THE TANDEM REPORT

Volume XVI, Issue 2 April 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:

TEPID ECONOMIC GROWTH AND LOWERED EARNINGS EXPECTATIONS COULD LEAD TO HIGHER STOCK PRICES. HERE'S WHY.

The stock market has gotten off to a choppy start in 2015 but the S&P 500 still managed to record its 9th consecutive quarterly gain, posting a 0.95% advance through March 31st. Given the underwhelming rate of economic growth experienced during this recovery, it is somewhat remarkable that the S&P is working on its 7th consecutive year of gains.

GDP growth (the preferred measure of economic growth) has been lackluster when compared to previous recoveries, as illustrated by the chart below. Of the five recovery periods measured since World War II, growth in the current pe-

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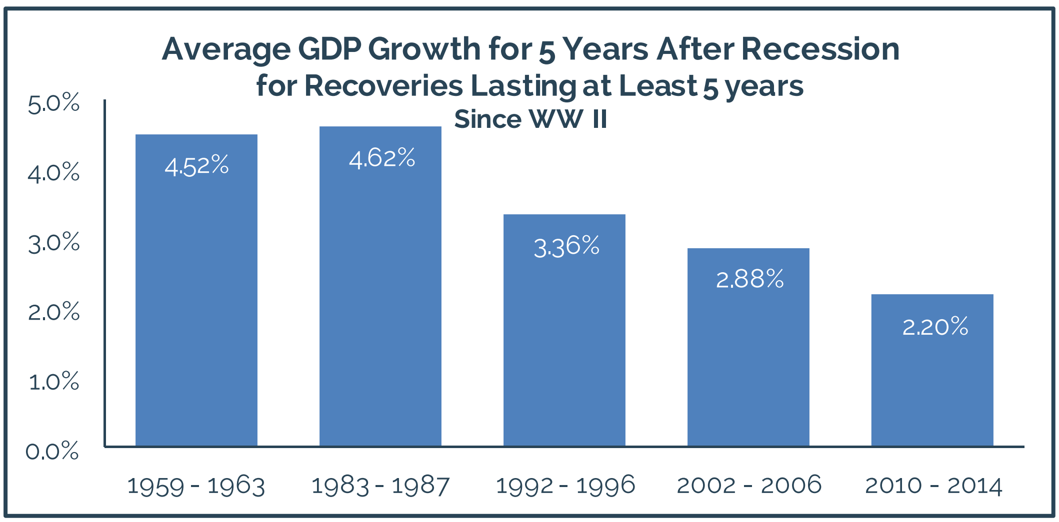

Source: U.S. Department of Commerce, Bureau of Economic Analysis (www.bea.gov)

COMMENTARY:

BEWARE THE RETURN OF VOLATILITY, AND HOW WE LIMIT ITS EFFECTS ON YOUR PORTFOLIO

What are we to make of this crazy stock market? It's like the Energizer Bunny. It keeps going and going. We often use this column to discuss underlying currents that could influence the market in the future. Recently we highlighted the considerable amount of margin debt that could trigger a selloff given the right set of circumstances. This quarter we turn our attention to the underutilized barometer of volatility to attempt to divine if and when the Energizer Bunny will need a recharge.

Volatility describes the variation of returns an investment experiences over time, typically measured in quarterly or monthly increments. Mathematically, volatility is a measure of the dispersion of returns for an investment or index. Most commonly volatility is expressed as standard deviation. The higher the

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standard deviation, the greater the volatility of returns. High volatility implies greater risk.

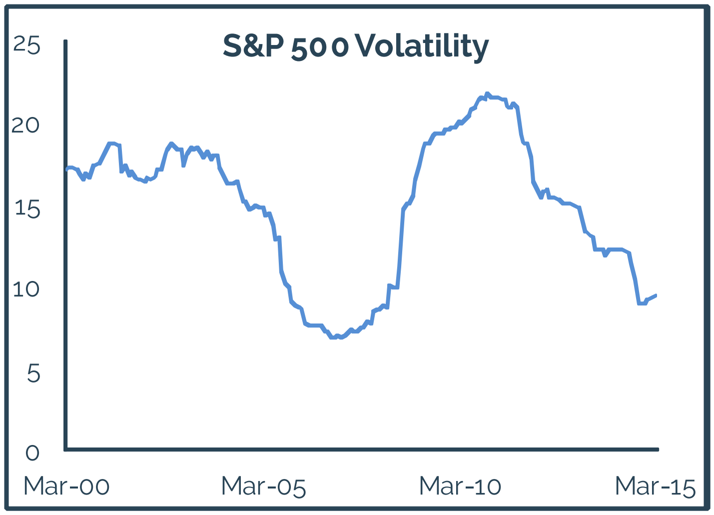
Think of it this way. Consider two hypothetical investments. The first returns a modest 1.00% gain every quarter, without fail. After 3 years, this investment produces an annualized return of 4.06%. The second produces far more random quarterly returns. After 3 years it produces an annualized return of twice the first example, or 8.00%. Which one is riskier?

	Hypothetical Investment 1	Hypothetical Investment 2
Quarter 1	1.00%	10.00%
Quarter 2	1.00%	1.00%
Quarter 3	1.00%	6.00%
Quarter 4	1.00%	-17.00%
Quarter 5	1.00%	8.00%
Quarter 6	1.00%	4.00%
Quarter 7	1.00%	2.00%
Quarter 8	1.00%	13.00%
Quarter 9	1.00%	-3.00%
Quarter 10	1.00%	-25.00%
Quarter 11	1.00%	15.00%
Quarter 12	1.00%	19.00%
Annualized Return	4.06%	8.00%
Standard Deviation	0.00%	24.55%

Hypothetical Investment 1 produces returns that never deviate. They are consistent and predictable with no variation. Therefore it is considered to have zero risk and its standard deviation is 0.00%. Hypothetical Investment 2 has a standard deviation of 24.55%, and is therefore considerably riskier. We all would prefer an 8% return to a 4% return, but the probability of that 8% return being something else, including negative, is far greater than the probability of the 4% return in this example being negative.

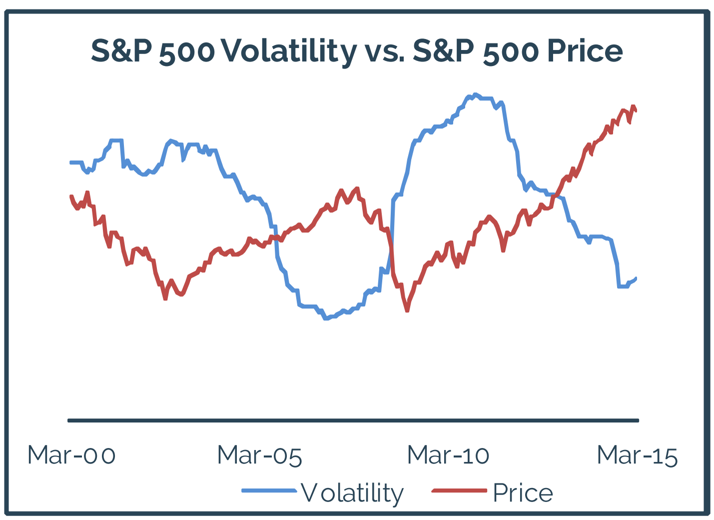
In the real world, there is no asset that produces returns with a standard deviation of 0.00%. But at Tandem, we believe it is important to get as close to that number as possible. We will discuss both why we believe this and how we try to achieve it. First, why.

Volatility can be measured mathematically, although few investors bother to try. Most of us feel about volatility as Supreme Court Justice Potter Stewart did about obscenity - we know it when we see it. What we too often fail to see is how wonderfully predictive volatility can be.



The chart above tracks the standard deviation for the S&P 500 over the last 15 years. It clearly peaks and troughs over time. Investor optimism is typically at its highest when volatility is at its lowest. We prefer consistency and predictability to randomness and uncertainty.

Still looking to the chart above, volatility troughed from 2005 to 2008. At its lowest levels, market's were generally rising. In retrospect, this would have been a wonderful time to take some profits (see corresponding chart below). But evidence from this period suggests that investors were adding money to the market more indiscriminately than they had in previous years.



From 2008 until 2010, volatility began to spike to some of the highest levels ever recorded. As it did, share

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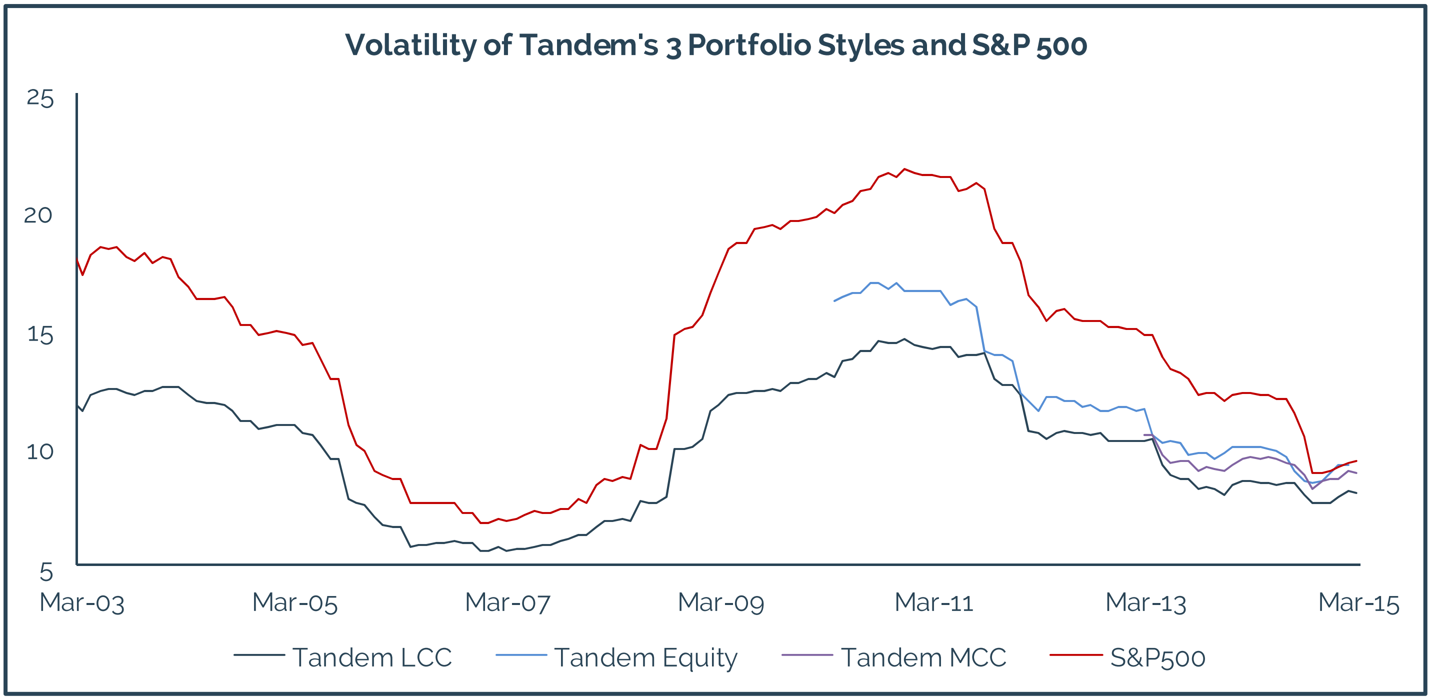
prices were bottoming and becoming more attractive. Yet evidence suggests investors continued to flee the market long after it had bottomed. Volatility makes investors do the wrong thing at the wrong time because it typically induces fear. And fear is the investor's enemy.

satisfactory balance between the two. Investors that prefer more volatility are more likely to find themselves trading in and out of the market, often at precisely the wrong time. Investors that prefer less volatility generally remain in the market and therefore capture more of the markets overall return. Tandem prefers this approach.

So how do we limit volatility? By identifying companies



that keep volatility out of their underlying businesses. If we can identify companies that do a good job of the things they control, they are more likely to enjoy consistent, less volatile stock performance. So what are the things a company can control? The growth of their business over time, regardless of economic environment, and the growth of their dividend if they pay one. The table below illustrates Tandem's portfolio companies have demonstrated the ability to do a good job of the things they can control.

If we study volatility's history in the bottom chart on the preceding page, it can tell us some amazing things that should not be overlooked. Volatility does nearly the perfect opposite of the market. When volatility is low, prices are generally high and vice versa. High volatility is a pretty good buy signal and low volatility is a pretty good sell signal. When volatility reverses, it's a pretty good bet that stock prices are about to do the opposite.

This is why we believe it is important to limit portfolio volatility. Low volatility keeps investors invested. High volatility chases them away. As you can see in the chart above, we do our best to put our beliefs into practice. Tandem consistently produces less volatility, regardless of investment style, than the S&P 500.

Every investor wants zero risk and infinite return. Unfortunately, as that has proven impossible throughout history, investors are forced to find a

	5 YR Dividend Growth	5 YR Earnings Growth
Tandem Large Cap Core	128.98%	78.25%
Tandem Equity	146.10%	104.92%
Tandem Mid Cap Core	153.55%	110.60%
S&P 500	86.96%	81.77%

The figures for Tandem's styles above represent the average of all equity holdings excluding REITs and MLPs. Dividend growth is the average of all included holdings that have paid a dividend for the last 5 years. Companies in at least one composite excluded from this list include Abbott Labs, Abbvie and ITT because of past spinoffs and divestitures. Past performance is no guarantee of future success and this data is not an indication of investment performance.

Low volatility is not in and of itself an indicator of investment performance. But it is in fact a terrific indicator of market direction over time. When the Energizer Bunny stock market begins to run out of steam, it is likely that volatility will increase. If we can limit our own portfolio volatility in the future as successfully as we have in the past, we should find ourselves better positioned to do the right thing at the right time.

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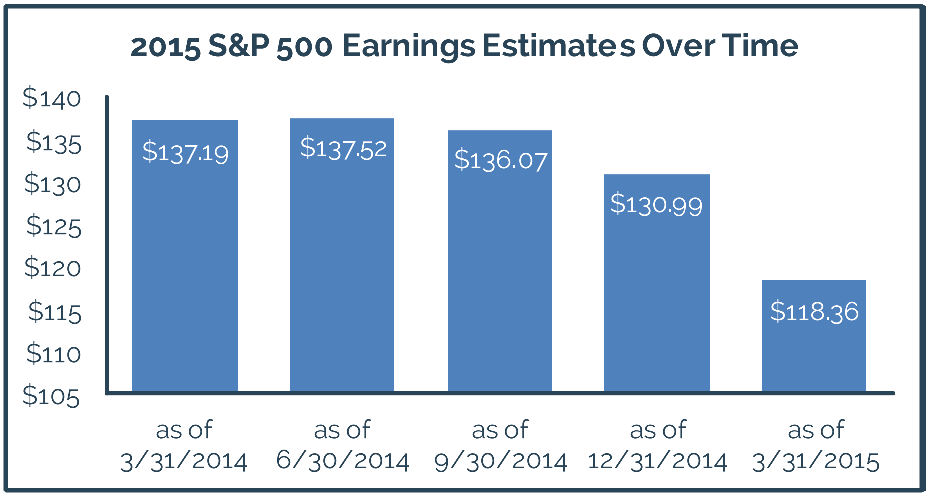
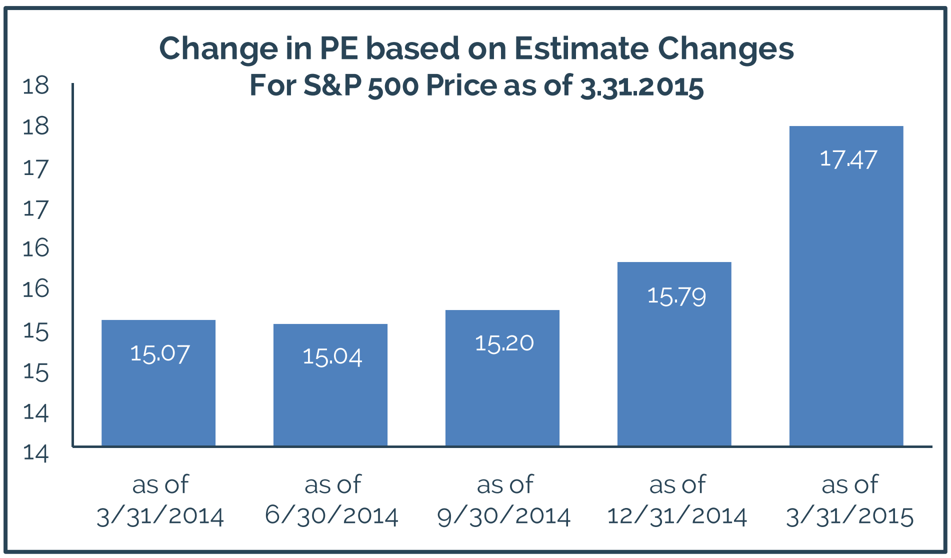
riod is by far the most modest.

While tepid economic growth continues to be a headwind, the steep decline in oil prices in the 2nd half of 2014 combined with the sharp rise in the dollar have resulted in dramatically lower earnings expectations for 2015. In fact, the decline in estimates from a year ago is as significant as we have seen in some time. One year ago, the S&P was projected to earn $137.19 in 2015. Today that number has been lowered to $118.36.



Source: Standard and Poors (www.standardandpoors.com)

With earnings expectations for 2015 declining by nearly $19 and 14% over the past year (see chart above), the

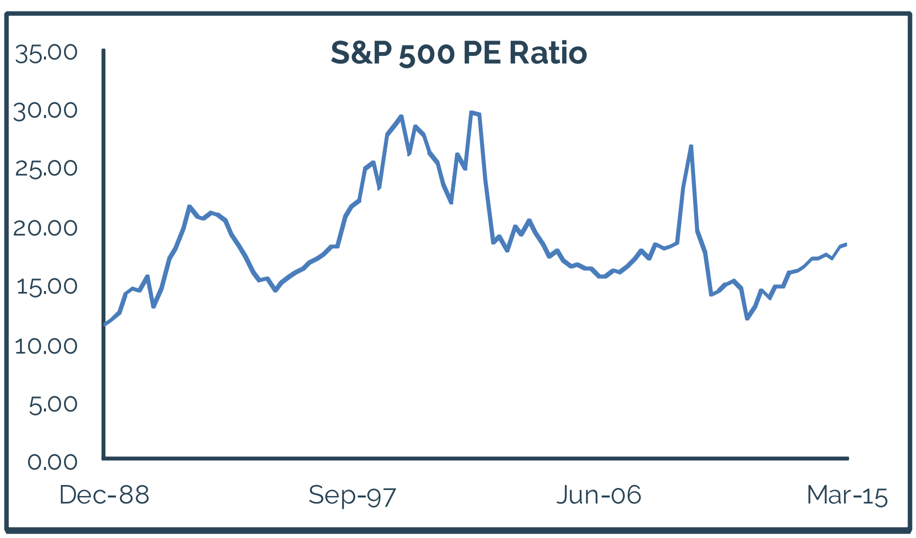


Source: Standard and Poors (www.standardandpoors.com)

market's valuation has become a bit stretched. Using the S&P's March 31st price, the PE (Price ÷ Earnings) would be 15.07 if the earnings estimate from a year ago where still in place. However, the new earnings estimate results in a PE of 17.47 (see chart directly above). While a PE of 17.47 is not outrageous, it is certainly approaching levels that might give investors pause.

A look at the chart to the right indicates that PEs have been rising steadily for the last 3 1/2 years. This means that prices have been rising faster than earnings, which is not a sustainable trend. It should be noted that the two previous PE highs occurred at market bottoms in 2009 and 2002, after earnings had collapsed. So high PEs are not always indicative of market tops. PEs rise because prices rise faster than earnings or because earnings fall faster than prices. High PEs at market bottoms anticipate an earnings recovery. High PEs at market tops reflect unrealistic expectations of continued earnings growth. Only time will tell if the current PE is based upon realistic or unrealistic expectations.

As noted earlier, the reason for the present PE level is because earnings expectations are declining. Typically, prices will adjust over time to reflect the new reality. It remains to be seen if lowered earnings expectations are justified and merit a new reality or if companies will somehow surprise the market and exceed expectations.



Source: Standard and Poors (www.standardandpoors.com)

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MARKET COMMENTARY (CONTINUED)

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Prices will likely be volatile and stay within a range until the earnings picture becomes clearer.

In the short run, a stronger dollar and lower oil prices will have a negative impact on corporate earnings. The dollar will shrink the profits of companies that export goods and services around the globe. The decline in oil prices will have a similar effect on the profitability of all the companies that have benefitted from the U.S. oil production resurgence. For these reasons, 2015 earnings expectations have been revised 14% lower.

In the long run, however, a strong dollar and cheap oil should prove to be a positive for the U.S. economy. Both act almost as tax cuts for American consumers and businesses. We pay less for imported goods and services and realize significant savings at the pump as well. As a result, savings, investment and expenditures all increase, resulting in economic growth. It just might take a few more quarters to realize these benefits.

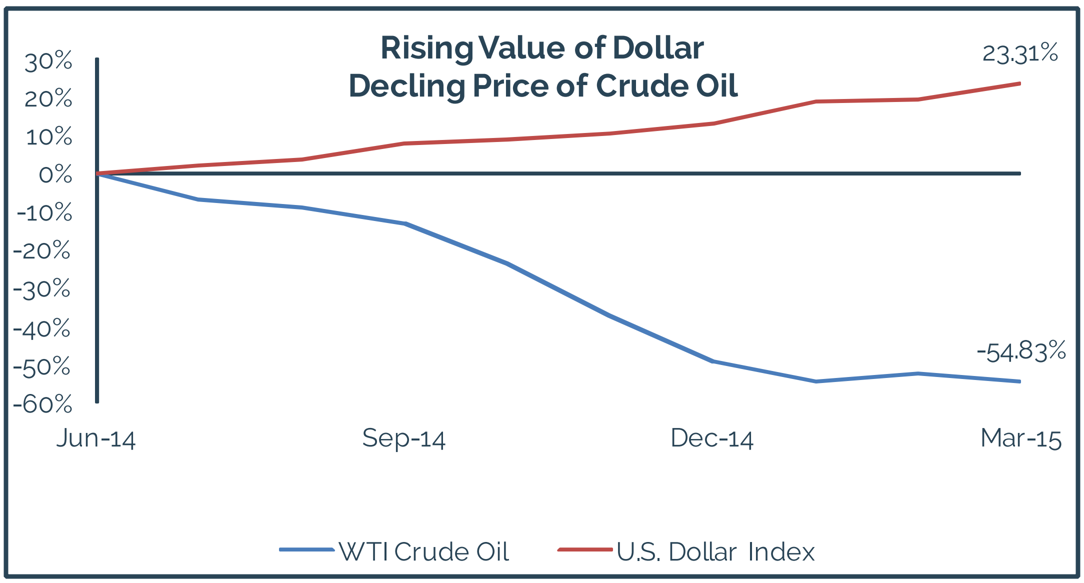
The reason the dollar and oil have a negative impact in the short run is largely because of the magnitude of the moves. The chart on this page shows that in just 9 months the dollar has appreciated more than 23% and oil has declined more than 54%. The size of these moves is without precedent. Currencies rarely move more than a few percentage points in a year. Commodities like oil tend to be more volatile, but rarely this volatile.

The severity of the moves has made it impossible for companies to weather the storm. As the volatility subsides, managing lower oil and a stronger dollar will become easier to do. And the benefits will begin accruing to the rest of us.

So the question for the market then becomes what of earnings. If the dollar and oil stabilize, or if the dollar weakens a bit and/or oil rises a bit, earnings expectations should rise as well. And if expectations rise, suddenly the market's valuation is less extended. Unless, of course, prices keep rising faster than earnings, and then valuations will continue to be stretched.

Uncertainty about the future is something investors always confront. It's why bulls and bears coexist and why the market's direction is never obvious. Yet the level of uncertainty we presently face is a bit different. There are influences present that are new. We are not used to seeing currencies, commodities and even interest rates make moves as dramatic as have been occurring in recent months. To read more about these extreme moves, please read Billy Little's latest *Observations* column from April 1st. You may find it on our website at www.tandemadvisors.com under the News & Commentary heading.

Because there exists a more extreme array of sentiments than we would normally expect to find in the market, it would be reasonable to assume that the bull vs. bear tug of war we saw in the 1st quarter will continue for awhile. However, the overriding influence remains the Federal Reserve.



Source: Baseline by Thomson Reuters

Please pardon the editorializing, but it is becoming quite apparent that the Federal Reserve is more concerned with how the stock market reacts to its policies than how the economy does. For some time it has been conjectured that the Federal Reserve would finally begin to raise interest rates in 2015, perhaps as early as their June meeting. Now that earnings expectations have taken a hit, some on the Fed have stated publically that rate hikes can wait.

The current level of Fed meddling can sustain stock price increases regardless of earnings expectations and other fundamentals. If investors come to believe, as many have, that the Fed will not take any action that causes stock prices to fall, then they will continue to buy stocks and drive prices higher. If we get the earnings improvement that might result from lower oil and a stronger dollar, well that's just icing on the cake. We may just be in for a 7th consecutive up year. We will continue to enjoy it cautiously.

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YIELD TABLE			
	Current	3 months ago	1 year ago
3-month Treasury Bill	0.02%	0.04%	0.03%
2-year Treasury Note	0,56%	0.67%	0.42%
5-year Treasury Note	1.37%	1.65%	1.72%
10-year Treasury Bond	1.93%	2.17%	2.72%
30-year Treasury Bond	2.54%	2.75%	3.56%
Prime Rate	3.25%	3.25%	325%
Federal Funds Rate	0.04%	0.03%	0.04%
Discount Rate	0.75%	0.75%	0.75%
30 yr Fixed Mortgage	3.28%	3.40%	4.00%

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				
	3/31/15 Close	% Change 1 Year	% Change 3 Years	% Change 5 Years
S&P 500	2,067.89	10.44%	46.82%	76.83%
Dow Jones Industrial	17,776.12	8.01%	34.54%	63.74%
NASDAQ	4,900.88	16.72%	58.52%	104.38%
Russell 2000	1,252.77	6.80%	50.88%	84.60%
German Xetra DAX	11,966.17	25.22%	72.25%	94.46%
London FTSE 100	6,773.04	2.65%	17.42%	19.25%
Shanghai Composite	3,747.90	84.33%	65.63%	20.55%
Crude Oil	47.60	-53.14%	-53.80%	-43.17%
Gold	1,187.00	-8.11%	-28.60%	6.41%
CRB Index	211.86	-30.46%	-31.32%	-22.49%
U.S. Dollar Index	98.38	22.81%	24.61%	21.31%
Euro/Dollar*	107.41	-22.02%	-19.50%	-20.46%

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