Tandem Investment Advisors, Inc.

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THE TANDEM REPORT

INSIDE THIS ISSUE:

MARKET SCORECARD:

S&P 500:

year-to-date	-21.16%
Annualized returns:	
1 year ended 9/30/01	-27.54%
3 years ended 9/30/01	2.35%
5 years ended 9/30/01	8.65%
7 years ended 9/30/01	12.27%
10 years ended 9/30/01	10.37%

COMMENTARY

"The United States is like a gigantic boiler. Once the fire is lit under it, there is no limit to the power it can generate."

Winston

There it was, on live television, for all to see. Burned into our memories, it was a horror we shall never forget. In a society that expects instant answers, we were left only with questions. How can this happen to us? Why couldn't we stop it? Who is responsible? As we began to comprehend that answers would not be easy, a numbness set in. But that numbness has been transformed to resolve.

The terrorist attacks of September 11, 2001, on our own soil, no less, will forever stand as a redefining moment for this nation. We have been violated in an unthinkable way. Our world will never be the same. Years from now, each of us will remember, as if it were yesterday, where we were when the second plane hit. It will remain with us like December 7, 1941 has for previous generations.

Our nation has been put to the test before. And each time, we have risen to the challenge. Our stock markets are but one collective symbol of the enduring prosperity that freedom begets, and the resiliency of our capitalism. No matter what the crisis - Pearl Harbor, the assassination of JFK, the resignation of Nixon, or the stock market crash of 1987 - our markets have always endured. This event will be no exception.

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ANALYSIS

After the terrorist attacks, markets were closed until the following Monday. The selling that ensued was dramatic, to say the least. As a result, it is difficult to know how much credence to place in today's valuations. We must decide if the attacks accelerated the inevitable, or if the market merely overreacted to a tragic event. The distinction is relevant. The market's history of recovery from significant events is solid. If, however, the reaction was an acceleration of the inevitable, further analysis is required.

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Top Ten Holdings in the Tandem Growth Composite

As Of September 30, 2001

The list to the right reflects our ten largest holdings, ranked by total market value, in the accounts that make up our Tandem Growth Composite. The market really reshuffled the deck since the end of June. Relatively speaking, the drug stocks performed well. As a result, they have moved up in ranking, with AMGEN reappearing. Applied Materials and AES Corp. woefully underperformed the group, and disappeared from the list.

Once again, we compare the list to that of one year prior. The rankings have certainly changed, but six of the ten holdings from October, 2000 remain on the list. AES, Cisco, Dover, and American Express have been replaced by Microsoft, Exxon Mobil, Tyco and Home Depot.

1. Merck & Co.
2. Pfizer, Inc.
3. General Electric
4. Johnson & Johnson
5. Microsoft Corp.
6. Exxon Mobil Corp.
7. Tyco International
8. Home Depot
9. AMGEN
10. T. Rowe Price

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

Commentary Continued

In uncertain times such as these, we must allow history to be our guide. History teaches us that there is nothing to fear. Our way of life and our liberty have been threatened. As we have each time prior, we will defend them. Life will become normal for us once again. “Normal” likely will be different, but it will be normal nonetheless.

As a people, we must stand united against this assault. As investors, we must keep things in proper perspective. Many times in our past, naysayers have predicted the worst, and taken credit for their prescience when their predictions “came true”. We have endured war, assassination, nuclear threats, depression, recession, oil embargoes and impeachment. And to what end? Each time, the market has moved on to higher highs. We must not lose sight of the future, simply because the present or immediate past seem troublesome.

Words cannot adequately express the depths to which this tragedy has touched us at Tandem, and you, our clients. Who among us has not re-evaluated life, and our priorities, since that fateful day? While what we do here seems far less important now, we must get back to living our lives. It is the appropriate way to honor our fallen heroes, and to demonstrate to the world that good conquers evil. This nation stands for liberty. We will honor and defend our freedom with all that we have. The fire underneath us has been lit.

SPOTLIGHT ON THE STOCK SELECTION PROCESS

Ordinarily, we use this section to highlight and inform our readers about a particular stock that we own. Typically, the stock comes from among those that make up our top 10 holdings. In light of recent events, we thought we would better use this column to re-address the fundamental process of stock selection.

The market sold off dramatically when trading resumed on September 17, and many investors went bargaining shopping in the days that followed. This, in fact, may have been a prudent thing to do. But like many shoppers on December 26th, some may have bought simply because it seemed cheap, even though they didn't really need it.

We have always emphasized the importance of having a plan, and sticking to it. We prefer action to reaction. Buying simply because something seems cheap is not always the best approach. Buying what you want to own, what you intended to own, at a reasonable price is sound.

We outline below our investment discipline.

- We employ a well-defined investment philosophy rooted in sound principles to which we strictly adhere.
- We believe that investing in the common stock of an enterprise is the equivalent of buying an interest in a business. The fundamental health of the entity, its future prospects, and the cost of ownership must all be considered carefully. We wish to be in business with the best, at the best price.
- We recognize as essential the importance of remaining true to our convictions and making all investment decisions through the same lens. There are a variety of sound methods to achieve investment success, but none can work consistently if amended in midstream.
- We seek to own the stock of companies that possess the following fundamental characteristics:

1. **Earnings** should exhibit a steady increase over time, with every indication the trend will continue at some quantifiable rate in the future. If a company is able to increase earnings at or above a consistent rate of growth, the stock price should ultimately follow this upward trend.
2. **Dividends**, if they are paid, should exhibit the same steady increases as earnings. Rising dividend payouts serve both to reward the patient investor and to facilitate stock price appreciation.
3. **Market Share** is an important measure of the quality of the product or service the company offers. We look for dominant companies with a secure market share due to some competitive advantage, companies with expanding market share, or companies with unique technology or advantages that should enable them to gain market share.
4. **Management** must be skilled and sensitive to investor concerns. We like to see consistency in personnel, with flexibility in management's approach. If a company is not well run, it is unreasonable to assume the stock can perform well over time.
5. **Price** determines whether a stock meeting the first four criteria is worth buying. If a stock is overvalued, it is unlikely to experience significant price appreciation. We measure price relative to our expected rate of growth of the company's earnings and to the stock's historical valuation in the marketplace.

Spotlight Updates

Suffice it to say, all stocks are down since our last update, and the news for some is not particularly bright. Dover continues to struggle to meet earnings expectations, although the stock has held up surprisingly well. AES, featured in our last newsletter, warned Wall Street analysts that earnings would fall short of expectations this year, and the price of the stock was halved overnight. The biggest concern for AES is their increasing reliance on acquisitions to fuel growth. We believe this to be a problem that is within management's ability to address, but we wish to see evidence that our faith will be justified before we rush to own more.

It should be noted that many analysts have similar concerns regarding Tyco. We remain pleased with their ability to grow businesses they already own, but keep a watchful eye to be sure this trend continues. The management transition at General Electric appears to be running smoothly, and new CEO Jeffrey Immelt is proving to be a capable and respected leader. Microsoft has unveiled Windows XP with much fanfare. The future for all three of these companies remains bright.

Market Strategy

The single most important thing we, as investors, must do is remain disciplined. The landscape has changed since September 11, and some stocks now seem attractive when they did not before. That said, the price we pay for stocks still matters. Buying defense stocks because we are at war may be logical. Buying overpriced defense stocks is not.

In the body of this newsletter, we have put forth reasons for optimism concerning the outlook for the market and the economy. History tells us that the first stocks to rally in the aftermath of bear markets, recessions and tragedies are typically those of impeccable quality. Therefore, now more than ever, we wish to emphasize stocks that meet the criteria we have outlined on page 3, while being mindful of the potential offered by a changing world.

It seems to us that much of our communications infrastructure needs to be rebuilt. During the unfolding crisis in New York, phone lines were overloaded or destroyed, and traditional means of communications were silenced when they were needed most. Curiously, cell phones and e-mails continued without interruption. We believe that future communications developments will be centered around a wireless infrastructure, and companies like Cisco Systems will play a significant role.

Millions of square feet of office space were destroyed. In the future, greater emphasis will likely be placed on backing up and restoring electronic records. IBM is a prominent player in data retrieval and business continuity. Also, we may see businesses decide to not have employees concentrated in one location. This would create greater demand for technology and communications in general. We suspect Microsoft to carve out a role for itself. But we hasten to emphasize that we have no interest in companies with a "neat" product or story. We only wish to own real businesses with real earnings that make real products with real demand.

Pharmaceutical stocks have proven to be resilient in the past, and we look for this to be an area that benefits going forward. Defense companies are attractive in theory, but most were too expensive ***before*** September 11. We would rather own, at this time, companies like General Electric and Tyco that are not directly in the defense business, but are prominent manufacturers of things necessary for a rebuilt world.

It is not our intent to view the current set of circumstances as an opportunity to make a new shopping list. Rather, this is a time to take stock of what we own, and what we expect the future to look like. Remember, earnings ***always*** matter.

ANALYSIS CONTINUED

For the sake of argument, let us assume that there was more to the market's sell-off than a simple reflex. Perhaps we were in the midst of a long, protracted bear market. Since it peaked in early spring 2000, the S&P fell about 35% to its bottom after the attacks. Further, evidence mounts that the domestic economy had already entered into the first recession since 1991. Reasonable people could conclude that the market, already troubled, viewed the onset of uncertainty as the straw that broke the camel's back. It seems the market's reaction was perhaps more than knee-jerk. Where does this leave us?

A client first made the observation for us that the stock market is basically flat for the last three years. Think about that for just a moment. On September 30, 1998, the S&P 500 closed at 1017.01. On September 30, 2001, the S&P 500 closed at 1040.94. In three years, the S&P has gained 23.93 points. Most would agree that it feels a lot worse. Certainly, the market decline has been deep and painful. Yet, all it really amounts to is that we are back to where we began three years ago. This revelation sent us to the history books to determine what, if any, precedence there was for such stagnation.

We discovered that, since the end of World War II, there have been six different three year periods when the S&P was flat or down. The average return in the fourth year has been +18.9%. The low return was +10.3% in 1949, and the high was +31.5% in 1975. That statistic certainly breeds hope for 2002.

Further inspiring optimism about the market is the fact that the S&P 500 has produced below average returns for the last three, five and ten years. Historically, equities have averaged a bit more than 12% annually. For the last five years, returns have averaged 8.65%. For the last ten, average annual appreciation has been only 10.37%. It, therefore, is reasonable to deduce that, at some point, returns must increase, simply to revert to the average. The question before us, then, is when.

As we have observed on previous occasions, the Federal Reserve has been cutting interest rates aggressively throughout the year, and more cuts seem likely. While there has been much frustration with the apparent lack of impact by these rate cuts, anecdotal evidence before the attacks was mounting that lower interest rates were beginning to be felt. Interest rates are now so low, the real cost (adjusted for inflation) to corporate borrowers is virtually zero. Homeowners are refinancing their mortgages in record numbers. Whether they are taking principal out or simply lowering their payments is immaterial. The money they extract or save will eventually find its way into the economy.

In addition to the Fed's action (monetary stimulus), the Federal Government has now pledged well over $100 billion (fiscal stimulus) of aid, support and new initiatives. Further, private donation and corporate spending (private stimulus) to aid victims and rebuild now totals in the billions of dollars. This combination of monetary, fiscal and private stimulus historically has been strong medicine for a weak economy. The depression era economy of the 1930's was overcome when our nation entered World War II. It is our contention, here, that the combination of circumstances and events outlined above will have a similar impact on today's economy.

To be sure, tragedy has struck and exacerbated a very painful investing and economic environment. While our analysis leads us to believe improvement is on the way, we are not so bold as to put forth a time frame. But we leave you with this notion. It is not a question of where we are now that really matters. Rather, where we expect to go tells us how best to prepare for the future. The attacks of September 11, will be forever with us, but they may in fact hasten a powerful recovery.

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...working in tandem with you to attain your investment goals

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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 one of us at the following:

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