

The **TANDEM** Report



Volume 6, Issue 4, October, 2005

INSIDE THIS ISSUE:

<i>Market Commentary</i>	1
<i>Our Take on Oil Prices</i>	1
<i>Top 10 Holdings</i>	2
<i>Composite Updates</i>	2
<i>Market Statistics</i>	3
<i>S&P 500 Sector Performance</i>	3
<i>The Diminishing Risk Premium</i>	5
<i>Thank You</i>	5

MARKET SCORECARD:

S&P 500:

<i>Annualized returns:</i>	
<i>1 year ended 9/30/05</i>	10.25%
<i>3 years ended 9/30/05</i>	14.65%
<i>5 years ended 9/30/05</i>	-3.08%
<i>7 years ended 9/30/05</i>	2.74%
<i>10 years ended 9/30/05</i>	7.72%

MARKET COMMENTARY: **THE MARKET WITHSTANDS MUCH, MOVES LITTLE**

With three quarters of 2005 in the books, the S&P 500 has managed to eke out a positive return thus far. The Dow and NASDAQ are slightly negative year-to-date, but all three indices turned in positive performances for the third quarter. That's pretty heady stuff considering we endured two hurricanes, record energy prices and two interest rate hikes.

Stocks are holding up surprisingly well against significant headwinds. The fact that the market has not suffered a correction is encouraging, but we appear to be stuck in a trading range until investors gain more conviction. Both corporate profits and the economy continue to grow. As a result, the market remains attractive relative to other investment alternatives. And growth, particularly large-cap, appears to be the most attractive asset class of all.

The Federal Reserve continues to battle inflation fears, real or perceived, making for a challenging bond market. The yield curve is beginning to reflect its acceptance of higher rates, as longer rates have finally begun to move up. U.S. interest rates on government bonds remain the highest in the industrialized world, which lends some strength to the dollar. Higher rates attract global investors, increasing demand for dollar denominated assets. Historically, such an environment has also been good for stocks.

Turning back to the equities markets, not all sectors have performed equally. If your portfolio did not contain energy and utility stocks for the first nine months, you likely have experienced a negative return. The energy sector is up 40% through the end of September, and utilities are up 20.4%.

(Continued on page 4)

OUR TAKE ON OIL PRICES

In the April issue of *The TANDEM Report*, we discussed the law of supply and demand. Did we miss something?

Hurricane Katrina shut down a significant portion of the nation's refineries, so naturally the prices of refined products spiked. But why did the price of oil rise as well? Crude oil must be refined in order to have any practical use. With refineries off-line, all the crude in the world would not have averted a shortage of usable products.

In fact, one could make a reasonable argument that there was a temporary crude glut. With the ability to refine crude severely curtailed, demand for oil would logically decrease. According to the old supply and demand law, the price of crude should have fallen. So why didn't it? Why did the price of crude reach all-time highs in late August and early September, when refineries couldn't possibly process all the crude that was available to them?

(Continued on page 4)

TOP TEN HOLDINGS

AS OF SEPTEMBER 30, 2005

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 Corp.	7.83%
2. BP, plc	5.76%
3. Altria Group	5.21%
4. FMC Technologies	4.49%
5. Exxon Mobil Corp.	4.39%
6. Amgen	3.86%
7. Home Depot	3.84%
8. FMC Corp.	3.55%
9. T. Rowe Price	3.18%
10. General Electric	3.03%
Total	45.15%

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	5.01%
2. General Electric	4.81%
3. Home Depot	4.75%
4. BP, plc	4.26%
5. Microsoft	4.25%
6. Allied Capital Corp.	4.12%
7. Exxon Mobil	3.88%
8. T. Rowe Price	3.86%
9. General Dynamics	3.25%
10. Boston Properties	3.22%
Total	41.10%

COMPOSITE UPDATES

EQUITY COMPOSITE

In the third quarter, we purchased two new holdings. *Constellation Brands (STZ)* manufactures and markets wine, imported beer and distilled spirits in the U.S., U.K., Australia and New Zealand. It has an admirable record of earnings growth and a solid acquisition track record. *Cooper Companies (COO)* develops, manufactures and markets health care products principally for the eye care and surgical industries. COO is also an impressive growth story. We sold *AES Corp. (AES)* and *Dover (DOV)* largely because we have lost confidence in managements' abilities to deliver consistent growth. We also sold the little bit of *Intel (INTC)* we held in composite accounts over similar concerns. Companies making news during the quarter were *Amgen* (up over 30% on earnings news), *Fortune Brands* (spun of office products maker *Acco Brands, (ABD)*), *Engineered Support* (agreed to be acquired), *Techne* (up 24% on no news) and *Avon Products* (down 28% on poor earnings).

EQUITY INCOME COMPOSITE

There were no major purchases during the quarter, but we did make two sales. *Dover's (DOV)* was sold because earnings and dividend growth has become suspect, and *Duke Realty (DRE)* was sold to scale back our REIT holdings in search of more growth potential. We did add small amounts of American Express and Pfizer to certain accounts that we felt did not own enough. Companies that increased dividends during the quarter include *Allied Capital, BB&T, Biomet, Boston Properties* (special dividend of \$2.50), *BP* and *Wells Fargo*. Dividend growth, as opposed to high dividend yield, is a key component of our Equity Income strategy. We expect most of our companies to increase their dividends annually.

The accounts that comprise a composite are not necessarily identical. For more information on Tandem's composites, please visit www.tandemadvisors.com.



MARKET STATISTICS AS OF SEPTEMBER 30, 2005

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	1,228.81	1.39%	10.25%	50.72%	-14.46%	110.27%
DJIA	10,568.70	-1.99%	4.85%	39.21%	-0.77%	120.68%
NASDAQ 100	1,601.66	-1.20%	13.37%	92.39%	-55.14%	173.75%

YIELD TABLE				
	Current	3 months ago	6 months ago	1 year ago
3-month T-Bill	3.53%	3.12%	2.77%	1.70%
5-year Treasury	4.15%	3.70%	4.17%	3.37%
10-year Treasury	4.30%	3.91%	4.48%	4.12%
Prime Rate	6.75%	6.25%	5.75%	4.75%
Fed Funds Rate	3.75%	3.25%	2.75%	1.75%

PERFORMANCE BY SECTOR WITHIN THE S&P 500

THROUGH SEPTEMBER 30, 2005

(SOURCE: S&P 500 GICS SECTOR SCORECARD)

Sector	% of S&P 500	Return Last 13 Weeks	Return Year-to-Date
S&P 500	100%	3.1%	1.4%
S&P 500 (Growth)	48.72%	3.4%	0.9%
S&P 500 (Value)	51.28%	2.9%	1.9%
Consumer Discretionary	10.73%	-1.1%	-8.1%
Consumer Staples	9.64%	2.5%	1.5%
Energy	10.26%	17.8%	40.0%
Financials	20.08%	0.1%	-3.5%
Health Care	13.29%	1.1%	3.8%
Industrials	11.09%	1.9%	-3.9%
Information Technology	15.28%	5.8%	-0.5%
Materials	2.88%	1.3%	-7.6%
Telecommunication Services	3.10%	-2.0%	-8.0%
Utilities	3.64%	6.4%	20.4%



MARKET COMMENTARY (CONTINUED)

(Continued from page 1)

The next best performing sector is health care - up 3.8%.

Of the ten industry sectors defined in the S&P 500, four are up and six are down year-to-date. The worst performing sector has been consumer discretionary, which causes some concern. Consumers have been the driving force for the market the last few years, and they may be getting tired. Paying \$3/gallon at the pump can't help. Retail sales heading into Christmas (forecasted to be sluggish) will give a better indication of the consumers' strength.

A weak Christmas season would not necessarily indicate a

weakening economy, but avoiding retail stocks at this time is not a bad idea. While we don't know what the fourth quarter holds, October is traditionally a difficult month. It certainly has begun that way. But there really isn't any other place we can see for investors to put money to work. The bond market is tough, and there is abundant anecdotal evidence that real estate has peaked. Unfortunately, the market doesn't react to our opinions as we would like it to.

Stocks may remain undervalued for the foreseeable future, but we are convinced that this is a great opportunity to be a growth stock investor. Time will tell.

OUR TAKE ON OIL PRICES (CONTINUED)

(Continued from page 1)

We have a theory. Unfortunately, we can only speculate at this point, because we have no empirical evidence to support our notion. Nonetheless, allow us to share our thoughts on this matter with you.

The 1990's introduced us to a breed of speculators known as day-traders. They bought and sold stocks, mostly high tech, creating a sense of euphoria around all things tech related. When the bubble finally burst in 2000, we assumed we had seen the last of the breed.

The first half of this decade has seen a doubling in the number of hedge funds, from fewer than 4,000 known funds to more than 8,000 known funds today. As investors abandoned stocks in search of positive returns, they were easily seduced by the promise of big returns from hedge funds. When there were fewer of these funds, they could more easily maneuver in sophisticated markets to take advantage of inefficiencies. However, with so many dollars now chasing the same limited number of opportunities, returns are harder to come by.

We suspect that many of the less experienced fund managers now in charge of billions of dollars are today's speculators. The result? Energy Euphoria. The price of crude has doubled in the last few years, and energy related stocks are up 40% from the first of the year through the end of September.

While we certainly concede the point that there is a finite supply of oil in the world, and that we must find alternative sources of energy in our children's' lifetime, we do not accept that the problem is significantly worse today than it was three years ago.

The cost to extract oil from the earth in most places is between \$8 and \$15 per barrel. Investors are now chasing stocks of companies extracting oil from more difficult areas like the Canadian oil sands and Wyoming tar sands, where the cost of extraction can run three times as much. While we support the development of new crude sources, what happens to the price of these stocks if oil should fall back to \$45 per barrel?

We love energy stocks, and continue to hold big oil in our portfolios. There is still good value in these stocks. Further, we do not wish to bash the hedge fund industry. Most are responsible and savvy investors.

Yet with no regulation and investors that have little understanding of what they actually own, the proliferation of hedge funds has resulted a new speculative game. It occurs to us that perhaps the rise in demand that has sent oil prices through the roof is not actual demand for crude, but rather an unprecedented demand for crude futures contracts - the investment vehicle of choice for today's speculator. Time will tell, so stay tuned. It should be interesting to see how this plays out.



THE DIMINISHING RISK PREMIUM

Investors are a funny breed. They seem to take comfort in numbers, regardless of risk. The 1990's tech bubble is a classic example. Everyone piled in, because it was "different" this time.

We have already discussed oil in this issue, and while we do not consider the energy market to be in a speculative bubble, there is some sign of a safety in numbers mentality. Alan Greenspan recently addressed his concern over diminishing risk premiums. He is clearly worried about inflation risk, and his comments were directed at the bond market. When one has a healthy respect for uncertainty, he typically demands a higher interest rate for a longer holding period. Fed hikes have largely been met with a yawn from the bond market, as the yield curve has flattened. One would expect long rates to rise with short rates, but that has not been the case.

Greenspan also took a thinly-veiled swipe at real estate investors. Until recently, real estate was bought for one of two principal reasons; to live in, or to hold as an investment for cash flow. Real estate has always been considered a long-term hold. In the last few years, investors have began "flipping" properties quickly, shunning cash flow potential in favor of capital gains. But what happens when investors can no longer sell their properties quickly, and are forced to hold them? Are they still good

investments? Not without adequate cash flow.

We like to compare investments to the 10-year Treasury yield, because we view this as a riskless investment. Any other investment must have the likelihood of returning more, or there is little sense in taking on the added risk. The amount of greater return required is called the risk premium.

In the table below, we have used a representative sample of publicly traded Real Estate Investment Trusts (REIT's) as a proxy for real estate. This is not a perfect scientific comparison, but it serves our purposes. We compare the average yield of our REIT sample to the average yield of the 10-year for the last five years and currently. REIT's historically have sported a yield greater than the 10-year ranging from about 1.5 to 2.44 percentage points. That is as we would expect. Real estate carries a greater risk, so it should yield more. But in 2005, that spread dropped considerably. It now stands at 0.6 percentage points, which is significantly less than the historical average.

Our findings indicate a decline in investor demand to be compensated for greater risk. Why? Perhaps there is a feeling of safety in numbers. Situations such as this rarely end well. How quickly they forget.

	2000	2001	2002	2003	2004	Current
REIT	8.39%	7.16%	6.97%	6.50%	5.50%	4.90%
10-yr Treasury	5.95%	4.97%	4.53%	4.45%	4.01%	4.30%
Spread	2.44%	2.19%	2.44%	2.05%	1.49%	0.60%

Our REIT Index is a representative sample of 7 REIT's investing in apartments, office buildings and shopping centers. It includes Avalon Bay, Federal Realty, Kimco, New Plan, United Dominion, Washington REIT and Weingarten Realty. The yields for all years other than current are average yields for the respective years. Spread is the difference between REIT yields and the 10-year Treasury.

THANK YOU

Tandem Investment Advisors, Inc. was incorporated on October 5, 1990 without any clients to serve or portfolios to manage. We took an uncharacteristically big risk, but we held a firm conviction that this was the right way to do business and that this was how we wanted to serve investors.

Fifteen years and many stock market ups and downs later, we are still here. Grayer, perhaps, but definitely still

here. While fifteen years is no great milestone, it can feel like a lifetime in this business.

We would like to thank you for allowing us to serve you, and for giving us the opportunity to come to work everyday to do what we love. It is an honor to work for you, and a responsibility we cherish. We look forward to whatever is in store for the next fifteen years. Working in Tandem is the right way to do business.





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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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