

The **TANDEM** Report



Volume 6, Issue 1, January, 2005

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MARKET SCORECARD:

S&P 500:

Annualized returns:

1 year ended 12/31/04	8.99%
3 years ended 12/31/04	1.82%
5 years ended 12/31/04	-3.78%
7 years ended 12/31/04	3.23%
10 years ended 12/31/04	10.21%

MARKET COMMENTARY:

For the year, the S&P 500 advanced 8.99%. Nearly all of this gain came in the fourth quarter. While 8.99% is a decent return, one can't help but observe complacency among investors. More than eighty percent of all S&P 500 companies reported earnings in line with or greater than Wall Street's expectations, and the market has yawned.

Because earnings growth for 2004 was strong and price gains were modest, stocks have become relatively less expensive. Yet in spite of positive economic news, 2005 is off to a lackluster start. Go figure.

Without question, this environment is challenging. Good and bad news moves individual stocks, but the mar-

ket remains rudderless. We view the present circumstances with caution. While we continue to like individual stocks, the market as a whole seems a risky place.

Volatility is a key component of our analysis process. The volatility of a stock is measured by its beta, which is a calculation of a stock's price movement predictability in relation to the S&P 500. The S&P has a beta of 1. A stock that enjoys a high degree of correlation to a market move has a beta greater than 1, and a stock that moves in a manner less predicted by a market move has a beta of less than 1. Technology stocks, the darlings of the nineties, are typically high beta stocks.

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WHAT DRIVES STOCKS?

Wouldn't we love to know the answer to that question? There are many theories: the war, the economy, interest rates, tax laws, oil, the dollar, the president. But these events influence the entire market. What causes a stock to behave differently from the broader market?

Without a doubt, news drives prices up

or down. Certain environments can be favorable for one group of stocks, neutral to another, and detrimental to still another. Macro events such as headline-grabbing news are difficult to anticipate, and their effects tend to be short-term rather than trend influencing.

Many studies have been done by *(Continued on page 2)*

TOP TEN HOLDINGS IN THE TANDEM EQUITY COMPOSITE

AS OF DECEMBER 31, 2004

As always, the list that follows represents our ten largest holdings ranked by total market value in the accounts that make up our Tandem Equity Composite. These are not recommendations for purchase. Rather, the list is simply intended to provide some insight into how we manage accounts.

Rank by Market Value Original Purchase

1. Home Depot	06/03/99
2. Microsoft Corp.	12/06/96
3. General Electric	07/08/94
4. Amgen	10/31/96
5. Johnson & Johnson	06/03/97
6. T. Rowe Price	03/07/97
7. General Dynamics	11/13/01
8. Allied Capital	12/21/01
9. Engineered Support Systems	01/08/04
10. Exxon Mobil	11/08/94

Rank by Performance of the Top Ten Holdings in the Equity Composite for the Period 12/31/2003 - 12/31/2004

Company	Appreciation	Dividend	Total Return
T. Rowe Price	31.20%	\$0.78	32.84%
Exxon Mobil	25.02%	\$1.06	27.61%
Johnson & Johnson	22.76%	\$1.10	24.89%
Home Depot	20.43%	\$0.34	21.39%
General Electric	17.82%	\$0.82	20.46%
General Dynamics	15.72%	\$1.40	17.27%
Microsoft	-2.37%	\$3.16	9.17%
Engineered Support	7.56%	\$0.06	7.66%
Amgen	3.82%	\$0.00	3.82%
Allied Capital	-7.32%	\$2.28	0.86%

WHAT DRIVES STOCKS ?(CONTINUED)

minds far more analytical than our own, and the conclusions are well-documented. The response of stocks to market-influencing events is measured by volatility, or beta. The market is said to have a beta of 1. A stock with a beta greater than 1 is considered more volatile than the market, and less than 1 is considered less volatile. Simply put, volatility measures the degree to which a stock reacts beyond what is expected by the market's response. For a broader discussion of beta, please refer to the Market Commentary column in this issue.

Volatility explains short-term movements around the market. But what accounts for trends in price over time? In an effort to better understand what factors have a high degree of correlation with price

trends, we analyzed the two-year performance of those stocks currently in our composite. This is certainly not a broad sample of U.S. equities, but we felt it sufficient for our purposes. We focused our analysis on three variables: beta (to account for market trends and broad events), earnings growth and dividend growth (both of which are stock specific). The results were enlightening, but not surprising.

The sample of stocks and their relevant statistics can be found on the page to the right. The stocks are ranked by total return, and there appears to be little correlation between return and the other statistics, at least to the naked eye. In an effort to de-

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**STATISTICAL ANALYSIS OF STOCKS CURRENTLY IN OUR COMPOSITE
FOR THE PERIOD 12/31/2002 THROUGH 12/31/2004**

Stock	Beta	Dividend Growth	Earnings Per Share Growth	Total Return
T. Rowe Price	1.51	20.00%	96.05%	133.43%
Tyco International	2.04	180.00%	10.06%	110.36%
Kensley Nash	0.73	NA	158.82%	89.00%
Home Depot	1.31	61.90%	64.10%	80.43%
Fortune Brands	0.59	17.65%	49.22%	70.97%
Engineered Support Systems	0.16	200.00%	183.33%	61.76%
American Express	1.12	31.25%	54.73%	61.56%
General Electric	1.01	13.89%	19.87%	56.43%
Exxon Mobil	0.39	15.22%	115.53%	52.55%
Biomet	0.05	66.67%	78.41%	52.27%
BP	0.59	5.73%	114.35%	51.51%
Dover	1.28	14.81%	122.12%	47.91%
Cisco Systems	2.13	NA	128.21%	47.48%
Piedmont Natural Gas	0.13	7.50%	34.74%	40.95%
Wells Fargo	0.34	69.09%	37.65%	39.77%
Allied Capital	0.65	2.24%	5.38%	39.26%
SCANA	0.26	12.31%	18.49%	36.43%
Techne	0.39	36.16%	63.74%	36.16%
Outback Steakhouse	0.77	341.67%	22.71%	35.89%
General Dynamics	0.56	16.67%	33.73%	35.14%
Amgen	0.51	NA	103.60%	32.71%
Applied Materials	2.17	NA	230.00%	31.24%
IBM	1.58	18.64%	42.28%	28.92%
Johnson & Johnson	0.18	37.50%	51.47%	37.50%
BB&T	0.37	24.55%	12.68%	20.76%
Microsoft	1.52	NA	41.30%	15.90%
Colgate-Palmolive	0.25	33.33%	16.89%	1.13%
Pfizer	0.40	34.62%	50.00%	-7.79%
Average	0.82	55.69%	69.53%	47.10%
S&P 500	1.00	20.69%	55.91%	41.98%



MARKET COMMENTARY (CONTINUED)

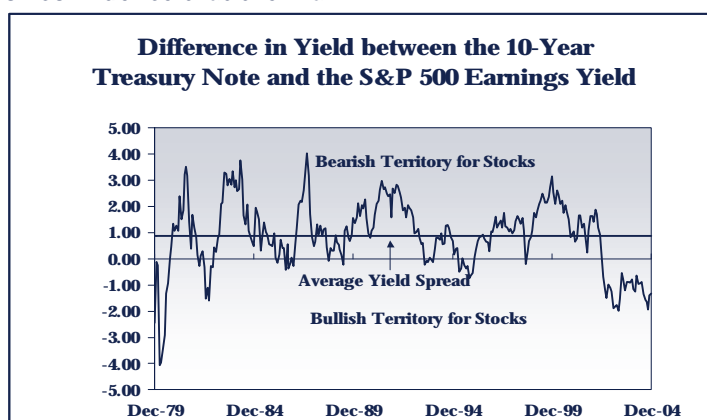
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When the market moves (up or down), these high beta stocks *really* move. On the other hand, defense contractors have less correlation to the market because they tend to move for their own set of reasons. As a result, they are low beta stocks.

In a market such as this, we would rather own stocks that move for their own set of reasons, because we don't have a high degree of confidence that the market will move the way we wish it to. A portfolio of high beta stocks will exaggerate the market's move. For example, if your portfolio has an average beta of 1.5, it is reasonable to say that, all things being equal, your portfolio should reflect 150% of the mar-

ket's move.

Most of our portfolios have a beta of about .87. This suggests that 87% of our return is explained by the market. We take comfort in this. As we discuss in another article in this report, low beta does not mean poor performance. There are other factors that drive the price of a stock. We believe a lower beta with strong earnings growth is a solid combination.



While we are perplexed by a lack of response to positive economic trends, we recognize that equities are still cheap relative to other asset classes. We are content to own low volatility while we watch earnings grow.

TOP TEN OUT-PERFORMERS FROM THE COMPOSITE

Stock	Beta	Dividend Growth	Earnings Per Share Growth	Total Return
T. Rowe Price	1.51	20.00%	96.05%	133.43%
Tyco International	2.04	180.00%	10.06%	110.36%
Kensey Nash	0.73	NA	158.82%	89.00%
Home Depot	1.31	61.90%	64.10%	80.43%
Fortune Brands	0.59	17.65%	49.22%	70.97%
Engineered Support Systems	0.16	200.00%	183.33%	61.76%
American Express	1.12	31.25%	54.73%	61.56%
General Electric	1.01	13.89%	19.87%	56.43%
Exxon Mobil	0.39	15.22%	115.53%	52.55%
Biomet	0.05	66.67%	78.41%	52.27%
Average	0.89	67.40%	83.01%	76.88%
S&P 500	1.00	20.69%	55.91%	41.98%



WHAT DRIVES STOCKS? (CONTINUED)

(Continued from page 2)

termine some correlation between statistics and stock performance relative to the market, we decided to look at the best and worst performers. When we narrow the list, some trends emerge. To analyze them, we refer to the tables at the bottom of this and the preceding pages.

First, the average beta of both groups is less than the market. The top performers enjoy a slightly higher beta, but one still only 87% of the market's. The higher beta represents a greater correlation to the market's movement, and the last two years have been positive. Thus, we would expect greater performance to have a higher beta. This does not explain market out-performance, given that the average beta is still below the market's. Dividend growth exceeds the market's in both groups, although the lesser performers have a higher rate of growth. Dividend growth more likely accounts for reduced volatility than for out-performance. That leaves earnings per share growth. And guess what? Earnings growth for the majority of the best performing

stocks exceeds the earnings growth of the S&P 500, while earnings growth for most of the under-performing stocks trails the market's earnings growth.

Each of these factors no doubt contributes in some way to a stock's total return. There is no other logical explanation for a stock to out-perform the market with less-than-market earnings growth, or for another to under-perform with stellar earnings growth. Multiple factors are at work. But the clear trend of each group is that earnings growth drives stock price.

We have said it numerous times in these pages, and this study, while less than scientific, yields the same conclusion - earnings matter. News and current events enjoy their fifteen minutes of fame, but in the final analysis, few actually base long-term investment decisions on the price of oil or who the president is. We buy stocks of companies because we believe the companies will grow. When they do, the patient are rewarded.

BOTTOM TEN UNDER-PERFORMERS FROM THE COMPOSITE

Stock	Beta	Dividend Growth	Earnings Per Share Growth	Total Return
Outback Steakhouse	0.77	341.67%	22.71%	35.89%
General Dynamics	0.56	16.67%	33.73%	35.14%
Amgen	0.51	NA	103.60%	32.71%
Applied Materials	2.17	NA	230.00%	31.24%
IBM	1.58	18.64%	42.28%	28.92%
Johnson & Johnson	0.18	37.50%	51.47%	37.50%
BB&T	0.37	24.55%	12.68%	20.76%
Microsoft	1.52	NA	41.30%	15.90%
Colgate-Palmolive	0.25	33.33%	16.89%	1.13%
Pfizer	0.40	34.62%	50.00%	-7.79%
Average	0.83	72.42%	60.57%	21.57%
S&P 500	1.00	20.69%	55.91%	41.98%





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Tandem Investment Advisors, Inc. was founded in 1990 to provide professional portfolio management with uncompromising service to investors. For more than a decade, we have worked in Tandem with our clients to attain their investment goals. If we can provide further assistance, please contact us.

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