The TANDEM Report

Volume XVIII, Issue 1 January 2017

"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

In This Issue

Market Commentary:
Valuation Provides Ceiling, but Policies May Provide Floor

What a crazy year. The stock market began 2016 worse than any year in history but closed strong. After declining 10.51% within the first 6 weeks of the New Year, the S&P 500 recovered all of its losses by March. From the low on February 11 it rose 16.97% through Election Day, making the S&P's year-to-date price gain at that point 4.68%. A whole lot of action without much change,

But then came the Election result the market didn't foresee. After selling off sharply overnight when we learned that Donald J. Trump would be the 45th President, the market found its footing quickly the following morning. From that point forward the S&P rose 4.64% to end the year up 9.54% and 11.96% with dividends included.

With 2016 now behind us, let us turn our attention to the elephant in the room. Many were/are dismayed by the result of the election. The stock market does not seem to be. So let us leave politics aside and move on to what the market should expect from a Trump Administration.

President Trump has put forth fiscal policy positions that appear to be pro-growth. It is understandable that the market would cheer such notions as tax rate reduction, infrastructure spending and job growth. Since the recovery from the Financial Crisis began in 2009, very little fiscal policy has been implemented by any developed nation. All the hard work and heavy lifting has been done with monetary policy by Central Banks through lower interest rates and asset purchase programs. Markets have become skeptical that such monetary policy has any meaningful bullets left in its gun.

So stimulative fiscal policy might prove a welcome change and just what the economy has needed. Time will tell. But the warm reception for these policies by the market cannot be denied.

The change in sentiment post-election has been dramatic. Surveys indicate that investors and consumers are as optimistic as they have been in years. The market now expects meaningful growth in corporate earnings and GDP, as opposed to the modest expectations

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Commentary:
Valuation and the Probability of Positive Returns

Intuitively we all understand that the price we pay for an investment matters. If we pay too much, we might limit our returns. But if we can buy cheap, we can make some money! After all, the name of the game is buy low and sell high, right?

What is less intuitive is actually identifying what is cheap and what is expensive. If we all agreed, then stocks would hardly trade! Everyone would want to buy and sell at the same time as we all identified cheap and expensive the same way. So there would be no one to buy from or sell too! Clearly this is not the case. One man's cheap is another man's expensive.

Cheap and expensive are relative terms. Some would say a Cadillac is an expensive car. Others might say it is a good value when compared to import-

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ed luxury cars. Which argument is right? In the case of cars, they both are. It depends on your perspective. But in the case of stocks, the argument is easier to quantify.

There are many ways to value stocks. For now, we will simply use the most common - PE. PE is Price/ Earnings ratio, or price per share divided by earnings per share. A stock with a low PE is said to be cheap while a stock with a high PE is considered expensive.

So let's look at the stock market as a whole to try to determine if it is cheap or expensive. We will use the S&P 500 as a measure of the market and collect monthly data going back 17 years to 12/31/1999. There are 204 months in a 17 year period, so we have 204 data points to examine.

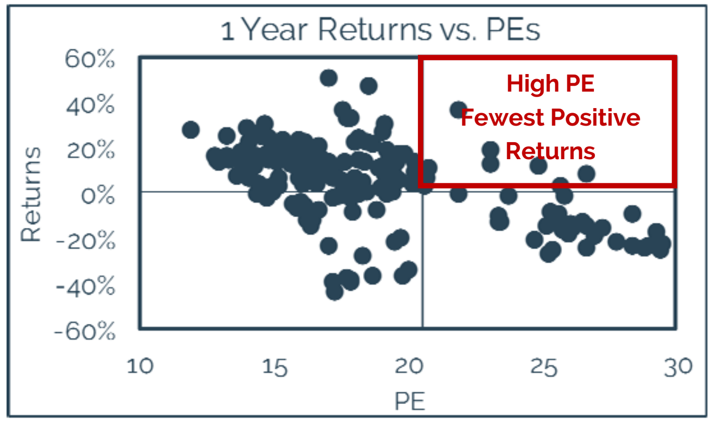
As of December 31, 2016, the S&P 500 had a PE of 20.57. Is that cheap? It is impossible to say without some perspective or some means of comparison. So of the 204 PEs calculated in our data, the S&P had a PE lower than the current PE 76% of the time. Which means the market is definitely not cheap.

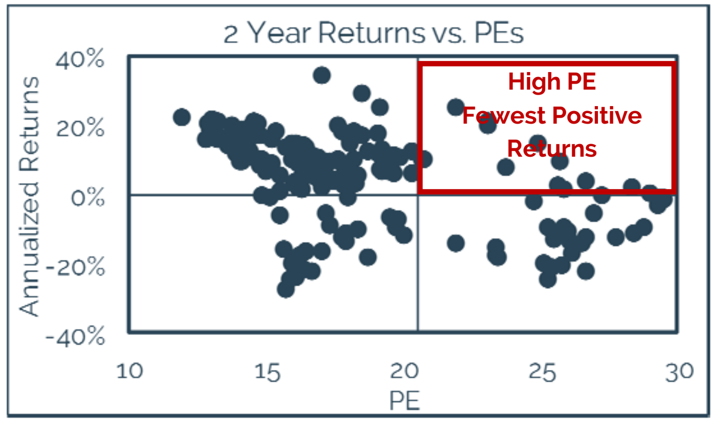
Does that mean the market is expensive? Not necessarily. Over this time span, the minimum recorded PE is 11.95, while the maximum is 29.55. So our current PE is almost exactly in the middle of the range. That certainly doesn't seem expensive.

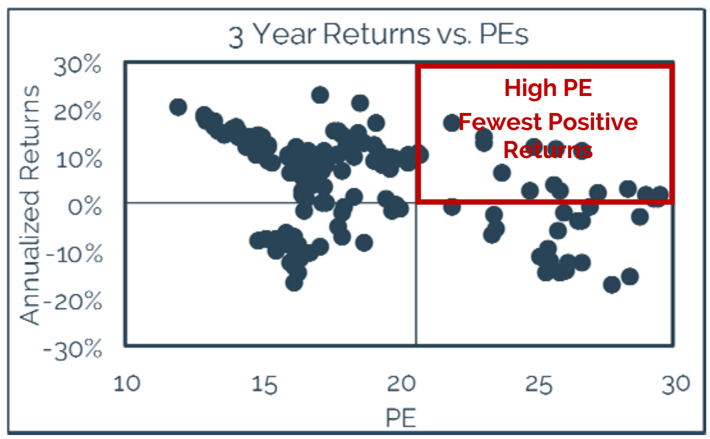
Obviously a PE by itself doesn't tell us definitively what is cheap and what is expensive. So let us now look at return probabilities for various PEs. Since the current PE of 20.57 is pretty much in the middle of the range, we will call any PE below the current one low and any PE above the current one high.

In the table below, low PEs produce a very high probability of positive price changes and average annualized price changes for 1, 2, and 3 years. However, when beginning with a high PE, probabilities of positive price changes decrease significantly. Even after three years the probability is below 50%. Worse, the average 1, 2 and 3 year price changes are all negative.

Price Change Probabilities for the S&P 500 based on PE			
S&P 500 PEs Monthly from 12/31/1999-11/30/2016	1 year	2 year	3 year
Low PEs			
Probability of Positive Price Change	78.95%	80.99%	73.85%
Average Annualized Price Change	7.65%	6.46%	6.06%
High PEs			
Probability of Positive Price Change	24.39%	33.33%	46.15%
Average Annualized Price Change	-9.54%	-5.13%	-1.55%







The charts above plot actual annualized returns at given PEs. Anything in the right hand quadrants represents a high PE and anything in the left quadrants represents a low PE. Clearly the least populated quadrant in each chart is the upper right one. This means that high PEs are less likely to produce positive returns over 1, 2, and 3 year periods.

The charts on the next page are even more dramatic. Up to this point we have only analyzed valuation based on PEs. As we noted earlier, there are

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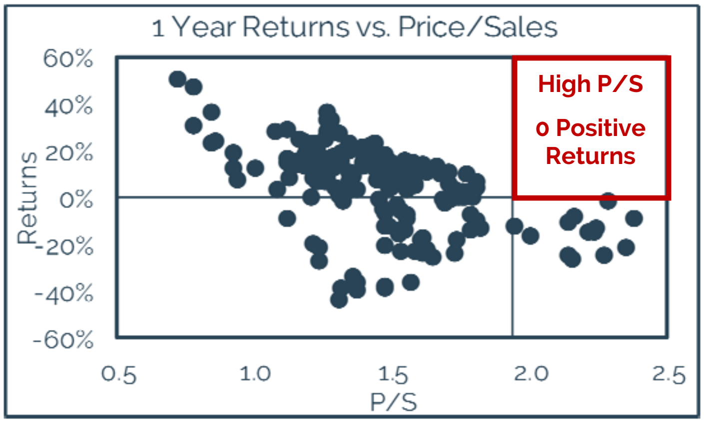

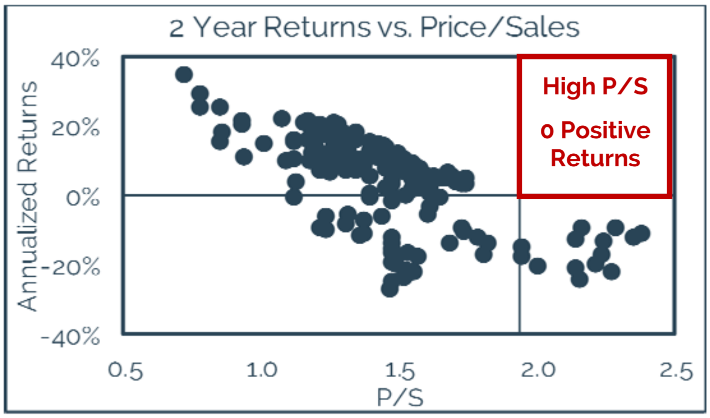

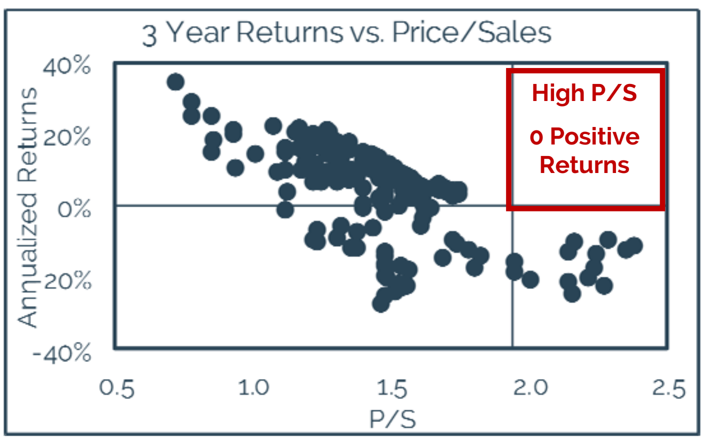

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many ways to value stocks. The one we turn our attention to now is the Price/Sales ratio. Sometimes earnings can be manipulated. Sales are not as susceptible. As a result, Price/Sales analysis is less volatile, and perhaps more reliable.

The evidence above is certainly unambiguous. High Price/Sales ratios failed to produce positive price change 100% of the time since 12/31/1999! 100% of the time! There is not a single dot in any of the charts above representing a positive return in the high P/S, Positive Return quadrant. Wow. The PE charts were sobering, but the P/S charts paint a very clear picture. Any valuation higher than our present one has yielded negative price changes 100% of the time for the periods we studied.

To be absolutely clear, the Price/Sales ratio for the S&P 500 (that is, as of 12/31/2016) is 1.94. For the past 17 years, no Price/Sales ratio this high has produced positive results for 1, 2, and 3 year time periods. This is remarkable data that demands our attention.

The price we pay for an investment is a huge determinant of the return we can expect. The data on these pages suggest that the market is not at extreme valuations by any means, but nonetheless the market is at a valuation that does not portend well for future returns.

There are only 3 ways for the data to improve and suggest better valuation - earnings and sales can grow faster than price, price can fall, or a combination of both. For the current PE to decline from 20.57 to 19, earnings would have to grow 8.26% or the price of the S&P would have to decline 7.63%. And even at a PE of 19, the S&P would not be considered cheap.

We don't claim to know how this overvaluation will play out. Right now the market seems to be taking a wait-and-see approach. S&P earnings are forecast to grow 20% this year and another 12.5% in 2018. We view this as unlikely. But if earnings did achieve such dramatic growth, the S&P's PE would decline to 17.31 in 2017 and 15.38 in 2018 if the price of the S&P doesn't change.

In other words, growth can cure a lot of ills. Hopefully earnings growth materializes. Last quarter was the first to see earnings actually grow in 2 years. The previous 7 quarters saw earnings decline. So at least a negative trend has reversed itself.

Thankfully, what is true for the stock market is not necessarily true for individual stocks. We continue to find and own many companies at reasonable valuations. We have also been forced to take a lot of profits in

Price Change Probabilities for the S&P 500 based on P/S

S&P 500 Price/Sales Monthly from 12/31/1999-11/30/2016	1 year	2 year	3 year
Low Price/Sales			
Probability of Positive Price Change	72.63%	76.65%	73.55%
Average Annualized Price Change	5.56%	5.69%	5.76%
High Price/Sales			
Probability of Positive Price Change	0.00%	0.00%	0.00%
Average Annualized Price Change	-15.94%	-16.58%	-11.86%

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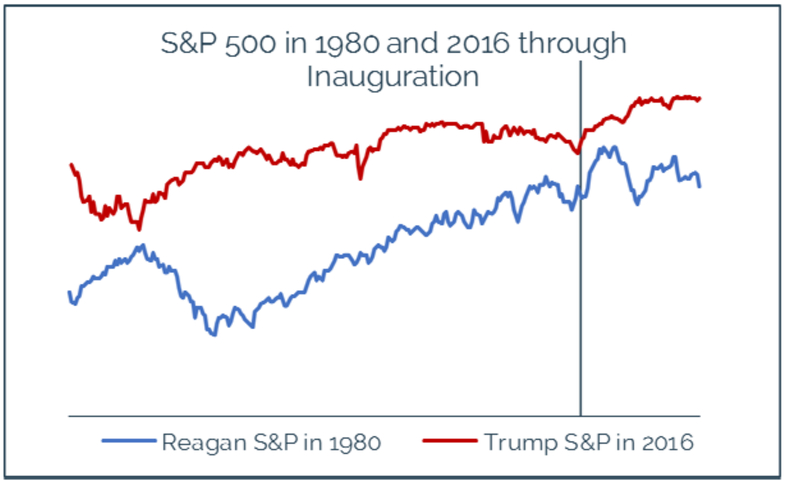
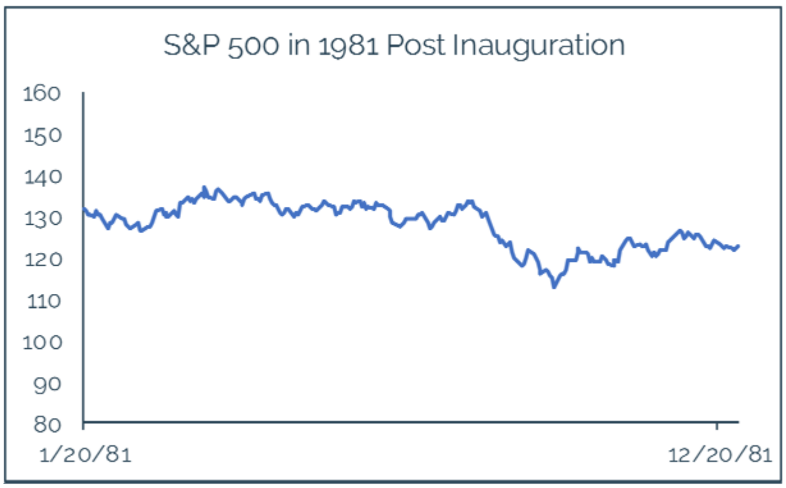
pre-election. One must go all the way back to 1980 to find such a dramatic investor sentiment change as the result of an election. Ronald Reagan rode a pro-growth, smaller government agenda into office and changed expectations dramatically. Reagan's victory was more anticipated than Trump's so the market began pricing in the change much sooner in 1980 than it did in 2016.





While history has been kind to Reagan, Congress was not. It took time for his plans to be enacted. And then it took time for them to work. As a result, recession ensued in his first year as much economic activity was deferred into the future until lower tax rates and other fiscal stimulus actually became law. Only then did the great 1980's Bull Market begin.

The Trump Administration kicks off with similarly high expectations. Important to note, President Trump would seem to have a friendlier Congress than did Reagan as the Republicans control both the House and the Senate. Republicans controlled only the Senate when Reagan took office. This fact has certainly boosted expectations of a very productive first 100 days for President Trump.

But these expectations may have caused the market to get ahead of itself. Potentially far ahead of itself. In this issue's *Commentary*, we discuss the valuation dilemma confronting the market. From an historical standpoint, positive returns from current valuations would seem unlikely. Yet the expectation of stronger economic growth is generally reflected in higher stock prices.

Unfortunately, stock prices have already borrowed from the future. Recall from the last issue of ***The TANDEM Report*** that S&P earnings first attained the present level in March, 2014. Prices are 20% higher now than they were then for the same amount of earnings. S&P earnings again reached this level in June, 2015 after several quarters of earnings declines. Today's price is more than 8% higher today than it was in June, 2015.

With zero earnings growth in nearly 3 years, the S&P's price is 20% higher. No matter how successful Trump's policies prove to be, prices will have a tough time rising to an extent that reflects this positive change, at least in the near future. Sentiment is a powerful thing and often underestimated by investors. The same can be said about valuation.

If the Trump Administration succeeds in instituting a pro-growth agenda, the market will ultimately reflect the improved economic fundamentals. We just don't expect it to be a smooth ride.

It is difficult to ignore the political noise that has thus far accompanied Mr. Trump. If it persists, it could overshadow any economic improvement. This could create greater uncertainty about the future and whether he and/or the Congressional Republicans can survive, or whether the Congressional Republicans turn on President Trump in an effort to protect their own political futures. But politics is another argument. We think the noise will dissipate with successes and increase with failures.

The conclusion we draw as the Trump Administration begins is that pro-growth fiscal policies are a welcome and needed transition away from the monetary experimentation to which we have been subjected these last 7 years. They will undoubtedly have a positive impact on stock prices. But that positive impact is likely to come in the form of a floor under stock prices rather than an immediate boost. Valuations are stretched. There is little room for prices to rise but plenty of room for them to fall. However, the probability of a significant price decline has been substantially reduced with improved sentiment and expectations. Prices may fall from these levels, but fundamentals are improving. That is good news.

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overvalued companies. But that is what we are supposed to do - buy low and sell high! Sometimes that requires a good deal of patience. Overvalued assets often become even more overvalued before prices correct. Think back to the housing market from 2005 - 2009 as an example. Overpriced homes continued to rise in price for several years. Looking back at the charts and tables on pages 2 and 3, overpaying limits future returns. Significantly overpaying increases the likelihood of negative returns.

We are about to enter some very interesting times. We may see the implementation of pro-growth policies that drive earnings higher than we can contemplate. That doesn't change the fact that we begin this new era from an historically overvalued position. And present value determines future returns. We must be patient investors and identify value when it presents itself.

5 Year Annualized Dividend Growth for Tandem's Holdings by Strategy
from Q4 2011 to Q4 2016

Large Cap Core 5Yr. Annualized Dividend Growth	
Company	**Dividend Growth**
Average Tandem Stock	**13.85%**
S&P 500	**10.81%**
Abbott Laboratories	NA
AbbVie	NA
Accenture Plc	12.38%
Aptargroup	7.78%
Bank of the Ozarks	26.97%
Becton, Dickinson	10.16%
Brown & Brown,	9.69%
Brown-Forman Cl B	9.36%
Coca-Cola Company	8.29%
Costco Wholesale	13.40%
CSX	8.45%
Dominion Resources	7.28%
Ecolab	13.09%
Expeditors International	9.86%
W.W. Grainger	13.07%
Hormel Foods	17.86%
Intercontinental Exchange	NA
ITT	NA
Microsoft	14.29%
National Retail Properties	3.40%
NextEra Energy	9.61%
NIKE Cl B	14.87%
T. Rowe Price Group	11.74%
QUALCOMM	19.78%
Republic Services	7.78%
ResMed	NA
SCANA	3.46%
Scripps Networks Cl A	20.11%
J. M. Smucker	9.34%
Stryker	14.87%
TJX Companies	22.31%
Tractor Supply	31.95%
United Technologies	6.58%
Westinghouse Air Brake	46.14%
Walgreens Boots Alliance	10.76%
Waste Connections	14.87%

Companies not paying a dividend on 12.31.2011 are listed as NA. Abbott Labs, ITT, YUM and YUM China restructured and are listed as NA because they do not have 5-year data that reflects restructuring.

Equity 5 Yr. Annualized Dividend Growth	
Company	**Dividend Growth**
Average Tandem Stock	**14.60%**
S&P 500	**10.81%**
Abbott Laboratories	NA
AbbVie	NA
Accenture Plc	12.38%
Aptargroup,	7.78%
Bank of the Ozarks	26.97%
Becton, Dickinson	10.16%
Brown & Brown	9.69%
Brown-Forman Cl B	9.36%
Cerner	NA
Coca-Cola	8.29%
Cognizant Tech Cl A	NA
Costco	13.40%
CSX	8.45%
eBay	NA
Ecolab	13.09%
Expeditors International	9.86%
W.W. Grainger	13.07%
Hormel Foods	17.86%
Intercontinental Exchange	NA
ITT	NA
MEDNAX	NA
Microsoft	14.29%
NextEra Energy	9.61%
NIKE Cl B	14.87%
O'Reilly Automotive	NA
PayPal Holdings	NA
T. Rowe Price Group	11.74%
QUALCOMM	19.78%
Republic Services	7.78%
ResMed	NA
Scripps Networks Cl A	20.11%
Signature Bank New York	NA
Stryker	14.87%
Thermo Fisher Scientific	2.90%
TJX Companies	22.31%
Tractor Supply	31.95%
United Technologies	6.58%
Westinghouse Air Brake	46.14%
Walgreens Boots Alliance	10.76%
Waste Connections	14.87%

Mid Cap Core 5 Yr. Annualized Dividend Growth	
Company	**Dividend Growth**
Average Tandem Stock	**14.15%**
S&P 400	**11.70%**
Aptargroup	7.78%
Bank of the Ozarks	26.97%
Becton, Dickinson	10.16%
Brown & Brown	9.69%
Brown-Forman Cl B	9.36%
Cerner	NA
Cognizant Tech Cl A	NA
Dominion Resources	7.28%
Ecolab	13.09%
Expeditors International	9.86%
Fiserv	NA
W.W. Grainger	13.07%
Hormel Foods	17.86%
ITT	NA
MEDNAX	NA
National Retail Properties	3.40%
O'Reilly Automotive	NA
T. Rowe Price Group	11.74%
Republic Services	7.78%
ResMed	NA
Ross Stores	19.67%
SCANA	3.46%
Scripps Networks Cl A	20.11%
Signature Bank New York	NA
J. M. Smucker	9.34%
Stryker	14.87%
Thermo Fisher Scientific	2.90%
Tractor Supply	31.95%
Westinghouse Air Brake	46.14%
Waste Connections	14.87%
Yum! Brands	NA
Yum China	NA

The list of holdings above for Tandem's 3 strategies are as of 12.31.2016. These lists do not constitute investment advice, nor do they represent performance of any Tandem investment product. FactSet is the data source for the above calculations. All percentages are annualized for a 5-year period.

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ANNIVERSARY 1990 25th 2015
TANDEM INVESTMENT ADVISORS
CELEBRATING 25 YEARS

YIELD TABLE			
	Current	3 months ago	1 year ago
3-month Treasury Bill	0.51%	0.29%	0.23%
2-year Treasury Note	1.20%	0.77%	0.98%
5-year Treasury Note	1.96%	1.18%	1.70%
10-year Treasury Bond	2.49%	1.63%	2.24%
30-year Treasury Bond	3.11%	2.35%	2.97%
Prime Rate	3.64%	3.50%	3.37%
Federal Funds Rate	0.54%	0.40%	0.24%
Discount Rate	1.14%	1.00%	0.87%

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				
	12/31/16 Close	% Change 1 Year	% Change 3 Years	% Change 5 Years
S&P 500	2,238.83	9.54%	6.60%	12.23%
Dow Jones Industrial	19,762.60	13.42%	6.03%	10.10%
NASDAQ	5,383.12	7.50%	8.83%	15.62%
Russell 2000	1,357.13	19.48%	5.26%	12.87%
German Xetra DAX	11,481.06	6.87%	6.32%	14.25%
London FTSE 100	7,412.83	18.75%	3.18%	5.87%
Shanghai Composite	3,103.64	-12.31%	13.62%	7.13%
Crude Oil	$ 53.89	20.86%	-12.98%	-9.79%
Gold	$ 1,150.00	8.46%	-1.46%	-5.99%
CRB Index	192.51	9.29%	-11.76%	-8.81%
U.S. Dollar Index	102.21	3.57%	8.49%	4.97%
Euro/Dollar*	1.05	-3.67%	-8.49%	-4.03%

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

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