THE TANDEM REPORT

Volume XVI, Issue 1 January 2015

"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:

THE BULL MARKET CHARGES AHEAD AS AN UNINTENDED CONSEQUENCE GOES UNNOTICED FOR NOW

For the third consecutive year the S&P 500 posted a double-digit gain. In fact, the S&P is now up in each of the last six calendar years with five of those years posting returns in excess of 10%. Since the market bottomed on March 9, 2009, the S&P is up an astounding 243.98%, including dividends, through year-end 2014. So the 13.69% advance in 2014 is really just par for the course it seems.

Granted, in March of 2009, the S&P had just lost roughly 55% of its value from the record high set on October 9, 2007. A strong rally would be expected. This market got back to even and just kept ripping higher. It has been nearly three years since the stock market has had a real correction (10% - 20% down). This has truly been a blessing for all stock investors that stayed the course.

As profitable as this Bull Market has been for those that have summoned the fortitude to participate, it does not yet rival the Bull Market runs of the '80's (8 consecutive positive years, 6 up double-digits) and '90's (9 consecutive positive years, 7 up double-digits). From the end of 1981 until 1999, only 1991 was a down year for the S&P. That was a Bull Market that only comes along once in a lifetime.

During the '80's and '90's, there was plenty of positive news economically and geopolitically, and stock prices rose to reflect the improving landscape. The current Bull just feels different. It feels artificial and propped up.

We have discussed ad nauseam Central Bank policies and asset price inflation resulting from them. We won't go

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COMMENTARY:

MEAN-REVERSION ANALYSIS IN EVERYDAY LIFE

Suppose you flipped a quarter 10 times and each time it landed heads. You instinctively know that tails is likely to come up soon. Imagine you have a golfing buddy who routinely shoots in the mid-90's. One day he amazes you (and himself) by shooting an 80 for no explicable reason. Having observed many of your mate's less-than-stellar rounds, you surmise that his next round will be less Tiger Woods-like and more like the golfer you know.

Experience tells us that unexpected outcomes are likely to revert back to the expected sooner or later. Whether it be coin-flipping, golf or any another activity that produces an observable outcome, we intuitively know that our cumulative observations matter more than the most recent. This behavior can be described as a form of mean-reversion analysis and it is an important element of our every day lives.

Mean-reversion is natural. Over time, nearly everything reverts to its mean, or average. For those that have taken a college statistics course, perhaps the simplistic beauty of mean-reversion analysis has been tainted by its close association with math. Nevertheless, we perform the basic calculations in our minds all the time and understand the importance of such analysis.

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Commentary (Continued)

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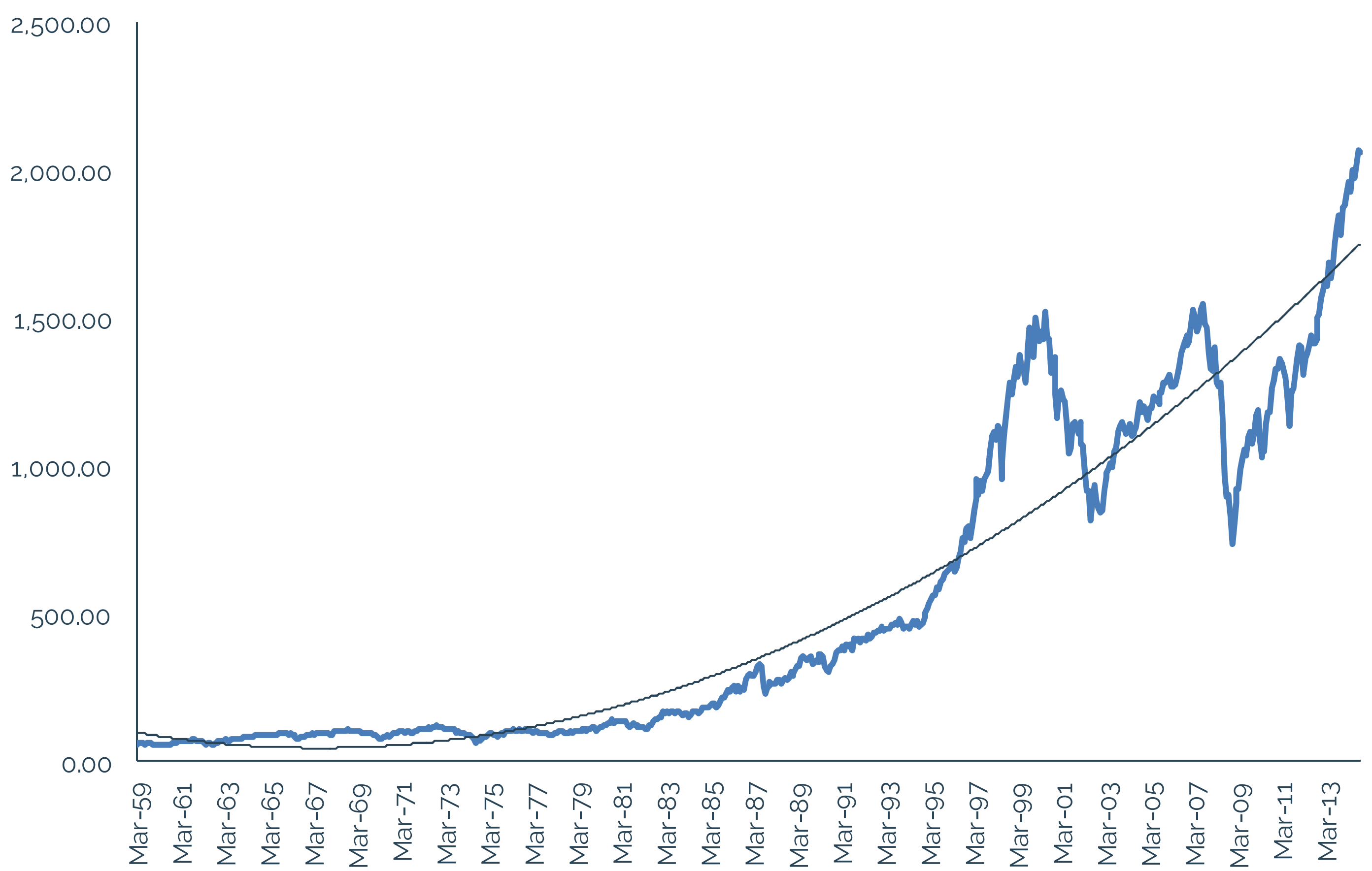
Why do shoppers get excited about a sale? Because prices are lower than normal! And they know that when the sale is over prices revert back to normal. This is mean-reversion analysis.

Mean-reversion analysis also works well when performing investment analysis. In fact, it is the cornerstone of Tandem's proprietary investment process. When followed, this analysis can tell investors when stock prices are on sale and when they are too high.

So why is mean-reversion analysis so rarely used by investors, even professional ones? Too often investors get caught up in the hype of the now, or allow some past outlier experience to cloud the ability to properly analyze the situation at hand.

S&P 500 Prices Relative to is Polynomial Trendline
March, 1959 - December, 2014



Presently, we see many investors split between two camps: those that believe everything looks grand and the market will continue higher and those that believe nothing is grand and the market is bound to fall precipitously once again. But a little bit of mean-reversion might suggest that neither outcome is the likely one.

Not every reversion to the mean has to be calamitous or glorious. Most aren't. But reversion always happens, and will happen again sometime.

The chart below illustrates the S&P 500 and it's approximate mean over the past 55 years. The price of the S&P routinely travels along its mean, sometimes above it and sometimes below it. Yet each deviation inevitably results in a reversion. Therefore, it is reasonable to conclude that the best times to buy are when the price is below its mean and the best times to sell are when the price is above its mean.

Some may infer that this analysis leads to the conclusion that there are times to get into the market and times to get out of the market. We could not disagree more strongly! We believe that one should never time the market. Getting out and back in and out again and back in again is folly.

Rather, we believe that mean-reversion analysis is more useful when performed on a stock-by-stock basis with little attention paid to the overall market. Tandem has built an entire investment process around

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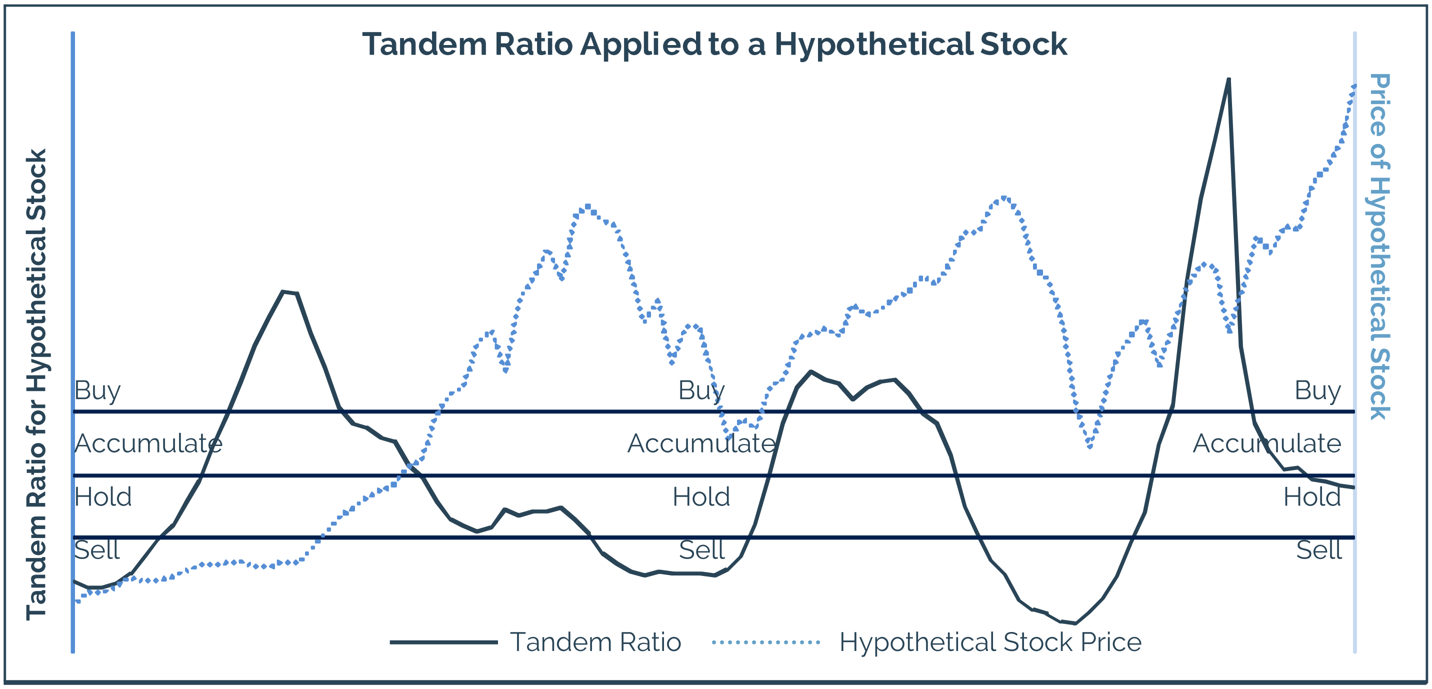
mean-reversion analysis. We apply it regularly to our universe of 1,600+ stocks, but never to "the market". It is a lot of math and proprietary formulas, but it is straightforward concept. We calculate our proprietary ratio for each stock and observe the ratio relative to its mean. stocks and wait for other stocks we like to go on sale. As Benjamin Graham asserts in *The Intelligent Investor*, "price determines return". In other words, paying a reasonable price is key to investment success.

Fortunately for us, most investors would appear to ignore mean-reversion analysis. Or at least they seem to



When a ratio travels too far above its mean, we buy the stock. When it travels too far below, we sell a portion of the stock. Hopefully the above chart illustrates this. We can buy and sell with confidence because we know the ratio will ultimately revert to its mean.

By observing and evaluating individual stocks relative to their mean, we are able to buy and sell accordingly. If we were to follow "the market" we might infer that all stocks are behaving similarly. Sometimes they do, particularly when "the market" is at an extreme. But mostly they behave individually.

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For the past year or so, we have found more stocks overvalued than fairly valued or undervalued. As a result, we have taken profits and not reinvested all of the cash we raised. This in no way reflects our opinion of stocks generally. Only that we have found more stocks to sell than buy - which means cash levels in our portfolios have been increasing. This makes our portfolios more defensive in nature right now because we are less fully invested then "the market"

But selling does not take us out of "the market". It simply reduces our exposure to overpriced stocks. Most stocks in our portfolios are still fairly valued, and some are even undervalued. By following our mean-reversion analysis, we naturally take profit in expensive

based upon observed behavior. If everyone practiced mean-reversion analysis, the market would be more efficient. We prefer to do the work required to discover its inefficiencies..

Mean-reversion analysis is by no means perfect. It is conceivable, albeit rare, that a stock may permanently break away from its mean and establish new territory, good or bad. We can live with missing out on the rare good exception. We simply want to avoid the bad exceptions. By doing so, we miss far more false opportunities than real ones.

We mentioned in our *Market Commentary* that the S&P has gone nearly 3 years without a real correction. Therefore, the S&P has traveled a bit north of its mean. It will revert. We don't know when, But that doesn't mean investors should get out of the market. The mean increases as prices rise. By the time the market reverts, the mean could conceivably be higher than current prices.

Instead of getting out of the market, we simply take some profit in individual stocks that have traveled too far from their mean. We are content to patiently hold cash as we wait buy stocks that are attractively priced. Mean-reversion analysis sounds terribly complicate. Perhaps even boring. But it works for us.

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down that road this time. We have also addressed the lack of improvement in key fundamentals like real wages and corporate earnings that would seem necessary to warrant the extent of the stock market's recent appreciation. Instead of covering old ground, we would rather explore a less publicized effect of artificially low interest rates - the expansion of margin debt used for stock purchases and the level of speculation in the stock market as a result.

Low interest rates are considered to be economically stimulative. By lowering borrowing costs, it is assumed that consumers and businesses will spend beyond their means and thereby grow the economy. That hasn't worked so well this time around, largely because consumers are still burdened by debt accumulated during previous stimulative periods.

But lower borrowing costs have certainly helped stimulate one area where speculators play. Margin borrowing has reached levels only seen twice in the last 55 years (2000 and 2007). If you are unfamiliar with margin borrowing, good! Using margin to buy stock is not new and it's not necessarily bad until it becomes excessive. The best way to explain margin is with an example. Think about buying a home with a mortgage. You make a down payment and borrow the rest. When you sell the home, you keep whatever is left after you pay off your loan.

	Initial Investment	Investment Increases to:	Investment Decreases to:
Investment Value	$10,000	$15,000	$5,000
Amount Borrowed	$5,000	$5,000	$5,000
Equity after Margin Loan	$5,000	$10,000	$0

The same can be done with stock purchases. Instead of using a mortgage, you use margin. Instead of buying an asset with a relatively stable value like a home, you buy a stock that can fluctuate greatly in value. When the stock price rises, you are happy. When the stock price falls, you still owe the lender, and the lender gets nervous as your equity evaporates. If your equity recedes enough, the lender issues a margin call and you must either deposit more capital or sell your stock. Hopefully the table above shows how this might work.

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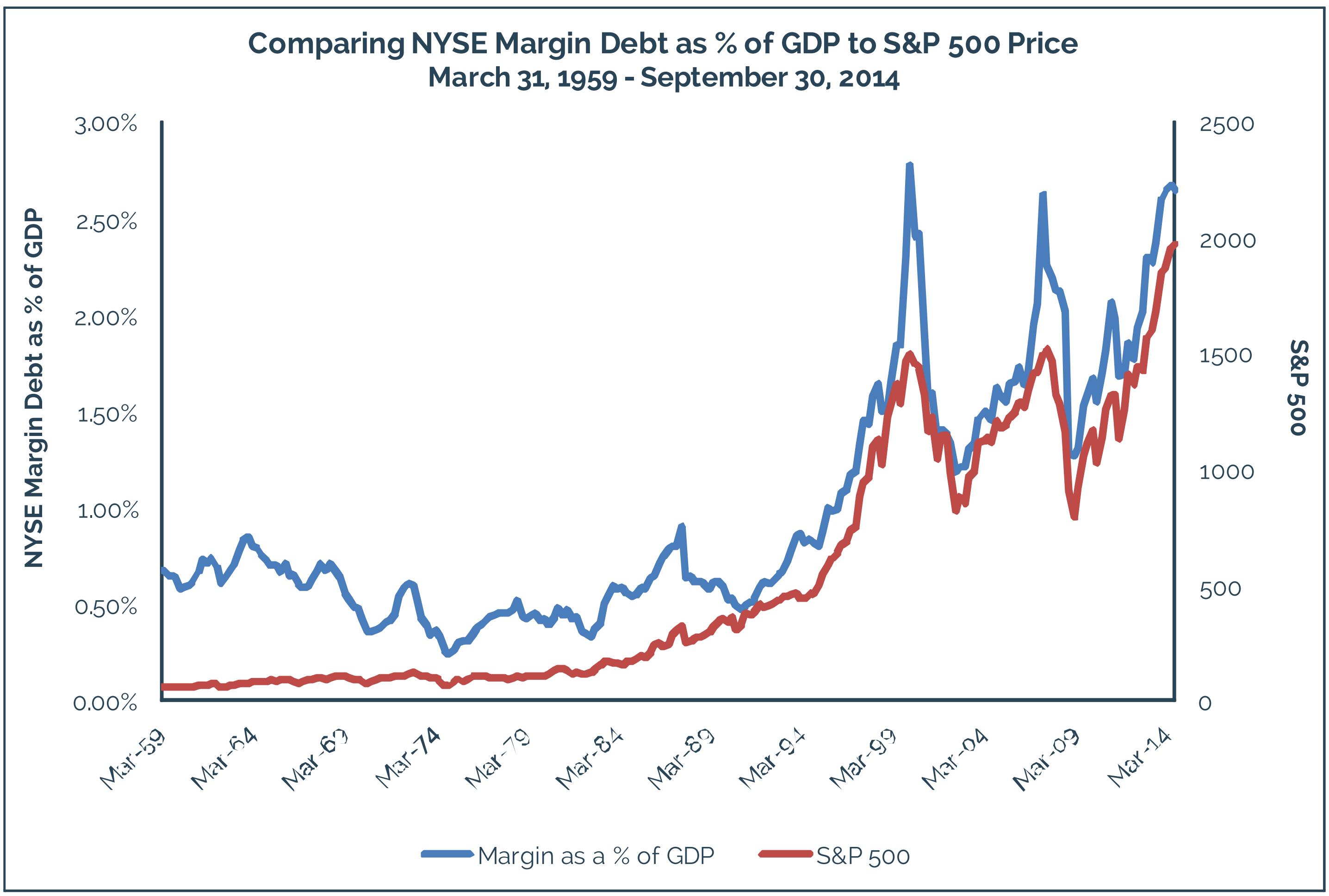

Market Commentary (Continued)

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In isolation, margin calls have almost no impact on the overall stock market. However, when the volume of margin borrowing becomes extreme, margin calls can come en masse and cause selling to accelerate dramatically. Further compounding the situation is the fact that margin is frequently the tool of speculators rather than long-term investors. Speculators are less likely to stay the course if the market goes against them. These factors can cause market corrections to happen very quickly.

The chart at the bottom of the preceding page illustrates this point beautifully. Market tops typically coincide with excessive levels of speculation, represented by margin debt. We don't have to go back very far in history to recall the excesses that manifested themselves in 1987, 2000 and 2007. A common way to speculate in the market is with borrowed money. So it is to be expected that margin peaks co-exist with market tops.

To be clear, high levels of margin do not indicate problems in the economy. Margin debt is not a predictive economic indicator. It is instead a coincident stock market indicator. When we see stock prices rising precipitously, margin debt levels may help us better understand why.

Sometimes recent history clouds judgment. The last two times margin debt reached these levels the S&P lost half of its value. Such behavior is not the norm. In 1987, margin levels reached historic proportion and the stock market fell 25% in a day. It was a scary day to be sure. However, the market quickly recovered and ended the year up 5.25%. It may be difficult to remember, but sometimes the stock market really does correct without collapsing.

These past six years have been a very profitable run for the market. A correction need not end that. However, artificially low rates have unintended consequences that cannot be ignored forever. One of them may in fact be increased margin debt. The longer free markets are prevented by artificial means from seeking their natural levels the more rapid the snap back to reality is likely to be when that time comes.

The market enjoyed a successful 2014. The economy grew steadily throughout the year and economic indicators are looking up. By all accounts, 2015 should be another fine year.

But 2015 could also prove to be a bumpy ride. Everything reverts to the mean eventually, When the time comes, it will be quick, healthy and it will hurt. But not for long if you are prepared. We think your portfolio is well prepared for whatever lies ahead.

Observations: A New Monthly Column

For years we have known internally how insightful Billy Little's market observations have proven to be. Now you will have the opportunity to read them for yourself. In December, Billy began sharing his thoughts through his monthly column ***Observations***, available both on our website and on our Tandem page on LinkedIn.

Observations is more technical in nature than ***The TANDEM Report***. It is also more bold. In his January column, Billy offers up a few predictions for the year ahead while giving his unique perspective on 2014.

As a monthly piece, we anticipate that ***Observations*** will prove to be a nice compliment to the quarterly ***TANDEM Report***, allowing us to share in a more timely and in-depth way Billy's reflections on current events. For instance, since this newsletter was set to go to press, the market has continued a selloff, interest rates have gone lower, the dollar has strengthened, the Swiss National Bank caught everyone by surprise and oil's collapse has deepened. Many of these events will impact how we manage your portfolio. Billy will no doubt address the most critical ones in his next column in February. So please look for it on our website and LinkedIn in a few weeks.

In the meantime, we have saved enough space in this edition to briefly address what we view as the most interesting recent event. Assuming you have already read the rest of this newsletter, you are aware of our positions on Central Bank intervention and mean-reversion. Since the Great Recession, Central Banks have been doing their darnedest to prevent markets from seeking their natural levels.

In 2011, The Swiss National Bank (SNB) pegged the Swiss Franc to the Euro in effort to keep the Franc from strengthening further and harming the Swiss economy. It was a bold and costly move for the SNB. On January 15th, SNB caught the world by surprise and threw in the towel. Once unpegged, the Franc surged nearly 20% in value against the Euro. We suspect this will not be the last Central Bank surprise to come and that as more follow, prices will begin a hasty return to their mean. Artificial pricing is not sustainable, and ***Observations*** may have something interesting to say about it in February.

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YIELD TABLE			
	Current	3 months ago	1 year ago
3-month Treasury Bill	0.04%	0.02%	0.07%
2-year Treasury Note	0.67%	0.57%	0.38%
5-year Treasury Note	1.65%	1.76%	1.74%
10-year Treasury Bond	2.17%	2.49%	3.03%
30-year Treasury Bond	2.75%	3.20%	3.97%
Prime Rate	3.25%	3.25%	3.25%
Federal Funds Rate	0.03%	0.03%	0.04%
Discount Rate	0.75%	0.75%	0.75%
30 yr Fixed Mortgage	3.40%	3.78%	4.15%

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				
	12/31/14 Close	% Change 1 Year	% Change 3 Years	% Change 5 Years
S&P 500	2,058.90	11.39%	63.72%	84.64%
Dow Jones Industrial	17,613.68	6.26%	44.17%	68.91%
NASDAQ	4,736.05	13.40%	81.80%	108.71%
Russell 2000	1,204.70	3.53%	62.60%	92.63%
German Xetra DAX	9,805.55	2.65%	66.24%	64.59%
London FTSE 100	6,566.09	-2.71%	17.83%	21.30%
Shanghai Composite	3,234.68	52.87%	47.07%	-1.30%
Crude Oil	53.27	-45.87%	-46.10%	-32.88%
Gold	1,199.20	-0.19%	-23.62%	9.02%
CRB Index	229.96	-17.92%	-24.68%	-18.85%
U.S. Dollar Index	90.28	12.64%	12.60%	15.95%
Euro/Dollar*	120.96	-11.99%	-6.63%	-15.55%

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

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