

The TANDEM Report

Volume 4, Issue 3, July, 2003

MARKET COMMENTARY:

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MARKET SCORECARD:

S&P 500:	
Annualized returns:	
1 year ended 12/31/03	-1.55%
3 years ended 12/31/03	-12.50%
5 years ended 12/31/03	-2.98%
7 years ended 12/31/03	5.48%
10 years ended 12/31/03	8.02%

To paraphrase an old television commercial, how do you spell relief? R-A-L-L-Y! And what a rally indeed. On October 9, 2002, the S&P 500 closed at 776.76, its lowest close since January 20, 1997. At that level, the S&P had fallen 48.9% from its high of 1520.77 on September 1, 2000. As of June 30, 2003, the S&P was at 974.50. While that is still 35.9% from its high, it is also 197.74 points and 25.46% above its October low. Traditionally, a bull market is defined as an advance of more than 20%. If so, let us welcome the return of an old friend. Perhaps now we don't need the R-O-L-A-I-D-S.

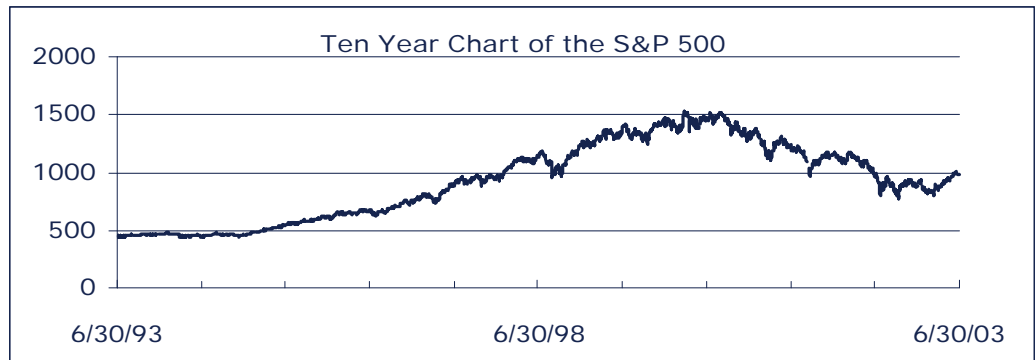
It remains to be seen whether this rally can sustain itself, but there is little doubt that the environment for stocks has vastly improved since October 9th. The war with Iraq has come and gone, and the world would seem to be a safer place today than it was nine months ago. As a result, the travel in-

dustry has improved. Many airlines actually enjoyed a profitable quarter, and hotel bookings are improving.

Corporate earnings are meeting or exceeding expectations for the first time in a while. Even more encouraging, earnings are growing as a result of increased revenue rather than decreased expenditures.

Always a good economic indicator, advertising spending in print, radio and television has improved. Not only is this positive for the earnings of media companies, it implies a greater willingness on the part of businesses to invest. Advertising typically precedes capital expenditure, and capital expenditure has been lacking since 2001. Perhaps in anticipation of increased business spending, tech and telecom stocks have been among the market's best performers over the last nine

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TOP TEN HOLDINGS IN THE TANDEM EQUITY COMPOSITE

AS OF JUNE 30, 2003

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 to how we manage accounts.

of our old faithfuls moved back onto the list.

For the quarter, seven of the ten stocks underperformed the S&P 500, which was up 14.89%. Only Johnson & Johnson posted a negative return. The performance of each stock follows.

Rank by Market Value Original Purchase

1. Merck & Co.	02/15/94
2. Amgen	10/31/96
3. Microsoft Corp.	12/06/96
4. General Electric	07/08/94
5. Pfizer, Inc.	12/18/96
6. Johnson & Johnson	06/03/97
7. Home Depot	06/03/99
8. General Dynamics	11/13/01
9. Applied Materials	03/07/96
10. Exxon Mobil	11/08/94

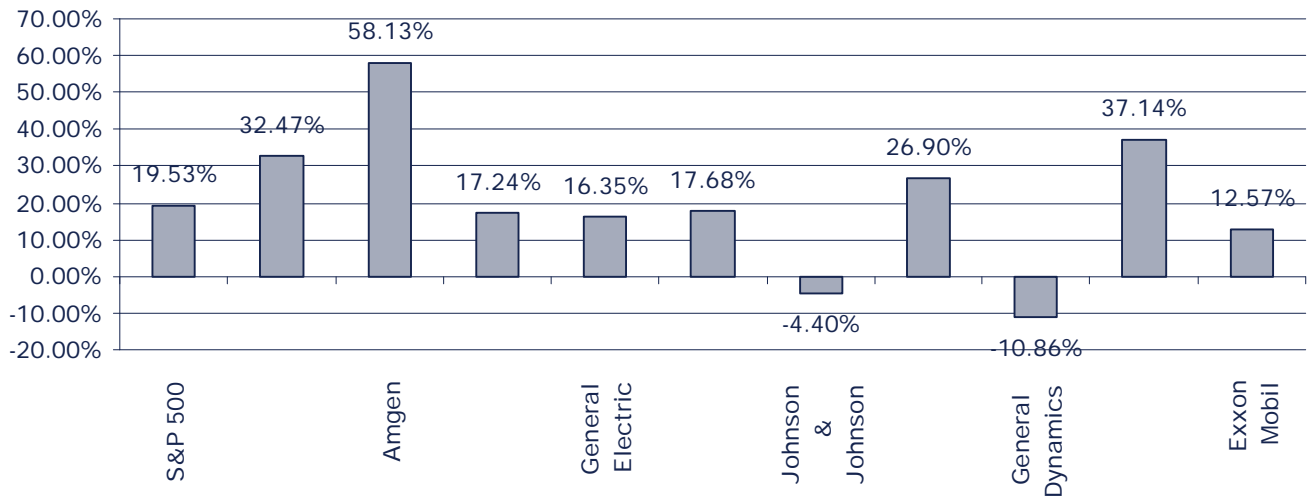
Rank by Performance for the 2nd Quarter

1. Home Depot	35.96%
2. General Dynamics	31.65%
3. Applied Materials	25.91%
S&P 500	14.89%
4. Amgen	14.58%
5. General Electric	12.47%
6. Merck & Co.	10.53%
7. Pfizer, Inc.	9.60%
8. Microsoft	5.91%
9. Exxon Mobil	2.75%
10. Johnson & Johnson	8.00%

The average holding period for a stock in the Top 10 increased from 4.75 years to 6.57 years as some

More detailed information about the Tandem Equity Composite, its performance, and the accounts that comprise it, is available upon request.

Price Appreciation for the S&P 500 and the Top 10 for the Nine Months ended June 30, 2003



TAX LAW CHANGES CREATE A NEW LANDSCAPE

In May, Congress passed a significant tax cut package. The changes have already had a positive effect on the markets, sending stock prices and some interest rates higher. While there is little doubt about the immediate impact of the new laws, there is some skepticism concerning their long-term benefits. It is our view that this is the most pro-growth tax cut since 1981.

The changes provide tax rate reduction on earned income, dividends and capital gains. The maximum rate on dividends drops from 39% to 15%, and the maximum rate on long-term gains declines from 20% to 15%. This should provide a meaningful and lasting boost to the stock market for a variety of reasons.

First, the reduction in the capital gains tax rate increases incentive to invest, creating a greater demand for equity securities. The gain on securities held longer than one year is taxed at a lower rate, thereby making capital appreciation a more tax-advantaged investment outcome than it had previously been.

Second, the reduced tax rate on dividend income makes the after-tax yield of securities paying dividends significantly higher than it had previously been, thus making dividend income more attractive to investors seeking income. This reduction in tax rates effectively makes the dividend yield for stocks higher.

These two outcomes certainly account for some of the rise in stock prices. As one time events, the near-term effect of the tax cuts is to cause the market to revalue stocks immediately, based on the changes as they are understood. But there is a deeper, more lasting consequence. A change in tax rates invariably leads to a change in corporate behavior.

Throughout the latter half of the twentieth century, as tax rates on individuals and corporations grew, the desirability of dividend income diminished. Sixty

years ago, it was common for dividend yields on stocks to be greater than interest rates on corporate bonds, because stocks were perceived to be riskier, and the tax code provided little incentive to invest in equities. Over time, the tax rate on capital gains declined, while the tax rate on dividend income remained high. As a result, corporations began retaining a greater percentage of their earnings to reinvest in their businesses, rather than payout a larger dividend. For certain businesses (high growth industries in particular), this strategy led to accelerated growth. The potential reward to shareholders was not a dividend, but rather price appreciation, which was taxed at a lower rate. Nearly across the board, dividends became less important than earnings growth.

Understandably, this rewarded the shareholders of the fastest growing companies. The unintended consequence was that the tax laws encouraged a greater level of risk-taking by investors and corporations alike. Earnings growth became the mantra, and cash flow was of little relevance. The decade of the nineties epitomizes in many ways the shortsightedness of such government policies.

As an aside, we should touch upon the “velocity of money”, a term which refers to the frequency with which money changes hands. In simple terms, the greater the number of people that handle and pass on a dollar bill in a fixed period of time, the better for the economy. Money changing hands is good for growth. Taxes, in general, impede money’s natural velocity. Some corporate actions do as well. Anything that causes money to be hoarded, as opposed to allowing money to flow freely to its best economic use, impedes economic growth. Keep in mind that these are economic, and not political, observations.

The tax policy that favored capital gains over dividend income fostered a corporate mentality that in essence led to the hoarding of earnings. And not all companies could reinvest those retained earnings as

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TAX LAW CHANGES CONTINUED

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effectively as investors might otherwise have been able to do.

The new law puts the tax rates for both dividend income and capital gains at fifteen percent, and this creates a meaningful long-term benefit to investors. For those companies that are able to invest their own capital at high rates of return, investors should want them to retain a high percentage of their earnings. On the other hand, companies that naturally grow more slowly are now free to share a larger percentage of their earnings with shareholders by increasing the amount they pay out in the form of dividends. There is no longer any artificial incentive to favor one policy over the other. The company has every reason to act in the shareholders' best interest – as it should be.

So, what are the drawbacks to these tax cuts, you ask? The media would have us believe that the tax cuts have already led to a budget deficit. Nothing could be further from the truth. The budget deficit is the result of a slowing economy and a sagging stock market reducing tax revenue. Who among us has paid taxes on capital gains recently? Historically,

growing economies have led to growing tax receipts and budget surpluses, while weak economies typically have seen declining tax receipts compounded by increased government spending, leading to deficits. Economic growth, not tax rates, provides the overwhelming influence on deficits and surpluses.

Further, the effective “loss of revenue” as a result of these cuts is insignificant. The reported \$350 billion “cost” is approximately 1% of projected government revenue for the next ten years. How can the loss of 1% of revenue lead to such dramatic deficits? Simply, it can't.

Thus, if deficits are not the achilles heel of the tax cuts, what is? The significance of these changes is not the one-time effect on stock prices, but rather the lasting effect on corporate and investor decision making. However, because the tax cuts are not permanent (for political as opposed to logical reasons, Congress made these changes expire in 2008), change in behavior cannot be permanent either. Imagine the benefit to investors and the economy if corporations were not only free, but incentivized, to permanently act in shareholders' best interests. Okay, that is a bit of a stretch.

MARKET COMMENTARY CONTINUED

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months.

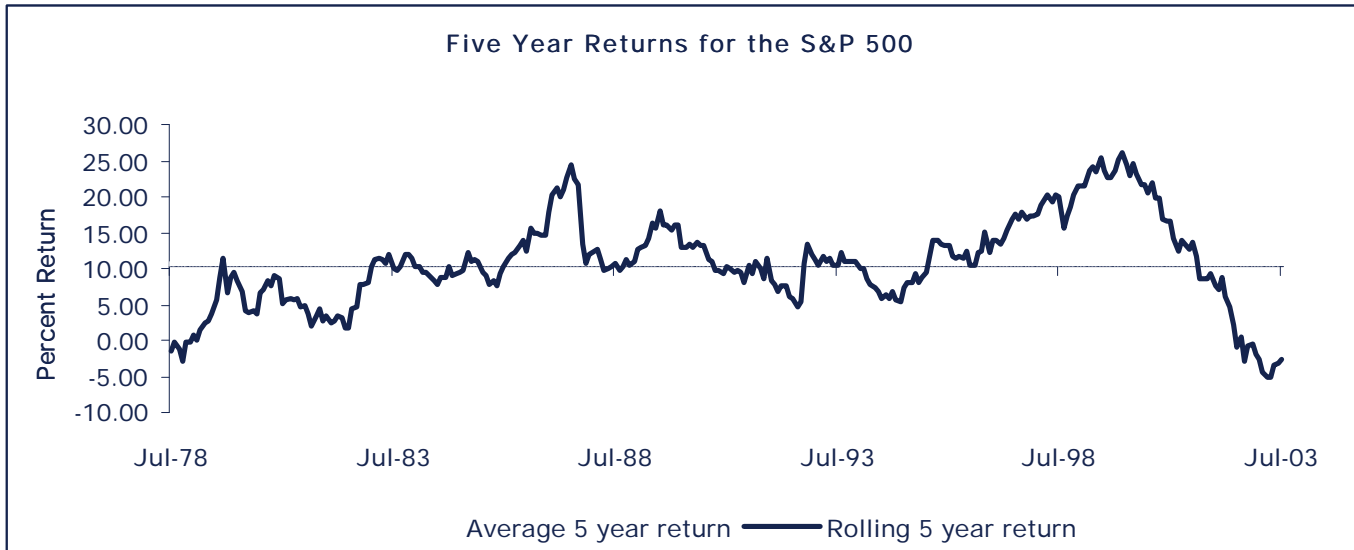
The tax package passed in May also provided quite a boost to stock prices. Companies with attractive dividends have seen their shares appreciate in value. Consumer stocks are benefiting in anticipation of increased spending as a result of the child tax credit. And most importantly, corporations are changing their attitudes regarding their dividend policies. Cash flow has become as important as growth.

After another interest rate cut by the Federal Re-

serve, rates remain at historic lows. Consequently, investors are taking money out of low-yielding fixed income investments in search of higher returns. With real estate prices at stratospheric levels, stocks have been the beneficiary of this inflow of investment dollars.

Indeed, the environment for stocks has vastly improved since the market bottomed nine months ago. How far the rally goes from here is anyone's guess. But what is clear is that the economy is on sound footing and corporate earnings are growing. We may not be out of the woods yet, but, at present, there are very few investments as appealing as stocks.

AFTER A NINE MONTH RALLY, HOW DO STOCKS LOOK NOW?

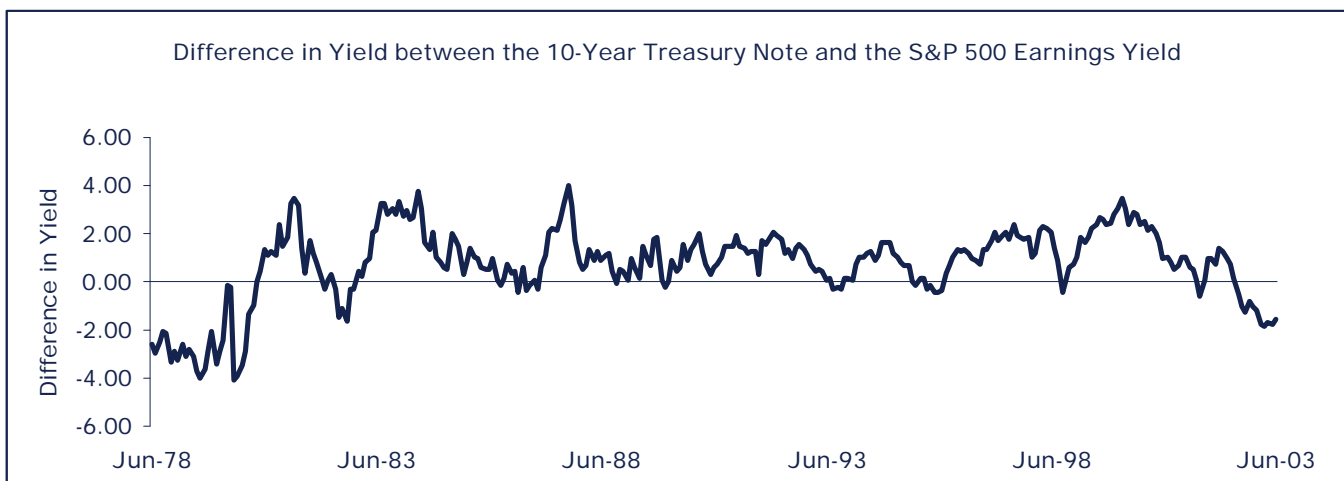


The chart above reflects the five year return for the S&P 500 over the last twenty-five years. At the beginning of July, the annualized five year return was -2.60%. The highest five year return over the last twenty-five years was recorded in December, 1999, at 26.18%. The lowest five year return, -5.04%, was in April of this year. Prior to that, the low was -2.97% in October, 1978. Clearly, we are a lot closer to the low than the high. It should be noted that the average five year return for the last twenty-five years is 10.78%.

We introduced the chart below in the January issue. This is a tool we use to help determine the

relative value of individual stocks, but it also works well for the market as a whole. Essentially, we compare the earnings yield of stocks to interest rates. The chart below reflects the difference in the two yields. When the difference is high, stocks have historically been overvalued. The difference today is near historic lows, when stocks have traditionally been undervalued.

Unfortunately, these charts do not predict the next move. They simply provide some insight as to where we have already been, and help us better anticipate future trends. As to where we go from here, what do the charts tell you?





www.tandemadvisors.com

In Charlottesville:

117 4th Street NE
Suite A
P.O. Box 2259
Charlottesville, VA 22902

Phone: (434) 979-4300 or
(800) 527-0101

(This section intentionally left blank)

In Charleston:

901 Daniel Island Park Drive
Suite 201
Daniel Island
Charleston, SC 29492

Phone: (843) 216-3791 or
(800) 303-8316

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.

John B. Carew

Phone: (434) 979-4300

e-mail: jcarew@tandemadvisors.com

Andres Gonzalez

Phone: (434) 979-4300

e-mail: agonzalez@tandemadvisors.com

Allen Ouzts

Phone: (843) 216-3791

e-mail: caotandem@email.msn.com