

# The **TANDEM** Report



Volume 8, Issue 1, January, 2007

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## MARKET SCORECARD:

### S&P 500:

#### Annualized returns:

1 year ended 12/31/06	13.62%
3 years ended 12/31/06	8.45%
5 years ended 12/31/06	4.32%
7 years ended 12/31/06	-0.50%
10 years ended 12/31/06	6.71%

### Russell 3000 Growth:

#### Annualized returns:

1 year ended 12/31/06	9.46%
3 years ended 12/31/06	7.17%
5 years ended 12/31/06	3.02%
7 years ended 12/31/06	-4.52%
10 years ended 12/31/06	5.34%

## MARKET COMMENTARY: *IS TWO QUARTERS A TREND?*

**F**or the second consecutive quarter, the stock market posted solid gains, leading the S&P 500 to its best annual return since 2003. While the index still remains more than 5% below its year 2000 high, the Dow managed to set several new all-time highs in the fourth quarter.

As the year came to a close, the price of oil was falling toward about a fifteen month low. As a result, the energy sector was unable to retain its title of best-performing sector for a third consecutive year. Instead, it finished a distant second to telecommunications services (who knew there was still value in that sector?). Also noteworthy was the surprising strength of the dollar. This

caught most forecasters off-guard, and can explain some of the sell-off in international markets and the migration to U.S. equities. A coup in Thailand didn't hurt either.

Still confounding to us is the continued disdain by investors for growth stocks. Value has now outperformed for six consecutive years - a string that has to revert to the norm soon. But there were several pockets of growth that performed nicely, and fortunately we were there. Our energy stocks, led by FMC Technologies and Exxon Mobil, some of our financial stocks (T. Rowe Price, Allied Capital, etc.) and a few others like General Dynamics all

*(Continued on page 6)*

***Our Charleston office has moved, and we have a new phone number. See back page for new contact information.***

## COMMENTARY: *I JUST DON'T GET IT*

**I**t has been said that the one constant in life is change. Maybe so, but does that mean we have to like it? Or even understand it?

There are so many things about today that I just don't understand. Close to home, I don't understand my children. I don't understand their music. I don't understand the television shows they like. And I can't play video games worth

a darn. I accept that the younger generation has always perplexed its predecessors, but I now understand why my father shook his head so often.

What I *really* don't understand, though, are the risks seemingly sophisticated investors are willing to take in the name of diversification and risk reduction. Major institutions, with literally hundreds of millions (if

*(Continued on page 5)*

# TOP TEN HOLDINGS

AS OF DECEMBER 31, 2006

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 and Equity Income Composites. These are not recommendations for purchase. Rather, the list is simply intended to provide some insight into how we manage accounts.

Market value is determined by the number of shares of a

## EQUITY COMPOSITE

Rank by Market Value	% of Composite
1. BB&T	7.79%
2. Altria Group	5.38%
3. FMC Technologies	5.21%
4. BP, plc	4.91%
5. Exxon Mobil	4.70%
6. Home Depot	4.38%
7. FMC Corp	4.25%
8. T. Rowe Price	3.82%
9. Johnson & Johnson	3.64%
10. Amgen	3.24%
<b>Total</b>	<b>47.33%</b>

company we own in a composite multiplied by the share price. Percentage of composite is a holding's value divided by the value of the composite. A composite is a group of accounts with similar investment strategies over which we exercise complete discretion.

For more detailed information on Tandem's composites, please visit our website at [www.tandemadvisors.com](http://www.tandemadvisors.com).

## EQUITY INCOME COMPOSITE

Rank by Market Value	% of Composite
1. Exxon Mobil	5.30%
2. General Electric	5.12%
3. Home Depot	4.58%
4. Johnson & Johnson	4.11%
5. Allied Capital	3.94%
6. T. Rowe Price	3.74%
7. Microsoft	3.70%
8. Amgen	3.37%
9. Abbott Labs	3.11%
10. General Dynamics	3.11%
<b>Total</b>	<b>40.08%</b>

## COMPOSITE UPDATES

### EQUITY COMPOSITE

**Important Note:** During our annual internal compliance review, we discovered that 6 of the 23 accounts that now comprise this composite were either omitted or not entered on the appropriate date. We have rectified this situation, and the effect on composite performance by this correction is negligible. Nonetheless, if you have received information from Tandem regarding The Tandem Equity Composite since June 30, 2002, we would like to correct the information provided. Please notify Billy Little at (800) 303-8316.

During the quarter, we sold Motorola and Texas Instruments in light of the diminished prospects in the cell phone market. We added to positions in Amgen, Biomet and Home Depot because the Tandem Valuation Model rated them uncommon values. Interestingly enough, we have been validated already on Biomet and Home Depot. We paid \$33.68 for Biomet in October, and the firm has agreed to be bought for \$44. Home Depot recently forced out its CEO and is rumored to be a target itself. We also added Genentech, Hershey and Pfizer.

### EQUITY INCOME COMPOSITE

**Important Note:** During our annual internal compliance review, we discovered that 2 of the 9 accounts that now comprise this composite were either omitted or not entered on the appropriate date. We have rectified this situation, and the effect on composite performance by this correction is negligible. Nonetheless, if you have received information from Tandem regarding The Tandem Equity/Income Composite since September 30, 2002, we would like to correct the information provided. Please notify Billy Little at (800) 303-8316.

During the quarter, we added Hershey and sold some Dominion Resources.

The accounts that comprise a composite are not necessarily identical. Some contain positions that Tandem did not buy. The Equity Composite is designed to produce principal growth, while the Equity Income Composite is designed for principal and income growth. For more information, please visit [www.tandemadvisors.com](http://www.tandemadvisors.com).



# MARKET STATISTICS AS OF DECEMBER 31, 2006

STOCK MARKET INDEX DATA						
Stock Market Indices	Close	% Change YTD	% Change 1 Year	% Change 3 Years	% Change 5 Years	% Change 10 Years
S&P 500	1,418.30	13.62%	13.62%	27.55%	23.54%	91.47%
Russell 3000 Growth	2,433.995	9.46%	9.46%	23.09%	16.02%	68.29%
DJIA	12,463.15	16.29%	16.29%	19.22%	24.36%	93.28%
NASDAQ 100	1,756.90	6.79%	6.79%	19.69%	11.40%	113.90%

YIELD TABLE				
	Current	3 months ago	6 months ago	1 year ago
3-month T-Bill	4.97%	4.86%	4.99%	3.99%
5-year Treasury	4.64%	4.56%	5.15%	4.32%
10-year Treasury	4.65%	4.61%	5.19%	4.35%
Prime Rate	8.25%	8.25%	8.25%	7.25%
Fed Funds Rate	5.25%	5.25%	5.25%	4.25%

## PERFORMANCE BY SECTOR WITHIN THE S&P 500

THROUGH DECEMBER 31, 2006

(SOURCE: S&P 500 GICS SECTOR SCORECARD)

Sector	% of S&P 500	Return 3 Months	Return 2006 YTD	Return 2005	Return 5-Yr Annual
S&P 500	100%	6.2%	13.6%	3.0%	4.3%
S&P 500/Citigroup Growth	48.67%	5.3%	9.4%	-0.2%	0.6%
S&P 500/Citigroup Value	51.33%	7.1%	18.0%	6.2%	7.9%
Consumer Discretionary	10.62%	9.8%	17.2%	-7.4%	4.6%
Consumer Staples	9.25%	2.9%	11.8%	1.3%	4.2%
Energy	9.82%	10.7%	22.2%	29.1%	16.6%
Financials	22.27%	6.3%	16.2%	3.7%	6.9%
Health Care	12.03%	1.0%	5.8%	4.9%	0.2%
Industrials	10.84%	5.3%	11.0%	0.4%	4.0%
Information Technology	15.14%	5.9%	7.7%	0.4%	0.2%
Materials	2.96%	10.7%	15.7%	2.2%	10.3%
Telecommunication Services	3.51%	7.8%	32.1%	-9.0%	-1.6%
Utilities	3.55%	8.3%	16.9%	12.8%	5.0%



# STOCK SCORECARD FOR 2006

## TOTAL RETURN OF EQUITY AND EQUITY/INCOME COMPOSITE STOCKS FOR THE FULL YEAR

TANDEM EQUITY COMPOSITE	TOTAL RETURN
ALLIANCEBERNSTEIN	48.63%
FMC CORP	45.33%
FMC TECHNOLOGIES	43.59%
EXXON MOBIL	38.70%
CHEVRONTEXACO	33.06%
GENERAL DYNAMICS	31.94%
CONOCOPHILLIPS	26.14%
AVERY DENNISON	25.75%
T ROWE PRICE	23.17%
COLGATE PALMOLIVE	21.22%
EXPEDITORS INTERNATIONAL	20.63%
BANK OF AMERICA	20.28%
ALLIED CAPITAL	19.51%
ALTRIA	19.30%
AMERICAN EXPRESS	18.95%
WELLS FARGO	16.63%
MICROSOFT	15.60%
PFIZER	15.18%
PIEDMONT NAT GAS	14.69%
FREEMONT-MCMORAN COPPER & GOLD	14.39%
BIOMET	13.67%
JOHNSON & JOHNSON	12.27%
FORTUNE BRANDS	11.37%
TXU CORP	11.34%
CONSTELLATION BRANDS	10.64%
MEADWESTVACO	10.52%
RUSSELL 3000 GROWTH	9.46%
GENERAL ELECTRIC	9.10%
BB&T	8.64%
BP, PLC SPONSORED ADR	8.07%
APPLIED MATERIALS	3.85%
HALLIBURTON	1.19%
HOME DEPOT	0.88%
CAPITAL ONE	-10.97%
AMGEN	-13.38%

TANDEM EQUITY/INCOME COMPOSITE	TOTAL RETURN
BOSTON PROPERTIES	61.88%
CISCO SYSTEMS	59.64%
AT&T	51.41%
EXXON MOBIL	38.70%
VERIZON	33.92%
GENERAL DYNAMICS	31.94%
ENTERPRISE PRODUCTS	28.18%
ABBOTT LABS	26.48%
T. ROWE PRICE	23.17%
COLGATE PALMOLIVE	21.22%
ALLIED CAPITAL	19.51%
NATIONAL RETAIL PPTYS	19.15%
AMERICAN EXPRESS	18.95%
WELLS FARGO	16.63%
MICROSOFT	15.60%
PFIZER	15.18%
PIEDMONT NAT GAS	14.69%
BIOMET	13.67%
PROCTER & GAMBLE	13.13%
JOHNSON & JOHNSON	12.27%
FORTUNE BRANDS	11.37%
RUSSELL 3000 GROWTH	9.46%
GENERAL ELECTRIC	9.10%
BB&T CORP	8.64%
BP, PLC SPONSORED ADR	8.07%
RAYONIER	7.73%
COMERICA	7.54%
SCANA	7.41%
APPLIED MATERIALS	3.85%
HOME DEPOT	0.88%
AMGEN	-13.38%

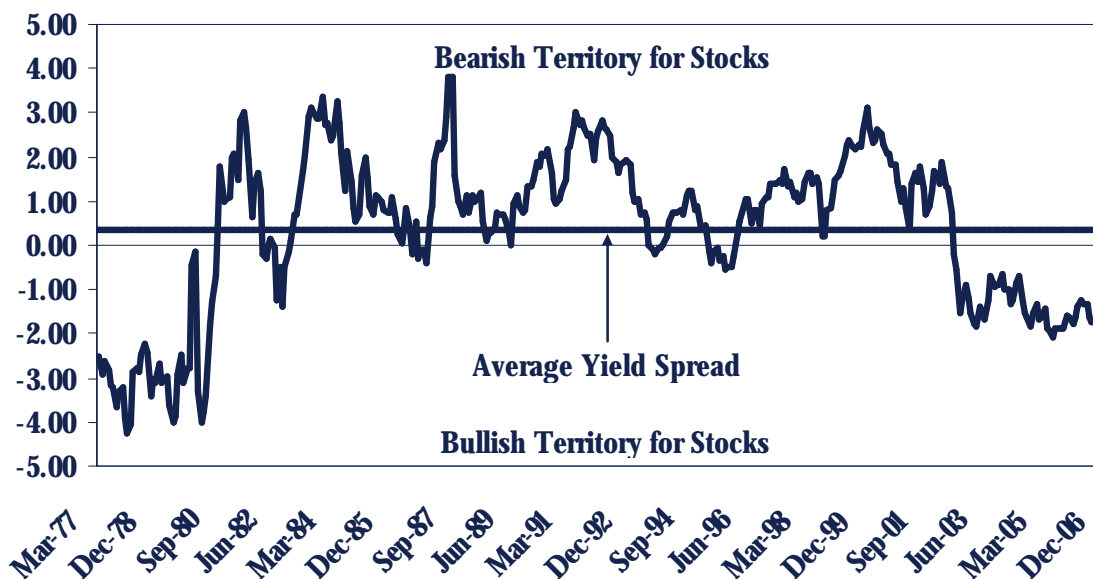
stocks without significant dividends. This was not the case in 2006, as the best performers were a mixed bag. Some paid substantial dividends, like AllianceBernstein, while others enjoyed dramatic price appreciation, like FMC Technologies. Also of note, there is no clear industry emerging as the leading or poorest performer.

The stocks listed in the two tables above represent only those securities that were held for the entire year. Not every account held every security, and these returns should not be construed as any form of recommendation. Nor are these returns meant to imply portfolio or composite returns. It is simply intended to show what worked, and what didn't.

**T**otal return has two components: price appreciation and dividends paid. In recent years, dividend paying stocks have fared slightly better than



## Difference in Yield between the 10-Year Treasury Note and the S&P 500 Earnings Yield



### COMMENTARY (CONTINUED)

(Continued from page 1)

not billions) of dollars to invest, are “diversifying” their endowments and retirement plans in manners I just don’t understand. Don’t get me wrong. I understand diversification, and I understand managing risk. What I just don’t get is how they believe they should accomplish this.

I make presentations to prospective clients regularly, and some of those prospective clients are large institutions. Ten years ago, diversification was achieved with a well-constructed stock portfolio, some bonds, and maybe some real estate (although at the time, real estate was viewed to be a bit too illiquid). Most institutional portfolios held about 60% of their assets in U.S. equities, and alternative investments (hedge funds, private equity and the like) made up typically less than 5% of a portfolio.

Today, allocations to U.S. equities are down to about 25%, while alternative investments are nearing 50% of a typical portfolio and heading higher. No wonder the stock market has had a tough time this decade. It seems everyone is leaving it. But even more startling is the way these bright investors are crowding into alternatives.

The first time I witnessed this herd mentality profession-

ally was in the 1980’s when options trading was in vogue. Institutional investors believed they could use options to make larger bets while reducing their exposure. They actually called it “portfolio insurance”. As more and more traders entered this new arena, stock market volatility spiked, and the options traders were trapped. The result of this new game of sophisticated speculation thought to better manage risk was Black Monday, October 19, 1987.

The next craze I had the pleasure of living through came in the 1990’s with the technology boom. Everyone was making a killing in something called venture capital - seed money for start-up companies. As these start-ups grew, their shares were sold to the public in wildly successful IPO’s, and investors poured money into the stock market to participate in the wealth-fest. What drove the market to its precipice was *new* money coming into the stock market. This created a spike in demand, and as we all know, prices rise as demand grows if supply can’t keep pace. It is inflationary, and we had serious inflation in stock prices.

We remember how that game ended. Stocks were driven higher by the influx of new money, but when all the money finally got there, there was no one left to buy. So stocks retreated to their natural level.

(Continued on page 6)



## MARKET COMMENTARY (CONTINUED)

(Continued from page 1)

posted robust returns (*Editors Note: We sold our entire position in Allied Capital on January 11, 2007*). The real disappointments for the year were our newer purchases: Capital One, Legg Mason and MultiFineline. Capital One and Legg Mason show promise and warrant patience on our part. MultiFineline gave us an opportunity to profit, but we missed it. We sold the stock after year-end.

Although the market appears healthy and off to a good start in '07, there are many concerns that must be reckoned with. We continue to be faced with an inverted yield curve, an alarmingly accurate predictor of recessions. There is no sign of this situation reversing itself soon, either. The Federal Reserve has made clear it re-

mains vigilant on inflation, and that continued raising of rates remains an option. This would further invert the yield curve unless we saw a substantial sell-off in bonds of longer maturities. Neither a recession nor a sell-off in bonds would be particularly good news for stocks, but one could argue that either wouldn't be all bad for growth stocks.

Another concern the market must come to grips with is the tax rate on capital gains and dividends. Will the lower rates be extended, will Congress allow them to expire, or will Congress raise them? Two of these three possibilities are not good for investors.

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## COMMENTARY (CONTINUED)

(Continued from page 5)

After the market bust, investors found hope in real estate, and the cycle was repeated. Today's wonder-asset is "alternative investments".

The new fair-haired son of alternative investments is private equity. Last year alone, investors poured over \$215 billion into private equity, most of it from institutions. As we have witnessed, prices soar to lofty levels as new money arrives on the scene. But how much more money can reasonably be expected? If institutions already allocate 50%, will they take it to 60%? 70%? At some point, demand cannot continue to grow. And when this spike in demand has run its course, to whom do they sell?

The returns being realized in alternative investments today are, in my view, no more sustainable than the returns of the tech stocks in the nineties or real estate just a few years ago. You cannot convince me that over a ten-year period any asset class outperforms a good stock portfolio. We have done studies demonstrating this in these very pages. And I can sell my stocks today and get my money. But can I sell my hedge fund or private equity investments? If I had any, the answer would be no.

Hedge funds and private equity funds believe they can buy an undervalued asset and sell it for a better price. It seems like a perfectly logical strategy. Perhaps Warren Buffet best summed up this notion of investing in his 2005 letter to Berkshire Hathaway shareholders when he wrote "*by buying and selling that is clever or lucky, investor A*

*may take more than his share of the pie at the expense of investor B. And, yes, all investors feel richer when (prices) soar. But an owner can exit only by having someone take his place. If one investor sells high, another must buy high. For owners as a whole, there is simply no magic – no shower of money from outer space – that will enable them to extract wealth from their companies beyond that created by the companies themselves".* To succeed, there must always be an investor B. So what happens when there is not? I do not believe that Mr. Buffet has made any investments in hedge funds or private equity funds to date.

Let me be clear that I do not take issue with alternative investments. What I do take issue with is investing in an asset class (any asset) that is exploding in unsustainable popularity without contemplating the added risk. Institutions have a fiduciary obligation to the ultimate beneficiaries of the money they control, and I do not believe they are adequately discharging their duties.

History has demonstrated that the most reliable way to accumulate wealth is through direct ownership of physical assets. In college, I studied great builders of entities. I never studied successful flippers of perplexing financial instruments. The firms that develop and manage these alternative investments will no doubt create great wealth - for themselves. Only a fortunate few will realize any lasting benefit from passive participation in these instruments. I just don't get it. I liked things better the old way. It might be easier to understand my children.

JBC



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## MARKET COMMENTARY (CONTINUED)

(Continued from page 6)

And finally, we continue to see assets allocated away from U.S. stocks (see *Commentary*). When this trend reverses itself, there will be a strong rebound in stocks. But as we well know, manias tend to overshoot the mark.

Attempting to look ahead, we are optimistic for many of our holdings. Home Depot shows up in our Tandem Valuation Model as an uncommon value, and it certainly has begun to attract some positive attention. The bottoming of housing (if we have seen it) will also be a boon to HD, as well as Fortune Brands. There are early signs of life in the Health Care sector as well. Both Amgen and Genentech recently reported strong earnings, and Johnson & Johnson continues to chug along like a champ. Our old friend Biomet got a tremendous boost when it agreed to be acquired for \$44/share. Many of the financial stocks look strong, and as of this writing, we still like big oil, although we are wary of the political

## TANDEM NEWS

As we close the books on our sixteenth year of operations, 2006 was indeed an exciting year for Tandem. We exceeded \$60 million in assets under management, closing the year with almost \$64 million under management. To put that in perspective, we managed only \$6.7 million ten years ago. The best part about this phenomenal growth is that we have managed to keep the number of clients we serve low, which means our growth has not come at the expense of the service our clients depend on. Today we serve fewer than 75 relationships.

Four years ago, we began compiling a list from the Yellow Pages of every firm in both Charlottesville and Charleston calling themselves investment advisors. Every investment advisor is required to file at least annually with the SEC, and assets under management is disclosed in that filing. By monitoring these firms' annual updates, we have been able to track the growth in assets of our peers. Using this information, we are the fastest growing investment advisory firm in Charleston and the second fastest in Charlottesville since 2002 among all firms listed at that time. In fact, we are number 1 in both cities if you exclude firms with assets under management greater than \$5 billion. This is not a scientific study to be sure, but we are using the information provided by these firms to the SEC. We are humbled, and grateful to our loyal

attacks that may be headed that way.

As our favorite indicator of market health (earnings yield of the S&P 500 vs. Treasury yield) illustrates graphically on page 5 of this issue, stocks remain an undervalued asset class. While this does not necessarily mean that stocks will rise, it certainly means they are likely to outperform *relative to other asset classes*. We view this as a strong vote of confidence for stocks.

And one last note. It seems that whenever all the pundits agree, they are almost invariably wrong. They seem to be in agreement on dollar weakness, so don't be surprised if the dollar finishes the year stronger than it began. This will support the market by repatriating dollars.

Overall, we are upbeat about the New Year. We see some exciting values in the market, but we will have to be patient.

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clients.

To accommodate our growth, we have had to relocate the Charleston office from Daniel Island to Downtown. The contact information is on the back page. The new space is beautiful and in a great location. When in Charleston, please stop by for a visit.

Also during the year, we invested considerable time, money and effort in making our investment process state-of-the-art. We haven't changed any of our modeling, but it is now fully automated. With the help of Thomson Financial, the world's leading financial information provider, we have designed, developed and implemented a completely automated analysis program we call the Tandem Valuation Model (TVM). Thomson representatives tell us they have never seen anything like it, and they say they had a blast watching TVM work. With this new technology, we will be able to make consistent and easily repeatable investment decisions by eliminating human interpretation of events. Technology is remarkable when used properly. To learn more about TVM, please call for a kit we have put together, or visit the Knowledge Center at [www.tandemadvisors.com](http://www.tandemadvisors.com).

TVM is already paying dividends, and we look forward to 2007. Thank you for allowing us to serve you.





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*All performance figures, charts and graphs contained in this report are derived from publicly available sources believed to be reliable. Tandem makes no representation as to the accuracy of these numbers, nor should they be construed as any representation of future performance.*



*Because Working in Tandem  
is a Better Solution*

*Portfolio Management Since 1991*

*Equity*

*Equity/Income*

*Balanced*

*Fixed Income*

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