September 25, 2022 - Tandem Investment Advisors, Inc.

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MARKET MOVERS & SHAKERS

Equities continued their slide last week as the major U.S. indices closed lower for the 5th time in 6 weeks. The Nasdaq fell more than 5% for the second time in as many weeks, while the Dow and the S&P 500 fared slightly better – falling 4% and 4.7%, respectively. Small caps bared the brunt of it as the Russell 2000 slid 6.6%. Stocks, by and large, began the week with a more stable tone, albeit a defensive one. The PPI print out of Germany, in hindsight, was perhaps a sign of what was to come for the week – and also a thankful reminder that it can always be worse elsewhere! German producer price inflation rose 45.8% year-over-year, which outstripped the consensus forecast of nearly 38%. That is a massive rise in cost for producers. The upside surprise was enough to send German Bunds higher and lifted our own domestic yields as well. The Fed then met on Wednesday and yields continued to rise post-FOMC. In fact, the 2-year U.S. Treasury, which closed the previous week at 3.85%, got as high as 4.28% during Friday's trading session. The 2-year is at its highest point since July 2007. The 10-year, which closed just under 3.7% on Friday, is yielding its most since early 2011. And, perhaps most importantly for the stock market, real yields are also at their highest levels in more than a decade. Real yields tend to be inversely correlated with stocks – specifically highly valued or growth stocks. Should real yields continue to surge higher, one would expect the Nasdaq to continue to underperform its peers. Sure enough, real yields bottomed on November 19th – the same day that the Nasdaq last set an all-time high. Since then, the Nasdaq has fallen 32%, which is more than its drop during COVID.

The bond market certainly is beginning to pique the interest of investors. And traders have begun to bet on bonds once more. TLT, an ETF that is designed to track long dated (20+ Year) treasury bonds, currently has a record low short interest according to Bloomberg. For the past decade+ TINA has been thrown around ad nauseum as justification for exceedingly high valuations. TINA, which stands for There Is No Alternative, was the argument that yields were so low and other asset classes looked so dire that there was little worth owning outside stocks at any price. This justification, one admittedly that I do not subscribe to, was easily made when the yields were near zero. Post-COVID, the 10-year was yielding less than 1%. Meanwhile, the S&P 500 was sporting a dividend somewhere between 1.5% and 2%. An investor could pick up a higher yield by owning the S&P 500 than they could by owning a 10-year Treasury. Hence, there was no alternative to stocks. Yields were too low elsewhere.

This line of logic, which has even been touted by Warren Buffett, is often referred to as "The Fed Model". In its simplest form, the Fed Model asserts that stocks must be owned when the dividend yield on the S&P 500 is greater than that of yields in the fixed income market and vice versa – bonds must be owned when they yield more than the dividend yield on the market. Simplistic models like this are often appealing and easy to understand. That begs the question, with Treasuries yielding far more than the S&P 500 (after all, the 2-year Treasury yield is nearly twice that of the S&P 500's dividend yield), are Treasuries now more attractive than stocks?

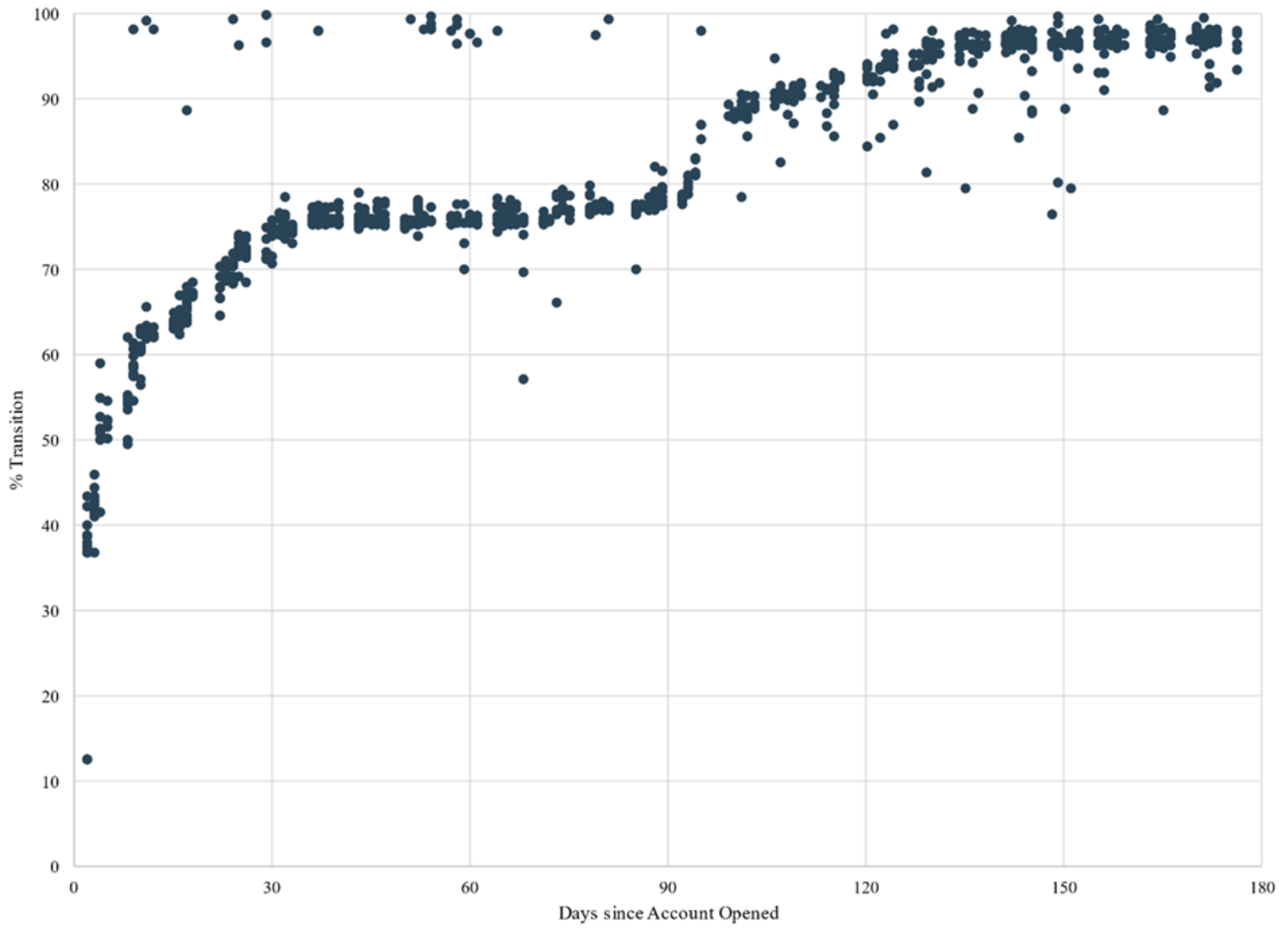
First, the answer would completely and 100% depend on an investor's risk tolerances, their preferences, and the suitability of any sort of investment for that individual. Second, this is not meant to be advice, just data and food for thought. With that out of the way, there are many criticisms of the Fed Model. For example, yields are nominal – they are not adjusted for inflation. Earnings are real, they have inflation inherently baked into its output. Secondly, owning stocks is very different than owning fixed income. In stocks, one is investing a company whose earnings have the ability to grow, which in theory can then create greater value for the investor. The 10-year U.S. Treasury cannot grow. Sure, it can appreciate or depreciate, but its is not like owning a slice of a viable and growing business. A dividend can (and in our opinion, should) grow over time producing rising income for the investor, while a Treasury would produce a fixed coupon. Perhaps though, most egregiously, the Fed Model further exacerbates an already rampant mindset. Too often investors are faced with the seemingly binary decision of being in the market, or out of the market; being in stocks, or in bonds. One or another. This versus that. That is what we at Tandem would call a false choice. The question should not be in versus out. Rather, it should be a question of exposure – how much exposure should one have to stocks, how much risk should one have in their portfolio? At Tandem, we take that question to heart. Depending on the strategy, cash, as a percentage of the strategy, has ranged anywhere from the low single digits to the mid-20s or even the mid-30s. That is managing one's exposure to equities. When one is deciding to be in or out, they are trying to time the market – a task that is either foolhardy or done with luck if done successfully at all. When one is managing exposure, like a sliding scale, they are simply weighing probabilities and risk/reward.

Valuations are now slightly below their 22-year average. The S&P 500 closed last week with a P/E ratio of 15.7x – slightly below its average of 16.4x. The Nasdaq 100 closed with a P/E of 21x, just a hair below its longer-term average. Being just slightly below average certainly does not equate to being cheap. But it certainly presents a better risk/reward than the S&P trading between 21x and 23x last year or the Nasdaq 100 trading at valuations last seen during the Tech Bubble. In other words, from a valuation perspective, the scale between risk and reward is certainly tilting less toward risk and more toward reward than it was 12 months ago. Logically, it probably makes more sense to have more exposure towards equities, or less cash, today than one did 12 months ago. Are valuations cheap? For some stocks they are, for some stocks they aren't. Some stocks today are even still outright overvalued. For the broader market – cheap? Not yet. The Nasdaq bottomed in 2003 with a valuation closer to 20x, and 14x in 2009. Similarly, the S&P 500 bottomed closer to 10x earnings in 2008/2009 and 15x in 2002. If those serve as guideposts, then today's valuations would need to come back down a bit more before presented with those similar "generational buys" where one would have liked to be all in, hand over fist. Logically, it makes a bit more sense to have a little bit more cash in the portfolio today than one would have had then. Again, it's not binary in versus out – it's how much. Valuations have come down. Opportunities have arisen. That is likely worth increasing one's exposure.

Sometimes, as equity investors, especially in turbulent markets like these, its important to gain some perspective. According to Bespoke, so far this year 25% of all trading days have been met with at least 1% loss in the S&P 500. Post WWII, that has only ever happened in three other years – 1974, 2002, and 2008. Each of those were scary times and mark scary company to keep. But, major market bottoms occurred in each of those years (or in the case of 2008, within the first quarter of 2009). With that in mind, volatile markets and down markets can present terrific opportunities to the disciplined investor that can, and is willing, to take advantage of discounted prices. It does not mean that there will not be further volatility. It seems likely that there will be. It just means that if one thinks that a successful investor buys low and sells high, there are more stocks to buy lower this year than compared to the previous year and a half.

TRANSITION UPDATES & NEWS **

The uptick in volatility over the last 6 weeks has presented plenty of opportunity for us to transition into our strategy at prices we think are more reasonable. Generally speaking, accounts that have been with Tandem for ~2-3 weeks are roughly 2/3s of the way through the transition process. As seen below, there is a bit of a plateau for accounts that have been here for 30 – 90 days. These accounts are generally ~75% of the way through the transition. That plateau is the result of there being a few names that haven't really made it into the transition yet. There are 10 or so names that have not been transitioned heavily into, and in some cases, haven't been bought at all in newer accounts. Most of the names were names that we were trimming for valuation purposes back in late July and early-to-mid August. Some have sold off slightly since we sold them, some haven't. Either way, we will continue to exercise our ability to buy low and pay prices we think are reasonable to the best of our ability.



***The transition update describes activity taken by Tandem on the transition level, not the composite or firm-wide level. The transition update is applicable to new accounts and new money. New accounts and new money are not automatically invested on the first day. Rather, they are transitioned into our strategy over a longer time period that is dependent upon market conditions. This update describes that transition.*

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Ben Carew is a shareholder, Vice President, and Portfolio Manager for Tandem Investment Advisors, Inc. Mr. Carew joined Tandem in 2013. Mr. Carew manages Tandem's trading desk, overseeing day-to-day investment operations, including trading, quantitative and fundamental research, and portfolio management. Mr. Carew also oversees Tandem's internship program. Mr. Carew is a regular member of the CFA Institute and the CFA Society South Carolina. Mr. Carew currently serves as the Vice Chair for College of Charleston's School of Business Investment Program, a student program seeking to provide the opportunity for a select group of students to distinguish themselves academically, professionally, and personally. Mr. Carew is a graduate of the College of Charleston's School of Business, earning a Bachelor of Arts in Economics with a minor in Finance.

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