SPECIAL UPDATE
Notes from the Trading Desk

February 11, 2018 Tandem Investment Advisors

Market Turbulence

After 15 consecutive months of positive returns for the S&P 500, it looks like February wants to have something to say about whether the streak will reach 16. It was a rough week on Wall Street. Some investors took the renewed volatility in stride. Others didn't fare as well. In this **Special Edition** of ***Notes from the Trading Desk***, we will attempt to analyze what happened, put things in perspective and let you know how we are responding.

It is impossible to know in the moment if this sudden move lower is just a hiccup in a bull market or if something more sinister is afoot. If you were hoping we had the answer, well, sorry to disappoint. However, regular readers of this piece, ***Observations*** or ***The TANDEM Report*** surely know that we believe valuations matter. Some valuations have become more attractive since the S&P was last at this level in November. The stock market has a long way to go before it becomes cheap, but we have been able to strategically deploy some of the cash we have worked hard to accumulate. We do not invest just to be invested. We invest when we see opportunity. Last week we saw a little opportunity. Here is what happened.

Market Movers & Shakers

For months now the lack of volatility in the marketplace has been noted. If this past week is any indication, volatility has certainly made its presence known. Since the end of January, the CBOE Market Volatility Index (or VIX) is up 115%. This so-called "fear gauge" has more than doubled. During the same time span, the S&P 500, the Dow Jones, and the tech-heavy Nasdaq have all fallen by more than 7%. If the month were to end today, it would be the 4th worst February for the S&P 500 since 1928. Only during the Great Depression, the Tech Bubble, and the Financial Crisis has the index experienced a worse February. When painted with that brush, it sounds like this market has waded into some very choppy water. However, in markets like these, a little perspective is always necessary.

For starters, the whipsaw experience of last week is not unprecedented. In 2011, from August 4th to August 11th, the S&P experienced much more violent swings than we saw this past week. The recent decline just feels extraordinary because the marketplace has been without any meaningful setback for some time. Investors have forgotten that moves like these were once the norm! The current streak of 15 straight months of gains in the S&P smashed the old record of 11 that dates all the way back to 1958-59. Only four times in 2017 did the S&P 500 even fall by 1%. Four times! The historical average, dating back to 1928, is 28 1% down days in a year. Not since the early 1960s has the S&P been less volatile than it was prior to last week. Sentiment was also approaching record highs. Bullish sentiment in a recent Investors Intelligence report was 66% — the highest level recorded since 1986. Lastly, January was the best start to a year since 1997. At one point, the S&P 500's annualized return for 2018 was well north of 100%. Yes, we are now down 9% from our recent all-time highs, and yes the market briefly entered "correction" territory. But at the end of the day, the S&P 500 isn't even down 3% YTD.

With the backdrop now set we can now examine what actually sparked the recent selloff. Well, pressure began to mount on Friday the 2nd on the heels of the largest year-over-year increase in average hourly earnings since 2009. The nearly 3% growth in wages sparked fears that inflation could become a problem, which in turn would cause the Fed to accelerate its tightening cycle. The 10-Year Treasury jumped nearly 10 basis points in about 5 minutes — a dramatic move for sure. Sharply higher yields quickly caused equity markets to move lower as we closed down 2% with the VIX up 28% for the day. In hindsight, this initial inflation scare was the first domino to fall. However, it was hardly the biggest problem.

The most crowded trade on the street for the past few months has been to short volatility. Typically in the stock market, you try to buy low and then sell high. A short sale is the opposite. You first sell something high with the hope of buying it back at a lower price. Shorting volatility has been a favorite trade of professional and individual investors alike (but not Tandem). In fact, in Bank of America Merrill Lynch's January survey of global fund managers, "Short Volatility" was deemed to be the most crowded trade.

With volatility so low over the past few years, it was an easy way to make money. The XIV — an inverse VIX ETN designed to sell volatility — has posted an average annual return of 84% over the last 6 years, before this year of course. In 2017, the product had a return of 187.57%. Like we said, it was easy money. Traders were selling volatility short — that is, betting that it would go lower — and in turn going long the market — betting that stocks would move higher. It was a great trade throughout all of last year.

However, Friday's selloff sparked a considerable move in volatility and the VIX spiked. The trader's that were short volatility were now underwater and were forced in turn to sell their positions in the market to cover their losses. There's an old adage that "selling begets selling." Well this certainly rang true last week. On Monday, the VIX surged another 124%, causing another market selloff as the S&P dropped over 4%. The Dow at one point lost nearly 1,600 points. Traders short volatility were forced to buy it back at ever higher prices. As short covering caused the price of volatility to rise, more were forced to sell their equity bets as well. Computer algorithmic trading has basically been programmed to sell the market as a whole when volatility goes higher and buy the market as volatility moves lower. This is why the market experienced such dramatic swings intraday. Selling begot computer selling until it begot computer buying, and so on.

There was a phrase used to describe the hedge fund Long-Term Capital Management (LTCM) that infamously blew up in 1998. They were "picking up nickels in front of a steamroller." The short volatility trade was similar, and it too blew up — the previously mentioned XIV is down 96% this year and is being liquidated. On Monday, we witnessed an entire asset class of inverse VIX products get completely wiped out. It was truly historic and spectacular to watch. I suspect over the next few days, weeks, or even months we will begin to hear about a hedge fund or two that blew itself up just like LTCM did in the '90s. In fact, we already saw it happen to one mutual fund, LJMIX, as it fell over 80% this past week and is closing.

So what does this mean for the market going forward? In the short-term it is likely that we see a continuation of the choppy market as traders continue to unwind their short positions as best they can. The trading pattern for much of the week was a selloff into the close during the last 30 minutes of trading. This was typically viewed as traders unwinding their shorts. However, Friday showed a pleasant break from this trend. The S&P 500 surged more than 3% over the last two and a half hours of trading. Some view this as the market having shaken out all of the short sellers. It's possible. It is also possible that the shorts haven't been completely unwound. However, we also saw a complete reversal in momentum in the S&P. The S&P went from record levels of being overbought to being oversold in just 7 trading sessions. On Friday we had fallen more than 10% from our January 26th highs in just 9 sessions. According to CNBC, this is the fastest "correction" ever.

For the time being, selling appears to be a little overdone. However, little has really changed. Even accounting for this recent blip in the marketplace, the S&P 500 is still in the 97th percentile for its Cyclically Adjusted PE Ratio according to data compiled by Robert Shiller. The only time the market has been more expensive is during the tech bubble and the Great Depression. the Price-to-Sales ratio for the S&P is 1.98. This is off its recent December high of 2.14, but still well above its peak in 2007 and even north of where it was at the end of February in 2000. The point is, not much is different than it was a few weeks ago. The markets are still on the expensive end of the spectrum. Even though we are almost 9% off our January highs, we have just reverted back to price levels last seen at the end of November. Here at Tandem we do not buy the market as a whole. We buy individual names when the opportunity arises. We hope to buy low and sell high. This week we were able to take advantage of the selloff and put some cash to work in names that sold off to attractive levels.

Portfolio News

As for our investment strategies, it shouldn't come as a surprise that an increase in volatility and a correction in the market does not change how we go about implementing our investment discipline. As mentioned in ***Observations***, the activity level on the composite level at Tandem has really slowed down. A lot of what we wanted to sell had already been sold. And, the *FOMO* trade that had gripped the markets never gave us much of an opportunity to put cash to work. As difficult as it was to see equity prices go higher every day, our discipline and process kept us grounded and prevented us from chasing. For this reason, we were able to be opportunistic and invest some of our clients' cash over the past week. The table on the following page shows cash levels among our different strategies on 1/31/2018 and 2/9/2018.

	1/31/2018	2/9/2018
Tandem Large Cap Core	25.3%	20.5%
Tandem Equity	21.2%	18.2%
Tandem Mid Cap Core	34.4%	32.5%

You'll notice cash levels fell measurably in each of our strategies. However, the most important takeaway from this table should be that our clients still have a significant allocation to cash. Just because the S&P 500 declines nearly 10% from its record high doesn't mean we get an all-clear signal to invest 100% of the cash. Everything we do is based on the individual company. And even with such a significant decline over a short period of time, nearly 75% of our core holdings among all of our strategies are trading at or slightly above fair value. This just goes to show how extended equities have been over the past several months. However, the 25% of our core holdings that have become undervalued are where we focus our efforts. Over the past week, we have added to the following positions and took one new position in our Mid Cap Core strategy.

Tandem Large Cap Core	Tandem Equity	Tandem Mid Cap Core
CTSH	CVS	HRL
CVS	HRL	NNN
D	TJX	HSIC (new)
HRL	TSCO	TSCO
NNN	WBA	
TJX		
TSCO		
WBA		

All of our purchases, except for the initial position of HSIC in Mid Cap Core, were incremental additions to an existing holding. Our research has uncovered an additional 30+ companies that meet our fundamental criteria. On a quantitative basis, these companies have gotten closer to being ranked a "buy", but not quite yet. We will continue to let the market's new found volatility bring these individual companies to us rather than going out on a limb and reaching for them. In the meantime, we will continue to abide by our discipline and process—stocks will only be bought if and when the value and opportunity presents itself.

	WTD	MTD	QTD	YTD
Dow Jones	-5.2%	-7.5%	-2.1%	-2.1%
S&P 500	-5.2%	-7.2%	-2.0%	-2.0%
Nasdaq	-5.1%	-7.2%	-0.4%	-0.4%
Russell 2000	-4.5%	-6.2%	-3.8%	-3.8%
Consumer Discretionary	-4.6%	-6.5%	2.2%	2.2%
Consumer Staples	-5.1%	-7.2%	-5.9%	-5.9%
Energy	-8.5%	-11.3%	-7.9%	-7.9%
Financials	-5.8%	-7.0%	-1.1%	-1.1%
Health Care	-5.6%	-6.9%	-0.8%	-0.8%
Industrials	-5.4%	-7.5%	-2.7%	-2.7%
Information Technology	-4.4%	-7.3%	-0.3%	-0.3%
Materials	-3.4%	-7.2%	-3.4%	-3.4%
Utilities	-2.8%	-5.0%	-7.9%	-7.9%
REITs	-4.1%	-6.8%	-8.8%	-8.8%

The Fox and the Hedgehog

Apparently, a Greek poet named Archilocus once wrote, "the fox knows many things, but the hedgehog knows one big thing." Over the years, the quote has taken on a life of its own, as a parable, as a psychological study, as part of the MBA lexicon, and perhaps most importantly to Tandem, as our business model. We proudly pattern ourselves after the hedgehog, as one very astute family member recently reminded us.

We first learned of the Fox and Hedgehog parable through the business classic Good to Great by Jim Collins. Paraphrasing, it seems everyday the clever fox concocts ever more brilliant ways to catch his preferred prey, the hedgehog. Rather than creating new defenses for each ever-more-extravagant fox attack, the hedgehog simply relies on his one big thing - curling into an impenetrable ball of prickly needles. The hedgehog only needed the one big thing because it worked.

Sometimes, in an everchanging world, it is easy to forget that one big thing, if it is the proper one big thing, is timeless. It works in all circumstances. For Tandem, our one big thing means that no mater what the market throws at us, we stick to our discipline. We buy when valuations are low and attractive, we take profits when valuations are stretched and we liquidate when the fundamentals no longer live up to our standards. Sometimes this makes us popular and other times it doesn't. No matter. We stay true to who we are and who we promised to be. We are the hedgehog.

Disclaimers