Tandem Investment Advisors

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Observations -
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by William “Billy” L. Little, Jr., CFA

Financial Markets Review

U.S. equity markets ended November with a whimper, which continued into the first few trading days of December. The major U.S. indices made all-time highs during November. And since then, the S&P 500, Nasdaq Composite and Russell 2000 have traded off by 5%, 8%, and 13%, respectively. Equities are not the only asset class to suffer, as Crude oil declined over 25% and high-yield spreads widened nearly 70 bps over the span of a few weeks. Over that same timespan, the yield curve continued to flatten with the 2-year Treasury yield rising roughly 20 basis points and the 10-year Treasury yield falling 20 basis points.

There are many factors that can be attributed to the recent shake up in financial markets. Some of these factors include the emergence of the Omicron variant, Fed Chair Jerome Powell’s comment about accelerating the Fed’s asset purchase taper, the U.S. debt ceiling fast approaching, and geopolitical issues flaring back up between Russia and Ukraine. Individually, any one of these reasons could rattle markets. However, I think the finger can be pointed in the direction of an economic growth scare and reduction in future liquidity.

As of now, little is known about the Omicron variant. The only known is that the variant is more transmissible, but beyond that, it’s all speculation. When the World Health Organization labeled Omicron as a “variant of concern”, fears of further economic restrictions and lockdowns, which would crimp economic growth, rippled through the markets. A few days later, Fed Chair Jerome Powell suggested that the liquidity punchbowl might be taken away a little faster than originally planned. A taper ending a few months sooner than originally expected inherently means the expectation of the rate hike cycle would also begin earlier. And lastly, there is a fiscal stimulus program set to expire at the end of January 2022 that does not get a lot of attention. The student loan payment moratorium is set to expire soon, which will undoubtedly have an impact on current consumption and investment trends. It is estimated that student loan holders save roughly $7 billion a month by not having to make payments on these loans.

According to Bank of America, investors have put nearly $900 billion into ETFs and long-only funds in 2021. This amount of cash exceeds the combined total from the previous 19 years. That is a stunning amount of cash that has found its way into equities. And it is certainly no coincidence that it comes after a record amount of monetary and fiscal stimulus has been pumped into the economy over the past couple of years.

An economic growth scare coupled with a faster than expected reduction in liquidity is a recipe for financial asset volatility. And this is what has transpired over the past couple of weeks. Volatility has now entered the building. In our last edition of Observations and throughout our latest Tandem Talk, we discussed at length why volatility in financial markets was likely to make a comeback. For starters, at the beginning of October, the S&P 500 posted its first 5% drawdown in nearly a year of trading. There are only a handful of times in history when the market went as long as it did without experiencing a 5% drawdown with 2017 being the last time. And when the calm subsided, it gave way to significant volatility shocks throughout 2018.

So, here we are again. The baton has been passed from a low volatility regime to a high volatility regime. Just as most things in life are mean reverting, volatility is no different. The longer you stay below the mean, the probability increases of a sharp and sustained move above the mean. As such, we remain steadfast in our belief that the next 12 months will not look like the last 12 months.

Tandem Strategy Update

You will often hear us say that our strategies are not the “market”. They are not designed to look like or perform like the “market”. We are active managers who look for opportunities in individual businesses regardless of what is going on in the “market”. Our clients are business owners, not “market” owners.

Oftentimes, short-term volatile moves in the broad equity indices present opportunities to buy or sell companies that are currently trading at unsustainable valuation levels. The current price or even valuation level of, let’s say the S&P 500, makes no difference to us. It’s all about the individual company. And that is why you will see us buy individual businesses when the “market” has sold off and when the market is near all-time highs. On the flip side, you will see us sell individual businesses when the market is near all-time highs and when the market has sold off.

Even with all of the recent volatility, the S&P 500 is still only a few percent off its record high. As a reminder, volatility doesn't mean the market just goes down. The market may go up or may not go anywhere, but the day-to-day and week-to-week swings are dramatic. Over the past few months, there has been significant volatility and weakness under the surface of the stock market. Most of the damage is within the speculative pockets of the market – high growth companies with little to no profits. These companies do not meet our fundamental and quantitative criteria, so there have not been a lot of opportunities to take new positions or add to existing positions amongst this cohort of businesses. However, the most recent volatility spat has started to afflict weakness on a few companies we do own and even a few companies that have been on our watchlist for quite some time.

Over the past couple weeks, we have been able to add to PayPal (PYPL) in our Equity strategy. Earlier this year, we had the opportunity to sell 25% of our PYPL position on a valuation sell signal generated by our quantitative model. With the stock down roughly 40% from all-time highs, our quantitative model gave the signal to start adding back to this position. PYPL is a high-growth company, but it is also a highly profitable one. Over the last twelve months, PYPL has generated net income of $4.9 billion and, most importantly, they have been able to convert nearly 100% of that profit into free cash flow.

Lastly, we've had the opportunity to establish two new positions across all three strategies. Per usual, I won't divulge the names of the businesses until we get closer to having our position built out, but both companies would fall into that profitable growth category. One company provides technology solutions and payment processing services primarily to financial services organizations. The other company operates an electronic trading platform geared toward bonds and fixed-income securities. Both companies have strong top and bottom-line growth, generate a healthy amount of cash, and have history of growing their dividends at a robust double-digit clip. As volatility ebbs and flows over the next year, you will likely see us continue to build out these positions and others as opportunities become more abundant.

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Billy Little is a shareholder, Vice President and Portfolio Manager for Tandem Investment Advisors, Inc. Mr. Little began his career in the investment industry in 2004, as a Financial Advisor with Ameriprise Financial in Baltimore, Maryland. Mr. Little joined Tandem in 2006 where he directs Tandem's quantitative research. He is a regular member of the CFA

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