May 2023 - Tandem Investment Advisors, Inc.

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Financial Markets Review

The month of April was marked by a dearth of volatility at the broad index level. The S&P 500 rose a modest 1.5%, while the Nasdaq was flat, and the Russell 2000 declined 2%. The equity markets found support from better-than-expected earnings, stabilization within the financial sector and continued strength amongst the mega-cap tech companies. However, the events during the first week of May brought volatility back into the fray.

The uptick in the day-to-day volatility of essentially all financial assets over the first week of May coincided with yet another bank failure, U.S. debt ceiling drama and a FOMC meeting that continued to show a gap between Fed expectations and market expectations regarding the path of future monetary policy. None of these issues appear to be abating any time soon, so the expectation would be for financial markets to act more like they did in the first week of May than they did throughout the month of April.

Given all of the concerns, the S&P 500 has remained resilient for much of the year. This strength can be attributed to a number of factors – better than expected Q1 earnings reports, corporate margin stability, loosening of supply chains, lower inflation rates, and continued strength in the labor markets. Outside of the labor market, the news hasn't been great, but it has been better than feared and that is what matters most. Coming into the year, the consensus expectation was for markets to be weak in the first half of the year and to rebound on strength throughout the second half as corporate earnings recover. That is how everyone was positioned, so it shouldn't come as a great shock that what actually has happened is far different than what was expected.

The million-dollar question now is whether or not the resilience of the equity market can sustain itself through year-end and beyond. And the answer is – sure it can! But the risks associated with continued market strength are higher today than they were at the start of the year. Year-to-date, the S&P 500 has advanced nearly 8% and, over this timeframe, S&P 500 earnings estimates for calendar year 2023 have fallen 4%. So, from just a simple earnings valuation, the S&P 500 is roughly 12% more expensive today than it was at the start of the year.

In addition, much of the S&P 500's advance has been driven by just a handful of names. As a reminder, the S&P 500 is a cap-weighted index, which means that the largest companies make up a greater allocation of the index than the smaller companies. In the case of the S&P 500, five companies comprise nearly a quarter of the index. Apple and Microsoft make up 14% of the entire index and the next three largest companies being Alphabet, Amazon and Nvidia, make up an additional 8% of the index. As of this writing, these companies have climbed 33%, 29%, 20%, 26% and 97%, respectively, so far this year. To say that the performance of the S&P 500 has largely been driven by the mega-cap tech companies would be an understatement. Ideally, as an index advances, you want broad participation, which is also known as strong market breadth. Today, the breadth is pretty weak. One way to view this is to compare a S&P 500 Equal-Weighted Index to the normal market-cap weighted S&P 500. By doing this, all 500 companies are on equal footing and the index's performance is not skewed by any one company. Currently, the S&P 500 Equal Weighted Index is up 1% this year. The largest companies are clearly masking the lack of strength in the underlying index.

As we have highlighted over the past few months, there are so many conflicting market and economic signals that it's hard to figure out where we go next. The good news is that you shouldn't have to guess where the market is headed. All you need to know and come to grips with is how much risk you can stomach. And only you will know that answer. As financial markets have recovered from last year's depths and with so much lingering uncertainty, now is a good time to reflect and perform a risk assessment. What do you own and are you comfortable owning it? The answers to those two questions are vital to one's investment success.

Tandem Strategy Update

Although volatility was suppressed at the broader index level, there was a bit more noise under the surface. Corporate earnings season tends to do this, as volatility amongst individual companies tends to pick up as they give a glimpse into their business. Over the past month, we took the opportunity to make several transactions at the strategy level.

Across all three strategies – Large Cap Core, Equity and Mid Cap Core – we added to our core position in Hormel Foods (HRL) and Jack Henry & Associates (JKHY). 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 and, in fact, appear to be abating. JKHY is in a completely different line of business than HRL, but similar to HRL, recent headwinds have given us the opportunity to add to our position. JKHY provides technology solutions and payment processing services to banks and credit unions. The ongoing regional bank crisis has put fear into just about any company tied to banks, with some of this fear being a bit misplaced. JKHY provides vital technology platforms and solutions that are not going away. Their business might slow, but their product will still be in demand.

We also had the opportunity to pare back long-time core positions in AbbVie (ABBV) within our Large Cap Core and Equity strategies and Stryker (SYK) within our Large Cap Core and Mid Cap Core strategies. Both companies continue to pass through our quantitative model on a fundamental basis, but reached a point where our model was signaling them both to be overvalued. Therefore, we still own ABBV and SYK, but just at a reduced portfolio weighting.

And lastly, we liquidated two companies that no longer met our criteria for investment. McCormick & Company (MKC) was sold across our Large Cap Core and Mid Cap Core strategies. Similar to HRL, MKC really struggled with cost control and supply chain issues. Unfortunately for MKC, their margin headwinds were impaired enough that they could no longer meet the growth criteria to successfully make it through our quantitative model. We also finished up the liquidation of UMB Financial (UMBF) within our Mid Cap Core strategy, which was the only bank that we owned. Last month, we highlighted the troubles that the regional bank crisis brought to UMBF and that at the time we found it prudent to begin reducing our exposure. Well, after a decent earnings report, we had the opportunity to fully liquidate our position in UMBF, as it was even more apparent that UMBF would not make it through our quantitative model in the coming months.

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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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