



## February 2023 - Tandem Investment Advisors, Inc.

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### Financial Markets Review

Last month, we closed out [Observations](#) by stating: “even though the calendar has flipped to a New Year, most of the uncertainty and questions regarding our economic future remain.” Since the start of the year, there has been nothing to dispel this notion. The only thing one can be certain of at this point is to expect the unexpected.

After equities traded lower through December amidst consistently disappointing macro-economic surprises and the constant barrage of layoff news, investor sentiment was fairly dour coming into 2023. Consensus was for economic weakness to continue through the first half of 2023, which would be met with a declining equity market. Then in the second half of the year, economic and equity weakness would force the Federal Reserve’s hand. As a result, the Fed would cut interest rates to spur economic growth and equities would inherently rally on the back of expansionary monetary policy.

In typical fashion, the consensus’ path for equities has not gone according to plan. All major indices climbed higher in January, as the Nasdaq set the pace with a blistering 10.68% return. Not to be outdone, the S&P 500 and the Russell 2000 also advanced by 6.18% and 9.69%, respectively. For the most part, the rally was led by those that underperformed the most last year. And in some sense, it’s been a very bifurcated rally. Consumer Discretionary, Consumer Services, REITs, and Technology have driven the bulk of equity gains; whereas, the Utilities, Healthcare, and Consumer Staples sectors, which are historically more “defensive” in nature, each posted declines in January.

The recovery in equity prices has a bit of a 2021 feeling to it. It’s not one driven on fundamentals or valuation, but rather it’s fueled by speculation. Those companies with the weakest balance sheets, least profitability and most short interest are the stocks going up the most. And investors are speculating in these companies using out-of-the-money short-dated call options. These types of options are simply a gamble and in no way represent an investment. You are either going to make multiples of your capital or lose 100% of it; there really is no in between. Just last week, the volume in call options being traded hit an all-time record. Another way to view the exuberant change in investor sentiment is through the CNN Fear & Greed Index. This index has moved from Fear to Extreme Greed in a matter of four weeks.

The looming question is whether or not this speculative chase for the riskiest of assets is justified and has any staying power. To be fair, this is how every new bull market begins. The lowest quality securities are what drives indices out of bear markets. Their advance is typically questioned and then accepted once a few pieces of fundamental data confirm a marginally improved economy. On one hand, this could be the start of a new bull market, as expectations for a "soft-landing" get ratcheted higher. The economy is weakening and inflation is receding, but at the same time the labor market remains alive and well, as seen by the most recent January non-farm payrolls report. Over a half million jobs were created with an unemployment rate of 3.4%, which is the lowest in 50 years. That type of employment report does not signal an impending recession. Under this evolving scenario, the equity market advance would be justified and could have some longevity to it.

The counter argument is that this is just another bear market rally. Rallies within bear markets are brutal since they are designed to confuse the masses and play with one's emotions until all hope is lost. If equity indices were to trade back toward the lows made last year, then this would be just that. There are a number of indicators flashing warning signs that have historically predicted a recession; however, just maybe, this time really is different. Unfortunately, I'm not bold enough to make that claim, since most of the time, things aren't different. But it's not something that can be dismissed. Only time will tell if this is the start of a new trend or a continuation of the old. Either way, it's safe to say that if anything has staying power at the moment, it's confusion. The confusion lies within the economy, Fed policy, corporate earnings and markets, which brings me back to my first point – expect the unexpected.

## **Tandem Strategy Update**

Even though you can expect the unexpected when it comes to the economy and financial markets this year, as a partner of Tandem, you will not be asked to hold us to a similar standard. When it comes to our investment discipline, process, how we manage money and the service we provide, you can expect the expected. We pride ourselves on a consistent, repeatable experience and that won't change regardless of the investment environment we find ourselves in.

Our approach is simple and straight-forward. We invest in businesses that can consistently grow revenues, earnings, and cash flows through any economic cycle. When a company ceases to meet these criteria, it is liquidated from the portfolio. As long as a company meets these criteria, it passes through our proprietary quantitative model and receives a valuation ranking. Strictly based on math and the size of the position, the quantitative model will dictate when we increase or decrease our position in that company. We do not opine on the perceived direction of the market, or the path of Fed monetary policy or who the next President of the United States will be. There is no room for human bias, which ultimately allows for a repeatable experience.

This process has led to a few changes in the portfolio over the past week. As markets have recovered, our quantitative model flashed a sell signal on a couple of our core holdings – BlackRock (BLK) and Stryker (SYK). BLK is held in our Equity and Large Cap Core strategies, while SYK is held across all of our strategies. Both of these companies experienced price movements that caused them to be flagged as significantly overvalued relative to certain growth metrics. This signal gives us the opportunity to sell a portion of our position and reduce our exposure, while continuing to hold the company within its respective strategies.

Toward the end of last year, we had a long-time core holding that was held across all of our strategies no longer pass through the initial step of our quantitative process. Based on the way we account for consistency in growth, T. Rowe Price Group (TROW) no longer was able to meet this criterion and the company was liquidated from our strategies. There were a number of factors that led to a shift in TROW's fundamentals, but the main culprit was their exposure to equities and, more specifically, growth stocks. Equity growth strategies have been TROW's bread and butter for a really long time and they even made a large acquisition a year ago into the alternative credit space to diversify into other asset classes. However, it was probably just a little too late. As interest rates soared and growth stocks cratered, TROW faced nearly \$62 billion in net outflows. This put significant pressure on revenues and expenses weren't able to be cut fast enough to maintain the mid-40s operating margin that TROW had experienced for so long. TROW is and will continue to be a great company. The human in me says they will be all right and will ultimately successfully weather the storm. However, our discipline doesn't care what I think. Remember, it's just about the math and the math no longer worked in the case of TROW.

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Billy Little is a shareholder, Senior 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. Mr. Little oversees Tandem's corporate financials, including business planning, budgeting, and vendor negotiations. Mr. Little also directs Tandem's quantitative and fundamental research. He is a regular member of the CFA Institute and past President of the CFA Society South Carolina. Mr. Little graduated from the College of Charleston with a Bachelor of Arts in Business Administration with a concentration in Finance.

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