Tandem Investment Advisors

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Notes from the Trading Desk
- September 13, 2021
by Benjamin “Ben” G. Carew, CFA

MARKET MOVERS & SHAKERS

Red was the color of last week as the S&P 500 recorded a loss each day. The S&P 500’s 1.7% drop was its worst weekly performance since June. The Nasdaq and the Dow Jones Industrial Average fell 1.6% and 2.2%, respectively. The action was much poorer in small caps as the Russell 2000 slid 2.8%. Despite the negative trading environment, some defensive pockets were out of favor as REITs, Healthcare, and Tech were all laggards. Even gold saw its first weekly loss in nearly a month. Clearly one haven was working though, as the U.S. Dollar Index, which had been slipping since mid-August, was up for the week.

Despite the down week, it has frankly been a dull market for months. It’s been 214 trading days since the S&P 500 closed more than 5% from an all-time high – that’s highly unusual. It’s an impressively mild stretch that has only been surpassed three times in the last 50 years. It’s not totally unsurprising though. We’ve witnessed a record annualized inflow into equities in 2021. Nearly $1.1 trillion will flow into equities if this pace is maintained through the end of the year. For reference, *only*$0.8 trillion flowed into equity funds from 2001 to 2020. In addition to the record equity inflows, investors have a seemingly insatiable demand for fixed income, and issuers are rushing to get deals done. According to Bloomberg, the investment-grade deal flow on Tuesday, Wednesday, and Thursday of last week was one of the busiest of all-time. High yield spreads are nearly as tight as they were in 2007, and effective yields are substantially lower than they were at that time. As the financial system has become flush with cash, money has found its way into nearly every asset class. Perhaps some of that money has found its way into the volatility market as well. That would certainly provide one explanation for the elevated VIX that has been a hallmark of this summer market. Another explanation could be that the wounds and scars from the March 2020 market crash are still fresh enough that some investors remain fearful or less trusting of the market backdrop. Regardless of the reason, investors are still hedging themselves against a larger correction. Despite the bid in volatility-related products, investors clearly cannot get enough equities! According to CNBC's Mike Santoli, investors total allocation to equities across all funds and ETFs is only matched by their appetite for equities in both 2000 and 2007. Everyone is at the equity party, but for now, there has been no rush for the exit.

I was recently reminded by a friend of the infamous quote from the old Citi CEO, Chuck Prince. He said, "When the music stops, in terms of liquidity, things will be complicated. But as long as the music is playing, you've got to get up and dance." That aphorism was certainly indicative of sentiment in 2007 and I think it is equally applicable today. Everyone seems to know that inflation (transitory or not) is hurting margins, that issues within the supply chain are causing problems for companies both large and small, that the Delta variant is slowing economic activity, and that valuations are rich. The justification, by and large, is to not fight the central bank infused liquidity – just keep dancing. When presented in that manner, it seems like there are two options: keep dancing or leave the party. That framework provides a false choice to investors though. At Tandem, we're still dancing – we always are. We've just also started to gather our things and we're hanging out near the exits. Eventually, this impressively dull market will get a bit more interesting. And, because of our discipline we will be ready when opportunities do arise. Tandem won't be rushing for the exit with the stampede of the crowd. Instead, we will be ready and present for when the next party begins!

RECENTLY ASKED QUESTIONS

This is a new section for *Notes from the Trading Desk*, but I thought I would use this space to answer some of the questions that we have been receiving lately. We received a good question the other day, when someone asked why Tandem didn't have more exposure to vaccine stocks. Tandem's investment process tries to identify companies that can grow through any economic period – including things like the Financial Crisis, the Pandemic, etc. Our process is dictated by our quantitative model which is how we identify these companies that exhibit less cyclicality and the ability to grow their businesses regardless of the economic backdrop. The model aims to eliminate human bias and emotion as we are able to rely solely on the numbers and the math. This also prohibits any one person from driving the decision or having an "idea" to invest in. We don't sit around tables and have idea generation discussions or anything like that – everything is driven by our model which runs across nearly 3,000 names overnight.

With regards to vaccine makers: we actually do own JNJ. Johnson & Johnson has exhibited the ability to grow regardless of what's going on in the economy, so we have owned the stock for a few years now. However, with regards to Pfizer, Moderna, and AstraZeneca, they simply do not meet our fundamental criteria. Moderna had negative earnings for much of its operating history until the middle of last year. Any company that is not profitable will always fail to meet our criteria. Pfizer has actually exhibited the ability to grow regardless of the economic backdrop, but they cut their dividend during the financial crisis which is a violation of our investment criteria – any stock that pays a dividend must consistently grow that dividend. This dividend cut precludes us from investing in Pfizer. Finally, AstraZeneca does not have a history of growing their business. They do not have negative earnings like Moderna. However, they have been unable to grow their business over the last decade or so – which violates our model.

The reasons above for not owning Moderna, Pfizer, or AstraZeneca do not mean we think they are bad stocks, or even that we think they are not worth owning somewhere else. They just simply do not meet our criteria, so we cannot own them in our portfolios. We strive to provide a consistent, repeatable experience for our clients. In doing so, we have a discipline that we feel we must adhere to so that our clients know what to expect.

TRANSITION UPDATES & NEWS **

A new name, Ollie's Bargain Outlet (OLLI), was introduced to the Equity and Mid Cap strategies last week. Ollie's is a closeout retailer that operates mostly on the east coast. In addition to Ollie's, the down week provided ample opportunity for money to be put to work on the transition level as well. AbbVie, Check Point Software Technologies, Essential Utilities, Fiserv, JM Smucker, and Johnson & Johnson were all purchased multiple times in our various strategies. A few other names were also purchased just once last week.

In terms of news, it was slow besides the usual small M&A. Accenture, Tyler Technologies, and Microsoft all had small bolt-on acquisitions announced throughout the week. PayPal made a bit of a bigger splash announcing their acquisition of Paidy for roughly $2.7b. The deal should bolster PayPal's presence in Japan. Elsewhere, a longtime holding, Brown & Brown, received news that they will be included in the S&P 500 following the September 20th rebalance. The $16b insurance brokerage firm has seen its market cap swell these past few years. Just five years ago it was hardly a $5b company!

***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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Written By: Benjamin “Ben” G. Carew, CFA

Ben Carew is a shareholder and Portfolio Manager for Tandem Investment Advisors, Inc. Mr. Carew joined Tandem in 2013. His duties include quantitative and fundamental research and portfolio management. Mr. Carew also oversees Tandem’s internship program. 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.