

The TANDEM Report



Volume 7, Issue 3, July, 2006

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MARKET SCORECARD:

S&P 500:

Annualized returns:

1 year ended 6/30/06	6.62%
3 years ended 6/30/06	9.24%
5 years ended 6/30/06	0.74%
7 years ended 6/30/06	-1.10%
10 years ended 6/30/06	6.60%

Russell 3000 Growth:

Annualized returns:

1 year ended 6/30/06	6.84%
3 years ended 6/30/06	8.96%
5 years ended 6/30/06	-0.43%
7 years ended 6/30/06	-6.22%
10 years ended 6/30/06	4.60%

MARKET COMMENTARY:

THE EFFECT OF THE FED'S MONETARY POLICY ON FINANCIAL MARKETS

On June 23, 2003, the Federal Reserve lowered the Federal Funds Rate by .25% to an historic low of 1.00%. Three years and 17 rate *hikes* later, the Fed Funds Rate now stands at 5.25%, with another 1/4 point hike expected in August. In the quarter just ended, markets around the globe finally felt the effects of this trend.

According to Wikipedia, "The **federal funds rate** is the interest rate at which depository institutions lend balances (federal funds) at the Federal Reserve to other depository institutions overnight. It is *not* (as the name might initially suggest) the rate at which the Fed lends to financial institutions. That is the discount Rate."

Every depository institution (bank) is required to keep a percentage of total customer deposits (usually about 10%)

readily available at all times. Often, banks fall short of or exceed this mark overnight. Those that are short must borrow, and those that exceed the target are free to lend. And the interest at which all this happens is the infamous Fed Funds rate.

When the Fed Funds Rate was at 1%, it was exceedingly inexpensive for banks to borrow the reserves they needed. At the same time, there was little financial incentive for banks to hold excess reserves, because the interest rate for lending was too low. The net result was lots of cash (liquidity) in the system.

As rates have steadily risen, some liquidity has been removed. It is now more expensive for banks to not meet their reserve requirements. The Fed Funds Rate is the Fed's most effective weapon to drain liquidity from the system, and they do this

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TEMPTATION:

THE INVESTOR'S UNDOING

I just returned from summer vacation, and one of the books I read (or in this case, re-read) was the classic The Intelligent Investor by Benjamin Graham. Mr. Graham devotes a fair amount of attention to differentiating between investment and speculation. He defines the difference as such: "An investment operation is one which, upon thorough analysis promises safety of principal and an ade-

quate return. Operations not meeting these requirements are speculative."

He goes on to lament that the line between the two has often been blurred. In our view, investing should provide competitive returns with less risk than the overall market. It's that simple. Investing is not a useful method to create wealth. It

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TOP TEN HOLDINGS

AS OF JUNE 30, 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. FMC Technologies	8.05%
2. BB&T	7.73%
3. BP, plc	5.63%
4. Altria Group	5.15%
5. Exxon Mobil	4.16%
6. FMC Corp	4.10%
7. Johnson & Johnson	3.58%
8. T. Rowe Price	3.56%
9. Home Depot	3.47%
10. Amgen	3.05%
Total	48.49%

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.

EQUITY INCOME COMPOSITE

Rank by Market Value	% of Composite
1. Johnson & Johnson	5.24%
2. General Electric	4.98%
3. Home Depot	4.70%
4. T. Rowe Price	4.53%
5. BP, plc	4.24%
6. Allied Capital	4.20%
7. Abbott Labs	4.00%
8. Amgen	3.90%
9. Microsoft	3.90%
10. Exxon Mobil	3.80%
Total	43.48%

COMPOSITE UPDATES

EQUITY COMPOSITE

Once again, all things oil related have posted solid returns for the first half of the year, still led by FMC Technologies (up 57.18%) in our portfolios. Industrials have also been a strong-performing group, with Expeditors International setting the pace (up 65.93% year-to-date). Outside of these two groups, there has been little to cheer about so far this year.

On the negative side of the ledger, Consumer Discretionary and Information Technology stocks in our portfolios have really been under pressure this year. Home Depot, despite being the only stock in the Dow to record 4 consecutive years of 20% earnings growth, is down 11.59% year-to-date. Fortune Brands, another tremendous growth company, is down 8.98%. Microsoft has had its own woes, down 10.90%. Oddly enough, the stock is up a bit since Mr. Gates announced plans for his departure.

EQUITY INCOME COMPOSITE

The Equity Income Composite had similar experiences. Oil and Industrials were strong, while Consumer Discretionary and Information Technology were weak. Of note, however, is that the real estate component of Equity Income (with the notable exception of Boston Properties) was down. This sector is showing signs of deterioration.

Conversely, and to some extent inexplicably, Telecommunications continues to perform better than all other sectors aside from Energy. Go figure.

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.



MARKET STATISTICS AS OF JUNE 30, 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	1,270.20	1.76%	6.62%	30.34%	3.74%	89.40%
Russell 3000 Growth	2,216.47	-0.32%	6.84%	29.36%	-2.12%	66.69%
DJIA	11,150.22	4.04%	8.52%	24.09%	6.17%	97.19%
NASDAQ 100	1,585.23	-4.25%	5.47%	31.08%	-13.93%	132.54%

YIELD TABLE				
	Current	3 months ago	6 months ago	1 year ago
3-month T-Bill	4.99%	4.60%	3.99%	3.12%
5-year Treasury	5.15%	4.83%	4.32%	3.70%
10-year Treasury	5.19%	4.86%	4.35%	3.92%
Prime Rate	8.25%	7.75%	7.25%	6.25%
Fed Funds Rate	5.25%	4.75%	4.25%	3.25%

PERFORMANCE BY SECTOR WITHIN THE S&P 500

THROUGH JUNE 30, 2006

(SOURCE: S&P 500 GICS SECTOR SCORECARD)

Sector	% of S&P 500	Return 2006 YTD	Return 2005
S&P 500	100%	1.8%	3.0%
S&P 500 (Growth)	47.77%	-1.0%	1.9%
S&P 500 (Value)	52.23%	4.9%	4.1%
Consumer Discretionary	10.18%	1.9%	-7.4%
Consumer Staples	9.62%	3.3%	1.3%
Energy	10.20%	12.8%	29.1%
Financials	21.43%	1.8%	3.7%
Health Care	12.27%	-4.6%	4.9%
Industrials	11.68%	6.0%	0.4%
Information Technology	14.85%	-6.2%	0.4%
Materials	3.06%	5.7%	2.2%
Telecommunication Services	3.33%	11.8%	-9.0%
Utilities	3.38%	-2.6%	12.8%



MARKET COMMENTARY (CONTINUED)

(Continued from page 1)

because excess liquidity is inflationary. Simply put, when there is too much money chasing too few goods and services, prices rise, and we have inflation.

But the Fed Funds Rate has an impact beyond the banking system. When interest rates stood at unprecedented low levels, the cost of borrowing was cheap for *everyone*, not just banks. Think about the types of things we buy with borrowed money - real estate, jewelry, automobiles, appliances and other “big ticket” items. We undertake home renovations, buy a second home, speculate in real estate, and generally treat ourselves well.

Unlike the sorts of things we buy in more “normal” times, most of these items require basic materials or commodities as either part of their manufacturing process (metals such as copper, gold, silver, steel and aluminum) or part of their ongoing operating process (coal and natural gas to provide electricity, gasoline and oil to provide fuel). As consumer demand for these products rises, demand for the underlying materials similarly rises.

This demand spurred by low interest rates was felt beyond our own borders, as well. Developing nations rich with natural resources have experienced dramatic economic growth from the exportation of their bounty. Further, now flush with cash and low borrowing costs, industrial development has increased around the globe.

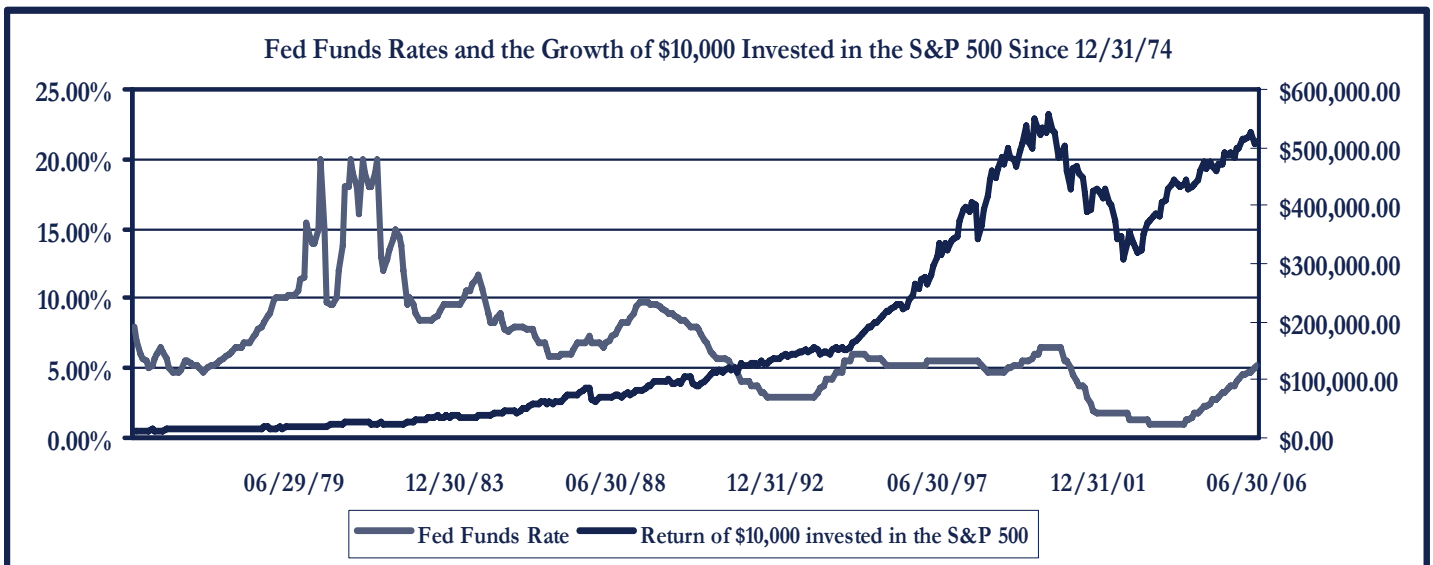
And finally, given the paltry rates of return the stock mar-

ket has provided this decade, many investors searching for better returns have forgone the conventional route of stocks and bonds in favor of more exotic investments such as those benefiting from this increased demand. And because interest rates have been so low for so long, they have borrowed money to fund their “investments”. The result is that these investors (or more aptly, speculators) have caused an even further increase in demand for raw materials and the like.

While money was cheap, these alternative assets brought exciting returns. As the Fed has attempted to take away liquidity, some investors are getting squeezed. Their cost of borrowing is rising, demand for these investments is shrinking, and in many instances there are no more buyers around upon which to unload these investments. In other words, a tighter monetary policy is forcing many speculators out of these markets.

One would think that this would mean good news for the stock market, and in time, it no doubt will. But ponder this example. Assume you purchased a rental property with an adjustable rate mortgage. Your mortgage payments were low and at least partially offset by your rental income from the unit. But now your mortgage rate has risen, and the rent you receive has not kept pace. It is time to “flip” that property at a profit, right? But to whom do you “flip” it? Everybody is in the same boat, and yesterday’s buyers are today’s sellers. If you have to get out, you sell at a reduced price. You might even lose money on the transaction. So now you are out of the real

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A DISCUSSION ABOUT BENCHMARKS

Since the inception of Tandem, we have used the S&P 500 as our performance benchmark. We seek to be competitive with the S&P over a complete market cycle while assuming less risk. Recently, we have been made aware of other managers that use the S&P 500 as their benchmark even though their performance has little correlation to the S&P. A manager's benchmark should be indicative of the manager's style so there can be a legitimate basis for performance analysis.

To illustrate, suppose an investor is deciding between two managers. One manager beats the S&P, one does not. Further suppose that the manager beating the S&P is a hedge fund while the other only invests in stocks that pay dividends. Both styles have their merits, but neither is adequately represented by the risks and returns of the S&P 500.

Last year, a gentleman told us he was satisfied with his energy fund investment because it was beating the S&P. True enough, but that same fund was *underperforming* the energy component of the S&P. To us, he hired a bad manager. To him, we were bad managers. Knowing the appropriate benchmark is imperative. The value a man-

ager adds can only be determined by comparing the manager to the appropriate style.

Our frustration has caused us to undertake an in-depth analysis of our own style relative to benchmarks. We have found that we have a high degree of correlation with the S&P 500. We also have a high degree of correlation with the Russell 3000 Growth Index, and nearly all of our holdings are members of this index. That cannot be said for the S&P, which is comprised of only the largest US companies. We hold many small- and mid-sized companies as well, so we feel the Russell 3000 Growth is a *better* measure of our performance relative to our style.

It would be self-serving to change our benchmark in the midst of a growth stock bear market. We told you we aimed to beat the S&P, and we are standing by that. Therefore, we have elected to report both benchmarks to you in your statements.

We hope this provides more useful information. We believe it is the appropriate way to honor our commitments while providing the most useful means of comparison.

TANDEM NEWS

We are pleased to announce that William L. Little, Jr. has joined Tandem. Billy previously worked for McGuire, Tapscott, Hyden and Associates in Mt. Pleasant, South Carolina as an Associate Financial Advisor.

A graduate of the College of Charleston, Billy is an Associate in our Charleston office. He will be involved in all aspects of serving our clients, with the specific responsibilities of portfolio management and client development. He is a great addition, and we are pleased to have him.

MARKET COMMENTARY (CONTINUED)

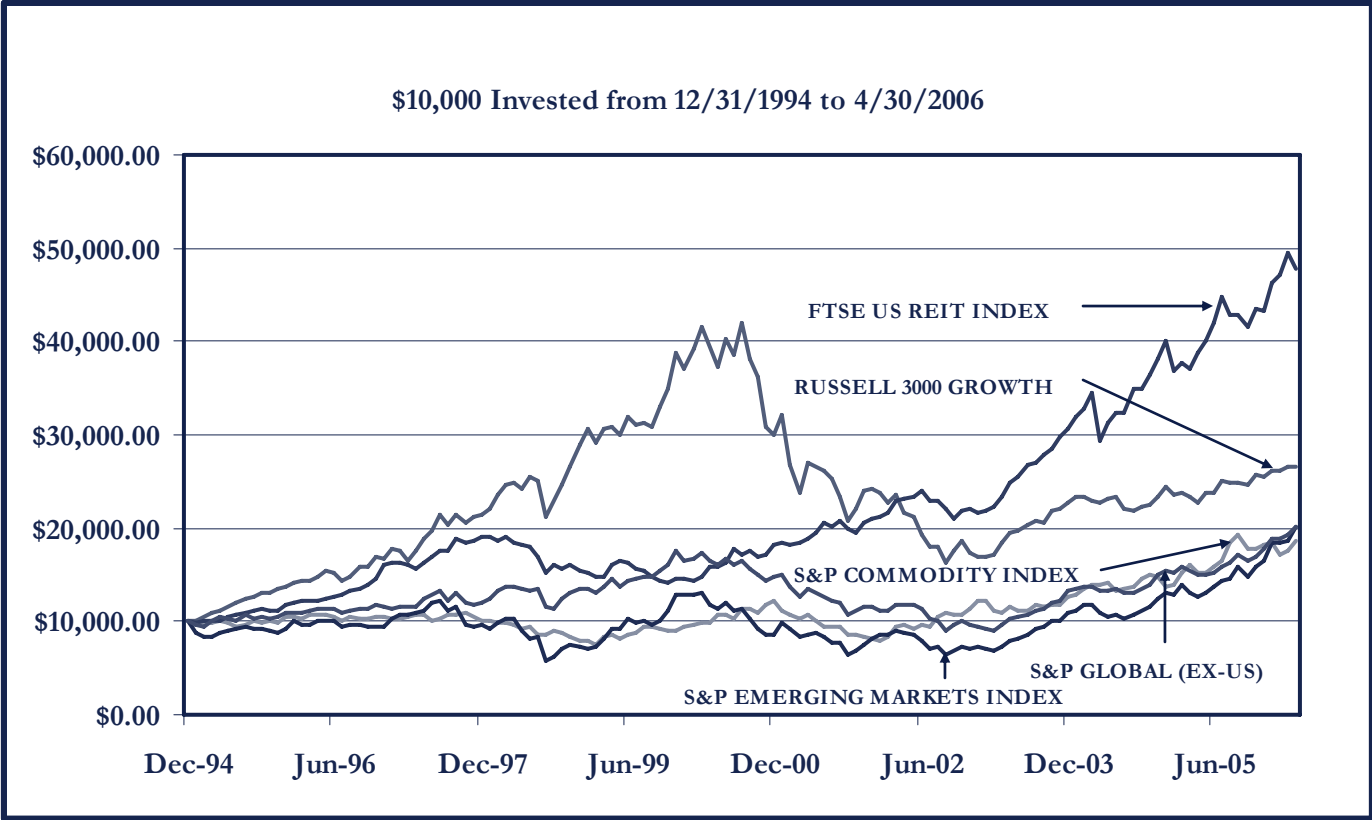
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estate game. But do you have any money left to put in the stock market. Maybe not.

In short, rising rates will curtail demand for commodities, real estate and other big ticket items. When the Fed tightens too much, as it inevitably does, investors will rush for the exit because they don't want to be the last to leave. Prices will fall, and fortunes will be lost. Wealth that was once significant (at least on paper) will evaporate. And the end will be brought about potentially in a very painful manner for these investors because the Fed has dried up all the excess liquidity. The incentive to speculate has been taken out of the market and risk begins to matter again.

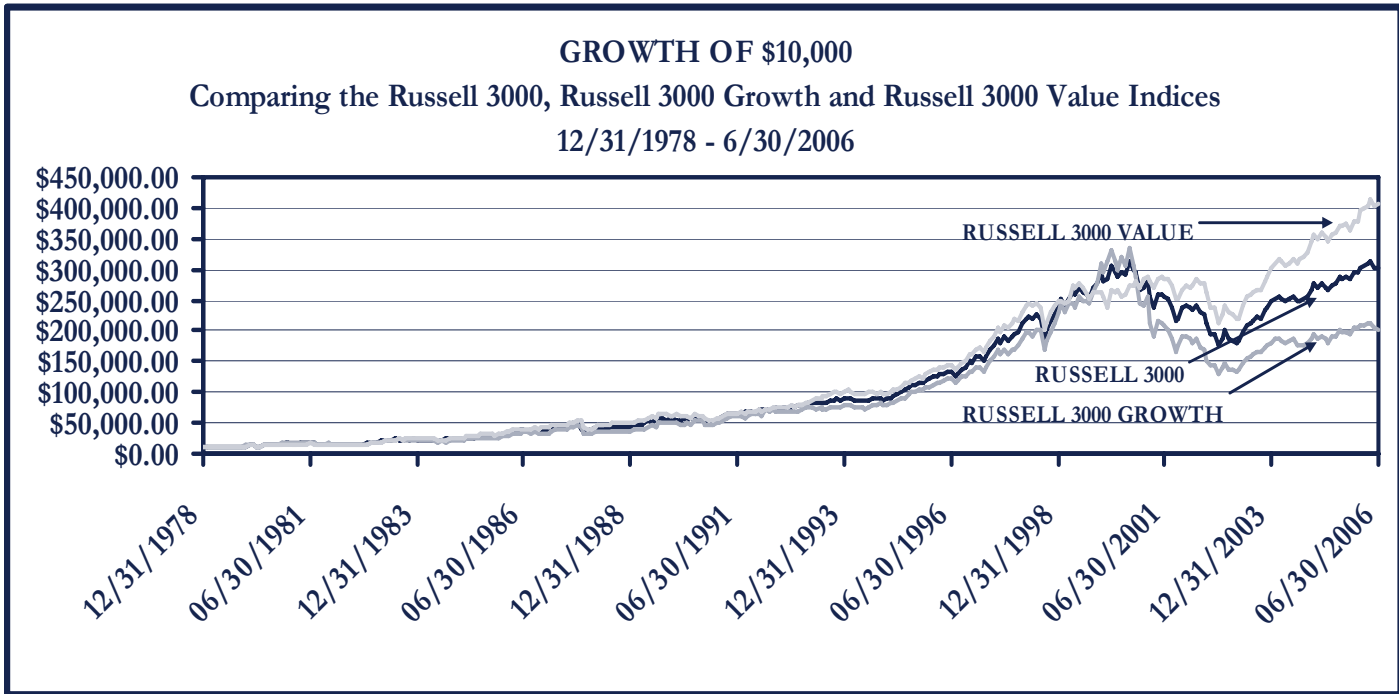
As the chart to the left illustrates, the stock market can go up regardless actual rates. It is the perceived trend that influences stock prices most. Other investments depend on the actual rate of interest. The quarter just ended brought this point home as virtually every speculative market other than crude oil declined sharply. Commodities, real estate, precious metals and emerging markets all took big hits. Some will be brave (or foolish) enough to venture back in, but these investments become far less attractive when rates are high. The great frustration is that we are not likely to see a reallocation to stocks as a result. When the money is lost, there is nothing to reallocate. In time, this trend, like every other before it, will reverse itself. Once again, as has almost always been the case, stocks will be the best performing asset class. Until that time, be smart, and be patient.





The chart above illustrates the long-term growth of a \$10,000 investment in various asset classes. We had to use the time period 12/31/94 - 4/30/06 because those were the only dates for which we could obtain valuations for the international and emerging market indices.

The table below illustrates that historically there is little difference between growth and value prior to the spring of 2001. Since that time, value has set new highs, while growth languishes at 1998 levels. Is it different this time? Is growth no longer viable? We doubt it. Time will tell.



TEMPTATION (CONTINUED)

(Continued from page 1)

is the best way we know of to *preserve* wealth.

If your aim is to amass a sizable fortune, you should focus your efforts on an endeavor in which you can influence the outcome to your favor. The stock market is not such a tool. However, if you wish your portfolio to afford you the same lifestyle ten years from now as it does today, investing in the stock market is the most practical way. This is what we mean by preserving wealth.

And the best way to invest is to have a plan and stick to it. There are many proven methods, or styles, of investing. As you know, we are growth investors. We favor this style because we believe that, regardless of the market's movement, if our companies' earnings and dividends increase steadily over time, their stock prices will eventually follow.

Since the market top in 2000, stocks have underperformed other investments, and growth stocks have fared worse than the general market. Many investors have been tempted by the lure of lofty returns in other areas.

It has been our experience that succumbing to these temptations and chasing returns rarely ends happily. All investment styles move in cycles. Sometimes they are in favor, and other times they are not. But all things revert to the mean, and what is unpopular today will be back in vogue soon. The challenge is to stick with it. Timing the markets, or shifting styles in mid-stream, may seem perfectly logical, but it requires a great deal of luck to succeed consistently. An "investor" need only be right once, while a timer (speculator) needs to be right all the time.

To the point, I recently had the opportunity to present our style of management against a portfolio allocated across domestic stocks (65%), international stocks (20%), emerging markets (5%), commodities (5%) and real estate (5%). Using representative indices for the asset classes, our findings are summarized in the table to the left.

Asset Class	Return of \$10,000 (12/31/94—4/30/06)
Stocks (Russell 3000 Growth)	\$25,509.04
International (S&P Global Index Ex- US)	\$20,238.10
Emerging Markets (S&P Emerging Markets Index)	\$20,209.29
Commodities (S&P Commodity Index)	\$18,563.30
Real Estate (FTSE US REIT Index)	\$47,882.92
Blend of All Indices	\$25,666.50
Blend (REIT removed and allocated to Stocks)	\$24,602.05

The staggering performance of the REIT index caused the blend to slightly outperform the stock index. With the real estate allocation removed, the Russell 3000 Growth index outperformed the blend. We would argue that real estate is overvalued, so its performance is to be expected. But we view stocks as being significantly undervalued, and they still outperformed.

The top chart on the page to the left further illustrates our findings. Since the spring of 2002, nothing can compare to REIT's, and we have discussed at some length the overvaluation of real estate in this and other issues. But for the long-term investor (we use 12/31/94 because no international indices are available to us prior to that date), the growth stock investor would have done *worse* by diversifying into other asset classes, in spite of the current bear market in growth stocks (illustrated by the bottom chart on the left).

While we do not equate diversification with speculation, we do believe that changing one's portfolio allocations to include the hot investments of the day is simply that. Large endowments and such must diversify because they require a 5% (on average) annual distribution. Diversification reduces a portfolio's volatility, thereby making those annual distributions more predictable. But the average investor has no such requirements. Diversification across multiple asset classes may in fact reduce volatility, but it can also reduce returns over time, as illustrated. And constant re-allocation to yesterday's winning asset increases the likelihood of missing out on tomorrow's.

One is simply guessing, no matter how educated the guess may be, at what will work tomorrow.

The conclusion to be drawn is that over time, U.S. stocks beat all other asset classes. Do not be tempted by the latest hot sector. Eliminate the guesswork by sticking to your plan. If it is sound, you will be rewarded. After all, "An investment operation is one which, upon thorough analysis promises safety of principal and an adequate return. Operations not meeting these requirements are speculative." ~ JBC





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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 fifteen years, 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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Note: 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.

