

# THE TANDEM REPORT

Volume XIX, Issue 1, January 2018



**"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](http://www.tandemadvisors.com) or upon request. We hope you find this report useful.

Respectfully,

John B. Carew  
President

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All performance figures, charts and graphs contained in this report are derived from publicly available sources believed to be reliable. Tandem makes no representation as to the accuracy of these numbers, nor should they be construed as any representation of past or future performance.

## MARKET COMMENTARY: This Bull Market is Officially Historic

The stock market closed 2017 on an epic hot streak. For the first time ever, the S&P 500 Total Return Index was up for every month of the year. Not a single down month on the way to a 21.8% return. In fact, the S&P has produced positive monthly returns for 14 consecutive months and 21 of the last 22 on a total return basis. These streaks are similarly unprecedented. It has been quite a run for investors.

Bank policy. But that could only take things so far. In fact, the market seemed overvalued and stagnant as S&P earnings declined in 2015 and the Fed took its foot off the gas (see chart below).

After a pause, however, the market took off again. Unlike in 2009 when valuations were clearly cheap, this re-launch was from valuation levels that historically have not been conducive to the start of another extended run high-



Having now become the 2<sup>nd</sup> longest bull market on record, the first 8 years of this ascent, which began in March of 2009, were largely fueled by Central

er in share prices.

The beginning of this glorious streak  
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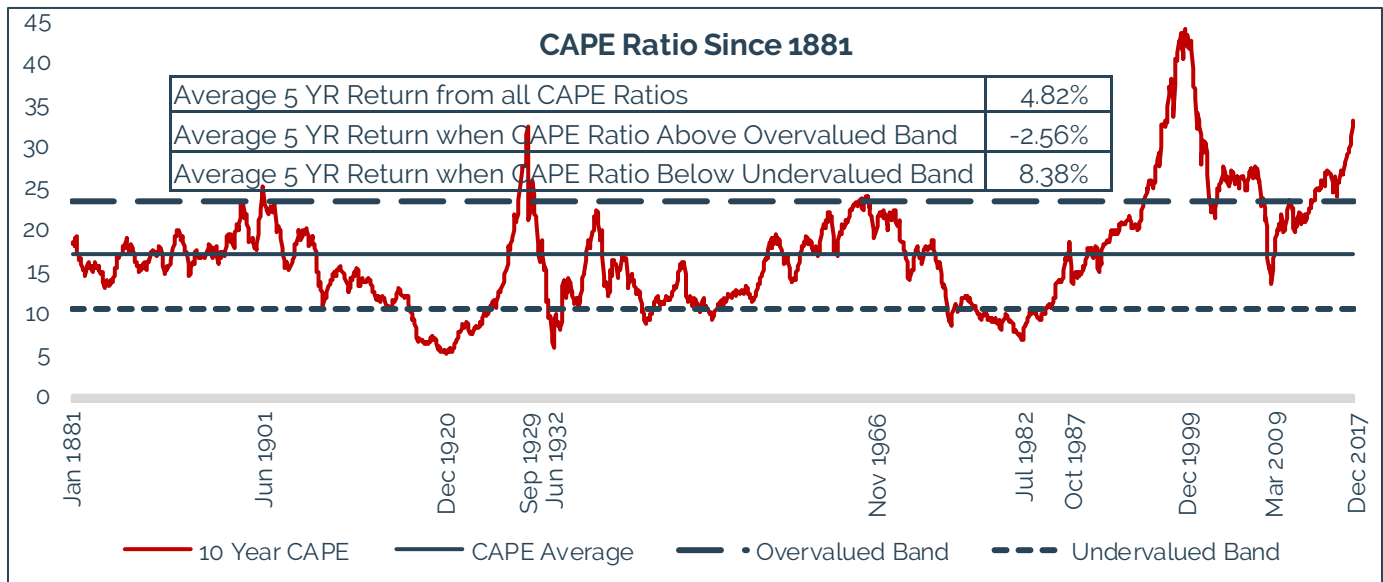
## COMMENTARY: Price Matters (Eventually)

All too often investors fail to adequately diagnose risk. When a market declines by 50% it is perceived to be risky, yet in reality it has become a good deal less risky than it had been previously. And when markets rise by more than 20% over a 12 month span, many perceive the risk of the market to be reduced because it is

going up. In fact, some think it is risky to miss out!

Have you ever overpaid for something? Of course you have. But did you know it at the time and just not care? Or did you not know and only found out later when you tried to sell it? How do we  
*(Continued on page 2)*

## COMMENTARY (CONTINUED)



The above chart represents the Shiller CAPE Ratio. CAPE stands for Cyclically Adjusted Price-to-Earnings ratio. Data is calculated from January 1881 through December 2017. The ratio is a valuation measure usually applied to the S&P 500. It is defined by Wikipedia as price divided by the average of ten years of earnings, adjusted for inflation. As such, it is principally used to assess likely future returns from equities over timescales of 10 to 20 years, with higher than average CAPE values implying lower than average long-term annual average returns. In this chart, we have calculated the average value of the ratio over the 136 year period, then measured 1 1/2 standard deviations from the mean in either direction. Any ratio above the upper band would imply lower than average future returns, while a ratio below the lower band would imply better than average future returns. Average returns can be found in the table embedded within the chart above.

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really know what the value of things ought to be? One answer is to ask a trusted professional.

As professional managers of your money, it is our job to correctly perceive risk, even when it doesn't make us popular. It would certainly be easier to throw caution to the wind and take the plunge (with your money). After all, why are we so concerned about this market? We should be fully invested with your money! Right?

We believe that price paid is nearly as critical to investment success as the underlying fundamentals of a business. And we have plenty of examples prepared to illustrate our point.

First, let us begin with the Shiller CAPE Ratio, a valuation tool that has become somewhat controversial of late. The CAPE ratio averages 10 years of actual earnings and adjusts them for inflation. Some suggest that CAPE is capturing the earnings trough of the financial crisis, thereby causing its present value to be overstated. They argue that when those depressed earnings roll off, CAPE will not be nearly as inflated. Perhaps.

In our view, the CAPE Ratio is useful not as a timing tool, but rather as a reliable predictor of future direction. Much like our own quantitative model used in Tan-

dem's investment process, this ratio identifies unusual valuations. Our process relies on reversion-to-the-mean theory, and 136 years of Shiller CAPE data clearly show consistent reversion to the mean. Whenever valuations stretch too far in either direction, they ultimately return to more "normal levels", brought about either by a change in price or a change in earnings, or both.

You will note from the embedded table above that we have calculated the average 5-year annualized return for all time periods for the S&P 500 and its previous iterations according to Shiller. The average 5-year return is 4.82%. We have then calculated the average annualized returns for periods when valuations have stretched considerably away from the mean. When valuations are at their highest levels, the ensuing return averages -2.56% for 5 years. When valuations are at their lowest levels, resulting returns average 8.38%.

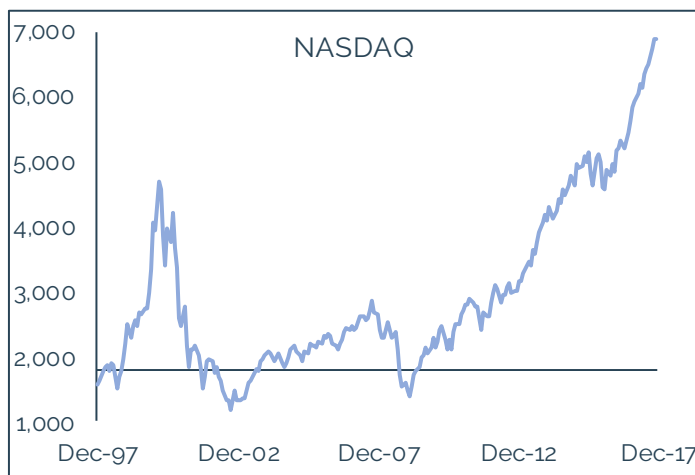
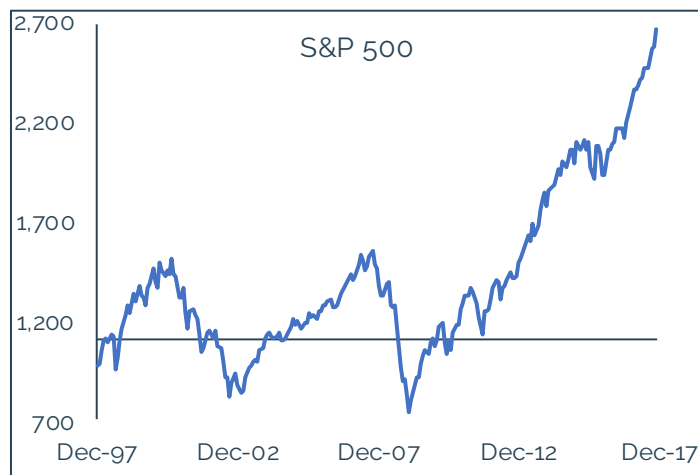
Clearly valuation matters! This is a huge difference in returns: -2.56% when the ratio is expensive vs. 8.38% when it is cheap! What is the ratio telling us today? The Shiller CAPE is at its 2nd highest recorded value, exceeding September 1929 but short of December 1999.

To be absolutely clear, we do not believe that the CAPE ratio is forecasting impending doom. Not by any means. But we do believe that prices matter, and that

(Continued on page 3)

## COMMENTARY (CONTINUED)

The charts below for the S&P 500 and the NASDAQ illustrate the amount of time it takes just to get back to even when you overpay. The period where the horizontal axis is first crossed on the left represents 2 years before the market top. Investing 2 years (3/1998) before the market topped means it took 12 1/2 years to finally stay above even in the S&P 500, and 11 1/4 years to stay above even in the NASDAQ.



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the price of the overall market today limits the likelihood of future positive returns. If we were to experience merely the average return going forward from valuations such as these, the market would certainly underperform the cash we hold in our portfolios.

We will not hang our hat on the value of the CAPE Ratio to forecast the current market. We will, however, acknowledge that 136 years worth of data is tough to ignore, as is the predictive value of the ratio at some very overvalued and undervalued periods in history.

There are many examples to illustrate the importance of price. Of course we all know the perils of buying at the market top. But what if we buy well ahead of the market top? What if we buy a full two years before the market tops out?

The two charts at the top of this page will serve to make this point. During the Tech Bubble of the 1990s, the market reached its peak in March 2000. If we had purchased the S&P 500 2 years prior, in March of 1998, we would have experienced a gain over that span of 36%. And the NASDAQ, over the same 2 years, gained 149%! Surely these returns were worth it, no?

No. You would have been better off missing out on

those gains. The S&P did not return to its March 1998 level for good until September 2010, 12 1/2 years later. The NASDAQ got back to break even in only 11 1/4 years. Were those two years of gains worth overpaying for?

And one final example. In the table below of returns for the Sectors of the S&P 500 for 1 year and since 12/99, please look at the returns for the Information Technology sector highlighted near the middle of the table. Technology returned a very handsome 36.91% in 2017. It returned only 0.09% more since 1999. That's pretty remarkable isn't it? A sector that climbed so high in the 90's has returned only 37% since. Clearly price matters.

We do not invest based upon what the market as a whole is doing. That is irrelevant to us. We search for individual stocks that represent good value with a high

likelihood of positive future returns. In some instances, attractively valued stocks are easy to find. In other instances attractive sell prices present themselves. We do not invest your money simply to have it invested. Rather, we invest for a solid return over a complete market cycle, not just one part of a market. We have the patience to buy low and sell high. And at all times we measure the likelihood of success relative to the risk we are taking. Many investors are concerned they are missing out on gains. But price matters.

S&P 500 Sectors	1-YEAR	FR 12/1999
Energy	-3.80%	150.75%
Materials	21.39%	136.90%
Industrials	18.54%	133.31%
Consumer Discretionary	21.23%	162.38%
Consumer Staples	10.46%	182.33%
Health Care	20.00%	192.65%
Financials	20.03%	44.21%
<b>Information Technology</b>	<b>36.91%</b>	<b>37.00%</b>
Telecommunication Services	-5.97%	-48.55%
Utilities	8.32%	87.71%
Real Estate	7.17%	
<b>S&amp;P 500</b>	<b>19.42%</b>	<b>81.97%</b>
<b>DJIA 30</b>	<b>25.08%</b>	<b>115.00%</b>

## MARKET COMMENTARY (CONTINUED)

(Continued from page 1)

corresponds with the election. The anticipated policies of the new administration provided the spark the market needed to get going again. The tax cuts in December provided rocket fuel to lift off to even greater heights.

Now the market finds itself at rarely seen levels of valuation. This should be little cause for concern to investors, at least in the short run. Corporate earnings (a beneficiary of administration policy) are healthy and growing. Growing so fast, some would argue, that

S&P 500 Sectors	2017 Returns
Energy	-3.80%
Materials	21.39%
Industrials	18.54%
Consumer Discretionary	21.23%
Consumer Staples	10.46%
Health Care	20.00%
Financials	20.03%
Information Technology	36.91%
Telecommunication Services	-5.97%
Utilities	8.32%
Real Estate	7.17%
<b>S&amp;P 500</b>	<b>19.42%</b>
<b>DJIA 30</b>	<b>25.08%</b>

stocks are actually not expensive at all. In fact, just about all economic data globally is positive for stocks. Unemployment is low, GDP is rising, taxes are lower, consumers are spending. There is good news coming from every direction.

And investors are getting on board. Recent data suggests that inflows into equity funds are approaching an all-time high, with passive funds and ETFs winning the lion's share of the new money. Active managers like Tandem see less value in the market. Index funds and ETFs don't care about value. They simply track the market. It can even be a bit of a self-fulfilling prophesy. Investors add money to index funds so the stocks in the index go up. People see indices rising and want to participate, so more index funds get bought and prices go higher again. Of course, it can also work the same way in reverse.

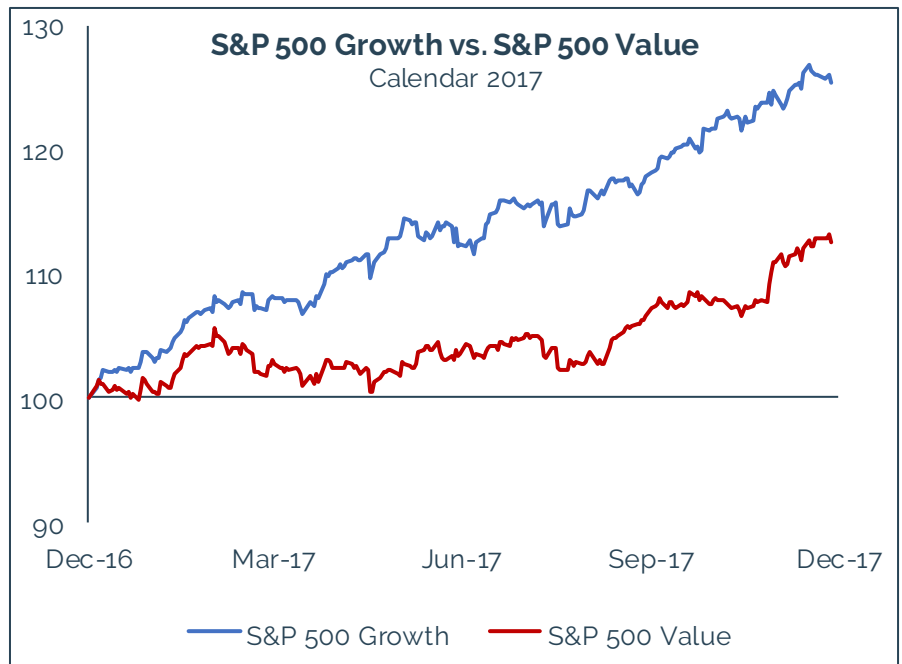
For now, it appears investors don't want to miss out on this opportunity. We refer to this as FOMO, or Fear Of Missing Out. This is what happens when investors see

prices continually rising. They don't want to miss the move so they jump right in, even if they don't understand it. A perfect example of this is bitcoin. Bitcoin has exploded in value by over 1,000%. People are now actually using credit cards to purchase bitcoin. And most don't even begin to understand what they are buying. All they know is that it keeps going up. Until it doesn't. FOMO drives virtually every market top.

YEAR	S&P 500
	NEW CLOSING HIGHS
1995	77
2017	62
1964	62
1928	59
2014	53

Bitcoin aside, economically sensitive stocks, those that benefit most from a growing economy, are driving the market. Information technology led the way last year with a nearly 37% advance. While that return pales in comparison with bitcoin's march, it is sufficient enough to continue to draw new money to the technology sector. Names like Facebook, Apple, Amazon, Netflix and Google (a.k.a. FAANG) are wildly popular these days.

This is a stock market that clearly favors growth over value. In 2017, the S&P 500 Growth Index was up 25.38%, while the value index was up only half that amount, or 12.57%. This says the investors are less interested in how much they are paying and more interested in how much they expect to get back. A value investor believes that price ultimately determines the return



on investment, while a growth investor is more content to ride a wave of momentum. Over time, either strategy is equally effective. They just tend to be different expe-

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## MARKET COMMENTARY (CONTINUED)

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riences - sort of like the rabbit and the hare.

In many respects, this market is beginning to resemble that of the 1990's. Everyone knows it keeps going up. Everyone knows it will eventually come crashing down. But nobody knows when. As a result, investors are compelled to continue to play the game and hope they can time their exits perfectly. There is an old saying that comes to mind - *Lord, make me chaste, but not yet.*

One other characteristic of note regarding this bull

market is its notable lack of volatility. The market has not sold off more than 5% in nearly two years. Ordinary markets (which this is definitely not) experience pull-backs of 10% or more nearly every year. This market is completely void of volatility. Its rise has been slow and steady. Even news that other markets might find disturbing can't shake this market.

Maybe it really is different this time. After all, this truly is a market that is officially historic. Maybe low interest rates, low inflation and strong earnings growth are the only ingredients required to set records high. Maybe valuation just isn't important as it once was. Nah!

### 5 Year Annualized Dividend Growth for Tandem's Holdings by Strategy from Q4 2012 to Q4 2017

Tandem's average dividend-paying holding has increased its dividend by more than 13% on an annualized basis for the last 5 years. This growth is the result of strong and growing earnings, cash flow and revenue.

Large Cap Core 5Yr. Annualized Dividend Growth	
Company	Dividend Growth
Abbott Laboratories	NA
AbbVie, Inc.	NA
Accenture Plc	10.43%
Becton, Dickinson	8.67%
Brown & Brown	10.76%
Brown-Forman CLB	9.15%
Cognizant Tech Solutions	NA
Costco	12.70%
CVS Health	24.82%
Dollar General	NA
Dominion Resources	7.86%
Ecolab Inc.	12.26%
Expeditors International	8.45%
FactSet Research	12.56%
Hormel Foods	17.78%
Intercontinental Exchange	NA
Microsoft	12.80%
National Retail Properties	3.76%
NextEra Energy	10.37%
NIKE, Inc. Class B	17.32%
T. Rowe Price	10.89%
Republic Services	7.98%
ResMed	15.54%
SCANA	4.35%
Scripps Networks	20.11%
JM Smucker	8.45%
Stryker	12.14%
TJX Companies	22.13%
Tractor Supply	21.98%
United Technologies	5.52%
Wabtec	36.85%
Walgreens Boots Alliance	7.78%
Waste Connections	15.88%
<b>Average</b>	<b>13.19%</b>

Companies not paying a dividend on 12.31.2012 are NA. Abbott Labs and Abbvie restructured and are also listed as NA.

Equity 5 Yr. Annualized Dividend Growth	
Company	Dividend Growth
Abbott Laboratories	NA
AbbVie, Inc.	NA
Accenture Plc Class A	10.43%
Becton, Dickinson	8.67%
Brown & Brown	10.76%
Brown-Forman Class B	9.15%
Cerner Corporation	NA
Cognizant Tech Solutions	NA
Costco Wholesale	12.70%
CVS Health	24.82%
Dollar General	NA
eBay Inc.	NA
Ecolab Inc.	12.26%
Expeditors International	8.45%
FactSet Research	12.56%
Hormel Foods	17.78%
Intercontinental Exchange	NA
MEDNAX, Inc.	NA
Microsoft	12.80%
NextEra Energy	10.37%
NIKE,	17.32%
O'Reilly Automotive	NA
PayPal Holdings	NA
T. Rowe Price Group	10.89%
Republic Services	7.98%
ResMed	15.54%
Scripps Networks	20.11%
Signature Bank	NA
Stryker Corporation	12.14%
TJX Companies	22.13%
Tractor Supply	21.98%
United Technologies	5.52%
Verisk Analytics	NA
Wabtec	36.85%
Walgreens Boots Alliance	7.78%
Waste Connections	15.88%
<b>Average</b>	<b>13.54%</b>

Mid Cap Core 5 Yr. Annualized Dividend Growth	
Company	Dividend Growth
Becton, Dickinson	8.67%
Brown & Brown	10.76%
Brown-Forman Class B	9.15%
Cerner Corporation	NA
Cognizant Tech Solutions	NA
Dollar Tree, Inc.	NA
Ecolab Inc.	12.26%
Expeditors International	8.45%
FactSet Research	12.56%
Fiserv	NA
Hormel Foods	17.78%
MEDNAX, Inc.	NA
National Retail Properties	3.76%
O'Reilly Automotive	NA
T. Rowe Price Group	10.89%
Republic Services	7.98%
ResMed	15.54%
Ross Stores	17.98%
SCANA	4.35%
Scripps Networks	20.11%
Signature Bank	NA
J. M. Smucker	8.45%
Stryker	12.14%
Tractor Supply	21.98%
Verisk Analytics	NA
Wabtec	36.85%
Waste Connections	15.88%
Yum! Brands, Inc.	NA
Yum China Holdings, Inc.	NA
<b>Average</b>	<b>13.45%</b>

The list of holdings above for Tandem's 3 strategies are as of 12.31.2017. 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.

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*Past performance is no guarantee of future results. Indices are unmanaged and not available for direct investment. They are shown or referred to for illustrative purposes only and do not represent the performance of any specific investment.*

YIELD TABLE			
	Current	3 months ago	1 year ago
3-month Treasury Bill	1.32%	1.03%	0.51%
2-year Treasury Note	1.84%	1.38%	1.20%
5-year Treasury Note	2.18%	1.80%	1.96%
10-year Treasury Bond	2.40%	2.20%	2.49%
30-year Treasury Bond	2.77%	2.78%	3.11%
Prime Rate	4.40%	4.25%	3.64%
Federal Funds Rate	1.30%	1.15%	0.54%
Discount Rate	1.90%	1.75%	1.14%

KEY MARKET DATA				
	12/31/17 Close	% Change 1 Year	% Change 3 Years	% Change 5 Years
S&P 500	2,673.61	19.42%	29.86%	87.47%
Dow Jones Industrial	24,719.22	25.08%	38.69%	88.64%
NASDAQ	6,903.39	26.80%	45.76%	128.63%
Russell 2000	1,535.51	13.14%	27.46%	80.79%
German Xetra DAX	12,917.64	12.51%	31.74%	69.69%
London FTSE 100	7,687.77	7.63%	17.08%	30.35%
Shanghai Composite	3,307.17	6.56%	2.24%	45.75%
Crude Oil	\$ 60.42	12.47%	13.42%	-34.20%
Gold	\$ 1,309.30	13.85%	10.59%	-21.82%
CRB Index	196.95	1.66%	-14.56%	-33.34%
U.S. Dollar Index	91.83	-10.23%	1.30%	14.97%
Euro/Dollar*	1.20	14.09%	-0.83%	-9.08%

*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.*

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