The TANDEM Report

Volume 4, Issue 1, January, 2003

INSIDE THIS ISSUE:

MARKET SCORECARD:

S&P 500:

Annualized returns:

1 year ended 12/31/02	**-23.37%**
3 years ended 12/31/02	**-15.71%**
5 years ended 12/31/02	**-1.94%**
7 years ended 12/31/02	**5.23%**
10 years ended 12/31/02	**7.28%**

MARKET COMMENTARY:

"AS FAR AS I AM CONCERNED, THE STOCK MARKET DOESN'T EXIST. IT IS THERE ONLY AS A REFERENCE TO SEE IF ANYBODY IS OFFERING TO DO ANYTHING FOOLISH."

WARREN E. BUFFET

If only that were so. If only the stock market *didn't* exist, or at least didn't matter. But who among us feels as though we have the luxury of being indifferent to the irrational daily fluctuations of what the legendary investor and Buffet mentor Benjamin Graham referred to as "Mr. Market"?

Warren Buffet is, without question, a great investor. He is also one of the world's wealthiest men. Maybe it is a little easier for him to ignore the market. After all, his retirement doesn't depend on how the market performs. He already has plenty of money.

That way of thinking too quickly dismisses the beauty of his reasoning. Imagine a different type of investment most of us have made. Think back to when you purchased your home, and the emotions you experienced at the time. Perhaps this was the perfect home in which to raise a family and to provide safety and comfort. Perhaps there was a sense of pride in ownership of your new residence. Maybe you got a great bargain. What ever it was that you were feeling, it is unlikely that you were thinking of its value tomorrow, next week, next month or even next year. You purchased this home for a purpose greater than immediate financial reward.

And the beautiful thing about buying a home is that it is easy to remember why you bought it in the first place. The reminders are there every day. But for the sake of this discussion, let us suppose that the value of your home were quoted in the newspaper every morning. On day one, the paper would report that your home was worth less than you paid for it. If you paid $500,000, it would immediately be worth only $470,000 to you, because there would be a 6% real estate commission deducted if you wanted to sell. Would you still feel as good about your purchase?

Then, after a year or so, there is talk of a Fortune 500 company relocating to your town, and it is widely reported that their executives are well-paid, and will be looking for houses. The value of your home soars to $750,000, and

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TANDEM Investment Advisors

Top Ten Holdings in the Tandem Equity Composite

As of December 31, 2002

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. In keeping with the buy-and hold theme of this newsletter, we also provide the date we first purchased the stock in a composite account.

Rank by Market Value	Original Purchase
1. Merck & Co.	02/15/94
2. Microsoft Corp.	12/06/96
3. Johnson & Johnson	06/03/97
4. General Electric	07/08/94
5. Amgen	10/31/96
6. General Dynamics	11/13/01
7. Pfizer, Inc.	12/18/96
8. Exxon Mobil	11/08/94
9. IBM	07/08/94
10. BB&T	05/15/02

The average holding period for a stock in the Top 10 is 5.97 years and rising.

The market experienced the first positive quarter since the fourth quarter of 2001. The best performing sectors that we follow were tech, telecom and pharmaceuticals. This time, we have added a new twist by ranking the stocks by performance for the period 9/30/02—12/31/02 as well.

Rank by Performance for the 4th Quarter	
1. IBM	32.91%
2. Merck & Co.	23.85%
3. Microsoft	18.20%
4. Amgen	15.92%
5. Exxon Mobil Corp	9.53%
S&P 500	**7.92%**
6. BB&T	5.57%
7. Pfizer, Inc.	5.34%
8. Johnson & Johnson	-0.68%
9. General Electric	-1.22%
10. General Dynamics	-2.41%

More detailed information about the Tandem Equity Composite, its performance, and the accounts that comprise it, is available upon request.

Buy and Hold:

A winning Strategy

Do you know why Buy and Hold is a winning strategy? In order to examine the concept, we need a good definition of a market index. The S&P 500, for example, is an index commonly used to represent Large Cap equities. According to Standard & Poor's, "The S&P 500 Index consists of 500 stocks chosen for market size, liquidity, and industry group representation. It is a market-value weighted index (stock price times number of shares outstanding), with each stock's weight in the Index proportionate to its market value." As equity prices of those companies fluctuate, so does the value of the index. Prices in some companies grow faster than in others. Laggards are a drag on the index, while leaders pull it up. Thus, the index is an average!

Some experts argue that an index is the best portfolio for its asset class. In other words, these experts suggest that if someone wishes to own a Large Cap stock portfolio, the best choice would be one that mirrors the S&P 500. The basic rationale behind this argument is that the market index accumulates the intelligence of every person who

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ARE STOCKS CHEAP?

THAT DEPENDS ON YOUR PERSPECTIVE

It seems like a logical question: are stocks cheap? Well, cheap compared to what? We like to compare stocks to many things in our effort to determine the fairness of their value, but one of our favorite measuring sticks is the 10 year U.S. Treasury Note. The 10 year note offers a riskless return, and stocks, in our view, need to be priced to outperform the yield of a 10 year Treasury note in order to be attractive.

How do we compare a stock to a bond? Without being overly esoteric, we compute a stock's earnings yield (the rate of earnings per share), and compare that yield to the yield of the Treasury. What we have found is that there is a meaningful relationship between these two yields. For example, over the last twenty-five years, the 10 year Treasury's yield has been higher than the S&P 500's earnings yield, on average, by 0.569 percentage points. Therefore, to simplify, when the spread between the yields is less than this, stocks are relatively more attractive than bonds. Conversely, when the spread between the two widens, bonds become relatively more attractive.

The beauty of this model is its simplicity. As an in-

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BUY AND HOLD CONTINUED

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contributed to its construction. Therefore, the aggregate knowledge embedded in the index will be greater than that of any individual player. In other words, the index knows more than any individual dealing in the specific market.

Investing is a for-profit business. Like any business, the profit equates to income minus expense. The sources of income for this business are capital appreciation and dividends. The expenses are risk and transaction costs (i.e. trading, custody, transactional). Thus, for any portfolio to be better than the index, it must make a larger profit through a combination of higher income and/or lower expenses.

Different strategies yield different results. Some are able to beat the benchmark in the short run, while others beat it in the long term. Rarely will strategies effective in the long-term be equally so in the short term, and vice-versa. Buy and hold is a long-term strategy that leads to identifying investments to be held for a long and undefined period of time. When implemented successfully, this style tends to yield better returns than the index over time.

Why do buy and hold portfolios tend to appreciate faster than the index portfolio in the long run? Because they increase income (i.e. capital appreciation and dividends) and decrease transaction costs (i.e. trading commissions). A buy and hold portfolio identifies companies that represent a good investment over long periods of time. This kind of commitment is only possible with companies that dominate their industry. If the holding period for a specific stock in the portfolio is longer than that in the index, then transaction costs for the portfolio are lower than those associated with the index portfolio.

Tandem's investment process identifies companies with a history of earnings growth, key competitive advantages and strong management teams. Because these tend to be only the best companies, some have appreciated faster than the index. Therefore, they increase our income. Then, we hold them patiently to allow our effort to pay off over time. Thus, we minimize transaction costs. Further, we use leading portfolio theory to monitor and manage risk. Risk management helps us maintain portfolio costs below the index's level. Therefore, our buy and hold strategy helps to increase income and decrease expenses, which makes for a winning strategy.

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you are rich! Brilliant, too. You decide it is time to sell. So you look for another home that offers you all of the things that you desired in your present home. After a great deal of searching, you discover that homes are pretty expensive right now, but they are only going to go higher. So, you spend a little more than you wanted, but you get the perfect home for $800,000, and once again, you feel secure and comfortable and proud. The market has justified your move to this new location, and you feel good about having found a place where you can retire.

Then, two weeks later, the value of your house plummets from $813,923.25 to 503,618.75 because not only is the new company not coming to your town, but the reason is because the ground water is contaminated. Eventually, after several environmental studies are concluded, the ground water contamination is isolated, and does not affect your water supply. What will that do to the price of your home?

Who cares? That is not why you bought the home in the first place. Remember? You paid $500,000 for your first house because it offered you a great place to raise a family, and it afforded a sense of security, or whatever your reasons were. And in spite of the market's volatility, you still own a home that does those things, and it is still worth what you paid for it. But in the helter-skelter world of priced-daily real estate, perhaps you had forgotten those things. It is easy to forget longer term objectives when the short-term is constantly before us.

In this example, we introduced a short-term component that does not exist in the real world. While we all certainly do think of the value of our home, it is more of a long-term focus. Real estate always goes up over time. Right? Well, so do stocks. But they *feel* more volatile because they are quoted daily, and this makes for more emotional investing.

In his forward to the fifth edition of The Intelligent Investor by Benjamin Graham, Warren Buffet writes, "To invest successfully over a lifetime does not require a stratospheric IQ, unusual business insights, or inside information. What's needed is a sound intellectual framework for making decisions and the ability to keep emotions from corroding that framework….The sillier the market's behavior, the greater the opportunity for the business-like investor." His point is that emotion gets in the way by causing us to lose focus on what is important.

In the house analogy, introducing day-to-day pricing drew our attention away from the real reasons we bought the house. In a stock market like the present one, day-to-day news has a similar distracting effect. We must ask ourselves why we hold stocks in the first place. Of course it matters when values are halved, as they have been. But it only truly matters if prices *stay* at these levels for a very long period of time. The immediate value of stocks is determined by human greed and fear resulting in often-times foolish decisions. The long-term value of stocks is determined by the growth of the underlying companies.

To better illustrate this point, let us refer to the accompanying chart.

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Market Commentary Continued

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The dark line going straight across the chart just above 10% is the average five year return for the S&P 500 over the last twenty–five years. Think about that for just a moment. The S&P has *averaged* over 10% per year for every five year period since 1977. That's pretty good. More importantly, that includes the last three years.

Now observe the peaks and valleys of the dark line that represent each five year period since 1977 (300 five year periods in all). The line goes all over the place. Sometimes it is above the average, and sometimes it is below. Right now, we are below. But, each time prior to this point, the line has *always* moved back to the average. And remember, no matter how different it is this time, it is not different this time. It wasn't different during the bull market of the 'nineties, it wasn't different during the Gulf War, it wasn't different during the market crash of 1987, it wasn't different during the Arab oil embargo, and it wasn't different during the Cuban Missile Crisis. In fact, it is never different, because history matters.

The lesson Mr. Buffet intends to convey is a valuable one. On a daily basis, investors react differently to news and emotion. Over the long run, investors react to the inherent value of companies. Don't let today's noise disguise tomorrow's value.

Are Stocks Cheap Continued

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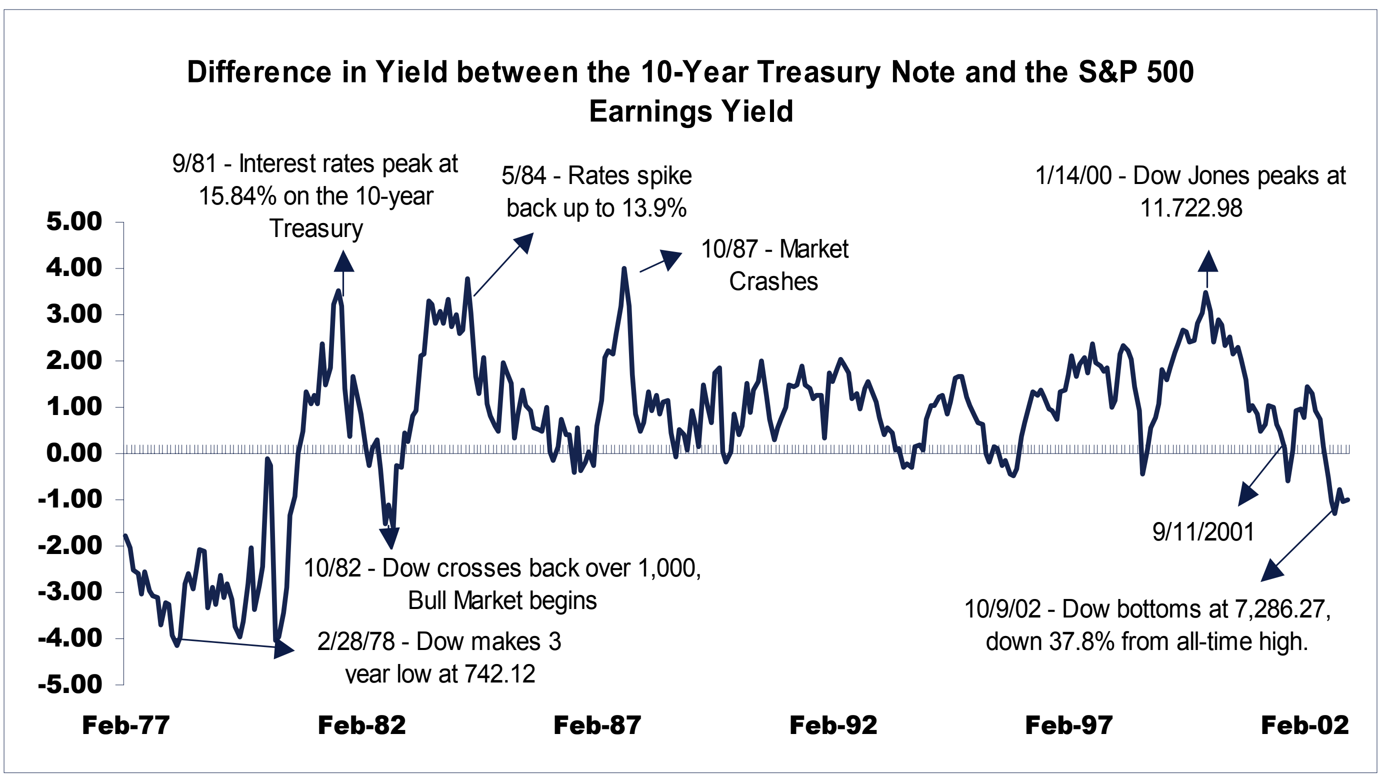
vestor, if you were able to get a 100% yield with a government guarantee, why would you ever own a stock? However, if government bonds offered a 0% yield, why wouldn't you own stocks? There is a trade-off. Obviously, these examples are extreme, but they do represent the sort of decision-making process investors go through every day. The chart below offers a look at the yield spread over the last twenty-five years, and the peaks and valleys of the stock market are pretty evident. Where do you think we are now? Are stocks cheap?



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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.

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