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 useful.

Respectfully,

John B. Carew
President,
Chief Investment Officer

In This Issue

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 MARKET WAITS FOR THE ECONOMY TO MAKE UP ITS MIND

Did bitter winter weather delay economic growth? Or simply mask a slowdown? The stock market wrestled with this question during the first quarter, apparently deciding to wait for a clearer picture from the spring data reports. Job growth, retail sales, wages and corporate earnings all looked anemic but the weather could certainly have been a contributor. So after a year of +30% gains for the S&P, the market paused for more clarity.

Before digging deeper into the economy let us first recap the market's performance for the first three months of the year. With dividends, the S&P managed to advance 1.81%. Without dividends the index posted a 1.30% gain, and that was the best of the domestic indices. The Dow was actually down 0.72%, the tech-heavy NASDAQ advanced only 0.54% and the Small Cap Russell 2000 posted a 0.81% gain.

Although the end result was little changed from year-end, the ride was exhilarating. Many have expected a meaningful pullback in the averages and the beginning of the year seemed likely to deliver. After drifting lower for the first two weeks of January, the S&P was able to eke out a closing record high on January 15th. From there, the S&P 500 fell 5.76% through February 3rd. However, rather than fulfilling the promise of an official correction (down at least 10%) the market regained its footing and closed the quarter at another all-time monthly high. For the correction seekers, the meager selloff was no doubt a disappointment and served to keep uncertainty in place.

The roller coaster ride was at least in part

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COMMENTARY:
MANAGING RISK GAINS TRACTION

The thought leaders of today's investment world are not academics. They are heads of large endowments, pension consultants and investment professionals that actually get their hands dirty managing money. Collectively they are making a strategic shift in how they approach investing. They target risk first, then return. To this we say welcome to the club. Tandem has managed risk since its inception 23 years ago.

The shift taking place began a decade or so ago and has been marked by consistently lower allocations to risky (volatile) assets. Although stocks historically have generated the best returns of any asset class, they can also produce the most volatility. And as we have discussed previously, volatility undermines an investment plan faster than anything else.

Because stocks generate the best returns over time they cannot be ignored. But they must be viewed in a different light if one hopes to manage risk. In a recent wide-ranging talk about industry trends regarding asset allocation, Dick Charlton, Founder and Chairman of leading pension consulting firm NEPC, said that his primary objective is to construct portfolios with about 2/3 of the volatility of the stock market. We welcome this type of thinking and believe it calls for a shameless plug. Tandem's Large Cap Core strategy produces about 2/3 of the markets volatility over the current market cycle! Our Equity

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strategy is roughly 79% as volatile and our Mid Cap strategy is 75% as volatile over the last 3 years.

As it has yet to be the case that every endowment and pension fund simply turns to Tandem to manage risk and produce returns, they have devised other strategies. More sophisticated strategies perhaps, but certainly not as elegant! Kidding aside, big money utilizes more tools than the average investor has at her disposal. They have increasingly turned to hedging, currencies, private equity and fixed income derivatives that are challenging to understand.

If the average investor wants to be in the vanguard (and she should) when it comes to managing risk, how does she do it? Many investors today manage risk by simply not investing. We think this is an unfortunate and ultimately harmful strategy. Staying out of the market has cost many the opportunity to capture the stock market's significant gains over time. Staying away does not produce returns. Yet many still have clouded judgment as a result of the gut-wrenching pain of 2008.

Tandem has always believed in the importance of limited volatility to the average investor and we have written about it in these pages repeatedly. We will not address its significance here. Instead, we will turn our focus to identifying it.

We will begin with the information most investors have at hand - returns. We studied 383 Large Cap Core mutual funds followed by Morningstar and ranked them based on their 3-year performance. We then assigned numbers to each fund based on their 3-year performance ranking. The best performing fund was labeled 1 and the worst 383.

In the table on the right we present our findings. Of the 383 funds, we took the top decile (the 38 best performers) for three different time periods. The first column shows how the funds stack up in 3-year performance, ranked 1 - 38. The second column ranks all 383 funds for 5-year performance, again listing only the top 38. Notice the numbers aren't in order any more? Several funds that did not make the top 38 for 3-year performance now are among the best for 5 years. In fact, only 17 (45%) of the best 3-year funds made the list. It gets even worse for the 10-year performance. Only 12 funds (31.58%) of the top 3-year funds make the list. In fact, some that made the 5-year list didn't make the 10-year list and vice-versa. So if you had chosen a fund based on its 3-year performance, you had less than a 1/3 chance of having that fund continue to be a top-performer.

So if past performance is not predictive of future performance, what the heck is? In short, nothing. For every manager, some markets are better than others. Tandem per-

Top Performers as Ranked for 3 YR Performance	3 YR	5 YR	10 YR
	1	4	274
	2	38	230
	3	187	197
	4	19	27
	5	25	25
	6	3	2
	7	44	53
	8	5	111
	9	10	140
	10	6	240
	11	17	44
	12	7	12
	13	1	8
	14	57	296
	15	166	297
	16	197	36
	17	278	11
	18	58	6
	19	93	20
	20	230	261
	21	191	236
	22	317	10
	23	12	187
	24	32	253
	25	71	7
	26	72	86
	27	184	134
	28	11	165
	29	13	351
	30	85	178
	31	103	243
	32	352	368
	33	148	19
	34	181	166
	35	301	300
	36	20	76
	37	40	303
	38	9	80
# of Top 3 Yr Performers	38	17	12
% of Top 3 Yr Performers	100%	44.74%	31.58%

Source: www.morningstar.com Morningstar reports on over 1,361 mutual funds they categorize as Large Blend (which is Large Cap Core). Most funds report multiple share classes for different types of investors. Eliminating extra share classes using only one representative class for each fund, and further eliminating all funds without at least 3-year performance, we end up with 383 funds. All data comes from Morningstar and is for performance through 3/31/2013. Tandem makes no claim to the accuracy and makes no recommendations on any fund.

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forms best in volatile markets and often trails in straight up markets. Warren Buffet performs best when value stocks are in favor over growth. And markets are constantly changing. How a manager performed last year provides little insight as to how the manager will perform next year if the market changes.

If performance is a poor guide, perhaps we should consider the likely investment experience otherwise. To do this we need to identify other characteristics of a manager rather than simply studying returns as of a given date. Particularly if we seek to manage our risk.

The first thing we believe investors should look to is Standard Deviation. While this is not a term most are familiar with, it is information that is readily available. Standard Deviation measures risk, or volatility. The lower the Standard Deviation, the less volatility the investment has experienced. It measures the volatility of returns over a period of time and is an essential tool in determining the type of experience an investment will present.

The table below examines 2 hypothetical investments with identical returns, but very different experiences. Although each produces a final return of 4.10%, Investment A delivers a very consistent return month-to-month. Investment B produces returns that are wildly up and down. We would prefer the steady returns over the volatile ones because if we need our money, we don't want to have to time our needs with the market. This is an extreme example meant to illustrate a point. The S&P has a Standard Deviation of 12.29 over the last 3 years. By way of context, Tandem's Standard Deviation for 3 years is 8.59 for Large Cap Core, 9.98 for Equity and 9.20 for Mid Cap. The average fund in Morningstar's universe had a Standard Deviation of 13.13 and the top decile had one of 12.85. So most funds are more volatile than the market. Ouch. But using this simple screen eliminates a lot of the noise and allows one to choose the best returns from among the least volatile managers.

Hypothetical Returns and Standard Deviation

	Investment A	Investment B
Month 1	1.00%	10.00%
Month 2	1.00%	-8.00%
Month 3	1.00%	10.00%
Month 4	1.00%	-6.50%
Return	**4.10%**	**4.10%**
Standard Deviation	**0.00**	**17.28**

Other useful measures that speak to risk-adjusted returns are alpha, beta and capture. Alpha represents the value added by the manager beyond what one would expect from the risk the manager takes on. An alpha less than 0 means the manager is actually detracting from returns. Alpha should generally be positive, and the higher the better. Tandem produces alpha of 5.44, 5.18 and 6.96 for its three styles over a 3 year period. The average for all 383 funds in the universe is -1.80 and the average for the top 38 is 1.84.

Beta measures the volatility of an investment relative to the market. A beta of 1 means the investment is as volatile as the market. Greater than 1 indicates more volatility and less than 1 indicates less volatility. Tandem's betas are 0.64, 0.77 and 0.62 for the last 3 years. The average for the 383 funds is 1.03 and for the top 38 is 1.00. So most funds are at least as volatile as the market by this measure.

Capture is the one statistic that is less readily available, which is unfortunate because it can tell us a lot. Simply put, capture measures the amount of a market's up move or down move an investment captures. The absolute number of each is less relevant than their relationship to one another. An investment with more downside capture than upside capture risks losing all its gains in a down market. The Upside capture should at least be 100% of the Downside capture, if not more. Tandem's capture ratios are 147.86%, 139.35% and 173.28% for the last 3 years. The average fund's capture ratio is 92.82% and the top 38 average is 112.71%

This is a lot of information to absorb. We provide it for a couple of reasons. First, we want to create a better understanding of what we do at Tandem. Second, we think it is important to convey that volatility is at least as important as performance. The brightest minds in the investment world place great emphasis on limiting volatility. If volatility scares you, it can cause you to limit volatility in the wrong way. Getting out of the market certainly limits volatility, but it likely limits returns as well. Less volatility makes it more likely that you stick around, and therefore participate more fully in the best returning asset class - stocks.

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fueled by confusing economic data. One year ago, corporate profit growth was expected to be about 16% in 2014. Now the expected rate of growth is down to less than 12% and likely shrinking. For the 1st quarter of 2014, profits are likely to be lower than in the 4th quarter of 2013. As for GDP, expectations have contracted similarly. Although there are some that still predict robust growth fueled by expansion in the second half of the year, the population of optimists is approaching the endangered level. A consensus is mounting for slow economic growth matched by slow corporate earnings growth. This likely means slow stock market growth as well.

While the stock market historically has been a solid economic indicator in the long run, the bond market is an outstanding indicator in the short run. There are 3 tables below that illustrate the bond market's forecasting through the yield curve. For those unfamiliar with a yield curve, it simply shows interest rates for varying maturities at a fixed moment in time. Generally speaking, short term rates are lower than long term rates as one might expect. We will lend money for 30 days at a lower interest rate than we will lend for 30 years. There is more risk in lending for 30 years so we demand greater compensation. In these charts we use Treasury securities for the time periods indicated on the *x*-Axys.

First is Yield Curve Comparison #1 for December 31, 2012 and December 31, 2013. Interest rates were much lower in 2012 and increased throughout 2013. Typically interest rates rise (in spite of the Federal Reserve's best efforts) when economic growth is expected. The rise in rates in 2013 corresponded with the rise in the stock market. Expectation of economic growth fueled these increases.

However, as we have entered 2014, expectations have been tempered. Whether the cause is a harsh winter or something else, the bond market is predicting slower growth today than it was three months ago. Yield Curve Comparison #2 is not nearly as dramatic as #1, yet rates are lower today than at the beginning of the year.

While the yield curve has shifted lower, this does not indicate anything other than a recognition of lowered growth expectations. The expectation is still clearly for growth, not recession. The 3rd chart at the bottom of the page is a hypothetical yield curve predicting recession. The yield curve inverts when investors shun other investment options in favor of the safe haven bonds provide. They crowd into the long end of the bond market, driving longer-term rates lower. The short end of the curve is influenced by the Federal Reserve and when an inverted curve occurs, the market has gotten ahead of the Fed. Lower rates are higher than longer rates because the Fed has not acted to lower rates as fast as the market. Yield Curve #2 indicates that we remain a long way from an inverted yield curve as the Fed continues to hold short term rates near zero to boost growth.

We have long believed that the direction of the unemployment rate is an excellent predictor of the stock market's direction. Indeed, as unemployment has fallen since the

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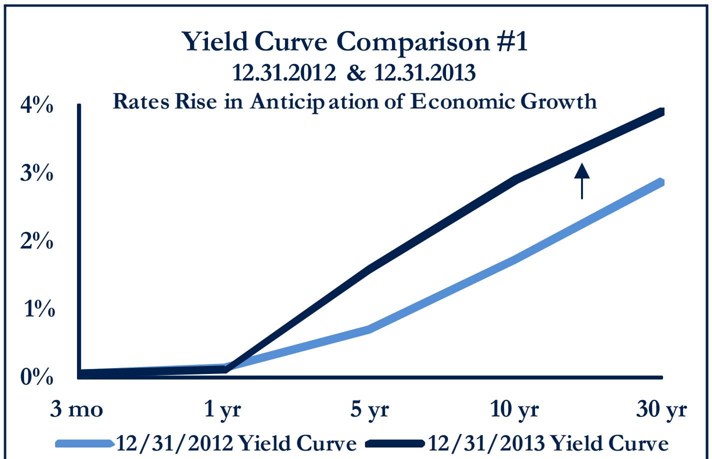

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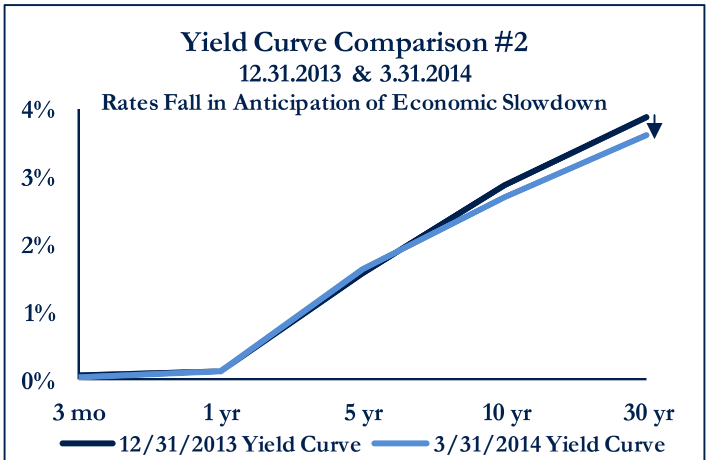

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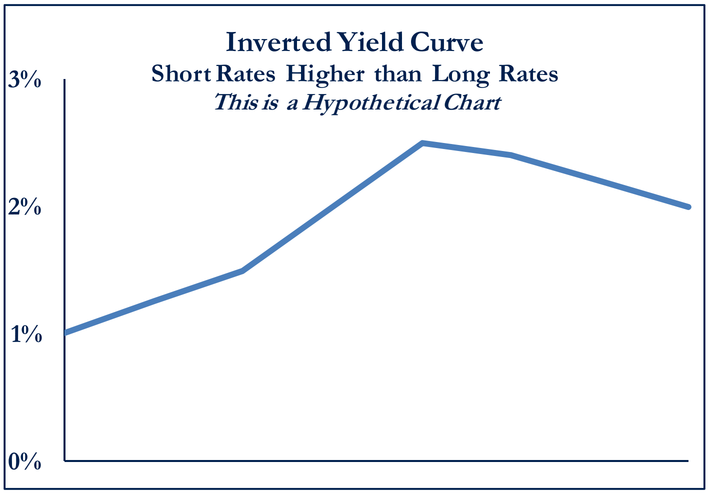

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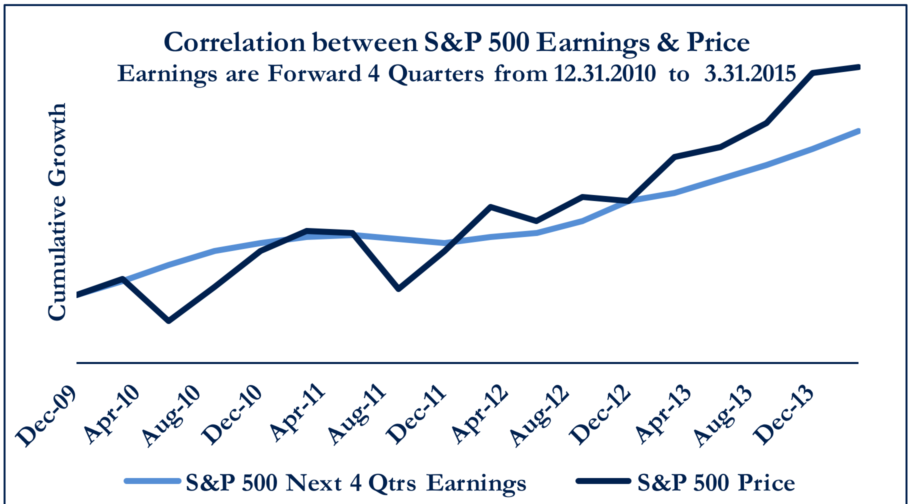
recovery began, the stock market has risen dramatically. Today's unemployment picture is a bit more muddled than usual and this no doubt causes uncertainty for the stock market. While the reported rate of unemployment continues to decline, the reliability of the reported rate has come into question. The percentage of the population that is employed is significantly lower than it once was. Has the decline in participation resulted from baby boomers retiring and leaving the job market? Or is it because so many have given up seeking employment but would gladly reenter the work force if the opportunity arose? We suspect it is both and that it will take time to sort out a clearer picture. So unemployment is not now the indicator that it once was.



Source: www.standardandpoors.com

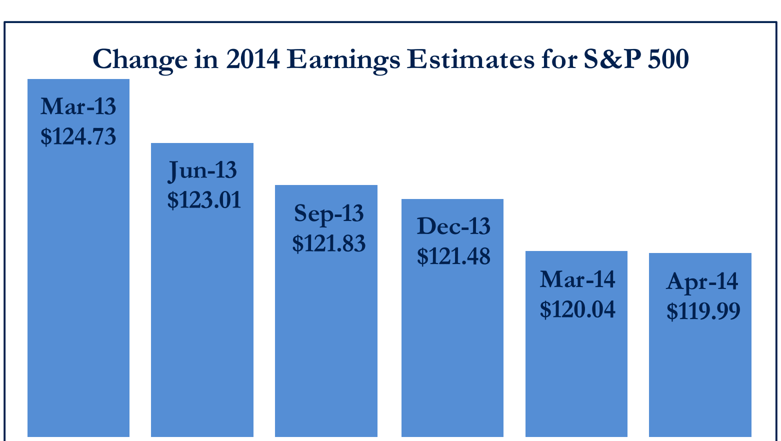
Similarly, GDP is not as predictive as it once was. Government spending contributes to GDP and it has declined from very inflated levels as we have emerged from the Great Recession. While there have been certain increases in expenditure, they are in areas that do not contribute to economic growth. Personal consumption is the biggest component of GDP. Unfortunately, we seem to know less about the average consumer today than we once did. The wealthy have been holding up their end of the bargain but the lower end struggles. And the wealthy consumer may be inclined to scale back consumption as a result of new taxes that took effect in 2013 and were largely realized on April 15th.

The murkiness of data leaves us with corporate profits as our most reliable predictor. The problem we are experiencing with earnings expectations is that they have become more volatile than normal. In 2009 and 2010 as we emerged from recession, expectations were lower and companies easily exceeded projections. As the recovery has matured and slowed, expectations have become more challenging to beat and earnings projections have been steadily lowered. The chart to the right illustrates the decline in earnings expectations just for calendar year 2014 in the past 13 months. They have declined nearly 4% and it is reasonable to expect them to be lowered again if economic activity doesn't pick up now that the snow has melted.

However, earnings growth and stock prices remain strongly correlated. The chart below shows the S&P's price history since the end of 2009. Placed alongside is S&P earnings for the 12 months to follow. In short, the price for 12/31/2009 corresponds to 12 months of earnings ended 12/31/2010 and the price for 3/31/2014 corresponds to 12 months of earnings ended 3/31/2015. Although price is more volatile, it historically returns to a similar rate of growth as earnings. In the early days of recovery, price lagged as investors were skeptical of the economy's strength. As time passed, prices began to trade more in line with earnings. At least until 2013.

In 2013, price gains reflected future earnings growth that is now being questioned. As earnings lag behind, stock prices seem to have paused to allow earnings to catch up. Some believe prices must fall to reflect the new reality. And they may. Or they may just continue to meander until a clearer picture emerges. We expect the market to be more volatile than in 2013 but think we are more likely in a range below last year's high than due for any sharp pullback.

It is important to note that you, our client, do not own *the stock market*. You own individual companies that will behave in ways unique to them. If our companies grow earnings (as they have) through this environment, their share prices will ultimately reflect earnings growth. Although we constantly refer to the stock market, it is really just a market of stocks. Lots of stocks. And we think we own some good ones.



Source: www.standardandpoors.com

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MARKET REPORT CARD

YIELD TABLE

	Current	3 months ago	1 year ago
3-month Treasury Bill	0.03%	0.07%	0.07%
5-year Treasury Note	1.72%	1.74%	0.77%
10-year Treasury Bond	2.72%	3.03%	1.85%
30-year Treasury Bond	3.56%	3.97%	3.10%
Prime Rate	3.25%	3.25%	3.25%
Federal Funds Rate	0.04%	0.04%	0.16%
Discount Rate	0.75%	0.75%	0.75%
30 yr Fixed Mortgage	4.00%	4.15%	3.16%

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

	3/31/14 Close	% Change 1 Year	% Change 3 Years	% Change 5 Years
S&P 500	1,872.34	19.32%	41.22%	134.67%
Dow Jones Industrial	16,457.66	12.89%	33.59%	116.29%
NASDAQ	4,198.99	28.51%	50.98%	174.70%
Russell 2000	1,173.04	23.28%	39.06%	177.48%
German Xetra DAX	9,555.91	22.59%	35.71%	133.94%
London FTSE 100	6,598.37	2.91%	11.67%	68.06%
Shanghai Composite	2,033.31	-9.08%	-30.56%	-14.32%
Crude Oil	101.58	4.47%	-4.82%	104.55%
Gold	1,291.70	-19.18%	-10.24%	40.94%
CRB Index	304.67	2.79%	-15.24%	38.24%
U.S. Dollar Index	80.11	-3.48%	5.41%	-6.39%
Euro/Dollar*	137.74	7.52%	-2.80%	3.89%

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

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