THE TANDEM REPORT

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"It requires a great deal of boldness and a great deal of caution to make a great fortune, and when you have it, it requires ten times as much skill to keep it."

~ Ralph Waldo Emerson

Dear Clients,

Tandem is committed to the preservation of your wealth by minimizing risk while adding value through superior investment performance. This issue of *The TANDEM Report* provides a summary of our views pertaining to the investment landscape and subjects that influence our decision making. More information about our firm, including our investment style and process, is available on our web-site. Please visit www.tandemadvisors.com. We hope you find this report informative.

Respectfully,

John B. Carew
President,
Chief Investment Officer

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COMMENTARY:

ARTIFICIALLY LOW INTEREST RATES HAVE CONSEQUENCES

In response to the global financial crisis, the Federal Reserve has taken several dramatic and unprecedented steps. Many would agree that Fed action kept markets from seizing, but an increasingly vocal group believes it is time for the Fed to allow markets to work on their own. A recent *Barron's* cover story implored the Federal Reserve to act immediately. We agree. Failure to restore market equilibrium will have consequences, and not all are good.

The Federal Reserve's traditional tool to either stimulate or restrict economic growth is the manipulation of the Fed Funds and Discount rates. Recall that the Fed Funds rate is the rate at which banks lend to one another through the Federal Reserve System, while the Discount rate is the rate at which the Fed lends to banks. The Fed lowers rates to stimulate growth and raises them to curtail growth.

Today, the Fed Funds rate is essentially 0.15% and the Discount rate is 0.50% - both historically low. Yet traditional tools were not enough to combat the global meltdown in 2008, so the Fed devised new methods to stimulate activity.

New Fed programs include:

1. the purchase of Treasury and Agency securities to keep longer-term interest rates low and add liquidity to the system;
2. the purchase of mortgage-backed securities issued by Fannie and Freddie to keep mortgage rates low and provide liquidity to the mortgage market;
3. the purchase of commercial paper to keep money markets functioning;
4. The purchase of other asset-backed securities to keep consumer lending operations functioning.

When the Fed embarked on these mis-

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MANAGING PORTFOLIO RISK ISN'T CONSERVATIVE. JUST SMART.

HOW INVESTORS CAN BETTER UNDERSTAND RISK WHEN ONLY RETURNS ARE REPORTED

Investors are at a disadvantage when trying to evaluate the merits of differing investment strategies. Past performance is typically the common yardstick, and as all professional investment managers must disclose, past performance is no guarantee of future results.

This problem is not the fault of the professionals. In fact, most of us report alpha, beta, standard deviation, correlation and a host of other mathematical ratios to describe risk associated with return. Yet these statistics provide few investors, let alone professionals, with a clear picture of how much risk portfolio managers assume in their effort to provide return. Most are left to simply infer or guess how much risk they assume with a particular manager or strategy.

Although we have argued for years that investors were failing to properly account for risk, it took the debacle that was 2008 to bring attention to this matter. We have

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Market Commentary:

Combating low and potentially rising interest rates

As we discussed in our *Commentary* on page 1, the Federal Reserve seeks to keep interest rates below levels they might otherwise attain if left to free market influences. Most assume equilibrium will be quickly realized when the Fed ceases its current undertakings. Some believe the Fed will not only exit intervention, but be forced to raise rates to combat inflation.

Whatever the cause of rising interest rates, investors will face a challenge not seen in any lasting fashion since the 1970's. Rising rates make investment returns far more difficult to achieve. We will highlight a few reasons.

Fixed Income Investments

Suppose you invest $10,000 in a bond today that pays a 3% interest rate. Then suppose a year from now you wish to sell your bond. Rates one year from today might be 4%. Do you think you can sell your bond at 3% for $10,000 when a buyer can get 4% on a new bond? Of course not. A buyer will offer you less money to compensate for the lower interest rate. Thus, *rising interest rates decrease the value of fixed income investments.*

Stocks with High-Yielding Dividends

Many investors seeking dividend income prefer stocks with high yields. Utilities, REIT's and certain ETF's, among other investments, often fit this bill. If these investments offer limited prospects for growth and most of the return comes from the dividend, the market will treat these investments much like bonds are treated when interest rates rise. *Rising interest rates can decrease the value of stocks that rely heavily upon dividend yield to provide returns.*

Real Estate

Historically, certain types of real estate have provided a hedge against inflation. Investments that provide cash flow (rent) have the ability to increase rent over time to keep pace with inflation. As interest rates typically rise during inflationary times, the ability to increase rent has proven in the past to be an advantage for real estate investors. However, this financial meltdown has resulted in vacancies that have forced many landlords to decrease rent just to maintain tenants. *The ability to increase rents in this economic environment may be limited, making it harder for some real estate investments to provide positive returns if interest rates rise.*

Foreign Investments held by U.S. Investors

Typically a country with rising interest rates experiences a strengthening currency. International investments held by U.S. investors will likely lose value when the investments are converted back to dollars in this environment. *Foreign investments bear currency risk that often works against the investor when rates at home rise.*

Commodities

Most commodities are traded in dollars. When the dollar strengthens in value, commodity prices typically fall. The strength we have seen in commodities like gold and oil have been at least partly the result of the declining dollar. *Should the dollar's weakness reverse itself as a result of rising interest rates, commodity prices could decline.*

The Strategy

Having outlined the challenges, we now turn to strategy. We see two issues facing investors. First, how to invest at present rate levels. Second, how to prepare for the inevitable rise in rates, whenever it may come. One strategy effectively combats both scenarios.

Stocks that routinely *grow* their dividends, rather than stocks that pay big dividends, are the only sure way we know of to offset low and/or rising interest rates. Consider this example of a $10,000 investment in a bond that pays 3% for 5 years versus a stock that initially has a dividend yield of 2.5% and grows that dividend by 10% every year for five years. The stock dividend exceeds the bond payment by year 3. Total dividends are greater than total interest payments, the stock does not have as much interest rate risk and the stock value has likely appreciated to be greater than the $10,000 the bond pays back.

	BOND	STOCK
Year 1 Income	**$300.00**	**$250.00**
Year 2 Income	**$300.00**	**$275.00**
Year 3 Income	**$300.00**	**$302.50**
Year 4 Income	**$300.00**	**$332.75**
Year 5 Income	**$300.00**	**$366.03**
Total Income	**$1,500.00**	**$1,526.28**

Dividend increases must be accompanied by corresponding increases in earnings. Without earnings growth to support dividend growth, future dividend income will be limited. But if the company can consistently grow earnings, the rising dividend stream is secure.

Investors are too often satisfied with dividend yield when dividend growth supported by earnings growth is the key. These stocks most often have lower volatility (risk) and less interest rate risk should rates rise. And if rates don't rise, at least the income stream grows from low levels over time. Bonds and high yielding stocks cannot offer these benefits.

Forecasting the actions of the Fed and the direction of interest rates is often futile. Yet we think it reasonable to conclude that rates will rise at some point - and they can't go meaningfully lower from here. Growing dividends supported by growing earnings offer today's surest approach.

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sions, there were no other market participants. The Fed was the only willing buyer of most of these securities (with the exception of Treasuries). Today, that has changed. Others are more than willing to participate, but the Fed's presence has kept rates artificially low, thereby crowding out others who would participate if they could be paid higher rates to compensate for risk.

And herein lies the predicament we face today. The Fed actions, while perhaps necessary, now keep rates lower than they might otherwise be. This has many negative consequences, some of which are outlined below.

Incentivizing Borrowers, not Lenders

Who wouldn't like to borrow money at a nearly 0% interest rate? It is practically free. Much has been made about the lack of lending taking place. Certainly many qualified borrowers are unable to find the financing they need. Few ask what incentive a lender has to make loans at these rates.

Individuals are lenders when they buy bonds, invest in CD's or have money in a money market account. Not many individuals get excited about lending money long term at rates this low. Banks lend money from their deposit base. Right now, banks can make as much money buying Treasuries with their assets as they can make lending money, and with no risk. So why lend?

Weakening Bank Balance Sheets

Banks face a great challenge - they borrow money short-term (from depositors) but lend it long-term. When banks fear that their cost of money (interest on deposits) is likely to rise, they are hesitant to make cheap long-term loans. For those banks that do commit to long-term lending, the loan becomes less profitable, or even a losing proposition, if deposit rates rise. This weakens balance sheets and impairs their ability to make future loans that might be more profitable.

The choice for banks is fairly simple. Lending now could hurt their ability to lend later. Buying Treasuries (a record amount of Treasuries are now held by banks) allows banks to make loans later when more favorable conditions return.

Discouraging Saving, Encouraging Spending

We have all been told that we have lived beyond our means. We borrowed too much money, and now is the time to become fiscally responsible. So why does monetary and fiscal policy still encourage spending over thrift?

Savers can't make any money on their deposits, but spenders can borrow cheaply. Higher rates would better address this paradox.

Hurting Retirees

An entire generation of Americans is being penalized by the current interest rate environment. Standards of living that were aspired to and planned for cannot be met, simply because low interest rates do not provide enough income to the retired fixed-income investor.

There is another, and perhaps even more sinister, penalty to the fixed-income retiree. If low rates spur inflation, not only is nominal income too low, but real income will decline as well. Real income is nominal income adjusted for inflation. With low nominal income and rising inflation, the retiree is hurt twice.

Increasing Financial Speculation

Investors frustrated by low rates are forced to look for higher returns. This is accompanied by higher risk. As has been the case far too many times this decades, investors chasing return without regard to risk create bubbles. Compounding matters, professional investors already comfortable with higher risk are now able to borrow money inexpensively to fund their speculative investments.

It has been said that the Fed's policies are designed to get investors to take on risk again. But which investors do they mean? Those who can ill afford it (happening now), the professionals (again, happening now), or those who can afford to wait for a more level playing field? We suspect the last of these would have the impact the Fed seeks, although the former two seem to be the ones changing their behavior instead.

Weakening the Dollar

Artificially low rates at home make investing abroad more attractive. In fact, many have now taken to borrowing in dollars and exchanging their borrowed dollars for other currencies offering higher rates of return. This activity helps erode the value of the dollar.

A weakening dollar makes the goods we import more expensive. Even if we don't experience traditional inflation for U.S. goods and services, we still experience a decline in our purchasing power around the globe (which is inflation).

Furthermore, investment capital flows away from us, not to us. This means other markets benefit from investment capital, job creation, and economic growth at our expense.

The Federal Reserve is in a difficult spot. With unemployment near 10% and the economy grudgingly emerging from the worst recession since the Great Depression, the Fed certainly does not want to hinder any recovery by raising rates prematurely. However, for those trying to return to "normal", the cost is dear.

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long-maintained that risk *and* return are equally important.

Before delving into possible solutions to this predicament, let us attempt to illustrate the problems posed. The examples that follow are completely hypothetical, and no real market or manager statistics are used. With that in mind, evaluate these three managers:

Yr.	Manager A	Manager B	Manager C	Market
1	7.00%	6.50%	10.95%	10.00%
2	16.82%	13.85%	8.16%	10.00%
3	9.60%	13.81%	14.58%	11.57%
Annual	11.06%	11.33%	11.20%	10.52%

What does this information tell us? They all beat the market by similar amounts, so are they all similarly good? Is Manager B the best? We don't have enough data to know, although this is the sort of information most decisions are based on.

What if we could quantify how much risk each manger assumed relative to the market in producing these winning returns? Would that be helpful? We believe it is not only helpful, but necessary, and we will expand on the above example to explain why.

A common measure of risk is called Standard Deviation. Standard Deviation is a measure of the volatility of portfolio returns. A portfolio that returns 1.00% every month without fail would have a standard deviation of 0 (and also would likely be fraudulent). A portfolio that produces returns all over the board would have a very high standard deviation. Investors differ in terms of the amount of volatility they can stomach, so knowing what to expect is helpful.

Taking the returns from the above table and adding arbitrary standard deviations, we can create a better understanding of how each manager performed. To do so, we introduce what we call the ***Tandem Ratio***. The Tandem Ratio is a tool we use to calculate how much return is achieved per unit of market risk, and the formula is *TR= (Portfolio Return ÷ Portfolio Standard Deviation) × Market Standard Deviation.* The Tandem Ratio can be used to directly compare risk-adjusted returns, with higher ratios equaling better management. We can go one step further and determine the return required given the manager's risk.

In the table at the bottom of this page, we see that Manager C did not have the best absolute returns, but did the best job of providing returns for the level of risk assumed. Manager B posted the best returns, but the risk taken should have yielded better results. This type of analysis allows an investor to identify both a comfortable level of risk and acceptable returns for that level.

We must recognize that there are problems with relying on this analysis. First, the Tandem Ratio has not been tested by academia and is not accepted as a valid analysis tool (although we think it works pretty well). This can hardly be viewed as industry standard analysis. Second, it is easy for managers like Tandem to report standard deviation for a composite (a group of accounts with similar objectives), but nearly impossible to report such information on an individual account basis. Since this is not common industry practice, portfolio accounting software like we use to produce quarterly statements does not offer such reporting. While we are hopeful this will change, producing such data as of today would be overwhelming. There is some movement in this direction, but the software isn't there yet.

A third short-coming is that managers are not required to report standard deviation. While most do, this information may be difficult to come by. And finally, it still requires mathematical analysis by the investor.

Given the challenges of utilizing the elegantly brilliant Tandem Ratio, which have provided some easier assessment tools investors can use to make risk analysis more attainable.

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	Manager A		Manager B		Manager C		Market	
	Return	Standard Dev	Return	Standard Dev	Return	Standard Dev	Return	Standard Dev
Annualized Data	11.06%	11.15	11.33%	14.25	11.20%	11.25	10.52%	12.25
Tandem Ratio	12.15		9.74		12.20		10.52	
Required Return for Risk Level	9.58%		12.24%		9.66%		10.52%	
Excess Return	1.48%		-0.87%		1.54%		0.00%	

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The table below lists five items that, when present, can help reduce risk. First, many investments are required to be fully invested. This is fine if the investor is willing to proactively manage how much to commit to that investment. At Tandem, we have no such constraints. When we have more securities to sell than buy, our portfolio cash levels increase. Conversely, when we have more securities to buy than sell, cash levels decrease. This was essential to us in 2008 as we were net sellers. Mutual funds and other investment vehicles can be prohibited from raising too much cash. We were able to reduce risk by not being compelled to remain fully invested.

While this checklist is not infallible, it certainly can help mitigate unintended risk. Risk is by no means bad. Appropriately managed risk can lead to greater returns. But risk level definitely needs to be a component of the evaluation process, and reporting standards today offer insufficient guidance.

At Tandem, we have two equally important jobs - to deliver superior returns *and* less risk to our clients. Doing one without the other is unacceptable. In the low interest rate environment present throughout this decade, the temptation to reach for better returns has caused many to dismiss risk considerations. We believe this contributed greatly to the global financial crisis.

In search of better returns, investors made decisions they might not have made had interest rates or stock market returns been more compelling. Instead, they were willing to accept being fully invested, no customization, less liquidity and transparency and no escape plan. The result was a disaster.

	TANDEM	Mutual Fund	ETF	Hedge Fund	Other Pooled Vehicles (Commodity Funds, Private Equity, Real Estate)
No Limit on Amount of Cash	Yes	No	No	Yes	Yes
Customized Portfolio	Yes	No	No	No	No
Instant Liquidity	Yes	Yes	Yes	No	No
Know what you own	Yes	No	Yes	No	No
Documented Sell Discipline	Yes	?	?	?	?

If an investment vehicle cannot take into account individual needs (like capital gains or losses, timing of withdrawals or lack of comfort), the investor is buying a one-size-fits-all portfolio. This means that individual risk tolerance is not being considered, and the investor must be proactive.

Many investment vehicles offer limited liquidity. Limited access to money brings on its own set of risks. Investors may occasionally need cash for various and unplanned reasons. When a particular investment does not offer liquidity, the benefits must be weighed in light of this.

Investment vehicles with limited transparency make it difficult to assess risk in the moment. The aforementioned portfolio statistics enable mathematical analysis looking backwards, but there is no way to know if the investment has become more or less risky since the last report.

Finally, all investment disciplines have a buy discipline, but do they have a documented sell discipline that investors can monitor? Sell disciplines are important when markets move against a particular type of investment, and investors that are unable to determine whether prescribed measures are being followed assume additional risk.

As we discussed in the July issue of ***The TANDEM Report***, diversification of asset classes and investment vehicles does not guarantee diversification of risk. The more an investor commits to illiquid investments, the more dependant she becomes upon the liquid assets she holds. When this approach becomes widespread, the liquid assets can fail to provide the safety originally envisioned because all investors are raising cash from the assets they can sell. This happened in 2008, and it can happen again.

We believe the most prudent strategy is the one we have followed since our founding in 1990. Understand what you own, customize it to meet your needs, be able to sell it freely, have a well-defined sell mechanism in place and do not be compelled to be fully invested.

Tandem does not avoid risk. Tandem manages it. This is not conservative. Just smart.

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MARKET REPORT CARD

YIELD TABLE	Current	3 months ago	1 year ago
3-month Treasury Bill	0.12%	0.18%	0.46%
5-year Treasury Note	2.37%	2.71%	2.91%
10-year Treasury Note	3.40%	3.72%	3.81%
30-year Treasury Bond	4.19%	4.52%	4.41%
Prime Rate	3.25%	3.25%	5.00%
Federal Funds Rate	0-0.25%	0-0.25%	2.00%
Discount Rate	0.50%	0.50%	2.25%
3-Month LIBOR	0.30%	0.62%	3.48%

The data used to compile the above tables come from publicly available sources. Tandem believes it to be reliable, but makes no such assertions. Such data is not meant to imply past or future performance for Tandem or any securities market.

STOCK MARKET INDEX DATA				
Stock Market Indices	09/30/09 Close	% Change 1 Year	% Change 5 Years	% Change 10 Years
S&P 500	1,057.08	-9.37%	-5.16%	-17.59%
Dow Jones Industrial	9,712.28	-10.49%	-3.65%	-6.04%
Russell 1000	579.97	-8.42%	-2.63%	-12.63%
Russell 3000	619.87	-8.64%	-2.00%	-9.48%
Russell 2000	604.28	-11.08%	5.47%	41.42%
GLOBAL MARKET INDEX DATA				
Hang Seng	20,955.25	16.31%	59.72%	64.57%
Shanghai	2,779.43	21.17%	99.00%	NA
Nikkei 225	10,133.23	-10.01%	-6.38%	-42.44%
Brazilian Bovespa	61,518.00	24.18%	164.65%	453.92%
London FTSE 100	5,133.90	4.72%	12.32%	-14.86%
German Xetra DAX	5,675.16	-2.67%	45.78%	10.20%

Returns are cumulative, not annualized.

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