

THE TANDEM REPORT

Volume X, Issue 4 January, 2009



“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:

GRIM BEGETS CHEERLESS, BUT WE SEE A CASE FOR PROSPERITY

How do we describe the year that was 2008? A search of the Micro-soft thesaurus for something more elegant than “dismal” yields the following possibilities; miserable, gloomy, depressing, dreary, bleak, grim and cheerless, among others. Grim seems to fit the bill, while cheerless may best describe sentiment about 2009’s outlook.

First we recount the grim. Financial markets entered 2008 with some trepidation. The Dow ended 2007 at 13,264.82, down almost 7% from its record close on October 9th. The price of oil was rising relentlessly, ending 2007 at over \$91/barrel. The 10-year Treasury note offered what at the time was a relatively uninteresting yield of 4.03%. The Fed Funds rate stood at 4.25% as the Fed continued to fear inflation, and the dollar continued to show weakness, with the dollar index entering 2008 at 100.196.

First Quarter, 2008

The first trading day of the new year was much like those to follow - the Dow lost 1.7%, making it the worst first trading day in 25 years. More “worst since” descrip-

tions would follow. During the first month of the year, we learned of major write-downs at Wall Street banks as mortgage fears took hold. Bank of America agreed to buy Countrywide, and the stock market sank into official “correction” territory, retreating more than 10% from its high.

In February, evidence mounted that the consumer was in trouble, with most retailers struggling and some closing. Congress and the Administration rushed a stimulus package in an effort to get us to spend.

March brought more bad news. On St. Patrick’s day, Bear Sterns, the country’s fifth largest investment bank, sold itself to J.P. Morgan for \$2/share after the Federal Government promised to absorb some of the losses Morgan likely would incur. After much shareholder outrage, Morgan increased the purchase price to \$10.

Quarter End Data:

Dow: 12,262.89, down 7.6% YTD.
Crude Oil: 105.45/brl, up 15.0% YTD.
10 Year Treasury Yield: 3.43%
Fed Funds: 2.25%
Dollar Index: 96.617, down 3.6% YTD.

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BERNARD MADOFF, PONZI SCHEMES AND THE SAFETY OF YOUR INVESTMENTS

Just when investors had decided to put off looking at their statements until things got better, they learned a valuable lesson about checking up on their advisor. When Bernie Madoff reportedly acknowledged to his sons that his fund was a Ponzi scheme, he taught us all that there are wrongdoers from which the government either does not or cannot protect us. While we would like to believe that the

appropriate regulatory authorities uncover, if not prevent, such fraud, reality says otherwise.

So how can Tandem investors know that their money is really there without relying on blind faith? How is Tandem different from Madoff Securities? Temptations at humor aside, Tandem never touches client

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WHAT WE GOT WRONG, AND WHAT WE GOT RIGHT

Self-examination is a necessary process for any organization striving to be its best. At Tandem, we seek to be the very best manager by providing both superior returns *and* less risk. We constantly review our processes in an effort to make them, and us, better. In studying our execution in 2008, we humbly confess that we have both identified and addressed areas in need of improvement.

While we correctly predicted the bursting of bubbles, particularly in alternative investments, we did not anticipate the effect on the overall stock market. We knew that Hedge Funds were highly leveraged and that it could end badly for their investors. The unwinding of this leverage, as we suspected, forced many to sell stocks. While we believed we had adequately prepared ourselves to withstand and then prosper from the fallout, the sell-off proved to be broader, deeper and more violent than we had foreseen.

The volatility that ensued, particularly in the fourth quarter, exposed a flaw in our process. When identifying a security for sale, our practice has been to allow a stock room to move higher while employing a mental stop price below the market price. This process has routinely served us well. We may view a stock worthy of sale, but the price may continue to rise. By using a mental stop, we can allow the stock to continue to appreciate as we move our stop higher, thus allowing a stock to exhaust its upward move before we sell. However, increased volatility in a few instances pushed stocks well below our stop price. General Electric, Greenhill and Piedmont Natural Gas were prime examples. We had every intention of selling a portion of our holdings if our stop was reached, but in each case, we never had the opportunity to sell near our price. So we had to review this.

The outcome is a change in policy that now mandates we execute future sales at market price when volatility becomes excessive. Excessive volatility is a subjective measure, but we believe this represents an improvement to our process.

Another thing we got wrong in 2008 was our failure to adequately monitor which of our stocks had significant exposure to Hedge Funds. Had we seen this in advance, we may have been able to avoid steep declines in the share price of stocks like Jacobs Engineering and FPL Group as Hedge Funds were forced to sell. Part of our future process will be to monitor large shareholders of our portfolio companies.

Perhaps less interesting, but far less humbling, is an examination of what we got right. Fortunately, our clients did not experience declines as severe as the market as a whole. The examination process reveals that the single biggest reason for this is our adherence to a discipline we call TVM.

Part of the TVM model is a sell discipline that we do not violate. By following the model, we began selling portions of our energy holdings in 2007, well before it looked like the smart thing to do. TVM also limited our exposure to bank stocks before they blew up. This process identifies stocks that should be bought as well as stocks that should be sold. For much of 2007 and 2008, we found more stocks to sell than we found to buy. The results reward our conviction in the model. Heading into the fourth quarter of 2008, our portfolios held an unusually large amount of cash - not because we are brilliant market timers, but because TVM worked.

One small but important thing we got right in 2008 was recognizing that money market funds were likely to struggle. We were able to move our clients' money market holdings to the safest venues *before* there was any trouble. To be clear, no money market funds our clients use experienced trouble, but back in September, we couldn't be certain of this. We opted for the safe approach.

The review process has yielded some new policies for us, but it was a useful examination. While we are not pleased that our portfolios lost value in 2008, it could have been much worse.

OUR NEW RANT

Now that all the bubbles we have warned about have popped, we turn our attention to a new issue, one that we believe creates potential instability in the markets - *indirect ownership of assets*.

This may be new terminology, but it is not a new concept. Pooled vehicles called unit trusts were popular in the period before the Great Depression. Today we have Exchange-Traded Funds, or ETF's. It is our view that these instruments, which pool investor money to buy a basket of stocks, lead to greater market volatility. So far, this view places us in a very small minority.

ETF's have become very popular trading vehicles, and

many use leverage to amplify returns. Buying and selling ETF's does not increase volatility directly. ETF's trade as any individual stock would. There is, however, one meaningful difference.

An ETF is a fixed pool. The individual stocks inside the ETF are not bought and sold when ETF shares trade. But the proliferation of ETF's takes money away from direct investment in stocks, thereby making direct ownership less significant, even if only marginally. When there are fewer direct shareholders making decisions, volatility increases.

Markets are weakened when indirect ownership is prominent. You will hear more from us on this topic.

MARKET COMMENTARY (CONTINUED)

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Second Quarter, 2008

April brought a bit of a bounce. Stimulus checks were finding their way into the economy, and the weak dollar bolstered imports. It would prove to be the best month of the year for the stock market.

Concerns over the rising costs of commodities boosted fears of inflation in May. The yields on bonds soared, while the Fed came under some criticism for its aggressive rate cuts.

June saw the credit crunch take a big toll on the market. Wachovia fired its CEO, IndyMac's share price neared zero and Lehman Brothers recorded massive losses. Gas prices topped \$4/gallon and consumer confidence plunged to lows not contemplated. Commodity prices continued to skyrocket, while auto manufacturers reported deep declines in sales. The Dow suffered its worst monthly decline since September, 2002, and officially became a bear market after declining more than 20% from its October peak.

Quarter End Data:

Dow: 11,350.01, down 14.4% YTD.
Crude Oil: 133.88/brl, up 46.0% YTD.
10 Year Treasury Yield: 3.98%
Fed Funds: 2.00%
Dollar Index: 97.426, down 2.8% YTD.

Third Quarter, 2008

July brought with it hopes of a summer rally. Banks reported more problems and the Treasury and Fed took steps to bolster Fannie and Freddie, but share prices bounced from their June lows. The price of oil reached an all-time high of over \$147/brl and immediately sold off.

Declining oil prices in August allowed the market to believe the worst may be over. With inflation fears moderating, Fed actions seemed more appropriate and the dollar improved.

The optimism of the summer proved fleeting in September. The Federal Government seized Fannie and Freddie on the 8th, Lehman failed on the 15th and the Government seized AIG on the 17th. The markets responded with the same fear and uncertainty displayed by our government officials, and the bear market took a new turn. What had begun as a liquidity crisis brought on by too much ill-advised borrowing and speculation had now reached far beyond the perpetrators. Companies previously viewed as financially strong encountered difficulties financing their daily operations. A major money market fund "broke the buck". Merrill Lynch

sold itself to Bank of America, and the U.S. was down to only two major investment banks. Just six months earlier, there had been five. As the perilous month drew to a close, Wachovia, after promising themselves to Citi, agreed to be bought by Wells Fargo. It was a very bad month.

Quarter End Data:

Dow: 10,850.66, down 18.2% YTD.
Crude Oil: 104.11/brl, up 13.5% YTD.
10 Year Treasury Yield: 3.83%
Fed Funds: 2.00%
Dollar Index: 101.814, up 1.6% YTD.

Fourth Quarter, 2008

October picked up where September left off. As our government leaders warned openly about the possibility of a depression, consumers, investors, families and companies got scared. Economic activity came to a complete halt. America watched with fear as Congress grilled Treasury Secretary Paulsen and Fed Chairman Bernanke about a \$700 billion bailout package that would come to be known as TARP. After being told of dire consequences should the package not be approved immediately, Congress voted the original plan down. A vote on a revised plan was ultimately passed, and markets breathed a temporary sigh of relief. But the damage was done. The Dow ended October with its largest monthly loss since August of 1998 and the fifteenth largest monthly drop since 1928. We had transitioned from a credit crisis to a confidence crisis.

With seemingly all assets classes in decline, investors around the globe threw aside risk in favor of the safety of U.S. Treasuries in November. Yields on the shortest-term Treasuries reached 0%. Investors were willing to accept no return *on* principal in order to insure return *of* principal. Crude oil and other commodities continued a staggering descent, while more bank bailouts and central bank stimulus packages emerged almost daily worldwide. Most stock markets retreated below their last bear market lows, making many wonder if this bear began in 2000, not 2008.

Just when many believed the news couldn't get worse, December brought us Bernie Madoff. Somehow, the S&P 500 managed to post a slight gain for the month, but the Dow's monthly close was lower for the ninth time in 2008.

Quarter End Data:

Dow: 8,776.39, down 33.8% YTD.
Crude Oil: 41.12/brl, down 55.2% YTD.
10 Year Treasury Yield: 2.24%
Fed Funds: 0.00% - 0.25%
Dollar Index: 110.025, up 9.8% YTD.

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ACCOLADES FOR TANDEM

Money Management firms typically provide information about themselves to independent databases that rank managers for performance, risk and other criteria over various time periods. Investment professionals such as pension consultants, family offices and brokerage firms subscribe to these databases to assist in their searches to hire money managers for their clients.

There are numerous databases available to financial professionals, but one of the best known is owned by a company called InformaIS, and their manager database is called PSN. Tandem provides its data to PSN quarterly, usually without much thought. We report on two of our composite styles - Equity and Equity Income. We have done so far awhile now, without much thought and without any effect. To us, this is a free marketing opportunity, but it is a bit like the

internet. We have absolutely no idea who sees our data, and we certainly do not get feedback. Until now.

After reporting our data at the end of the third quarter, we received an email from PSN asking us to confirm our third quarter performance for our Equity Income style. It seems they thought we may have made an error because we reported a positive return. We assured them there was no error, and had a good laugh amongst ourselves.

We then received another email from PSN, congratulating us on being named one of their "Top Guns" for the Large Cap Core Equity style. Apparently, Top Guns rank among the ten best managers in the PSN database for specific periods of time. Tandem was a Top Gun for both the quarter and year ended September 30, 2008. Who knew?

MARKET COMMENTARY (CONTINUED)

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Indeed, 2008 was a grim year for investors. It was the single worst year in percentage loss terms for the Dow since 1931, and the third worst we can identify. Investors have been left with more questions than answers, and confidence in financial markets is understandably shaken. The turning of the calendar greets us with a financial system teetering on the brink of insolvency and the prospect of even more government intervention. Federal bailouts, both enacted and anticipated, will no doubt lead to staggering amounts of borrowing. To date, one can only conclude that the Federal Government's answer to this crisis brought about by too much leverage is to transfer the debts of the private sector to the balance sheet of the public sector.

The New Year has begun with a cheerless outlook for the future. We are in the thirteenth month of a recession that accelerated downward in the fourth quarter. The speed with which the economy seized after the Lehman bankruptcy was staggering, almost like driving of a cliff. Corporate earnings for the fourth quarter have been predominately worse than even bleak expectations, and modeling for future earnings is proving difficult when we cannot reasonably forecast economic activity.

As a reminder, economic activity is expressed as Gross Domestic Product, or GDP. GDP measures consumption (spending), investment, government spending and net exports. GDP is typically expressed as a percentage gain or loss from the previous year. A recession's technical definition is two consecutive quarters of negative GDP growth.

Let us contemplate a few possible outcomes for the markets in 2009. An optimistic scenario might be that the fourth quarter was fear induced, that we soon believe that our

worst fears will not be realized and that we again spend our money, buy houses at bargain prices, take out new mortgages, businesses get the loans they need and corporate profits quickly normalize. Such a scenario would give the stock market much to be cheerful about and would likely limit the size of government spending. Financial institutions would again look for opportunities rather than operating from a preservation mode.

This is the blue print for economic recovery, and will most certainly be the case one day. When such activities can be anticipated, stocks will rebound sharply and interest rates will rise to reflect economic growth. These points cannot be easily argued. What can be argued is whether this can take place in 2009. While we believe such an outcome this year is possible, we do not view it as highly probable.

A worst case scenario is that too much damage has already been done and economic activity will continue to contract. With consumers not spending, businesses will struggle. Some will lay off more employees while others will close. This will exacerbate the cycle, causing interest rates to go still lower and stock prices to fall further. Referring to the definition of GDP, this scenario would suggest that consumption and investment will continue to be negative. Net exports are a negative number under any scenario, as we import more goods than we send abroad. This leaves government spending as the only positive contributor to GDP.

If GDP continues to contract, it is reasonable to expect massive amounts of government spending. While this may provide some short-term relief, it will leave us with a whole new set of problems that will likely dampen growth prospects farther out into the future. Increased government spending and control of the financial system will crowd out

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MARKET COMMENTARY (CONTINUED)

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the private sector, making investing less appealing. Government spending does not create lasting growth and employment. The deeper the government's tentacles reach into the economy, the more difficult it will be to retract them as the economy finds its footing. This scenario would lead one to expect years of minimal investment gains as economic activity struggles to become robust enough to lift expectations for the future. Again, while certainly possible, we do not view this scenario as the most probable.

This credit/confidence crisis is a watershed event that will have many long-lasting implications for economic and investor behavior. Some of these will be negative, but some will prove to be very positive.

On the negative side, there is almost no chance that government involvement will abate. Too many of our elected and appointed officials now believe that capital markets cannot fix themselves and that government must act in a substantial way. And so it will. As with any well-intended government action, there will be unforeseen consequences that markets will be forced to deal with for years. Further, many investors will leave the market for good, growing frustrated with the meager returns and high volatility. Oddly enough, this is exactly the sort of behavior that ultimately leads to market turnarounds - as the last investor throws in the towel, the market readies itself for take off.

Looking to the positive implications, we believe many valuable lessons will be learned. First, consumer behavior will likely be more prudent, paving the way for sustainable growth without the false stimulus of debt. Second, regulators will be more vigilant, more closely monitoring the risks our financial institutions take on. Third, as we have written about here many times, "sophisticated" investors spent the better part of this decade taking money away from stock and bond markets and allocating assets to less liquid, leveraged investments. We hope they have learned a lesson. If

so, we anticipate a major reallocation back to traditional investments, which will have a very positive impact on markets for years to come.

So our expectations for 2009 are modest but constructive. We believe that the U.S. economy will prove to be more resilient than many expect, and that the fear of depression or deep recession will yield to the light at the end of the tunnel. While the market will likely rally to some extent as a result of this shift in perception, we do not anticipate a new bull market any time soon. Rather, a choppy, volatile market stuck in a fairly wide trading range will be the story of 2009.

There are opportunities to be found in such an environment. As you know, we search for companies that control their own destiny, not relying on economic conditions for growth. There are fewer of these companies today than in the past, but they exist, and we have already benefitted from our ownership of these. We will continue our efforts to identify such companies. Growing earnings and growing dividends will be rewarded, while companies that struggle with their balance sheet and experience negative or erratic growth will be the laggards.

Further, the volatility that awaits the market can be used to our advantage as well. Shedding weaker businesses at the tops of rallies gives us cash to buy the good businesses at the bottom end of the trading range. This may result in increased trading activity, but it can add value to portfolios in choppy times.

It should prove to be an interesting year, but far less interesting than the one just past. The U.S. markets have always led the world out of troubled times, and we are confident this will be the case once more. This is not intended to be a patriotic trumpeting of Uncle Sam's horn. Rather, it is a conclusion we come to based on a study of economic history, business cycles and stock markets. There is prosperity ahead. It will not be easily achieved, but it is there. Here is to a rewarding, or at least calm, 2009.

MADOFF (CONTINUED)

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money. Madoff custodied his clients' assets, managed the accounts and brokered the trades, all under one umbrella. There were no checks and balances in place. Madoff could make fictitious trades and produce false statements because there was no other party involved.

At Tandem, clients have their assets held in custody by either a bank trust department or a brokerage firm. The custodian is responsible for providing asset statements and accounting that cannot be manipulated by Tandem. Our

clients can easily verify this by comparing their Tandem statement to that furnished by the custodian. Further, Tandem is not a broker, and therefore must place trades through a brokerage firm. The brokerage firm and the custodian then reconcile the trades. We operate with two independent entities actually handling our clients' money. Tandem's sole function is to use its limited power of attorney to authorize appropriate trades on our clients' behalf.

These simple checks and balances are absent from the Ponzi schemes we are now too familiar with. While such a system does not reduce market risk, it does reduce theft.

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MARKET REPORT CARD

YIELD TABLE				STOCK MARKET INDEX DATA				
	Current	3 months ago	1 year ago	Stock Market Indices	12/31/08 Close	% Change 1 Year	% Change 5 Years	% Change 10 Years
3-month Treasury Bill	0.51%	0.46%	3.25%	S&P 500	903.25	-38.49%	-18.77%	-26.52%
5-year Treasury Note	1.50%	2.91%	3.28%	Dow Jones Industrial	8,776.39	-33.84%	-16.05%	-4.41%
10-year Treasury Note	2.18%	3.81%	3.90%	Russell 1000	487.77	-39.02%	-17.96%	-24.13%
30-year Treasury Bond	2.87%	4.41%	4.35%	Russell 3000	520.60	-38.70%	-17.38%	-21.63%
Prime Rate	3.25%	5.00%	7.25%	Russell 2000	499.45	-34.80%	-10.32%	18.36%
Federal Funds Rate	0.25%	2.00%	4.25%	GLOBAL MARKET INDEX DATA				
Discount Rate	0.50%	2.25%	4.75%	Hang Seng	14,387.48	-48.27%	14.40%	43.18%
3-Month LIBOR	1.41%	3.48%	4.68%	Shanghai	1,820.81	-65.39%	21.63%	NA
				Nikkei 225	8,859.56	-42.12%	-17.02%	-38.90%
				Brazilian Bovespa	37,550.00	-41.22%	68.87%	359.50%
				London FTSE 100	4,434.20	-31.33%	-0.95%	-24.62%
				German Xetra DAX	4,810.20	-40.37%	21.31%	-6.78%

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.