OBSERVATIONS 5.1.2018

TANDEM Investment Advisors

Financial Markets Review

The resurgence of volatility has been on the forefront of everyone's mind. And, April looked to be a continuation of this newfound volatility. On the very first trading day of the new quarter, the VIX blew out to an intraday high of 25.72, which represented a 28.79% increase over the previous close. Meanwhile, the S&P 500 plummeted over 100 points amounting to a 3.30% decline to test the lows set in February and close the day 0.88 points above the February 8th closing low of 2,581.00. On a technical basis, the equity markets were given the all-clear signal to advance higher. A successful re-test of the prior lows, while making a lower high in the VIX is the textbook definition of a double bottom.

Over the following 2+ weeks, the S&P 500 clawed its way higher by nearly 5% amidst much lower volatility. And just as many financial pundits called an end to the two-month correction, due to dissipating volatility and an upcoming strong earnings season, stocks began to retreat again. Interest rates accelerated higher with the 10-year Treasury yield piercing the psychological 3% level, and stocks were being sold on the back of strong earnings reports.

Currently, the worry du jour for markets is inflation. With the Thomson Reuters/Core Commodity CRB Index up roughly 3% this month and the Labor Department reporting wages and salaries increasing at the fastest pace in 11 years, market participants are getting a little spooked. As we've mentioned in prior commentary, margins are at an all-time high. Corporations are the most profitable they've ever been on an operating margin and most certainly on a net profit margin basis. Much of this is credited to nine years of cost cutting, low wages, record low interest rates and the recently passed corporate tax reform. How much better does it get from here regarding profitability? Only time will tell. But, it is worth noting considering equity markets and fixed income markets are both starting to take heed.

"*There were several positives in the first quarter that we would not expect to continue for the full year. The price versus material cost delta was very favorable in the first quarter and better than we expected. We expect this delta of price versus material cost to be negative for the balance of the year.*" - Caterpillar Q1'2018 Earnings Call on April 24th, 2018

"*But to that end on raw material inflation, we are seeing some increases in raw material prices, in fact, more than what we originally estimated when we gave the guidance back in December. It's particularly around crude derivatives and transportation and logistics expenses.*" – 3M Q1'2018 Earnings Call on April 24th, 2018

Earnings Update

During the buildup to a typical earnings season, estimates get ratcheted down only to see companies easily hop over the lower bar. The anticipation of this earnings season has been much different. Rather than the bar being lowered, it has been continually taken up a notch. And now that we are halfway through earnings announcements for the companies that make up the S&P 500, it appears the estimates were still too low! Companies are beating earnings estimates by huge amounts. According to Factset, with 53% of

S&P 500 constituents having reported, earnings growth for Q1 has come in at 26.50%. In a world starved for growth amidst one of the weakest economic recoveries on record, one could not ask for much more.

As we noted last month, and in the commentary above, this level of profitability and growth could very well be as good as it gets. Once corporate tax reform was enacted, we've known that earnings growth was going to be huge this year. The bigger question was always if the increase in corporate profits would increase demand and in turn increase revenues. Accelerating revenue growth can justify high valuations and expanding multiples. A one-time increase in earnings growth is by its very nature unsustainable. And this will not support the near record high valuations that we are currently seeing in just about every other metric other than price to earnings.

Tandem Strategy Update

The volatility and market decline in the beginning of April allowed us to establish a couple of new positions in our Equity and Mid Cap Core strategies, respectively – Celgene (CELG)* and Euronet Worldwide (EEFT)**. And, we took advantage of the opportunity to add to existing positions – Walgreens (WBA)*** and Henry Schein (HSIC)**.

CELG is a global biopharmaceutical company that focuses on developing therapies to treat cancers and inflammatory diseases. Shares of CELG began to sell-off in October of last year after a weaker than expected earnings report and the announcement of discontinuing a late-stage study of a therapy to treat Crohn's disease. CELG's sales and earnings have slowed, but they are still growing 15% and 20% year-over-year, respectively. The deceleration in growth has been more than compensated by its decline to record low valuations on nearly all metrics – P/S, P/E, P/CF and EV/EBIT just to name a few. We will continue to build our position over the coming weeks and months as our quantitative model and technical analysis sees fit.

We received some welcomed news for two of our core holdings – CVS Health (CVS)*** and Walgreens Boots Alliance (WBA). On April 16th it was reported that Amazon (AMZN) had decided to halt its plans to enter the retail pharmaceutical drug industry. For nearly a year now, the shares of both CVS and WBA have been under pressure due to the theory that everyone would now buy their prescriptions using AMZN, which would render the bricks and mortar useless. There is no doubt that AMZN is putting several retailers out of business. But, selling prescription drugs is quite a bit different than selling a pair of jeans.

Lastly, as the markets bounced back over the last few weeks, we were able to take advantage of rebounding stock prices to take profits in a couple of our core positions – Brown Forman (BF.B)**** and Ecolab (ECL)****. Our quantitative model identified these stocks as valuation sales, which calls for us to sell 25% of our position. There is nothing fundamentally wrong with either stock, but rather an opportunity to trim a little bit of each position to lock in profits. Both companies have been long-time core holdings within our strategies. Over the course of the past several years, we've added to and trimmed our positions as the stock prices and valuations fluctuated. The table below sheds a little more light on how each stock has performed since our initial purchase.

Ticker	Date of Purchase	Cumulative Total Return*	S&P 500 Cumulative Total Return	Annualized Total Return*	S&P 500 Annualized Total Return
BF.B	3/20/2007	454.42%	139.72%	16.68%	8.19%
ECL	2/11/2011	222.90%	133.83%	17.65%	12.50%

** Cumulative and Annualized Total Return in the table above are derived from publicly available sources believed to be reliable. Tandem makes no representation as to future performance. No management fee has been deducted and these figures in no way indicate any performance measure relative to any Tandem investment product.*

What Year Is It?

The following excerpt from a recent Wall Street Journal article was too unbelievable to not share. On April 25th, Eliot Brown wrote about one of the most valuable startups today – WeWork. WeWork is valued at $20 billion and recently raised $702 million through a bond sale. The company's revenue doubled last year, while their losses subsequently more than doubled. And, here is the best part…

"In the offering documents, WeWork went to unusual lengths to show ways in which the company would be profitable. While many companies typically offer "adjusted" earnings, WeWork offered three different layers of adjustments.

It called the fully adjusted number "community adjusted Ebitda," by which it subtracted not only interest, taxes, depreciation and amortization, but also basic expenses like marketing, general and administrative, and development and design costs. Those earnings were $233 million, WeWork said.

"I've never seen the phrase 'community adjusted Ebitda' in my life," said Adam Cohen, founder of Covenant Review, a bond research company." – Eliot Brown, Wall Street Journal

-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

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** Purchased in Tandem Equity.*

*** Purchased in Tandem Mid Cap Core.*

**** WBA was purchased in Tandem Large Cap Core and Equity. CVS is owned in Tandem Large Cap Core and Equity.*

***** Sold across all strategies (Tandem Large Cap Core, Equity and Mid Cap Core).*