June 2023 - Tandem Investment Advisors, Inc.

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Financial Markets Review

If you are coming out of May even more confused than before, you are likely not alone. Much of the year has been dominated by conflicting economic and market signals. And unfortunately, there was nothing in the past few weeks that brought clarity to the environment we find ourselves in. The confusion and disparity were most evident amongst the four largest U.S. equity indices. In May, the blue-chip Dow Jones Industrial Average (DJIA) and small-cap Russell 2000 declined 3.49% and 1.09%, respectively. The S&P 500 was essentially flat with a meager 0.25% advance. All the while, the tech-laden Nasdaq soared 5.80%. One of these things is not like the others.

The deeper you wade into financial markets trying to make sense of everything, the murkier it gets. Of the 11 S&P 500 sectors, 8 of them were down and rather significantly.

Energy	-10.61%
Materials	-7.11%
Utilities	-6.36%
Consumer Staples	-6.21%
Real Estate	-4.64%
Financials	-4.48%
Healthcare	-4.44%
Industrials	-3.45%

As has been the case for most of this year, the large-cap technology companies saved the broader S&P 500 from contracting last month. The Information Technology and Communication Services sectors climbed 9.32% and 6.21%, respectively. Consumer Discretionary rose 3.09%; however, nearly half of that sector is made up of Amazon and Tesla, which tend to trade alongside the rest of technology-related companies. So basically, it’s tech and everything else.

Another way to view the significance of the divergence between Information Technology and everything else is through a stat recently shared by Bespoke Investment Group. The Nasdaq outperformed the DJIA by 9.29% in May. In the history of the Nasdaq, which goes back to 1971, there have only been 8 other months where the Nasdaq outperformed the DJIA by a greater margin. Those 8 months were all clustered in and around the height of the Tech Bubble in the late ‘90s and early ‘00s.

Last month, we touched on the divergence between the S&P 500, which is a market cap-weighted index, and. an equal-weighted S&P 500. That divergence expanded even further as the equal-weighted S&P 500 fell nearly 4% in May. Year-to-date, the cap-weighted S&P 500 is up 9.5% vs. a decline of 1.4% for the equal-weighted S&P 500. And, according to Howard Silverblatt, S&P Dow Jones Senior Index Analyst, when removing the top 7 companies from the cap-weighted S&P 500, the year-to-date return of the S&P 500 goes from a positive 9.5% to a negative 0.2%.

All of these different stats illustrate the same story and it’s that the S&P 500’s positive return this year has been driven by fewer and fewer companies. As May ended, there were a greater number of S&P 500 companies notching 52-week lows than there were hitting 52-week highs. It doesn’t matter whether you say the leadership is narrow or the breadth is weak, the truth is that the largest tech-focused companies are masking a lot of underlying weakness.

Tandem Strategy Update

It was a rather quiet month at the strategy level. Across all three strategies – Large Cap Core, Equity and Mid Cap Core – we continued to add to our core position in Hormel Foods (HRL). As a reminder, HRL is a consumer staples company focused on food processing with global brands such as Applegate, Jennie-O, Planters, Skippy, and SPAM. Similar to a lot of food companies, HRL has experienced significant cost and supply chain challenges over the past couple of years; however, these headwinds have not been enough to fundamentally change the business. In fact, after their most recent earnings call, management indicated that the business fundamentals appear to be troughing and set to reaccelerate in the back half of the year.

In our Equity and Mid Cap Core strategies, we pared back our core position in O’Reilly Automotive (ORLY). ORLY has consistently grown revenue, earnings, and cash flow, which we demand in every company that we own; however, there are times when the valuation gets ahead of itself, and our quantitative model gives us a sell signal in the company. Although the company still meets all of our criteria, the prudent thing to do from a risk management approach is to take a little bit off the table.

As Q1 earnings season winds down, it's always helpful to look back and see how our companies stack up with the broader index. Coming into the quarter, expectations were pretty low for most companies. The expectation was for S&P 500 earnings to contract by 6.73% and for the aggregate of our core holdings across all strategies to contract by 5.46%. Across the board, earnings came in much better than expected. Q1 earnings have declined, but not nearly as much as feared. S&P 500 earnings for Q1 fell by 2.03%; whereas earnings growth for our core holdings was essentially flat at -0.14%. Looking forward, the disparity in earnings growth widens even more between our core holdings and the broader market. For Q2, earnings for our core holdings are expected to grow by 2.64%, while the S&P 500 earnings are expected to decline by 6.42%.

The disparity in earnings expectations between our core holdings and the broader S&P 500 should not be taken as a plug for future performance expectations. But rather, it is meant to highlight what it is that we expect from our core holdings – consistent earnings growth through any economic cycle. If everything is consistent, from the characteristics of the companies we invest in, to how we manage the portfolio, then the element of surprise should be removed from the equation. A consistent, repeatable experience is what we strive to offer and the companies that make up the strategy are an integral part of that experience.

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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.