“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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A THANK YOU TO OUR CLIENTS IN TRYING TIMES

Thank you. Thanks to all of you for keeping your wits about you while others are in a state of panic. As we work hard to ensure that your portfolios get through this mess, your calm and patience have been welcomed gifts. You are to be commended.

Although we have frequently written about the unpleasantness that would accompany the simultaneous unwinding of multiple bubbles, we could not foresee the extent of the fear that has resulted. The month of October has indeed been one for the books. From our perspective, November can’t get here soon enough.

It is important to recognize the events of this month for what they are, as well as for what they are not. First, what they are not. This is not a market event. The stock market is the victim, not the culprit. While events have conspired against the economy and subsequently the outlook for corporate earnings, the market was never in a position of being deemed expensive. Most bear markets begin with stocks at lofty levels. This was certainly not the case when the market reached a new high one year ago, and it is not the case now.

This is the unwinding of excessive risk-taking and speculation by some of our most “sophisticated” investors, funds and institutions. As these sophisticates are being forced to reduce the amount of money they have borrowed for their speculative purposes, few assets other than stocks are available to them to sell. The stock market has ceased to move for fundamental reasons. Selling simply begets more selling.

All of this will end, and a proper fundamental perspective will return. When it does, we will again be rewarded for justifiable optimism about the future of our economy and our investments. Until then, we will continue to work to preserve your capital and find opportunities as they present themselves.

On a personal note, we here at Tandem have been lifted by the kind words of support many of you have provided. We are in your debt, and are deeply committed to providing you with superior returns and less risk. We very much try to keep things in proper perspective for you, but we have found you lifting our spirits as well. Thank you.

~ JBC

MARKET COMMENTARY

Please take a deep breath and recognize that the world is not coming to an end. It just feels that way. Nothing is as it seems, and the dire predictions are motivated more by fear than by logic. Take comfort in knowing that the masses are usually wrong. As we have written previously, market movement is governed by fear and greed. Fear is having a field day, but greed can only be suppressed but for so long.

We are paying a steep price for the stupidity of others. Eager for better returns after the last bear market, many poured money into alternative investments like hedge funds and commodities. These types of investments have two important characteristics in common: the use of borrowed money and a lack of liquidity. The flaws of both are concealed when prices go up, but become dangerously exposed when prices fall. The problem seems to be that those who chose these investments failed to adequately perceive the risk associated with them. Worse, most of the culprits actually got paid for their investment “expertise.”

(Continued on page 3)
MARKET STRATEGY

Some say there is no playbook for this market. We vehemently disagree. Being proactive better prepares us for both the immediate and the future. In managing our way through this bear market, we have relied on the same philosophy, strategy and discipline we have always deployed.

First, and most importantly, avoid emotional decision-making. When the stock market experiences 1,000 point swings and 700 point drops in a day, even the most hardened portfolio managers experience emotion - even fear. For this reason, Tandem relies on a system rather than instinct. We can’t always trust instincts, but we can trust a system we have developed and refined over time. Our system has been well documented in these pages. Suffice it to say that our research and implementation strategies rely on human input only at the final stage of the process. Analysis is automated. Our Investment Committee enters the process before implementation to be certain that the results of the system make sense. This process allows us to follow a thoughtful, proactive strategy regardless of circumstances.

Second, avoid disaster. We do not define disaster as a dramatic decline in stock price. This is a bear market that takes no prisoners. Rather, we define disaster as a company that ceases to exist. Before the Treasury unveiled its TARP plan, we recognized the potential for companies to fail. Accordingly, we identified all those in our portfolio that we felt might be at risk of at least the perception of failure and drew a line in the sand - a price through which we would not allow the stock price to fall without us selling it. This strategy has worked well for us. It allowed time for certain companies like Wells Fargo and BB&T to show their strength, while getting us out of others like American Express that do not have access to the Treasury’s capital. Thus far, we have avoided disasters.

Make certain reserves are safe. Over the course of the last year or so, we have been regular sellers of corporate bonds. On the rare occasions where we have actually purchased bonds, they have been U.S. Treasury issues of very short maturities. As for money market, we have moved all cash assets into money market funds that either invest only in U.S. government obligations or are guaranteed by the U.S. government. We did this before any money market funds disclosed troubles. We sensed there could be trouble, and this is not a time to take chances with reserves.

Have the courage to sell what needs to be sold. As we discussed in the last issue, buy and hold is not a useful strategy. Having the courage to be wrong is essential. In this market, no sale has yet been proven wrong, but we can’t know where the bottom is. If a stock deteriorates fundamentally, it must be sold. Period. As a result, we entered the month of October with very high levels of cash - not because we were prescient and decided to raise cash levels. Rather, it was because we followed our discipline.

Have the courage to buy what needs to be bought. Thus far, buyers have not been rewarded. Stocks are on sale, and there are many great values out there. This is a time to be selective, and buy only those stocks that we have extreme confidence in and that fit our view of the other side of the bear market.

Anticipate what a recovery may look like, and structure a portfolio accordingly. The world has changed dramatically in unforeseeable ways the last few months, and the changes will be lasting. Federal Governments and Central Banks around the globe are pumping trillions of dollars into economies to support a crumbling financial system. Governments are now stakeholders in banks and insurance companies, and likely in our homes very soon. There is reason to believe they will expand their activism to other industries as well. While these steps may have been necessary and helpful in the short-run, the long-term usefulness of such intervention is questionable.

To fund this massive intervention, governments will have to borrow nearly unprecedented sums of money through the issuance of bonds. With the market anticipating this flood of new debt, interest rates will have to head higher, perhaps much higher. Otherwise, it may prove difficult to entice investors to buy these instruments. This means, as we have said in the past, bonds remain unattractive. Remember that bond prices fall as interest rates rise, and vice versa.

So with the world awash in new debt, economies around the world in recession (or worse) and interest rates headed higher in the future, growth is likely to be challenging for all but the very best companies. We believe our system, TVM, identifies these companies.

In our view, two categories of stocks will perform well when the stock market turns. First, the companies that were subject to indiscriminate selling as a result of hedge fund liquidations should snap back quickly and dramatically. The bad news is that we own some of these. The good news is also that we own some of these. We expect them to return to more realistic valuations, and if we don’t buy them before the turn, at least we will still benefit by owning them already.

The second category that we believe will do well over time, in light of the new environment, consists of those companies that control their own destiny and do not require a buoyant economic environment or government largesse. These are the companies that have consistently increased earnings and dividends throughout all sorts of economies.

(Continued on page 5)
If you want to see what asset bubbles look like, see the accompanying chart at the bottom of the page. Nearly anything hedge funds collectively touched has experienced bubble-like symptoms. Emerging markets, credit markets and commodities all popular with the hedge fund crowd, experienced dramatic ascents, followed most recently by precipitous declines. As illiquid (meaning hard to sell), leveraged (meaning bought with borrowed money) assets fall in price, lenders start to want their money back, or at least more collateral. Since stocks were not in a bubble and are typically less leveraged and far more liquid, they were the best asset these speculators could sell. Unfortunately, when dealing with the unwinding of massive debt, selling begets more selling. And here we find ourselves.

It would be unfair of us to singularly blame hedge funds. What is fair to find fault with, and we have done so for years, is the widespread risk-ignorance of investment professionals, banks and governments around the globe. Their folly has put us all in the middle of a giant mess. Bear Stearns, Fannie Mae, Freddie Mac, AIG, and Lehman Brothers are all essentially gone. These are not reassuring events, to be sure. In order for Capitalism to work, flawed institutions must fail. These entities borrowed more money than they could repay. They were houses of cards. Others will likely fail as well, as we have predicted. The world will go on. As competition shrinks, strong institutions take market share and profit as a result of their competitors’ misfortune. It will not be different this time. It never is.

Navigating through the rubble is easier than navigating while the bombs are still falling. You expect us to do both, and you should. We believe that we have been mindful of risk all along, and that our holdings are not likely to fall prey to the troubles of the day. Certainly share prices are suffering, but good businesses will be able to withstand the environment. Companies that have relied on debt are now having trouble financing their needs. We will continue to do our best to avoid these. Banks are now obligated to the Federal Government. Other industries may well follow suit. We grudgingly applaud the actions taken thus far, but are uncomfortable with the long-term ramifications of the U.S. Treasury as shareholder. The landscape is clouded. Nonetheless, we will continue to be guided by our principles as we navigate.

For the time being, there is no asset class that is working. Panicked investors are literally selling everything and fleeing to the safety of U.S. Treasury Bills. Yields on T-Bills briefly became negative in September, as investors were willing to accept a loss on their money as long as they were able to be sure they got most of it back. We are reminded of the old adage about throwing the baby out with the bath water.

Eventually the forced selling will be done. There are already values in the marketplace that make us salivate. However, there has yet to be reward for those brave enough to venture in. For our part, buying this month has been a bit like trying to catch a falling spear. It looks doable, but it might be easier to just pick it up off the ground.

Our Market Commentary column is typically more about details and less about adages. Forgive us, but we believe that psyche is more important at the moment. It is our hope that when reason is restored, as it certainly will be, we will find a world that adequately prices risk - a world that makes sense. This may be asking a lot, but we are hopeful.
FOLLOW-UP ON PREVIOUS PROCLAMATIONS

We thought it might be fun, and even a little scary, to review some of the bolder pronouncements we have made in these pages over the years. As you will see, we didn’t cherry-pick. We have below a sample of both our best and worst from The TANDEM Report. Enjoy.

July, 2004
In “Market Commentary - Does the Reward Justify the Risk?”, we wrote:
“We simply suggest that, in light of the uncertainties surrounding us, the wise investor will be well served to take more appropriate risks.”
In one of our many commentaries about investors’ unhealthy fondness of risk, it appears we were right, but a bit early.

April, 2005
In “Commentary: Supply, Demand and the Wisdom of a Child”, John wrote about a conversation with his then 11-year old son about the price of oil:
“He explained that he could not predict when, exactly, that higher prices would make oil producers increase supply and buyers decrease demand. Whenever supply is once again greater than demand, prices will come down.”
We need to hire that boy.

From the same issue, in “Market Analysis: What’s an Investor to do?”, we wrote:
“While most of the economic and political news leaves room for improvement, patience with good stocks is advised. Remember, history tells us that the best time to buy is when everyone else is selling.”
A little early on the call, perhaps?

October, 2005
In “Market Commentary: The Market Withstands Much, Moves Little”, we wrote:
“Stocks may remain undervalued for the foreseeable future, but we are convinced that this is a great opportunity to be a growth stock investor. Time will tell.”
Time did. Boy we did miss that one.

From the same issue, in “The Diminishing Risk Premium”, we wrote:
“Our findings indicate a decline in investor demand to be compensated for greater risk. Why? Perhaps there is a feeling of safety in numbers. Situations such as this rarely end well.”
Utter brilliance on our part.

January, 2006
In “Market Commentary: What Will Cause a Sustained Advance? A Change in Asset Allocation Would Help”, we wrote:
“...the market suffers from a lack of demand for stocks among investors. The most troubling aspect of this development is that investors have traded the liquidity of stocks for investments that are not easily sold. This has two potential consequences. First, because alternative investments are illiquid, it is difficult to quickly reallocate to stocks. Second, when these alternative investments become less attractive to investors, their illiquidity can lead to an ugly exodus.”
We underestimated the impact on the stock market.

January, 2007
In his “Commentary: I just Don’t Get it”, John wrote:
“What I really don’t understand are the risks seemingly sophisticated investors are willing to take in the name of diversification and risk reduction.”

“...allocations to U.S. equities are down to about 25%, while alternative investments are nearing 50% of a typical portfolio and headed higher. No wonder the stock market has had a tough decade. It seems everyone is leaving it. But even more startling is the way these bright investors are crowding into alternatives.”

“The returns being realized in alternative investments today are ...no more sustainable than the returns of the tech bubble.”

“...I do not take issue with alternative investments. What I do take issue with is investing in an asset class...that is exploding in unsustainable popularity without contemplating the added risk.”

“The firms that develop and manage these alternative investments will no doubt create great wealth - for themselves. Only a fortunate few will realize any lasting benefit from passive participation in these instruments.”
Clearly one of our better issues.

July, 2008
In “Market Commentary”, we wrote:
“While a recession is a possibility, we view the greater concern to be the likelihood of inflation if interest rates remain this low...Of course, we still have to get through the current credit crisis before the Fed can start raising rates. And that could get uglier before it gets better.”
Apparently, a whole lot uglier. We didn’t foresee October.

We hope you enjoyed this piece. Don’t look for it again anytime soon. It is tough on the ego. For the most part, we have been consistent, and correct. It took a good deal longer than we had expected for things to come around to our way of thinking, and because it took so long, the pain has been more widespread than we envisioned. However, we hold to our conviction that the stock market is a victim, not the culprit.
These are the companies that stand out amongst their competitors and have strong and capable management teams in place.

**Earnings growth matters.** The chart below shows the amazingly strong correlation between the price of the S&P 500 and the earnings of the companies that make up the index. The same correlation holds for individual stocks. TVM identifies companies with a record of consistent earnings growth. It is our conviction, and history bears this out, that in the short-run, stocks trade for a variety of reasons (emotion among them), but that in the long-run, stocks trade where their earnings take them.

We have positioned our portfolios to benefit if we are right about these two categories, but we haven’t bet the ranch. We continue to be selective and avoid the temptation to “be a hero” and call a bottom. We stick to our discipline and buy what needs to be bought.

**Dividend growth, not dividend yield, matters.** Some investors prefer stocks that pay a high dividend. While there is nothing inherently wrong with this strategy, we do not subscribe to it. First, a quick refresher. Most stocks have two components of potential shareholder reward: share price appreciation and dividend payments. Dividend yield is the dollar amount of the annual dividend payment divided by the price of the stock. With that in mind let us know compare investing for dividend yield versus dividend growth.

A company like Consolidated Edison has a relatively high dividend yield (5.9% as of this writing). In 1998, it also had a somewhat enticing dividend yield of 4.1%, when it paid a $2.12 dividend and it stock price was about $52. In the ten years that followed, Con Ed raised its dividend every year, but only by meager amounts. Had you bought a share of Con Ed for $52 in 1998, the dividend today ($2.34) would make your yield on cost (what you paid for it) 4.5%.

However, had you bought a share of T. Rowe Price in 1998, you might have paid about $15. Your dividend at the time would have been $0.178, for an unimpressive yield of 1.2%. The current dividend yield at the end of September, 2008 was only 1.8%. However, the dividend today has increased to $0.96 - a 439% increase. If you held on to the stock, your yield on cost would be 6.4%. You would have forgone income in the early years had you invested in T. Rowe Price instead of Con Ed, but your patience would have been handsomely rewarded because your income now would be greater.

There is another reason to invest for dividend growth. Using the example above, the 10-year price appreciation for Con Ed was –17.8%, while the 10-year appreciation for T. Rowe Price was +265.6%. We believe, just like earnings growth, that there is a strong correlation between dividend growth and price appreciation. If for no other reason, healthy companies grow earnings and dividends and their share price reflects this strength over time.

**Be proactive and stick to your plan.** It is essential that investors stick to a tried and true discipline, rather than reacting to greed and fear. This market is challenging. So was the tech bubble, the recession and bear market that followed 9/11, and so on. We must be patient.

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*MARKET STRATEGY (CONTINUED)*

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**History Shows a Strong Correlation Between The S&P 500's Earnings and Valuation**

![Graph showing the correlation between S&P 500 Price and Actual EPS from Sep-88 to Jul-08.](image)

- **S&P 500 Price**
- **S&P 500 Actual EPS**
### Stock Market Index Data

<table>
<thead>
<tr>
<th>Stock Market Indices</th>
<th>9/30/2008 Close</th>
<th>% Change 1 Year</th>
<th>% Change 5 Years</th>
<th>% Change 10 Years</th>
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</thead>
<tbody>
<tr>
<td>S&amp;P 500</td>
<td>1,166.36</td>
<td>-23.61%</td>
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<td>Russell 3000 Growth</td>
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<td>DJ Industrials</td>
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<td>NASDAQ 100</td>
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<td>Russell Mid-Cap</td>
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<td>Russell 2000</td>
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### Global Market Index Data

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<th>Stock Market Indices</th>
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<th>% Change 1 Year</th>
<th>% Change 5 Years</th>
<th>% Change 10 Years</th>
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<tr>
<td>Hang Seng</td>
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<td>Shanghai</td>
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<td>Nikkei 225</td>
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### Yield Table

<table>
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<tr>
<th>YIELD TABLE</th>
<th>Current</th>
<th>3 months ago</th>
<th>1 year ago</th>
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</thead>
<tbody>
<tr>
<td>3-month Treasury Bill</td>
<td>0.46%</td>
<td>1.86%</td>
<td>3.69%</td>
</tr>
<tr>
<td>5-year Treasury Note</td>
<td>2.91%</td>
<td>3.35%</td>
<td>4.26%</td>
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<tr>
<td>10-year Treasury Note</td>
<td>3.81%</td>
<td>4.00%</td>
<td>4.62%</td>
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<td>30-year Treasury Bond</td>
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<tr>
<td>Prime Rate</td>
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<td>Federal Funds Rate</td>
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<tr>
<td>3-Month LIBOR</td>
<td>3.48%</td>
<td>2.79%</td>
<td>5.20%</td>
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</table>

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.