THE TANDEM REPORT

Volume XV, Issue 1 January 2014

"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

MARKET COMMENTARY:

GREAT YEARS ARE USUALLY FOLLOWED BY PRETTY GOOD ONES, EVEN IF THE RIDE GETS BUMPIER

What a great year 2013 proved to be. The S&P 500 increased by 29.60% and 32.39% with dividends. This was the best calendar year return for the market since 1997. Ordinarily we would expect this news to be received more appreciatively. After all, it's not every year that stocks increase in value by one-third. Instead, apparently still troubled by the memory of 2008 and suspicious of the ensuing monetary and fiscal policy responses, we hear investors express trepidation.

We have stated repeatedly that fundamentals have not kept pace with stock prices and that for this rally to be sustainable something has to change. In the 4th quarter economic data began to suggest the potential for such improvement. Yet most investors seem to remain skeptical as this bull market enters its sixth year.

Many have asked us what we see unfolding for the market in 2014. Forecasting has nothing to do with our investment process and it is not a skill we possess in abundance. That said, we do observe things that give us a somewhat informed opinion.

It is common for rising stock prices to precede good news. After all, the stock market is considered a leading indicator. It anticipates what is likely to happen in the future more than it reflects what has already happened. When the market rose after the financial crisis, it told us that the world was not coming to an end just yet. As corporate earnings returned to pre-crisis levels,

(Continued on page 4)

COMMENTARY:

REDUCE VOLATILITY, REMOVE EMOTION

Volatility is a double-edged sword for investors. Good volatility emboldens us and bad volatility makes us cowards. Good volatility sends markets higher and most welcome that. Bad volatility takes them lower and most fear that. When either one takes hold, it can make us think that whatever has happened in the past is likely to continue into the future. The old investment disclaimer *past performance is not an indicator of future results* is a warning too often unheeded.

Volatility can bring human emotion to the forefront. It can cloud decision making if it makes us greedy or fearful. The memory of the financial crisis is still present and makes many concerned that it will happen again. Those who fear a repeat of the catastrophe have been hesitant to embrace the remarkable bull market of the last five years. And they have missed a generational opportunity. Similarly, those who become greedy and chase a market ever higher leave themselves exposed to volatility's inevitable reversal.

We would all love to know the secret to eliminating all of the bad volatility while capturing all of the good volatility. It doesn't exist. You cannot have one without the other. And we mustn't permit our emotions to cause us to forget that.

Academic studies show that investors who succeed in limiting volatility, good and bad, have a greater probability of succeeding in

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Top 10 Holdings of Dividend Paying Stocks

12/31/2013

EcoLab
Wabtec
Walgreen
TJX Cos
CSX
Wal Mart
Enterprise Products Partners
Costco
Qualcomm
Valmont*

12/31/2012

Abbott Labs
EcoLab
Wal Mart
Walgreen
Qualcomm
Coca Cola
Praxair
Enterprise Products Partners
Microsoft
TJX Cos

12/31/2011

Abbott Labs
Coca Cola
Aptar
EcoLab
Wal Mart
Waste Connections
Praxair
TJX Cos
Enterprise Products Partners
Microsoft

12/31/2010

Abbott Labs
Coca Cola
Aptar
Enterprise Products Partners
ITT
Sysco
Becton Dickinson
Microsoft
Praxair
Harris

12/31/2009

Abbott Labs
Johnson & Johnson
Coca Cola
Harris Corp
ITT
Sysco
Becton Dickinson
Microsoft
Piedmont Natural Gas
NextEra

12/31/2008

Exxon Mobil
Johnson & Johnson
Abbott Labs
Piedmont Natural Gas
BP
Coca Cola
Praxair
Microsoft
Greenhill
United Technologies

* Valmont was the 11th largest holding. AbbVie was the 10th largest. It is not included due to insufficient history.

Commentary (Continued)

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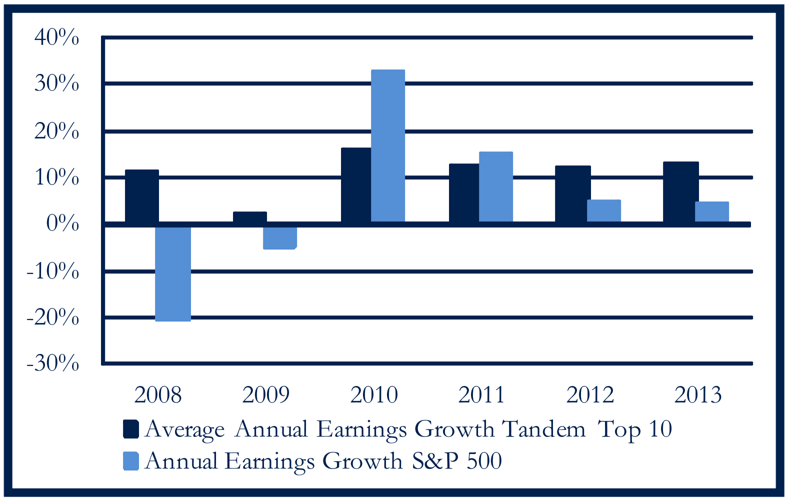
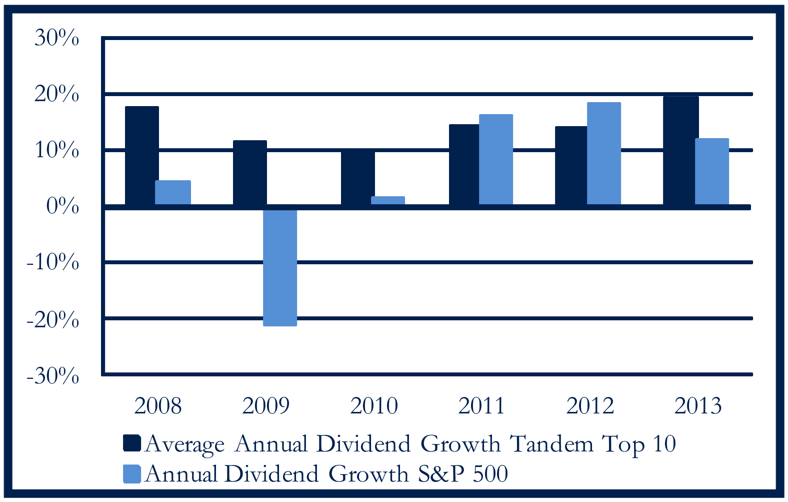
the long run. It only makes sense. If you lose less, you are ahead of the game. If you lose 50%, you have to make 100% to get back to even. If you lose 10% you only have to make 11% to get back to whole.

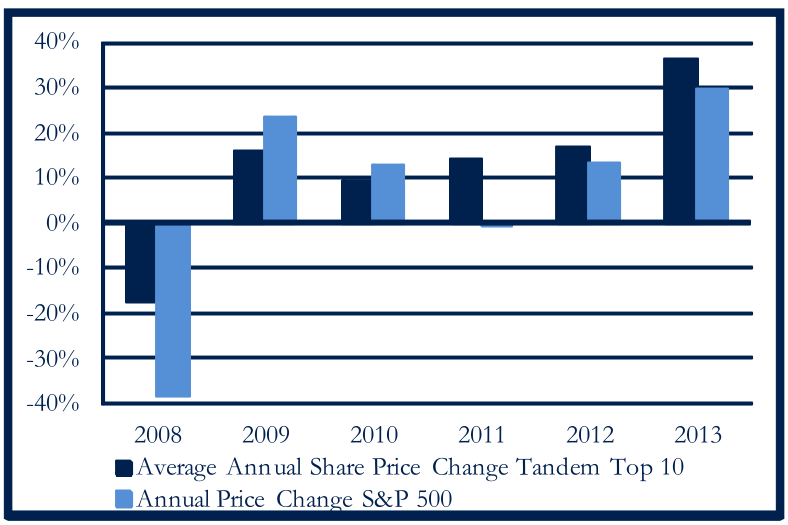
The problem with academic studies is that they tell us *what* we need to do but not *how* to do it. Some think they can limit volatility by timing the market, hoping to sell high and buy back low. This is easier in theory than in practice. There are plenty of people that claim to have gotten out of the market before the collapse in 2008. But did they get back in in time to ride the incredible bull market that began in March 2009? Or did they miss it? Even if they got back in at some point, they likely missed the biggest part of the move up. So what have they gained?

In order to successfully capture the ups and avoid the downs, you must time your decisions correctly over and over and over again. A crystal ball is not an investment plan.

In our view, the first key to limiting volatility is to remove all emotion from the investment process. There are three components to ignoring the noise and focusing on the task at hand: have a plan; execute the plan; trust the plan most when it is hardest to do so.







The charts above are not to be construed as a presentation of Tandem's investment performance. The data do not represent a Tandem portfolio, composite or model. Rather, the data compiled reflect the average for Tandem's 10 largest holdings in dividend paying stocks at the end of each calendar year. This is intended solely to illustrate Tandem's investment process.

The second key is to avoid volatile stocks. In Tandem's case, the plan is and has always been to invest in stocks that consistently grow earnings and dividends in any economic or market environment. Companies that accomplish this are typically less volatile than those that are more heavily influenced by economic conditions. When companies that meet these criteria are undervalued by

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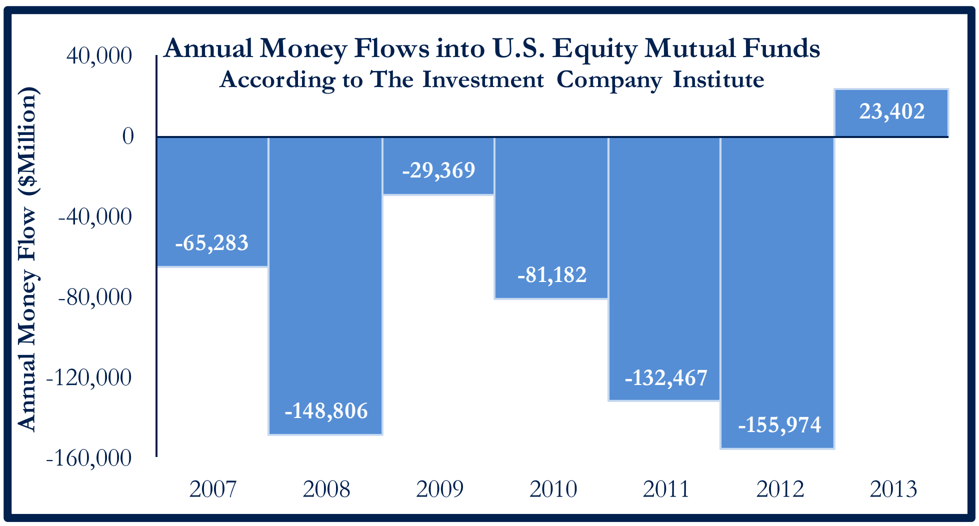
the market, we buy them. When they are overvalued, we take some profit. When they no longer meet these criteria, we sell them. And we do it over and over again. No crystal ball required.

The data in the charts on the preceding page illustrate why we have confidence in our plan and are willing to stick with it even in the most trying of times. The top chart shows the average annual earnings growth of Tandem's 10 largest dividend paying holdings every year since 2008 (see list to the left). These companies all met our criteria at the time and produced a much more consistent earnings experience than the broader market. Tandem's holdings produced average positive earnings growth within a range of 2.43% to 15.90% annually. The S&P 500's range of earnings growth varied from –20.37% to 32.89% with significant variance from year to year.

Similarly, the middle chart shows that Tandem's holdings demonstrated average annual dividend growth within a range of 9.69% to 19.28%. This is far more consistent (less volatile) than the S&P 500's record of dividend growth - a range of - 21.04% to 18.24%. Tandem stocks gave their shareholders an increase in income every year. The broader market cut dividend income by 21% in 2008.



As you might expect, such consistent growth in earnings and dividends produces a more consistent stock price experience. To be clear, stocks are not immune to the market's direction, but if they keep growing earnings and dividends, share prices tend to be far less volatile. The bottom chart demonstrates that these stocks can certainly go down in value when the market does, but often by less. And while the market may go up more than these types of stocks some years, Tandem's stocks demonstrate a more consistent (less volatile) pattern of behavior.

By creating a portfolio of companies that demonstrate more consistent behavior, we reduce portfolio volatility. Picking companies that control their own destinies allows us to de-emphasize external events and focus on the only things our companies can truly control - growing their businesses and increasing their dividends to shareholders. If their businesses grow, their share prices are likely to follow. When the market turns south, these companies keep growing, providing a level of support to their share prices that other companies lack. We pick *stocks* that meet our criteria, not *markets*. Consistency produces less volatility.

As important as limited volatility can be to investment performance, it is equally important to the investor's experience. As we stated earlier, volatility can cloud an investor's judgment. If too much volatility results in fear, we get out of the market at the wrong time. If we get out, then we will likely not be back in to participate in the market's turnaround. Mutual fund data suggests that individual investors panicked in 2008 and got out. And they kept getting out. Then they stayed out until 2013, which means they lost money before they sold and never gave themselves a chance to make it back until the market had already risen for 4 years. This is why limited volatility is important to the investor's actual experience. If limited volatility can keep an investor from getting out of the market, then the investor will participate in the recovery. Staying invested is as important to actual returns as how one is invested.

The chart below paints a rather disheartening picture. The experience of 2008 apparently did lasting damage to mutual fund investors. From 2007 through 2012, these investors withdrew over $613 Billion (with a B) from U.S. Equity mutual funds. Not only did they take money out when the market was going down, but they were apparently so concerned about a repeat experience that they continued to make sizable withdrawals as the market embarked on a terrific bull run. Not until five years after the disaster did they put more money into the market than they took out. The amount of money that came back into the market in 2013 was a drop in the bucket compared to what was taken out.

Taking money out of the market may have given investors peace of mind. Losing less in the first place may have accomplished the same thing. Volatility can make cowards of us all. It certainly doesn't make us good decision makers. Limit volatility, lose less and stay invested. No crystal ball required.

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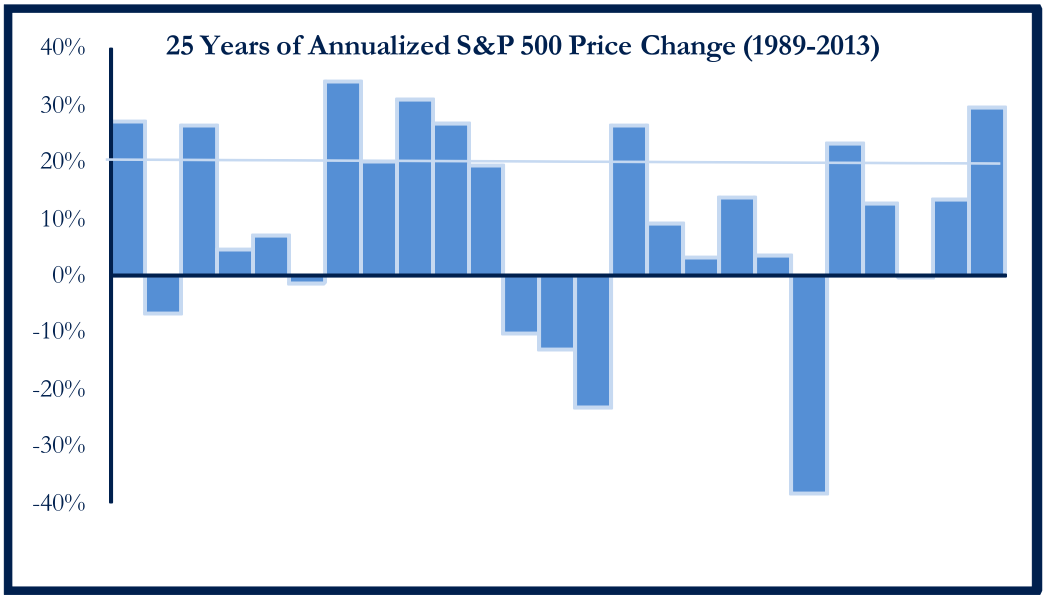
the stock market's advance correctly anticipated that. However, the market's predictive track record is not perfect and so it has its doubters.

In 2013, the market seemed to be telling us that the economy would perhaps return to more normalized levels of growth. And so prices rose appreciably in anticipation. Now corporate earnings have to deliver.

It remains to be seen whether fundamentals will catch up to prices or if prices must contract to match fundamentals. Such a hedged statement does not make this much of a prediction. However, there is a fair amount of data to suggest that prices are correctly predicting improvement.



The chart above reflects the annual price appreciation for the S&P 500 since 1989. In that time period, the S&P rose more than 20% nine times. Only once did the market decline the following year, and that was by only 6.56% in 1990. In 1999 the market was just shy of a 20% gain and contracted the next two years. That said, for the eight years following a 20%+ gain the average increase has been 14.64%. Historically then, great years are typically followed by pretty good ones.

We are comfortable with that as a prediction. We expect a pretty good year. We also expect it to be considerably bumpier than 2013. Valuation models tell us that the market seems to be fairly priced. There is nothing wrong with a fairly priced market. It can continue to go up. But if economic data or political events should be less than positive, a fairly priced market is more likely to react than an inexpensively priced one.

One traditional measure of valuation is Price/Earnings Ratio (PE). While there are limitations to the forecasting ability of PEs, most investors understand this measurement. It reflects how much we are willing to pay for earnings. Price divided by Earnings per Share equals PE. The chart at the bottom of this page shows a 25 year history of the S&P 500's PE. As we might expect, PEs have reached lofty levels at market tops and low levels at bottoms. There is certainly no "normal" level for PEs. They go up and down with stock prices and earnings.

While there is no "normal" PE level for the S&P, there is an average. The average PE for the last 25 years is 18.70. At the end of 2013, the PE for 2013 was 17.21. The range for the past 25 years is 11.51 to 29.55. It would be difficult to argue that this market is expensive from a PE standpoint.

What also is a difficult argument to support is that this market can continue higher in a straight line. During 2013 the Dow Jones Industrials closed at an all time high 52 times, including the last trading day of the year. The most significant pullback was less than 6% in the Spring.

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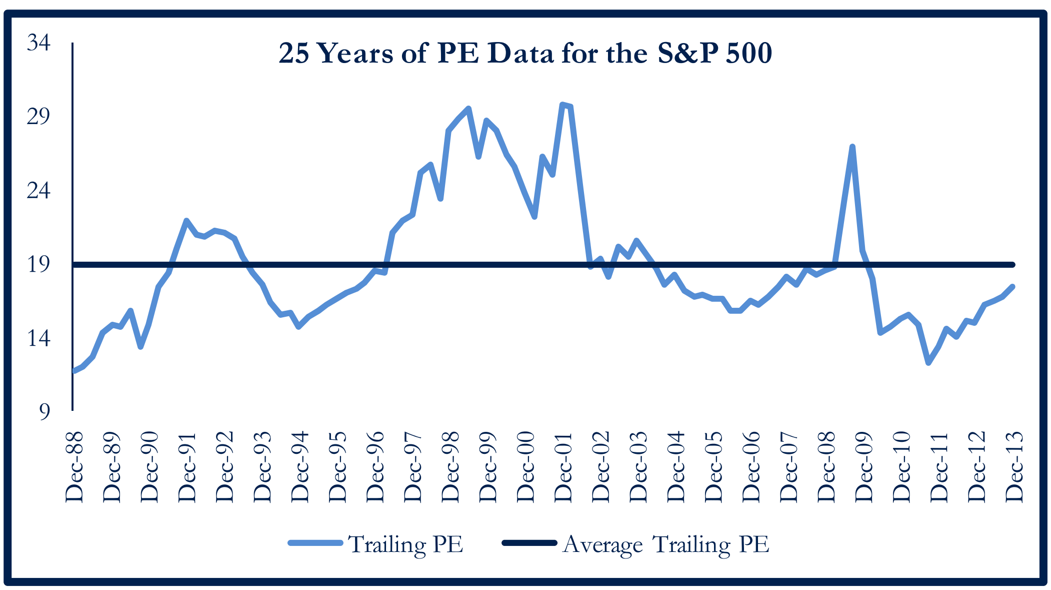

MARKET COMMENTARY (CONTINUED)

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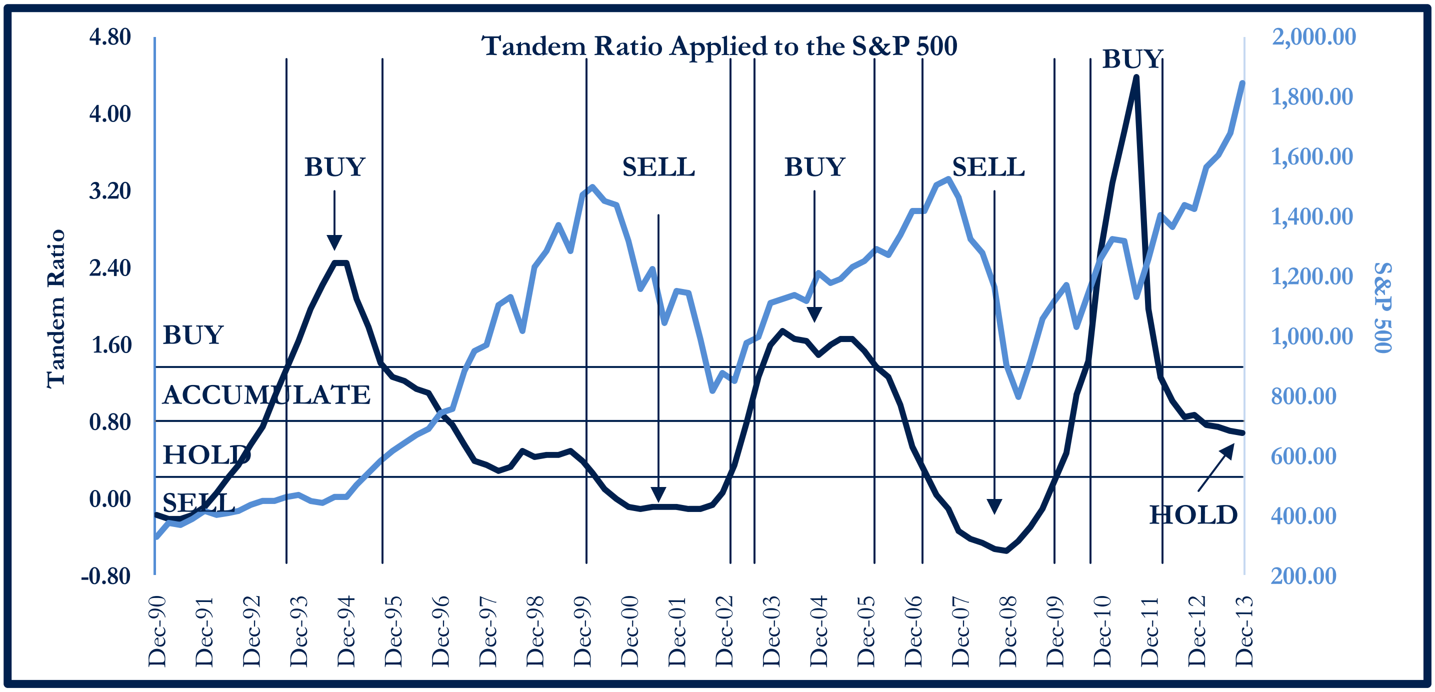
The market is overdue for a more meaningful correction and the longer one takes to occur the more significant it will likely be. Oddly, widely anticipated corrections rarely occur.

Tandem's view is that the market is fairly priced and not in any imminent danger. We rely upon our own proprietary ratio (chart above) in our research process to determine many things, including fair valuation. When we apply the ratio to the S&P 500, as we have done in the chart, we see a ranking of Hold, reflecting a fair valuation.



The chart of our ratio may be difficult to follow, yet it is vital to our work. So we will attempt to explain. Our ratio values growing earnings and dividends. When the ratio goes negative, that means a stock fails to meet our criteria and must be sold outright. If the ratio is positive, a ranking of Buy, Accumulate, Hold or Sell is assigned to the stock based upon where the ratio falls within a range. The process we have developed identifies points in time where the ratio is at an extreme valuation, or outside the normal range. Outside the range above the bands indicates a buy and outside the range below the bands indicates a sell.

As we apply our ratio to the S&P 500, the ratio is the dark blue line and the price of the S&P 500 is the lighter blue line. The chart begins in 1990 with the ratio indicating sell. From the summer of 1993 until late 1995 the market's ratio remained in buy territory, as indicated by the first set of vertical lines. There were subsequently two more sell periods (1999-2002 and 2007-2009) and two more buy periods (2003-2006 and 2010-2012). For the rest of the time, the ratio remained within the bands, indicating a fair price. Despite all the lines complicating the chart, it is clear that these buy and sell signals proved to be key inflection points in the price of S&P. It is also clear that during periods of fair valuation, the market continued to rise in value.

The chart runs through the end of 2013. The last data point for the ratio, all the way to the right, shows that the S&P's ratio represents a ranking of hold.

Our conclusion is that the market is fairly priced and it will continue to trend higher in a more volatile fashion. In other words, great years are generally followed by pretty good ones, even if the ride gets bumpier.

NEW TAXES AWAIT INVESTORS AS OBAMACARE TAKES EFFECT

Many of our clients will find themselves subject to new and higher taxes on realized capital gains and dividends as a result of the Affordable Care Act, or ObamaCare. A new tax bracket for income of at least $400,000 for single payers and $450,000 for joint goes into effect for 2013. Anyone in this bracket will have dividends and gains taxed at 20%. There is no change for those below this income level. However, those that don't reach this bracket don't necessarily escape new taxation. The 3.8% Medicare Surtax is applied to the lesser of one's net investment income or the amount by which one's modified adjusted gross income exceeds $200,000 ($250,000 for joint filers). Good news for accountants no doubt. Perhaps you should consult one.

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MARKET REPORT CARD

Yield Table	Current	3 months ago	1 year ago
3-month Treasury Bill	0.07%	0.02%	0.07%
5-year Treasury Note	1.58%	1.60%	0.70%
10-year Treasury Bond	2.90%	2.81%	1.72%
30-year Treasury Bond	3.89%	3.79%	2.88%
Prime Rate	3.25%	3.25%	3.25%
Federal Funds Rate	0.09%	0.08%	0.16%
Discount Rate	0.75%	0.75%	0.75%
30 yr Fixed Mortgage	4.46%	4.49%	3.35%

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	12/31/13 Close	% Change 1 Year	% Change 3 Years	% Change 5 Years
S&P 500	1,848.36	29.60%	46.97%	104.63%
Dow Jones Industrial	16,576.66	26.50%	43.18%	88.88%
NASDAQ	4,176.59	38.32%	54.68%	164.84%
Russell 2000	1,163.64	37.00%	48.49%	132.98%
German Xetra DAX	9,552.16	25.48%	38.15%	98.58%
London FTSE 100	6,749.09	14.43%	14.39%	52.21%
Shanghai Composite	2,115.98	-6.75%	-23.32%	16.21%
Crude Oil	$98.42	7.19%	7.70%	120.67%
Gold	$1,201.50	-27.71%	-14.51%	38.15%
CRB Index	280.17	-5.03%	-15.81%	22.06%
U.S. Dollar Index	80.15	0.44%	1.51%	-1.23%
Euro/Dollar*	137.44	4.14%	2.66%	-1.66%

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