

# TANDEM

INVESTMENT ADVISORS

## The Tandem *Report*

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Tandem is committed to the preservation of your wealth by minimizing risk while adding value through consistent and superior investment performance over time. This issue of *The Tandem Report* provides a summary of our views pertaining to the investment landscape and subjects that influence our decision making. More information about our firm, including our investment style and process, is available at [www.tandemadvisors.com](http://www.tandemadvisors.com) or upon request. We hope you find this report useful.



John B. Carew

*Founder & Chief Executive Officer*



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Ben Carew joined Tandem in 2013. He manages Tandem's trading desk, overseeing day-to-day investment operations, including trading, quantitative and fundamental research, and portfolio management. Ben also oversees Tandem's internship program. He is a regular member of the CFA Institute and the CFA Society South Carolina. Ben currently serves as the Vice Chair for College of Charleston's School of Business Investment Program, a student program seeking to provide the opportunity for a select group of students to distinguish themselves academically, professionally, and personally. He is a graduate of the College of Charleston's School of Business, earning a Bachelor of Arts in Economics with a minor in Finance.



Benjamin "Ben"  
Carew, CFA

*Co-Chief Investment Officer*

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Over the past several quarters we have written extensively about concentration, valuation, and the risks of a market being driven by a single narrative. Those themes have not changed. If anything, they have intensified a bit. A lot of what we have written about has also begun playing out in front of our eyes.

In the first quarter, markets fell for the first time in a year. The S&P 500, in part thanks to a strong rally on the last day of the quarter, closed nearly 5% lower. The Magnificent Seven, which we have warned about for some time here at Tandem, was down more than 15% intraquarter. So, if our warnings and concerns are potentially being realized, then why has our discipline not been recently rewarded? It is a fair question and one that we welcome.

The short answer is that over the past nine months, the market has experienced two distinct episodes in which sentiment, not fundamentals, drove dramatic divergences in return. Outside of those windows, our approach has generally performed as we would hope and expect. This is not a story of a broken or outdated process. It is a story of a market that, for a few brief but intense stretches, rewarded the opposite of what we do.

The first episode occurred in the fall, which we touched on in the previous edition of *The TANDEM Report*. From late August through late October, the market experienced what I can only describe as a melt-up in speculative and risky names. The Magnificent Seven surged more than 15%. High beta stocks posted double digit gains. Meanwhile, the low volatility space, which we tend to occupy, was down 5-6%. In about two months, the space we invest in lost 12% in relative performance versus the broader market. The magnitude of that spread has historically only occurred in the most extreme environments. The divergence likely signaled either a blow-off top or a generational buying opportunity. Given current valuations and concentrations, we believe one of those is more likely than the other.

The second episode arrived in late January and carried on for 2-3 weeks into early-to-mid February as AI disruption fears gripped the market. Over the course of roughly three weeks, the market evidently decided that artificial intelligence was about to render entire industries obsolete. Software companies, insurance brokers, private credit, commercial real estate, financial advisors, and trucking and logistics firms all got whacked. The sell-first-ask-questions-later mentality was extraordinary. Companies with decades of proven track records were treated as if they would cease to exist sooner rather than later.

To put the absurdity into perspective, Algorhythm Holdings, a company with a market cap of just a few million dollars which hardly gets you a 3-bedroom house in Charleston these days, issued a report saying that it had dramatically improved efficiencies in Indian freight business. Billions and billions of market cap were shed in the trucking and logistics industries in one day in response to that obscure report. One stock in our portfolio, Expeditors International of Washington, fell from \$163 to \$130 intraday. If you were curious as to why the company is *Algorhythm* instead of *Algorithm*, it's likely because it was previously known as The Singing Machine Company. It sold home karaoke machines.

We witnessed the death of software. The premise being that your

average consumer would soon be “vibe coding” their own tax software rather than using TurboTax. That accountants would write their own payroll systems rather than rely on Intuit. That individuals would build their own spreadsheet applications rather than use Excel. On another day, we witnessed the death of the financial advisor because a firm marketed an AI-powered planning tool, geared towards financial advisors, and the market extrapolated that to mean the end of human financial advising.

AI is real. It is impactful. And, it is a gamechanger. There will be winners and losers. But, the market was treating it like a zero-sum game — like there would be a singular AI winner that replaces every existing business. That is not how technological disruption has ever played out. The more likely outcome is that the winners will be existing companies that successfully implement AI into their operations. Which is more probable? Your accountant writes her own software from scratch, then debugs and supports that software on an ongoing basis? Or, that Intuit builds an AI agent that makes her more efficient? The answer should be obvious. AI is a tool, not a replacement for every employee and every business model that exists today.

Neither of these episodes reflected deterioration in the businesses we still own today. They were just temporary shifts in sentiment. Over the past twelve months, the average company in our portfolio has grown earnings in the low-to-mid teens. That is the terrific and consistent fundamental growth that, over the past decade, has historically translated into appropriate price appreciation. Yet over the past year, those same companies have on average seen their stock prices decline. That is an anomaly, not a new normal.

Jack Bogle studied market returns from 1900 to 2009 and found that nearly half of the market's long-term return was attributable to earnings growth and roughly 47% was attributable to dividend growth. Less than three percent came from changes in sentiment or multiples. Sentiment is loud and seductive and the short run is driven by sentiment. Fundamentals are quiet. They are boring and work in the background. The long run is driven by fundamentals. Eventually, the short run becomes the long run. It always does.

How far has sentiment shifted the market? Consider recent valuations. The S&P 500 entered this year trading at roughly 22x forward earnings — 33% higher than its 25-year average. By longer-term measures like the cyclically adjusted price-to-earnings ratio, which dates back to the 1800s, the market is more expensive today than at any point other than the late 1990s.

What is particularly unusual about this environment is that there is very little place to find value today within traditional frameworks. The so-called “value” trade can hardly even be considered value in some instances. Three of the six largest holdings in the S&P 500 Value Index today are Apple, Amazon, and Tesla. Apple trades at a significant premium to its twenty-year average P/E ratio. Amazon does not pay a dividend — traditionally a hallmark of a value stock. And, Tesla trades at a P/E ratio of nearly 175x. If someone showed you those top holdings and asked whether it was value or growth, most investors would almost certainly guess growth. Meanwhile, the S&P 500, which is supposed to be a “core” is nearly identical to that of a growth index as well. The largest companies in the S&P

500 today are Nvidia, Apple, Microsoft, Amazon, Alphabet, Broadcom, Meta and Tesla. The largest companies in the S&P 500 Growth Index today are Nvidia, Microsoft, Apple, Alphabet, Broadcom, Meta, and Amazon. Those lists might as well be the same. The traditional value, core, and growth style boxes have collapsed. When everything looks the same, the margin for error across the entire market becomes paper thin.

For those who invested through the late '90s, this should feel familiar. In that era, disruptors were all the talk, just as they are today. Drugstore.com launched in 1998, went public in 1999, and soared from the mid-teens to the high sixties. Walgreens, the established incumbent, fell more than 40 percent as the market decided that the traditional drugstore model was finished. The narrative was compelling. The stock price confirmed it. And then reality intervened. Go to drugstore.com today and see what you find. Walgreens, for all its challenges, is still standing. The disruptor is gone.

The lesson is not that disruption does not happen. It does, and I believe we are entering a new economic era. However, the market routinely overestimates the speed of disruption and underestimates the ability of well-run businesses to adapt. Ask Intuit — a recent pain point in some of our strategies.

In September of 1999, Lou Bega was dominating the radio playing Mambo No. 5 and the Journal of Accountancy published an article about how the internet represented an existential threat to tax software providers like Intuit. The internet was going to kill off legacy providers because you would just be able to file your taxes for free online. Sounds a lot like the narrative today around AI. Intuit's stock got hammered. What did Intuit do? They released QuickBooks Online in 2001, continued to dominate the tax software

space, and watched their stock price appreciate nearly 20x over the next two and a half decades. Good businesses adapt. Bad businesses go the way of the dodo.

Stocks can suffer from disruption in the short run, but good businesses adapt and thrive in the long run. We believe we own good businesses today. Most of these companies have navigated COVID, or the Financial Crisis, and some even navigated the last technology-led bubble. They will figure out Artificial Intelligence.

So, what are we changing? Nothing. The market went through a period where it rewarded the exact opposite of what we do. It rewarded speculation over fundamentals and momentum over consistency. That does not mean our approach has failed or is outdated. It means we are in an environment where discipline is being tested. We have been here before and we have always emerged on the other side.

The majority of the divergence in relative performance over the past year is attributable to roughly thirteen weeks of mania, not thirteen months of fundamental deterioration. If we look at the bigger picture, the signs are hard to ignore. Valuations remain extreme. Concentration persists. The style boxes have collapsed into one another. A former karaoke machine company erased tens of billions of dollars in market cap. These are the stories we will look back on in a decade and point to as the "obvious" signs of excess.

We have said it before, and we will say it again. We are not the market. We are not invested like the market. Sometimes that difference works in our favor and sometimes it does not. Over a full cycle, we believe our discipline will be rewarded, as it has been for decades. In the meantime, we will continue to do what we have always done. We will strive to own good businesses, be good stewards of your capital, manage risk, and invest with the conviction that fundamentals ultimately matter.

## Commentary

### *Good Decisions, Bad Outcomes*

Often, we judge the correctness of a decision from its outcome. If I took every last penny to my name, went to Vegas, put it all on red, and won, then I would have made a very bad decision which resulted in a very good outcome. We believe that investing in high quality growing businesses is smart investing. That does not mean it always works out quite the way that we want it to. This has been a difficult market for Tandem. The good news, which we will get to in a bit, is that we have been here before.

Across our three strategies, we own 47 different stocks collectively. Over the past decade, those stocks, on average, have grown their earnings at an annualized rate of growth close to 14%. That highlights the cornerstone of our investment philosophy — companies that can consistently grow and compound their businesses should appreciate commensurately over time. Sure enough, over the past decade those same stocks have increased in price at an annual rate of approximately 13%. In the long run, fundamentals and stock prices tend to move together.

In the short run, fundamentals don't always matter. Over the past 12 months, those 47 stocks have collectively grown their earnings by nearly 13%. Those same stocks have seen an average price decline of nearly 8% over the year. Making a good decision does not always lead to a good outcome.

13% growth. 8% decline. That is a stark disconnect in a market that is clearly not trading on fundamentals. We don't believe that's sustainable. If the companies we own continue to grow, we are confident that the short run will ultimately give way to the long run, and we will once again see commensurate price appreciation.

There is, however, reason for optimism. First, most of our underperformance at the strategy level over the past 6-12 months has occurred in two short episodes — both of which we discussed a bit more in depth in "Market Commentary." There was an 8-9 week period in the fall and a 2-3 week period this winter which hit our investment philosophy hard. Short windows like those are more

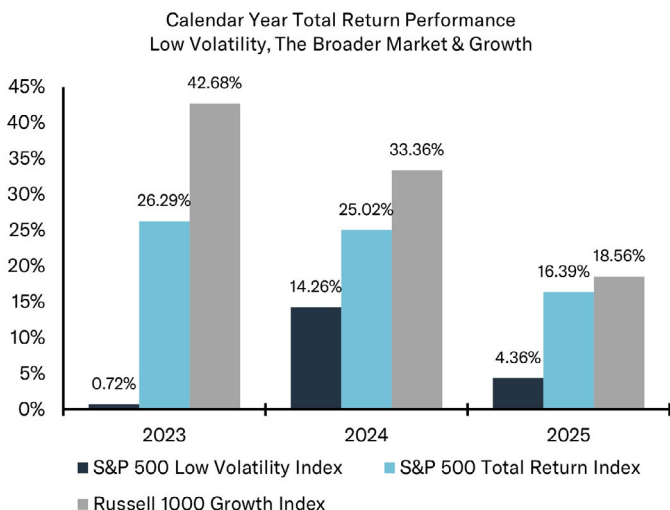
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often driven by sentiment, not fundamentals. In the fall, we saw a FOMO-driven risk-on rally in which the riskiest pockets of the market surged, and the defensive and consistent pockets, which we seek, actually fell. In February, we saw rampant fear grip various pockets of the market stemming from AI-related disruptions. Outside of that, our strategies have performed largely as we would expect.

Second, when you manage money for 35 years, you tend to see a lot of different investment environments. And we have been in a similar environment before.

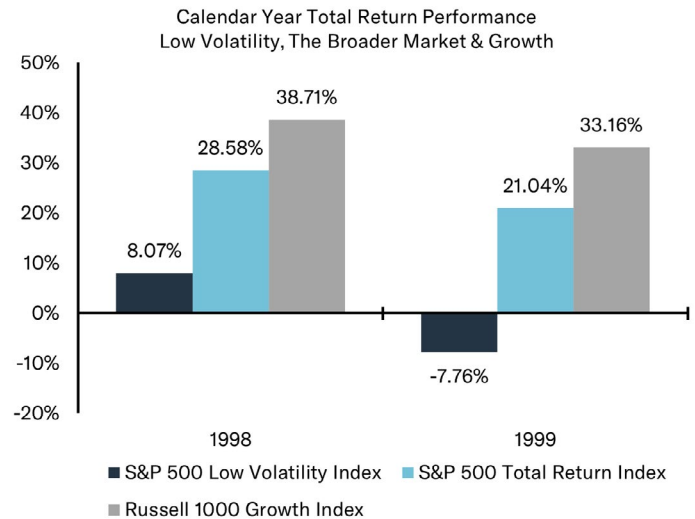
For the first 30 years of our history, the S&P 500 was a true benchmark for us. In our opinion, the S&P 500 is no longer diversified. It has essentially become a concentrated technology fund. That is very different from what it once was. A decade ago, some of the largest companies in the S&P 500 were things like Apple, Microsoft, Exxon, Johnson & Johnson, GE, Berkshire Hathaway, and AT&T. That's a diverse group of businesses — two tech companies, a health care company, an industrial conglomerate, a financial conglomerate, and a well-known telecommunications company. The correlations between those stocks were actually fairly low. That means a decade ago, the S&P 500 provided true diversification benefits. Today, the largest companies are things like Nvidia, Apple, Microsoft, Amazon, Alphabet, Broadcom, Meta, and Tesla. Technically, those companies span various sectors; but in reality, they are largely all tech companies and are all generally quite correlated. The higher correlation and higher concentration of today's S&P 500 means it is not the diversified index it once was. There is arguably much more risk in the index and passive investing today than there was a decade ago.

As a result of these changes, we look less like the S&P 500 than we have in perhaps 3+ decades. For the past few years, the S&P 500 Low Volatility Index has been much more indicative of the market and space we tend to occupy. Performance within the Low Volatility Index has paled relative to the S&P 500 and the Russell 1000 Growth Index (see below).



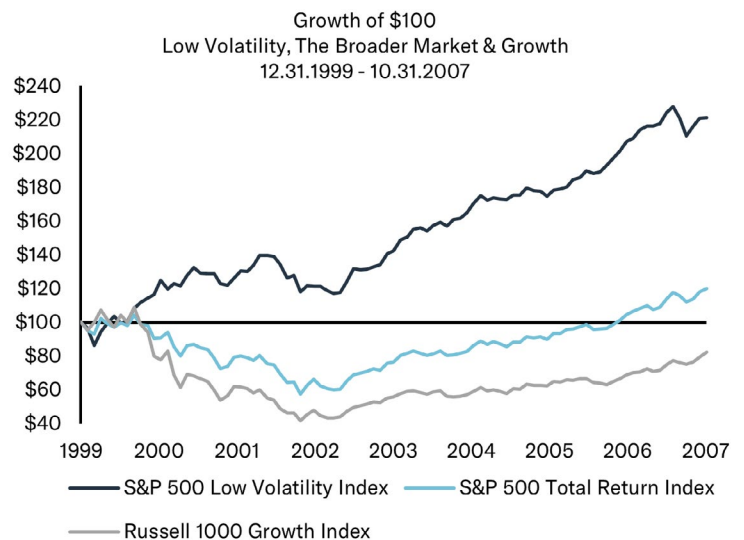
Source: FactSet

However, as mentioned earlier, we have been here before. Look at what the late '90s looked like:



Source: FactSet

It was an uncomfortable couple of years for the Low Volatility space then, much like today. However, the pendulum always seems to swing back and swing it did. Look at the returns of those various indices from the eve of the Tech Bubble at the end of '99 to the eve of the Financial Crisis in 2007. The Low Volatility space was not only vindicated but handsomely rewarded for looking nothing like the index.



Source: FactSet

So, why do we think these time periods are comparable? First, the market of the late '90s was largely centered around the advent of the internet. It was the dawn of a new era and the death of the old economy. Today, Artificial Intelligence is marking the dawn of a new era and the death of the old economy. The internet changed the

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## Commentary: *Continued*

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world. However, hype and mania greatly front-ran its usefulness. As a result, the late '90s witnessed concentrated markets and expensive valuations. Going back to 1880, there is only one other time period that has been more expensive than today's market and that is the market of the late '90s. Think about this for a minute. In nearly 150 years of market history spanning the First World War, the Gilded Age, the Great Depression, the Second World War, the post-war boom, Vietnam and the stagflation era of the '70s, Reaganomics and the great bull markets of the '80s and '90s, there has been just one period more expensive than today. Just one.

Despite the pullback in the market in the first quarter, it remains uncommonly expensive. However, the steeper pullback within our own space is beginning to create some opportunities for us to take advantage of. We were able to add a few new names to our various strategies this quarter. We purchased Procter & Gamble and McDonald's in both Large Cap Core and Equity. On the first day of April, we initiated a new position in Rollins, which owns pest control brands like Orkin, across all three strategies. In Large Cap Core and Mid Cap Core, we purchased WEC Energy, which provides power and gas services for much of Wisconsin. We have also pruned several companies from the portfolio that no longer meet our criteria. AI has begun to erode the competitive advantages of a few long-term holdings. We trimmed some of these positions back and exited others entirely. Opportunities still seem far from apparent in the broader market, but we believe our pocket is beginning to show reasons for optimism.

We recognize that patience is easier to preach at times than it is to practice. Watching "the market" climb while your portfolio lags is uncomfortable, regardless of the reason. We know that. I promise you, we feel it too. We are invested right alongside you.

Yet, a crucial component to successful investing is checking your emotions at the door. In this instance, the data is clear. Our companies are growing. The market is simply not paying attention to that growth right now. It has been distracted before by every other new era that was supposed to change everything. "In the short run, the market is a voting machine, but in the long run it is a weighing machine." Eventually the market stops voting, and it begins weighing. It always has.

We have been managing money through exactly these kinds of environments for 35 years. We did not chase the dot-com bubble. We did not chase the AI bubble. At times our discipline feels uncomfortable, perhaps even out of touch. History suggests that it is not. It is simply prudent.

We remain committed to the companies we own, to the philosophy that has guided us since 1990, and to the clients who have trusted us with their capital. We believe the best days for our portfolios are ahead of us.