OBSERVATIONS 3.2.2018

TANDEM Investment Advisors

Financial Markets Review

Coming into February it was well documented how equity markets in the U.S. and around the world were shattering records daily. The low volatility and one-way nature of stocks led many financial pundits and high-profile money managers to claim this time is different. It was becoming increasingly difficult to point to a reason stocks should fall more than a few percent or for volatility to ever rear its ugly head again. On January 23rd, Ray Dalio, who is head of the world's largest hedge fund, had this to say during a CNBC interview:

"If you're holding cash, you're going to feel pretty stupid." – Ray Dalio, Bridgewater Associates

Three days later the market peaked and proceeded to fall nearly 12% over the following 10 trading days. This is not a knock against Mr. Dalio, as he's clearly been extremely successful over the course of his career. It just goes to show what type of sentiment we were dealing with over a month ago at market highs.

There is no single reason to explain the volatility surge and subsequent correction in equity markets around the world. One could point to the worries of increasing inflation, rising bond yields, the decimation of volatility products or the uncertainty that comes with a new Fed chair. None of these reasons should have caught anyone off guard. In fact, we've touched on just about every one of these topics at one point or another in our commentary. However, the best explanation could be as simple as a return to normalcy. As we've said many times throughout last year, 2017 was not the norm. Rather, 2017 was the outlier. Typically, when a data series is at an extreme, you will tend to see it overshoot to the opposite extreme before gravitating around its mean. That is the process we are now dealing with regarding market volatility. Through the first two months of this year, there have been 15 trading days where the S&P 500 has moved up or down greater than 1%. This is twice as many as we saw during all of 2017! If the S&P 500 keeps the current pace up of 36% of all trading days exceeding a 1% move, it will be the most volatile on record, which follows one of the least volatile years on record.

Again, this should not come as a surprise. Extremes in either direction don't last forever. If I were to guess, volatility is here to stay for a while considering how long we endured such a calm equity market. This is the time to use volatility to your advantage. After all, I guess sitting on some cash wasn't that bad of an idea.

Tandem Strategy Update

To say February was a busy month on the trading front would be an understatement. To say February was an unnerving, wild and highly emotional month would be a misstatement. As I have said countless times, our discipline defines us as investment managers. By always staying true to our discipline, we can be proactive and not reactive. When equity markets are gapping up and down daily and even sometimes multiple times during a day, there is never the slightest bit of panic in our trading room. We turn the panic of others into opportunities for our clients. February was the first time in a while that our discipline got to be tested in a highly volatile environment and we were able to take advantage of others' fear.

February had a little something for everyone. During the first nine days of February, many were so overwhelmed by the selling that comparisons to the crash of 1987 began circulating. No sooner than the selling ceased, did calls for the well-known formation of a V-bottom take hold. The market went from melt-down and not being able to get out quick enough to melt-up and not being able to get in quick enough. This wide range of emotions allowed our process to play out perfectly.

Over those first nine days as many on Wall Street panicked, we added to our positions in Cognizant Technology Solutions (CTSH), CVS Health (CVS), Dominion Resources (D), Hormel Foods (HRL), National Retail Properties (NNN), TJX Companies (TJX), Tractor Supply (TSCO), and Walgreens Boots Alliance (WBA). We also established a new position in Henry Schein (HSIC) within our Mid Cap Core strategy. Even though the S&P 500 declined roughly 12% from its record high on January 26th to its intraday low on February 9th, it didn't mean we got an all-clear signal to add to every core holding or establish many new positions. 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 our strategies were still trading at or slightly above fair value. This just goes to show how extended equities had been over the past several months.

Once the selling dissipated and the intraday low of 2532.69 on the S&P 500 was set, we were off to the races over the course of the next 10 trading days. From the intraday low on February 9th to the intraday high on February 27th, the S&P 500 logged a 10.13% advance. It was during this panic buying that we were able to take advantage of higher prices to sell a few securities into strength. We continued the process of incrementally liquidating our position in Cerner (CERN), which was initially discussed last month. In addition, we have begun to liquidate our positions in Mednax (MD) and Wabtec (WAB). Both companies have failed to meet our most basic fundamental criteria of consistent earnings growth, which our quantitative model flagged as needing to be liquidated from our clients' portfolios. Lastly, our quantitative model identified Accenture (ACN) as a position needing to be sold for valuation reasons. Our sell discipline treats fundamental and valuation sales differently, which is why we sold only 25% of our clients' position in ACN.

Tandem Core Holdings Update

Q4 earnings season is swiftly coming to an end and the results of our core holdings appear to be pretty good. Through the end of February 90% of our holdings have reported aggregate sales growth of 9.59% and earnings per share growth of 12.88%. This compares favorably to the 8.21% sales growth and 14.86% earnings per share growth by the S&P 500. Due to the strong corporate results and future tax cuts, the dividend increases by many of our companies have been welcomed with open arms.

- AbbVie (ABBV) – announced a 35% increase, which follows an 11% increase last quarter. The next dividend to be paid in May represents a 50% increase over the dividend paid in November.
- Brown Forman (BF.B) – announced a $1.00 special dividend, which followed an 8% increase in their quarterly dividend back in December.
- Cognizant (CTSH) – announced a 33% increase to their quarterly dividend.
- Dominion (D) – announced an 8% increase to their quarterly dividend.
- Hormel (HRL) – announced a 10% increase to their quarterly dividend.
- Intercontinental Exchange (ICE) – announced a 20% increase to their quarterly dividend.
- NextEra Energy (NEE) – announced a 13% increase to their quarterly dividend.
- T Rowe Price (TROW) – announced a 23% increase to their quarterly dividend.

- TJX Companies (TJX) – announced a 25% increase to their quarterly dividend.
- YUM! Brands (YUM) – announced a 20% increase to their quarterly dividend.

I suspect over the coming weeks and months as more companies hold their analyst meetings, we will hear an increasing number of companies reporting similar dividend hikes, stock buybacks, increased investment in CAPEX, funding of pension plans and debt repayment. With the return of volatility to the markets, it is likely we will see attractive entry points to add to some of these current positions.

-Billy Little, CFA

"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