

The **TANDEM** Report



Volume 5, Issue 4, October, 2004

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MARKET SCORECARD:

S&P 500:

Annualized returns:

| | |
|------------------------|--------|
| 1 year ended 9/30/04 | 11.91% |
| 3 years ended 9/30/04 | 2..31% |
| 5 years ended 9/30/04 | -2.78% |
| 7 years ended 9/30/04 | 2.36% |
| 10 years ended 9/30/04 | 9.21% |

MARKET COMMENTARY:

Well, lets see. The price of oil is at record highs, the war in Iraq is increasingly challenging, there is no clear favorite to win the Presidential election in November, and Merck dropped its Vioxx bombshell on the last day of the quarter. Any guesses as to what the market has done this year? How about nothing! That's right - in spite of all the bad news, the market is basically flat for the year.

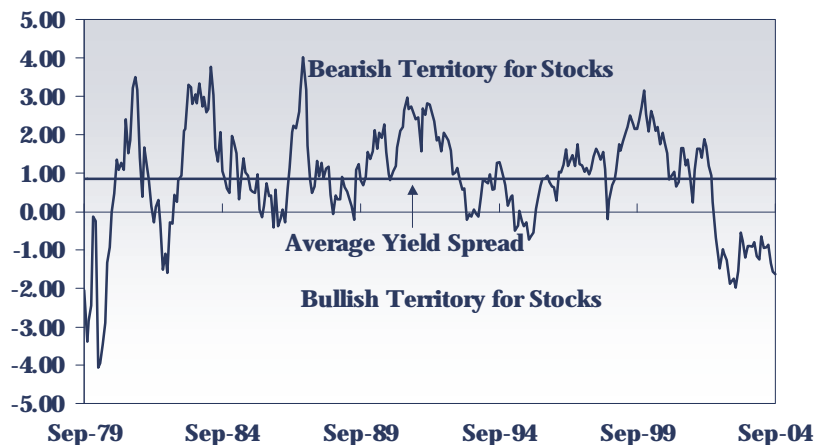
The market's resilience is the big story. Despite \$55/barrel oil, the economy continues to grow. With all the political rhetoric and uncertainty regarding tax plans and health plans and war plans and plans to have plans, investors have seemingly shrugged it all off and kept some since of perspective. All

the while, in spite of essentially going nowhere, the market has become cheaper. On a valuation basis, stocks are cheaper now than they have been for awhile. Earnings growth has made PE's contract, even without a big sell-off.

The chart below illustrates just how attractive stocks are now, relative to other things. Interest rates drive valuations of many investments - bonds, stocks, real estate, precious metals and commodities. Therefore, we like to monitor the relationship between stocks and the 10-year U. S. Treasury (also one of Alan Greenspan's favorite models). The present relationship is positive for stocks. In fact, we haven't

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Difference in Yield between the 10-Year Treasury Note and the S&P 500 Earnings Yield



TOP TEN HOLDINGS IN THE TANDEM EQUITY COMPOSITE

AS OF SEPTEMBER 30, 2004

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. These are not recommendations for purchase. Rather, the list is simply intended to provide some insight into how we manage accounts.

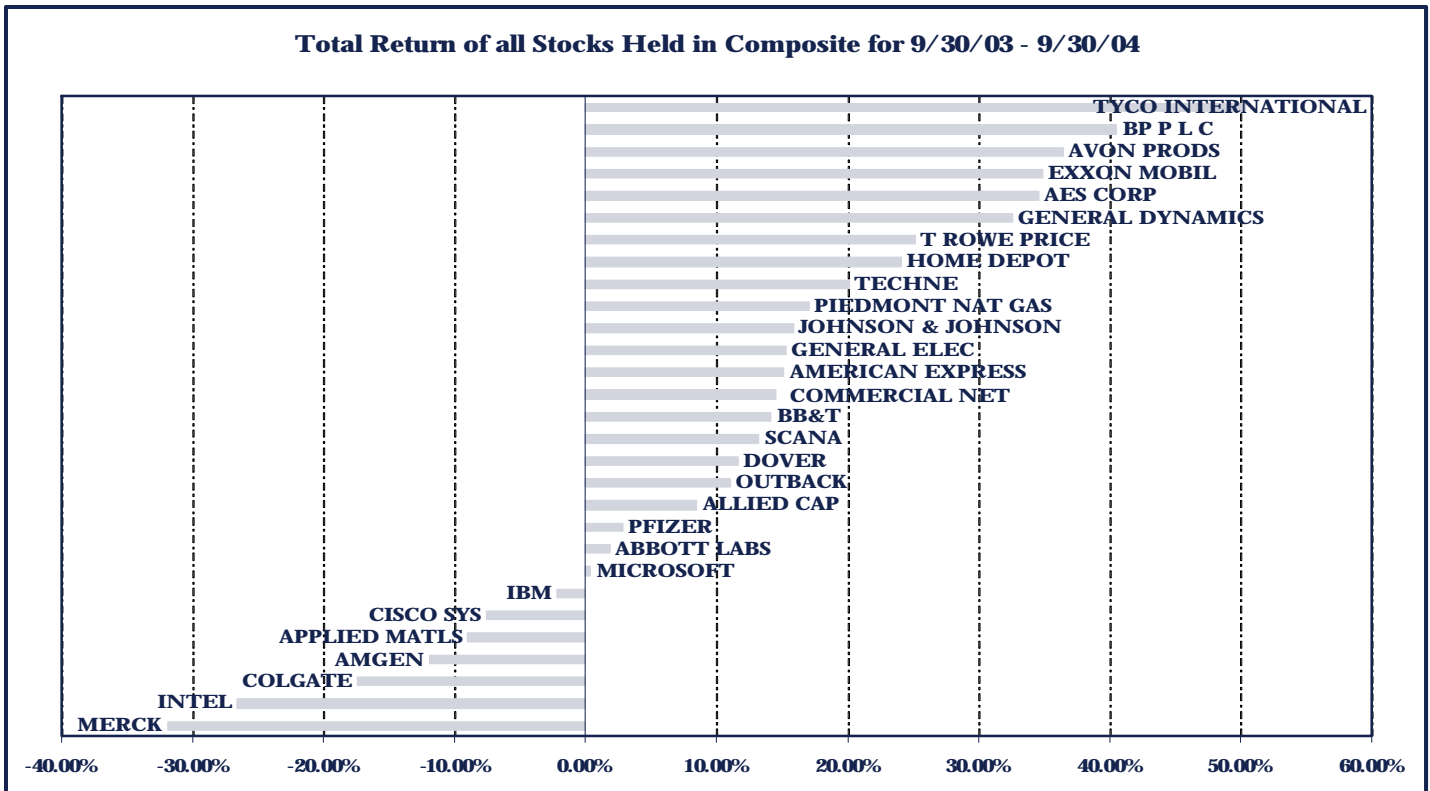
Rank by Performance of the Top Ten Holdings in the Equity Composite for the Period 9/30/2003 - 9/30/2004

Rank by Market Value Original Purchase

| | |
|-------------------------|----------|
| 1. Home Depot | 06/03/99 |
| 2. Microsoft Corp. | 12/06/96 |
| 3. Johnson & Johnson | 06/03/97 |
| 4. General Electric | 07/08/94 |
| 5. Exxon Mobil | 11/08/94 |
| 6. General Dynamics | 11/13/01 |
| 7. Amgen | 10/31/96 |
| 8. Allied Capital | 12/21/01 |
| 9. Piedmont Natural Gas | 12/21/01 |
| 10. BP, plc | 11/26/01 |

| Company | Appreciation | Dividend | Total Return |
|----------------------|--------------|----------|--------------|
| BP, plc | 36.65% | \$1.63 | 40.51% |
| Exxon Mobil | 32.05% | \$1.04 | 34.89% |
| General Dynamics | 30.80% | \$1.36 | 32.54% |
| Home Depot | 23.08% | \$0.31 | 24.05% |
| Piedmont Natural Gas | 12.67% | \$1.70 | 17.03% |
| Johnson & Johnson | 13.75% | \$1.05 | 15.87% |
| General Electric | 12.65% | \$0.80 | 15.53% |
| Allied Capital | -0.81% | \$2.28 | 8.46% |
| Microsoft | -0.54% | \$0.24 | 0.32% |
| Amgen | -11.95% | \$0.00 | -11.95% |

Total Return of all Stocks Held in Composite for 9/30/03 - 9/30/04



REVIEW OF THE COMPOSITE

One positive from the high price of oil is the performance of oil stocks. A quick look at the table on the left shows BP and Exxon at the top of the list in total return of our ten largest composite holdings. Overall, the theme of haves and have-nots is less clear than last quarter, with strong showings by General Dynamics, Home Depot, Piedmont Natural Gas and Johnson & Johnson. There is no industry theme at work.

On the flip side, drug stocks continue to struggle, but technology has really stumbled as well. We sold some Merck, Amgen, Pfizer and Abbot in many accounts, leaving Amgen as the only pure drug company still in the top 10. Johnson & Johnson obtains over half its earnings from pharmaceuticals, but is more diversified than the others.

Owing to poor performance, Cisco and Colgate disappeared from the list along with Pfizer. Of the new

names, Piedmont and BP make the list as a result of their strong returns, while we continue to buy Allied for its 9% dividend yield.

As discussed in detail in this letter, we do not foresee better times soon for drug companies. We will likely continue to move away from these names in favor of other medical concerns that are more likely to benefit in the present environment. We continue to buy Biomet for many of our accounts, and we added a new name, Kensey Nash, to those accounts with a fair degree of risk tolerance. Kensey is a small, volatile company whose principal business is the design and development of absorbable biomaterial products for the orthopedic, cardiology, drug and biologics delivery and wound care markets. That's a mouthful, but health insurance pays for their products. We also continue to like Tyco, who has a profitable health care division.

TANDEM NEWS

The big news here is that the SEC continues to review and improve its oversight capabilities for the investment advisor industry. In light of the mutual fund scandals and the emergence of the hedge fund industry, the SEC has introduced a steady stream of new rules and procedures designed to better police advisors. Failure to comply will now result in much stiffer penalties.

Our response to all this? Its about time. When Tandem first started in Charlottesville in 1990, there were maybe 5 companies listed in the yellow pages calling themselves investment advisors. Our biggest challenge back then to gaining new business was simply trying to explain the concept of managed money! Today, there 26 companies in the Charlottesville yellow pages claiming to provide investment advisory or investment management services.

With the growth in our industry came a big strain on the SEC's field offices. As you may know, agents

show up unannounced from time to time at our doorstep to audit our records. But it became increasingly difficult for the SEC to get to every one in a timely fashion.

And this is where the new rules come in. While surprise visits are still the principal form of monitoring, new rules have been implemented to allow advisors to do a better job of remaining in compliance. Among them, advisors now must adopt a Code of Ethics, and make it available to clients and prospective clients. There are stricter rules in place for personal securities transactions for advisors, as well. Further, each advisory firm is required to establish and monitor a compliance program.

We applaud these changes, and take pride in the fact that the only thing we had to do to comply with the stricter rules was to tell you that they are in place. Any changes the SEC can make to catch cheaters and keep our industry honorable are good by us.



HOW DO WE FIX HEALTH CARE?

FIRST, WE MUST DIAGNOSE THE AILMENT

Much of what we hear today about health care is simply emotional rhetoric, and understandably so. It is a very personal issue for many. No one seems to know how to fix it, only who to blame. The drug companies are gouging us, the politicians are lying to us, the insurance companies have turned their backs on us and the trial lawyers are ruining the system. We need price controls like other countries have imposed, and we should re-import drugs from Canada. Sound familiar?

Allow me to share a personal experience. Last year, my son had appendicitis, requiring three separate hospitalizations. The hospital bill was \$62,000. The total bill for his medications was less than \$200. Insurance paid the hospital, and I paid the pharmacist.

The point of this example is that Americans typically pay for prescription medications. As a result, we are keenly aware of their cost. We are less concerned with what it costs the insurance company because we only pay the premium and deductible. Therefore, drug prices have become a major political and social issue. Certainly medication could not have substituted for an appendectomy. But from a practical standpoint, medication is a far less expensive form of treatment than is a procedure.

It is amazing that the insurance companies have shared so little blame. Maybe the drug companies should hire the insurance companies' lobbyists. Nonetheless, the drug companies find themselves squarely in the political cross-hairs, and as investors, that is what we must analyze.

First, are drug companies gouging us? Maybe. The United States has the greatest health care system in the world because companies in this country are encouraged to assume great risks in pursuit of great reward. Profit potential leads to innovation. Recently, however, drug companies have eschewed innovation for quick profit. Long-term R&D efforts have too often been replaced by the development of "me-too" drugs with big market potential. How

many cholesterol-lowering agents do we really need to choose from? One, two, twelve? The pipeline of new drugs is far emptier than it ought to be. As a result, drug companies are now competing more intensely for your business, because they all market the same things. Market share, rather than innovation, drives profits. And the way to gain market share is by - you guessed it - advertising. Drug companies are estimated to spend more than twice on marketing and administration than they do on research and development. So maybe their prices are inflated, because marketing is now a huge part of their budget. Focusing on new, innovative drugs takes longer for profit to materialize, but might well be money better spent.

There is more blame to go around. Stopping with the drug companies is too easy. How about the politicians? Like the drug companies, their motivation is short-term. Election cycles make it impractical for any politician to implement meaningful, fundamental change, because that strategy rarely wins votes. It is enticing to vote for someone who promises to reduce costs and provide insurance coverage to all, but at what cost? Quick fixes have longer-term consequences.

Difficult to quantify is the indirect cost we bear as a result of litigation. Insurance companies and doctors fear it, and base their decisions accordingly. Insurance companies are hesitant to pay for new procedures, even if the doctor thinks it necessary. Doctors practice defensive medicine, ordering a barrage of tests or prescriptions because they don't want to be sued. Trial lawyers, on the other hand, make their livings from litigation. How can a drug company like Merck sell medicine properly approved by the FDA and still be sued by patients when the drug doesn't work as it was intended? Drug companies now must be prepared to face \$20 billion verdicts when a patient dies using their medication. That cost is passed on to the consumer, inflating the price of drugs.

For those who promote price controls and re-

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MARKET COMMENTARY (CONTINUED)

(Continued from page 1)

seen stocks this favorably relative to bonds since the late seventies and early eighties.

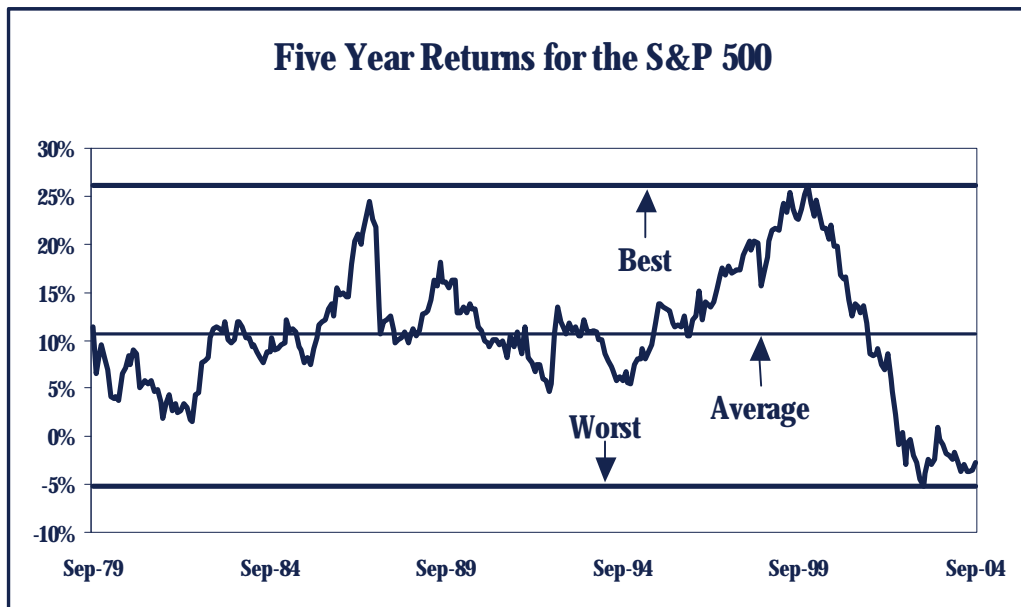
So what does this mean? Well, quite simply, it would appear that maybe there aren't many sellers of stocks left. At least for the time being. It does not mean that stocks must go up from here to nor-

malize the relationship. In fact, bonds could go down, or the relationship could remain out of balance for some time. But it does increase our confidence that, *relative to other investment choices*, stocks

make sense.

Stocks do have some room to grow. A quick look

at the chart on the left shows that the five year return for the S&P 500 has a long way to go just to get back to average. The annualized return for the last five years is almost -3%, while the average five-year return over the last twenty-five years is over 10%.



Maybe the market's ability to withstand all the uncertainty is a sign that we are poised for some good news. Maybe.

HOW DO WE FIX HEALTH CARE? (CON'T)

(Continued from page 4)

importation of drugs from Canada, please consider this. Nearly every developed country in the world, other than the U.S., has some form of price control. Consequently, citizens of other countries pay less for their medications than we do. But as a result of these policies, nearly every major drug company in the world is located in the U.S. because they can't make any money anywhere else. There are no great discoveries coming out of Canada and Europe, because there are no drug companies there performing meaningful research. The way to fix this problem is not to control prices here, but rather lift controls elsewhere so that we no longer solely bear the costs of research and development. Price controls kill incentive to innovate. It's about

time politicians stopped attacking our companies, and started focusing their energies on pressuring other governments to stop forcing us to subsidize their health care.

Health care is in a bigger mess than we can fix in a few paragraphs. All we can do is diagnose the illness. Short-sightedness by all parties has placed us in a very deep hole. Popular solutions to reduce costs impact the discovery of future live-saving science. Not reducing costs soon places a good many of our seniors in hardship. There needs to be a solution for both. Until this is addressed, we suffer. We can only conclude that there are better places to invest capital than in pharmaceutical companies, which, in our view, is a sad state of affairs.





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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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