit during recessions. At the end of the day, the two end up in virtually the same place, yet one enjoyed a steady march while the other experienced highs and lows. Guess which one we own?



churning out its products and consumers keep buying them. It would almost be a boring story if Smucker didn't do such an extraordinary job of making money for their shareholders.

The chart at the bottom of the page shows dividends paid over a ten-year period. Both are clearly solid companies that reward their shareholders. In 2002, Smucker paid a \$0.72/share dividend and Caterpillar paid \$0.70/share. Today,



Caterpillar, the hare in our story, produces significant returns in certain economic cycles while facing strong headwinds in others. Think of recessions as the hare's nap and

they both pay \$1.76. These two great companies have grown earnings and dividends by nearly the exact same

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COMMENTARY (CONTINUED)

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Fast forward to the late 1990's when the new nifty fifty became the Tech Bubble. Markets raced to record levels with technology stocks rising even further and faster. Then in 2000, the bubble burst. Today, many of the companies that were believed to represent the future no longer exist. Others, like Cisco, Applied Materials and Intel, are nowhere near their share prices of a decade ago. In 2000, the S&P 500 (representing the broader market) peaked at 1,517.68 and the NASDAQ (dominated by technology stocks) reached 4,696.69 on a monthly closing basis. Eleven years later, the S&P 500 is 12.64% below its high in 2000. The NASDAQ is an eye-popping 40.79% below its 2000 high.

Stocks that become popular tend to become overpriced. They may be terrific companies, but they are no longer terrific stocks. To be sure, one can make a lot of money investing in what is popular. It has always been equally certain that one can lose a lot of money in the same stocks if they are not sold at the right time. Popular stocks cannot be bought and held. They require an appropriate exit to be a good investment. And herein lies the challenge.

We were not investors when the *Nifty Fifty* ruled the day. We did, however, live through and survive the Tech Bubble. There were not many warning voices before the bubble burst and a lot of people got hurt. Many confused the collapse in share prices with a buying opportunity. It wasn't. History tells us that it is a heck of a lot easier to know when to buy something than it is to know when to sell something. Professionals and amateurs alike fall prey to the euphoria of making money and stay at the party too long.

The *Nifty Fifty* and the Tech Bubble were investment themes that resonated with investors at the time but ultimately ended badly. So why are we discussing past popular investment themes now? Because we see a theme persisting today that may end just as badly, in our view.

The common investment thesis today is built around the assumptions that the U.S. is in economic decline, the dollar is losing its place as the world's reserve currency, emerging economies (many with communist or less-than-stable governments) have a burgeoning middle class demanding a higher standard of living and the global demand for agricultural and industrial commodities and precious metals will continue to expand. While these assumptions may be valid, the real question, in our minds, is are they sustainable. Is it different this time? Likely not.

Equipment manufacturers that support infrastructure growth and mining operations are realizing record profits. Companies that extract important materials from the ground, even those that were relatively anonymous until

recently like rare earth elements, are as seemingly important today as microchip manufacturers were a decade ago and as plastics companies were in the 1960's. New ETFs are trotted out regularly to meet investor demand for such hot sectors as commodities, gold, silver and foreign currencies. The popularity of these sectors that are sensitive to a weakening dollar is proving to be a self-sustaining prophecy. The challenge investors face is when to take their money off the table. If the past is any guide, most will get it wrong.

Our main concern about the present theme du jour is that it largely depends upon interest rates remaining low. Why, you ask, do rates need to remain low? First, companies that manufacture heavy equipment borrow a lot of money to make their machinery and their customers borrow a lot of money to buy these big-ticket items. Low interest rates are good for business. Second, low interest rates keep the dollar weak relative to other currencies. Things priced in dollars (like oil and gold) become more expensive with a weaker dollar. So as long as rates stay low and the dollar weak, this theme works.

We think interest rates are destined to rise at some point. Even if the Federal Reserve fails to act to raise rates, the market may raise interest rates for us. Standard and Poor's just placed U.S. debt on negative credit watch. While they maintained our AAA rating, they suggested that if the U.S. does not bring its debt and deficit down, our sterling credit rating could be in jeopardy. Further, if we continue to issue so much debt, investors will likely demand a higher interest rate to buy more. And finally, if inflation takes hold, the Fed's hand may be forced as well.

The current investment thesis seems to us to be unsustainable. We do not know when it will end but suspect that most investors will be blind-sided by it. History does have a way of repeating itself.

On the preceding page we write about a tortoise and hare scenario. Sometimes all the stars align perfectly for a given company, industry or sector. Those stars rarely remain so perfectly aligned. Other companies realize their destiny not through the good fortune of catching a perfect wave but rather through hard work and good management. Such companies can grow their businesses consistently through any economic environment and usually do so without much fanfare or popularity. They just plod along and reward their shareholders through the consistency of their performance.

Our investment model is designed to discover these consistent achievers and buy them at reasonable prices. When they do gain popularity among investors, we begin to take some of our money off the table. Self-reliance is older than Ben Franklin, and it still works well. Riding the wave of popularity can sometimes result in a crash landing.

MARKET COMMENTARY (CONTINUED)

(Continued from page 1)

with Consumer Staples and Utilities performing the worst. However, it should be noted that all ten sectors returned positive results for the quarter.

The Fed's policy of keeping rates low by buying U.S. Treasury bonds (called QE2) is scheduled to conclude by the end of June. What happens then is anyone's guess. Will commodity prices continue higher? They will if our dollar doesn't strengthen relative to the world's other currencies. Most commodities, like oil, cotton and gold, are traded in dollars. A weaker dollar makes these commodities more expensive, providing a boost to commodity-related stocks. A weak dollar is also beneficial to U.S. companies that export. Their goods and services become more competitive or affordable in overseas markets.

Although no one from the Fed or the Administration has explicitly stated that their policies are designed to weaken our currency, policy makers seem comfortable with the result. And we are troubled by this. No nation in history has devalued its way to prosperity. The reason is simple. A devalued currency benefits the federal government while making its population poorer.

Our government has borrowed over \$14 trillion. If our currency declines in value, it makes our government's debt less expensive to pay back. The flip-side to this is that it lowers the population's standard of living. We can no longer afford the things we once could. Gas at \$5/gallon forces us to make choices about how we spend our money. The car, clothes, food and other basic necessities we consume all become more expensive while our wages are not rising fast enough (if at all, given the high unemployment rate) to keep pace.

In the 1970's, we called this stagflation - a combination of stagnation and inflation. Stagnation occurs because we can no longer afford to consume as much as we once did so the economy sputters, or worse goes into recession. At the same time, prices rise causing inflation. It is not a pretty world when this happens. You may recall that during the Carter Administration a popular index emerged called the Misery Index. This index combines the inflation rate and the unemployment rate. Today, the Misery Index is a little over 11%, its highest reading since Carter left office in 1980 with the index at 19.72%.

We are clearly a long way away from the dark economic days at the end of the 1970's and we do not mean to cause undo concern. We are optimistic that our Country will ultimately get this right. That said, the risk trade will continue to be successful for those willing to assume the risk until there is evidence, not optimism, that the U.S. can right the

ship.

And when that day comes, the risk trade will no longer be sustainable. U.S. interest rates will rise and the dollar will strengthen. Commodity prices will fall and we will consume again. Or, if we don't get it right, interest rates will rise because it will be harder to sell our debt. As a result, the dollar may strengthen. Commodity prices will either fall or at least stop rising because we can't afford them any more. The best fix for high commodity prices is high commodity prices! If gas goes to \$5/gallon, we buy less gas until the price retreats to a more affordable level. There is evidence this is already beginning to happen.

Either way, whether we get it right or we don't, the underpinnings of the risk trade, in our view, are shaky. Government policy, not economic fundamentals, is causing the rise in price of risky assets. Economic fundamentals ultimately drive economies, not central planning or policy. We cannot predict when rates will rise, commodity prices will fall and the dollar will strengthen. We can only say that when they do, the risk trade will be over as we know it now.

Commodity and currency related trades like gold, oil and exporters are very popular (see commentary) today. Popularity is not always the best predictor of future success. We prefer to invest in companies that can grow earnings and dividends on their own merits, not because of government policy.

When, not if, we have rising interest rates and inflation, history tells us that only companies that can drive earnings higher and pay higher dividends can keep pace. These are the sorts of companies we always hold in our portfolios. We do not favor energy right now because we do not think the current high price of oil is sustainable. We do not favor commodities at present for the same reason. A stronger dollar can alleviate these problems.

When QE2 ceases, we expect there will be a shock to the markets. Not major, but meaningful. We are already detecting a bit of a rotation into less economically sensitive stocks like health care and consumer staples and away from some of the more popular investment themes.

Eventually markets must rise because there are fundamental economic reasons for them to do so. Right now, markets are rising because of speculation. Speculation can last longer than we might like, but it cannot last forever. Our portfolios for our clients are built to withstand economic uncertainties and we think uncertainty is on the horizon. Not gloom, by any means. But perhaps reason may be restored. And the speculators will have to find a new place to play. This cheap money nonsense has got to stop. If not now, the next election should prove interesting.

TORTOISE VS. HARE (CONTINUED)

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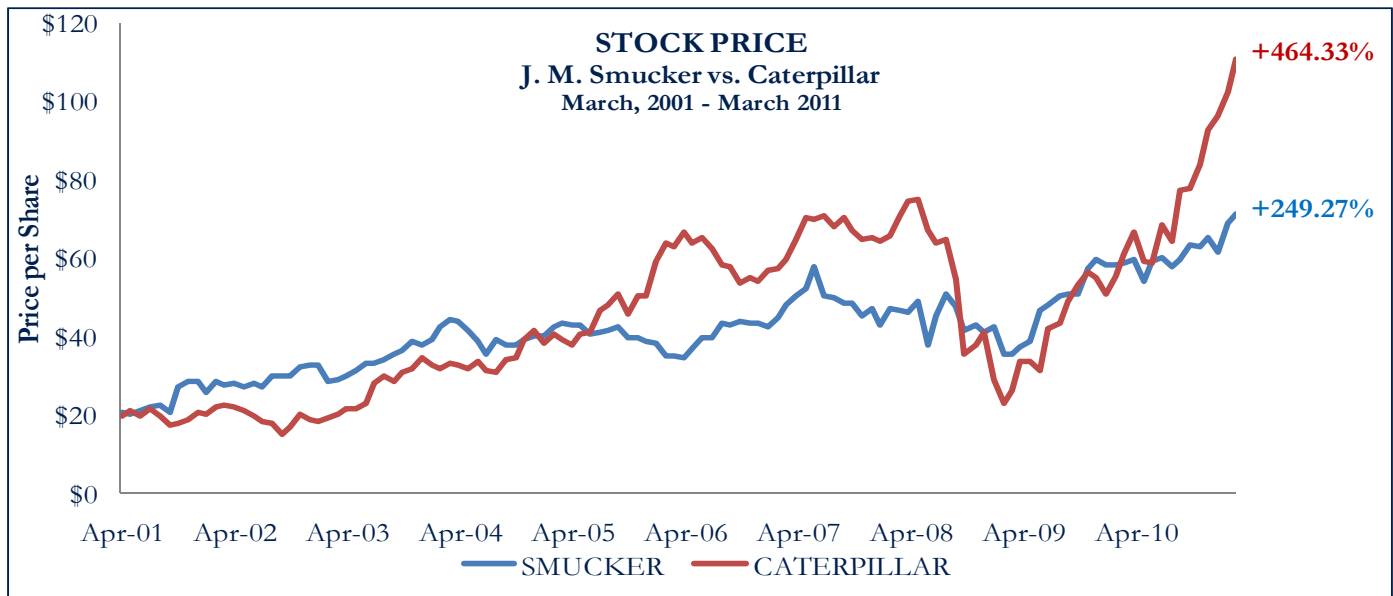
amounts over the last ten years. One was slow and steady, the other a bit more exciting.

And herein lies the moral of our version of Aesop's fable. When taking the slow and steady journey, we know we will end up in the same place as our more hare-like brethren. We just miss all the excitement. In our Commentary on the first page of this edition, we discuss the pitfalls of following the pack into the more popular investment themes. Caterpillar is a wonderful company that does nearly everything right. But it operates in an environment in which they cannot always control their own destiny and their share price has been swept up in the popular theme of the day.

Caterpillar requires a tremendous amount of capital to produce goods for its customers. A lot of that capital has to be

Now back to the Commentary. Caterpillar is the beneficiary of winning the popularity contest with investors. Look at the chart in the middle of this page. Caterpillar, the red line, races ahead, falls back and ends up in essentially the same place prior to the market bottom in March, 2009. But since that time look at Caterpillar's ascent compared with that of Smuckers. This is the popularity conundrum. Of course Caterpillar shareholders are pleased with the appreciation in share price. But flash back to the earnings chart on page 2. Earnings and dividend growth are virtually identical. So why does the hare merit so much more appreciation than the tortoise?

We don't believe that it does. And we also believe that the two will eventually end up in the same place again. Which means that either Smucker is in for one heck of a boom (unlikely) or that it will just keep plodding along and catch up again while the hare naps.



borrowed. When interest rates are low, as they typically are coming out of a recession, borrowing costs are low so profit margins are high. Similarly, many of Caterpillar's customers have to finance their purchases of Caterpillar equipment. They obviously can afford more equipment when borrowing costs are low. But as recession gives way to economic growth, interest rates rise and Caterpillar's profits can get squeezed. During recessions, demand for their equipment decreases. So, even though it is a great company, Caterpillar goes through boom and bust cycles like most big industrial manufacturers do.

Smucker, on the other hand, relies far less on interest rates. Hopefully, their customers do not need to borrow to finance the purchase of a PBJ and a cup of Folger's. Smucker does well regardless of economic cycles while Caterpillar is bound by them.

Now the bolder among you are asking why wouldn't we just buy Caterpillar while it's cheap, sell it when it gets expensive and then buy it back again when it is cheap and repeat the process? The answer is that we aren't smart enough to do that with success over and over. We find it much easier to be right once (buy Smucker) than 3 or 4 times (buy Caterpillar, sell Caterpillar, buy Caterpillar, etc.).

We selected Caterpillar and J.M. Smucker as our tortoise and hare because they make a near-perfect comparison. It is not our intent to disparage one or recommend the other. Earnings, dividends and price per share begin at roughly the same amount. Earnings and dividends end at the same amount. The only difference is their share price. Today's market is favoring the hare. Aesop had it right. The tortoise runs the steady race and crosses the finish line without fanfare. We could be nearing nap time for the hare.

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MARKET REPORT CARD

YIELD TABLE				KEY MARKET DATA				
	Current	3 months ago	1 year ago		3/31/11 Close	% Change 1 Year	% Change 5 Years	% Change 10 Years
3-month Treasury Bill	0.05%	0.07%	0.16%	S&P 500	1,325.83	13.37%	2.39%	14.26%
5-year Treasury Note	2.28%	2.01%	2.55%	Dow Jones Industrial	12,319.73	13.48%	10.90%	24.71%
10-year Treasury Note	3.47%	3.30%	3.84%	NASDAQ	2,781.07	15.98%	18.86%	51.12%
30-year Treasury Bond	4.51%	4.34%	4.72%	Russell 2000	843.55	24.30%	10.25%	87.22%
Prime Rate	3.25%	3.25%	3.25%	German Xetra DAX	7,041.31	14.43%	17.94%	20.78%
Federal Funds Rate	.09%	0.10%	0.02%	London FTSE 100	5,908.80	4.04%	-0.94%	4.88%
Discount Rate	0.75%	0.75%	0.75%	Shanghai Composite	2,928.11	-5.82%	125.53%	38.59%
3-Month LIBOR	0.30%	0.30%	0.29%	Crude Oil	\$106.72	27.41%	60.12%	305.93%
				Gold	\$1,439.00	29.00%	147.25%	458.40%
				CRB Index	359.43	31.50%	7.88%	70.95%
				U.S. Dollar Index	76.00	-6.29%	-15.30%	-35.28%
				Dollar/Euro*	141.71	4.94%	17.11%	60.31%

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.

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