The TANDEM Report

TANDEM Investment Advisors

Volume 6, Issue 3, July, 2005

Market Analysis:
Stock Declines and a Flattening Yield Curve

The first half of 2005 brought little for investors to cheer. The major market indices were negative to varying degrees, with the S&P 500 down 1.7%, the Dow down 4.71% and the NASDAQ 100 down 7.87%. In addition, the price of oil reached new highs and the Federal Reserve continued to hike short-term interest rates. Curiously, longer-term interest rates fell, puzzling such noted observers as Alan Greenspan. On the positive front, economic growth was robust, with most of the companies we follow meeting or exceeding earnings expectations. So, while it was not a profitable beginning to 2005, we like the trends we see emerging for the second half of the year.

Although the market as a whole was down, there were some pockets of strength. The S&P 500 is comprised of ten broad industry sectors: Consumer Discretionary, Consumer Staples, Energy, Financials, Health Care, Industrials, Information Technology, Materials, Telecommunication Services and Utilities. Energy, Health Care and Utilities all experienced positive returns. The other seven sectors did not. Among the worst performers were Materials, Consumer Discretionary and Information Technology. These tend to represent more cyclical areas of the economy, including metals, paper and chemicals in Materials, autos and other big-ticket consumer items in Consumer Discretionary, and what we have come to think of simply as "Tech" in information Technology. Beyond stocks, longer-term bonds and real estate performed well, while commodities (other than oil) mostly struggled.

We believe a trend can be discerned from all this data, and the yield curve provides a clue. The yield curve is simply a chart of interest rates. Typically, long rates are much higher than short rates, making for a "steep" yield

(Continued on page 5)

COMMENTARY:
The Value is in Large-Cap Growth

History tells us that equities (stocks) tend to perform better than other liquid assets classes over the long run. We can also learn from study that mid- and large-cap stocks outperform small-caps over time. Further still, there is relatively little historic difference between the returns of value and growth stocks for large companies. Yet, five years after the S&P 500 reached its all-time high valuation, history has been turned upside-down.

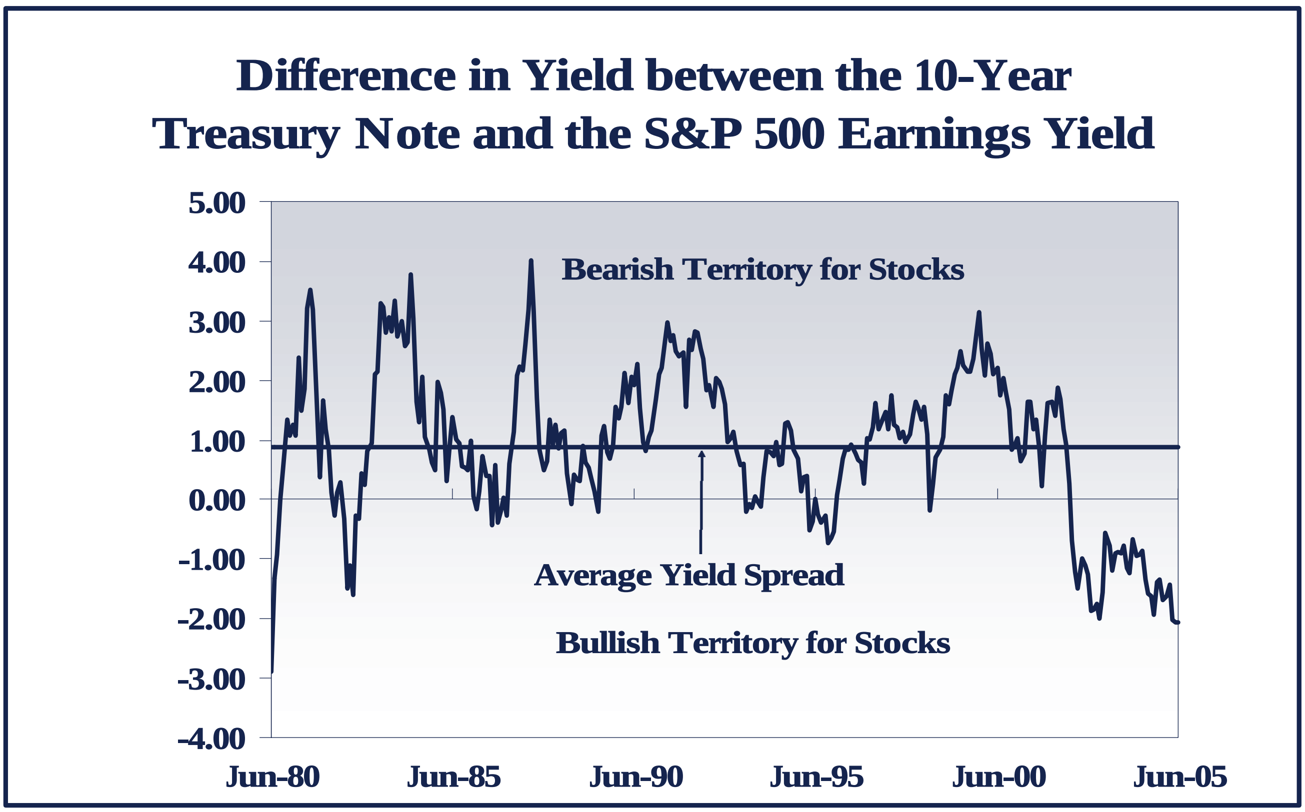
Equities are now clearly an unloved asset class, and large-caps are more unloved than their smaller counterparts. Most unappreciated of all categories of equities is large-cap growth. Certainly the reverse was true in the 1990's, so there is justification for a reversal. But five years later, isn't it time for the trend to begin to revert back toward the norm? We have studied the performance of different asset classes and different types of equities, and

(Continued on page 4)

MARKET STATISTICS

Stock Market Indices as of 6/30/2005						
	Close	% Change YTD	% Change 1 Year	% Change 3 Years Annualized	% Change 5 Years Annualized	% Change 10 Years Annualized
S&P 500	1,191.33	-1.70%	4.43%	6.37%	-3.91%	8.14%
Dow Jones Industrial Average	10,274.99	-4.71%	-1.54%	3.59%	-0.33%	8.47%
NASDAQ 100	1,493.52	-7.87%	-1.52%	12.45%	-16.88%	10.75%

Yield Table as of 6/30/2005				
	Current	3 months ago	6 months ago	1 year ago
3-month T-bill	3.12%	2.77%	2.22%	1.21%
5-year Treasury	3.70%	4.17%	3.69%	3.73%
10-year Treasury	3.91%	4.48%	4.32%	4.56%
Prime Rate	6.25%	5.75%	5.25%	4.25%
Fed Funds Rate	3.25%	2.75%	2.25%	1.25%



OUR TOP HOLDINGS BY INVESTMENT STYLE

EQUITY GROWTH

Company	Symbol	6/30/05 Price	YTD Return
Allied Capital	ALD	29.11	17.07%
Altria	MO	64.66	8.22%
Amgen	AMGN	60.46	-5.75%
Applied Materials	AMAT	16.18	-5.20%
BB&T	BBT	39.97	-3.28%
Biomet	BMET	34.63	-20.19%
BP	BP	62.38	8.56%
Colgate-Palmolive	CL	49.91	-1.41%
ConocoPhillips	COP	57.49	34.71%
Engineered Support	EASI	35.83	-9.20%
Exxon Mobil	XOM	57.47	13.21%
FMC Corp	FMC	56.14	16.23%
FMC Technologies	FTI	31.97	-0.71%
Fortune Brands	FO	88.80	15.91%
General Dynamics	GD	109.54	5.45%
General Electric	GE	34.65	-3.86%
Home Depot	HD	38.90	-8.52%
Johnson & Johnson	JNJ	65.00	3.46%
Microsoft	MSFT	24.84	-6.74%
T. Rowe Price	TROW	62.60	1.38%

EQUITY INCOME

Company	Symbol	6/30/05 Price	YTD Return
Allied Capital	ALD	29.11	17.07%
Amgen	AMGN	60.46	-5.75%
BB&T	BBT	39.97	-3.28%
Biomet	BMET	34.63	-20.19%
Boston Properties	BXP	70.00	10.25%
BP	BP	62.38	8.56%
Colgate-Palmolive	CL	49.91	-1.41%
Commercial Net Lease	NNN	20.47	2.52%
Exxon Mobil	XOM	57.47	13.21%
Fortune Brands	FO	88.80	15.91%
General Dynamics	GD	109.54	5.45%
General Electric	GE	34.65	-3.86%
Home Depot	HD	38.90	-8.52%
Johnson & Johnson	JNJ	65.00	3.46%
Microsoft	MSFT	24.84	-6.74%
Pfizer	PFE	27.58	3.98%
Piedmont Nat. Gas	PNY	24.02	5.34%
SCANA	SCG	42.71	10.32%
T. Rowe Price	TROW	62.60	1.38%
Wells Fargo	WFC	61.58	0.63%

PERFORMANCE BY SECTOR WITHIN THE S&P 500 *(7/8/05)*

	% of S&P 500	Last 13 weeks	Year-to-Date
S&P 500	**100%**	**6.1%**	**0.00%**
S&P 500 (Growth)	**49.17%**	**4.5%**	**-0.6%**
S&P 500 (Value)	**50.83%**	**7.6%**	**0.6%**
Consumer Discretionary	**11.52%**	**6.4%**	**-5.3%**
Consumer Staples	**10.08%**	**0.5%**	**-0.1%**
Energy	**8.95%**	**13.2%**	**23.3%**
Financials	**20.21%**	**7.8%**	**-2.3%**
Health Care	**13.27%**	**1.6%**	**3.7%**
Industrials	**11.13%**	**1.8%**	**-4.5%**
Information Technology	**15.30%**	**11.3%**	**-3.2%**
Materials	**2.94%**	**0.3%**	**-7.2%**
Telecommunication Services	**3.14%**	**5.6%**	**-5.9%**
Utilities	**3.45%**	**10.3%**	**14.5%**

THE VALUE IS IN LARGE-CAP GROWTH (CONTINUED)

(Continued from page 1)
we conclude that there is real value in growth - and more specifically, large-cap growth.

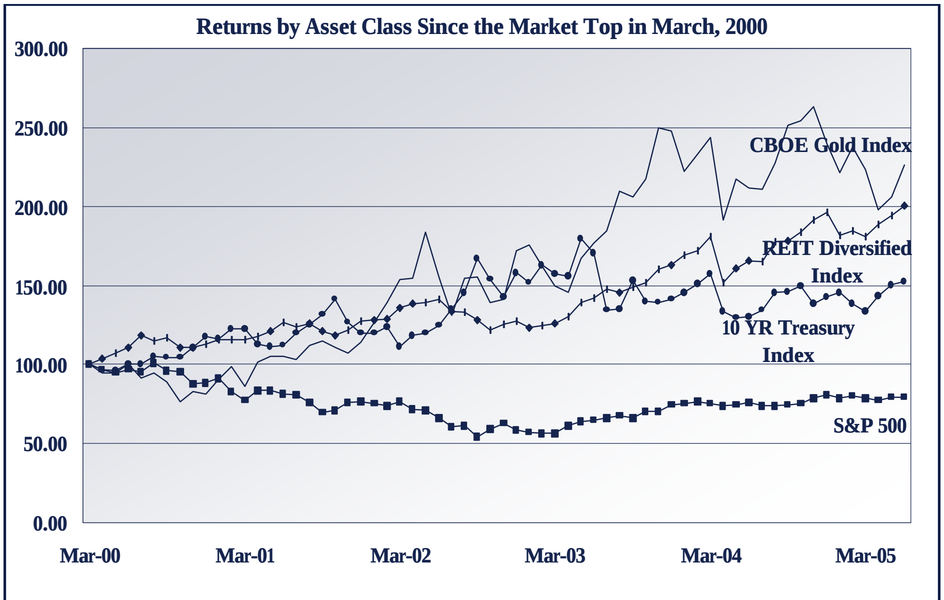
For those of you left scratching your heads, large-cap growth refers to names like Amgen, General Electric, Home Depot and Johnson & Johnson. In other words, they are household names in growing businesses. And they have seemingly been forgotten by investors.

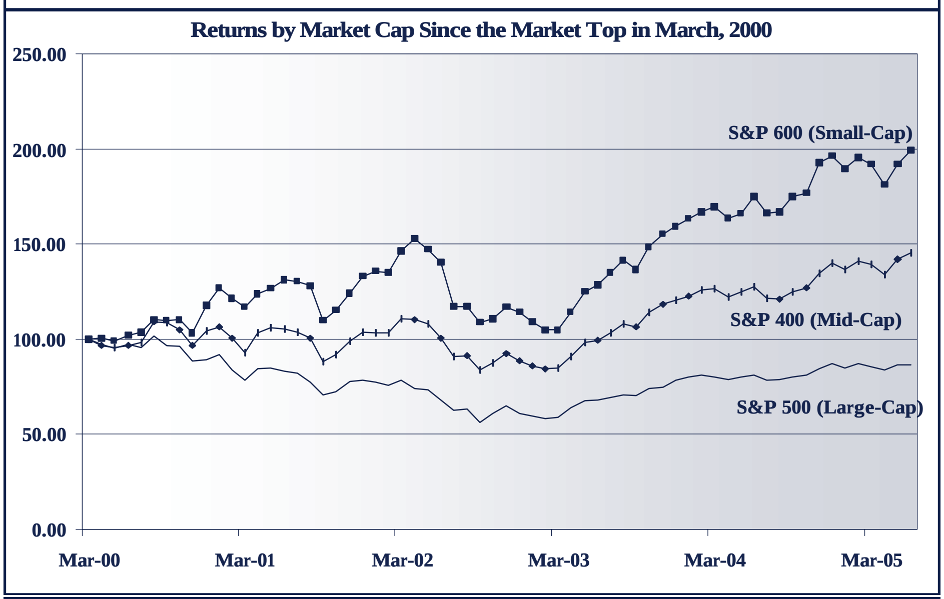
The chart at the top right outlines returns by asset class since the market peaked. Gold, real estate and the 10-year Treasury have all outperformed Large-caps as represented by the S&P 500. This is not the norm.

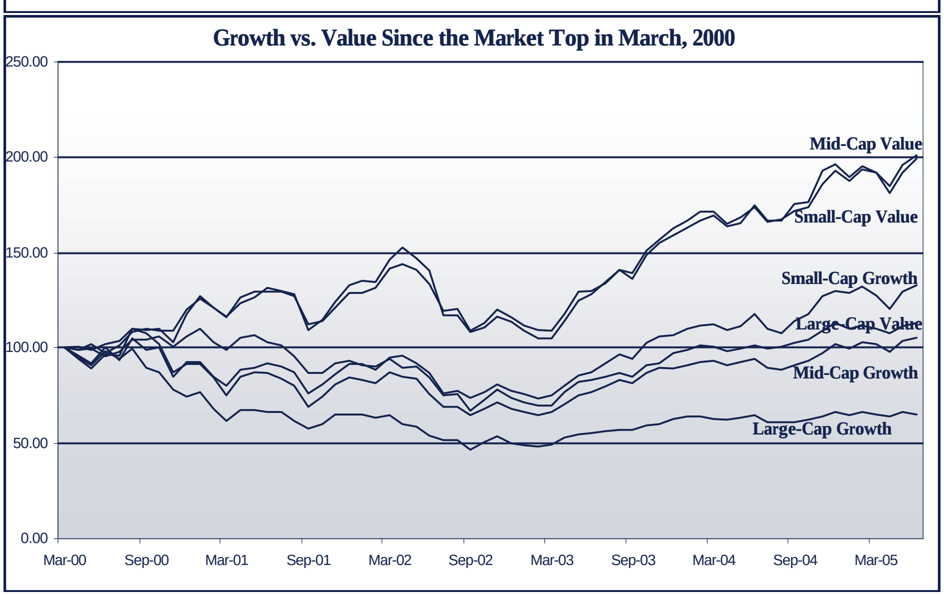
The middle chart highlights performance by market capitalization, or company size. Small caps outperform both mid– and large-caps. This, again, is not the norm. The underperformance of large-caps is striking.

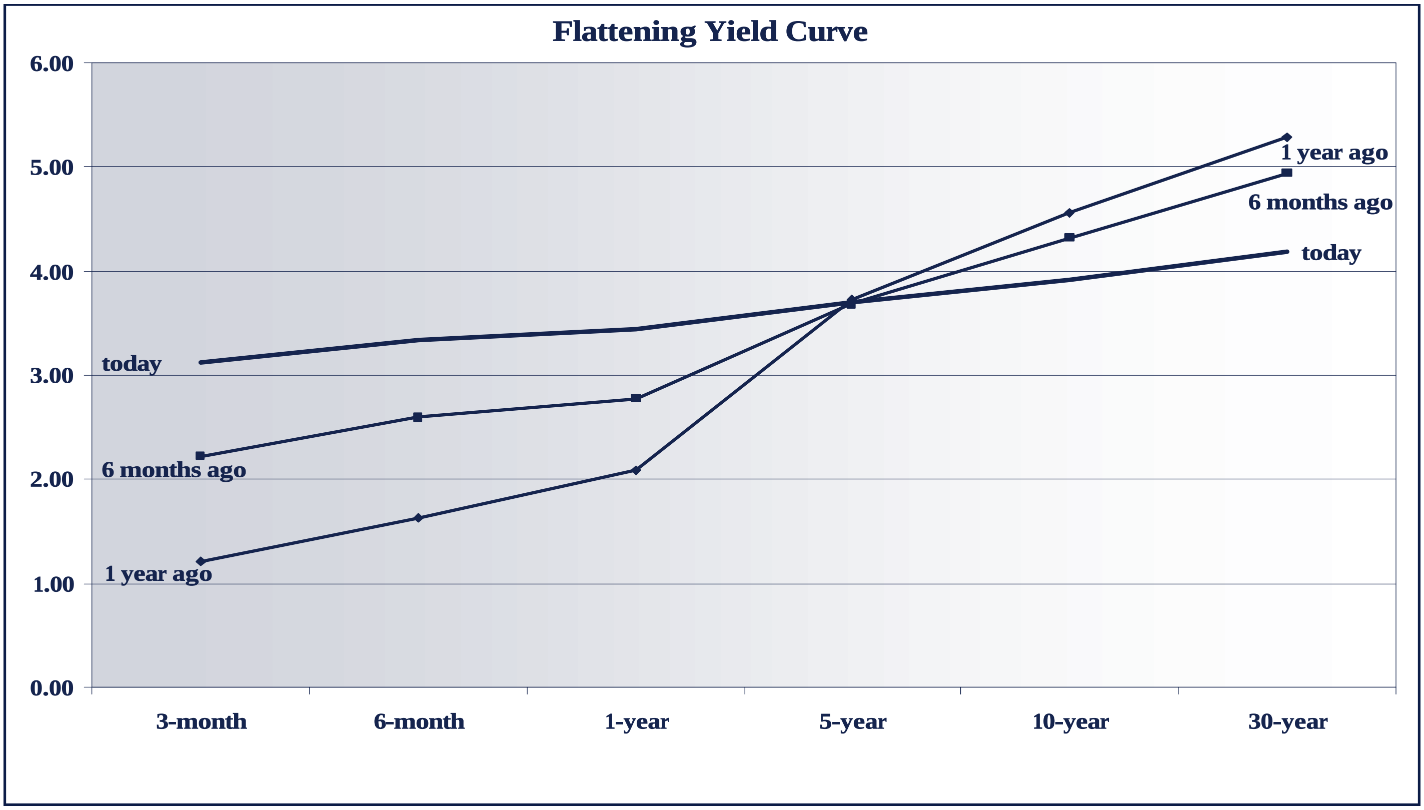
Lastly, we contrast growth and value in the bottom chart. Growth trails value significantly. To be sure, there have always been times when one style has been favored over the other, but a difference of this magnitude is unusual.

Does this mean that stocks are bad, and growth is the worst of the bad? Absolutely not. It should tell us that if we truly seek to buy low and sell high, the most compelling values can be found in large- and mid-cap growth stocks. The pictures to the right make a strong case.









MARKET ANALYSIS (CONTINUED)

(Continued from page 1)

curve. However, because short and long rates have been moving in opposite directions, the curve has flattened (see chart above).

The Fed apparently believes the economy is in a growth mode, and is raising rates to ward off inflation. However, the bond market may be saying that future growth is questionable, so long rates are falling. We subscribe to another theory. U.S. rates are high relative to the rest of the industrialized world, and with a cheap dollar, foreign investors have found our bonds attractive. As a result, the dollar is strengthening against most major currencies and demand for our bonds is driving rates lower.

The message we take from this is that the U.S. economy is not only strong, but that smart money is returning to dollar-based assets. We view this as positive. Anecdotally, U.S. mutual fund investors have been buying foreign funds at a much greater rate this year. Unfortunately, mutual fund investors have notoriously bad timing, so this is a positive contrary indicator. Because we view larger trends as turning positive for the U.S., we are increasingly optimistic about the stock market - with this caveat.

We are not bold enough yet to predict absolute positive returns for stocks. But we are confident that stocks are the single most attractive asset class, and therefore should perform better than others on a relative basis. However, that could mean that stocks just perform less badly. How's that for hedging our bets?

A look at the performance of the different sectors within the S&P also gives support to our view. The worst performing sectors in the first half were cyclical, which tend to outperform at the beginning of a recovery, but then subside as growth persists or slows. The best performers have little in common. We believe the oil stocks have mirrored the rise in oil prices and have received a further boost from speculators. The performance of the utility sector is a clear indication of investors seeking higher yields than they can find in bonds, while Health Care tends to be a traditional growth industry. Other traditional growth areas, like Consumer Discretionary and Financials, enjoyed strong returns in the second quarter. We think all this points to a shift toward growth stocks. The flat yield curve and a look inside the numbers give us confidence that the second half of the year is shaping up to be a good one.

www.tandemadvisors.com

In Charlottesville:

2 Boar's Head Place
Suite 105
Charlottesville, VA 22903

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

Allen Ouzts
Phone: (843) 216-3791
e-mail: caotandem@danielislandmedia.com