TANDEM INVESTMENT ADVISORS

A Year of Many Records; Some Noteworthy, Some Dubious

The year of endless Zoom meetings has mercifully come to an end, but not before making stock investors a happy lot. The year ended so robustly it is as if the market never crashed in March. Did we just imagine that?

The perils of the real world inexplicably manifested themselves as good fortune for the investment world. I say inexplicably not because it is unexplainable now, which is not the case, but rather because in the moment of panic, the manner in which the stock market ultimately responded was unfathomable, even to the most optimistic among us.

The S&P 500 appreciated 18.40% for the year. Not bad coming on the heels of 2019, which saw the S&P up more than 30%. Yet 18.40% doesn't begin to tell the story.

From an all-time high on February 19, the S&P collapsed at the fastest rate on record. The market fell 33.79% in only 24 trading days. That market bottom on March 23rd would never be tested again. The S&P was up more than 9% the very next day and it was off to the races. Record highs were reached again by August, less than seven months after a bear market ended, and the S&P closed the year at another all-time high.

When the dust settled, the S&P had rallied 70.18% from the bottom of March 23rd. Simply unbelievable. Earnings, however, did not keep pace. In March 2019, the S&P 500 companies were projected to earn $186.36 in 2020. By March 2020, that projection had fallen to $151.52. By December, expectations were lowered to $120.25, up from $109.06 in June, but still well shy of previous expectations.

While the economy and earnings struggled, stock prices soared. Earnings for 2021 are now expected to jump about 36% to $165. This number is down considerably from the expectation of $183 in March of last year. Still, a 36% increase in earnings understandably gets the attention of investors.

It is hard to know if the 36% jump will materialize, or if expectations will be lowered again. We suspect expectations are rosier than warranted, but what that means for the market is anyone's guess. Last quarter we joked that the Price/Earnings (or PE) ratio has been rendered irrelevant and that Price/Stimulus is the new measure of fair value. Turns out our jest was accurate. As long as Congress and the Fed keep the money flowing, stocks stand to prosper.

2020 was less generous to the Dow Jones Industrials. That index only managed a gain of 7.25%. The real action was to be found in the more speculative NASDAQ index, which advanced a whopping 43.64% for the full year.

Many other records were set as well. Some were noteworthy, others more dubious. In addition to record highs for nearly every U.S. stock index, 2020 saw a record number of new equity and debt offerings, record levels for the Fed's balance sheet, record amounts of stimulus, records for both job losses and job gains, record GDP declines and advances, record debt, record debt as a percentage of GDP, and of course record deficits.

It seems we probably pulled a great deal of gains forward in 2020. Let's enjoy them while they are here and see what happens next.

HISTORICAL TOTAL RETURNS (%)[1]
As of 12/31/20

			Annualized as of 12/31/20	
	Market Drop 2/19/20 to 3/23/20	**Market Comeback** 3/23/20 to 12/31/20	**1 Year**	**Since Inception** (3/15/19)
Castle Tandem Fund	-24.33	43.35	13.40	14.33
S&P 500	-33.79	70.18	18.40	19.43

Performance quoted represents past performance. Past performance is no guarantee of future results. Investment return and the principal value of an investment will fluctuate. Shares may be worth more or less than original cost when redeemed. Current performance may be lower or higher than performance shown. You may obtain performance data current to the most recent month end by calling 703-260-1921.

[1] The expense ratio for the Institutional Share Class is 1.18%. Effective November 1, 2020 the Adviser has contractually agreed to waive Services Agreement fees by 0.40% of its average daily net assets through October 31, 2021. The Services Agreement fee waiver will automatically terminate on October 31, 2021 unless it is renewed by the Adviser. The Adviser may not terminate the fee waiver before October 31, 2021. The total expense ratio excluding the Services Agreement fee waiver for the Institutional Share Class is 1.58%.

Commentary

STOCKS ARE EXPENSIVE. DOES THAT MEAN THE MARKET IS?

Predicting the next move in the stock market is a fool's game, in my opinion. Of course, that could be my opinion because I have never demonstrated any particular skill as a prognosticator. But let us leave that aside for now and focus our attention on what I perceive to be Tandem's skillset.

Tandem does not invest in "the stock market". We seek to invest in the stocks of companies that demonstrate the ability to grow consistently over time. And we believe that price, or valuation, matters a great deal.

By most traditional measures, stocks are expensive. Notice I say stocks, not the stock market. I cannot say with any certainty that the stock market is expensive. But I can comfortably say that stocks are expensive. Some are extremely expensive, and a few bring the bubble of the late 1990s to mind. There is certainly evidence of widespread speculation.

A year ago we felt that valuations were extended, and the cash levels in The Castle Tandem Fund reflected our inability to find enough places to commit your capital. Then came the COVID sell-off and we found plenty of places to deploy the cash we had accumulated. But that proved short-lived. With all the stimulus from both Congress and the Federal Reserve, asset prices reflated in record time. And today company valuations exceed even the lofty levels of one year ago. Again we find it less than compelling to commit your capital to securities we consider overvalued.

Valuations in some cases are reaching the absurd. Tesla is valued at more than $1.4 million per vehicle sold in 2020. GM is valued around $8,000 per vehicle sold. Tesla sold a little over 500,000 cars last year. GM sold more than 7 Million. We do not own Tesla (or GM).

Several new IPOs this year have skyrocketed in price on the day they first traded, some more than doubling. Bitcoin moves in huge swings, mostly to the upside, and is now trading at more than 5 times its price a year ago. The use of options as a speculative tool has increased dramatically. Options cost less than the underlying stocks, so less capital is required to own them. And typically options are owned with some measure of borrowed money. The amount of money borrowed to buy stocks is also approaching stratospheric levels.

The moves higher in Facebook, Apple, Amazon, Netflix and Google (the fabled FAANG stocks) seem pedestrian when compared to these speculative wonders. A new generation of investors is spreading its wings. They haven't yet been scarred by the sorts of things that keep us old-timers on the defensive in times such as these.

These examples are of stocks, not markets. It would be hard to argue that all stocks are overvalued, which makes it hard to argue that the stock market itself is overvalued. We clearly find plenty of stocks that we still like. After all, even if our portfolios are not 100% invested in stocks, they are certainly mostly invested in stocks. And if you read our Commentary from October 2020, you know that we believe being in or out of the market is a false choice. We should always be in the market. Just not always all in!

All this leads me to the following prediction: like all previous periods of speculative excess, this too will end badly. Take that for what it is worth, as I openly acknowledged in paragraph 1 that I have no particular skill as a prognosticator!

What I will not predict is when this will end badly. We are in the midst of some of the most dramatic asset price inflation in my lifetime. If you are fortunate enough to own assets (and if you are reading this you likely fall into the category), you have been given a great gift.

There is so much money (I would argue too much money) in the financial system that the value of financial assets is being radically overstated. In the 1970s we experienced a very different type of inflation. The costs of goods and services rose appreciably, not the value of financial assets.

Inflation, by definition, occurs as the result of too much money chasing too few goods. In the 70s, wage gains pushed higher the cost of goods and services. Fed Reserve Chairman Paul Volcker finally broke the back of inflation by raising interest rates to unheard of levels. I once had a money market account that yielded 21%. But high rates did the trick. The economy recessed and excesses were reigned in.

Today, there are no inflationary wage gains to speak of, nor is there anyone like Paul Volcker at the Fed. Sure, Volcker's actions were painful in the moment. But they were for the economy's long-term benefit. Ben Bernanke, Janet Yellen, and perhaps Jerome Powell, have pursued policies quite the opposite of Mr. Volcker's. The result has been a massive expansion of the wealth gap.

These Fed Chairs have pursued a zero interest rate policy, which has been discussed many times in these pages. Zero interest rates devalue savings and hope to increase borrowing, thereby creating a stimulus for the economy by putting more money to work. The Fed forced interest rates to zero by creating trillions of dollars and using them to buy government debt (which has become quite plentiful). Increased demand for fixed interest instruments like government bonds causes prices to rise, which in turn send interest rates lower.

Sadly, the policy has not worked as promised. Household borrowing is way down and savings has increased. Household borrowing is supposed to spur the economy, as we can buy more TVs, iPads and cars on credit. Theory has not become reality.

On the other hand, government borrowing has risen sharply, even if consumer borrowing didn't. Unfortunately, government borrowing is less stimulative to the economy, and it has a crowding out effect on investors. With the Fed buying nearly all of our government's new debt, investors are unable to buy as much of these bonds as they might like, and are forced into other instruments, like riskier bonds, stocks, real estate, bitcoin, gold...you name it.

Whether intended or not, this is how the Fed has managed to create asset inflation. And this is how they have widened the wealth gap - by inflating the value of assets the wealthy own without any equal advantage for the non-asset owners among us.

If you own stocks, bonds, a home, or anything that has lasting value, you win! If you don't, this Fed can't, or won't, help you.

I say with certainty that this will end badly, and I believe I can even tell you how. I just can't tell you when.

We caught a glimpse of how in 2018. Jerome Powell, newly appointed Fed Chair, continued his predecessor's policy of raising rates, which the stock market seemed to take in stride. But then he decided to really take away the punch bowl, which was the Fed's post-financial crisis policy called quantitative easing. This was the mechanism used to buy up bonds and force rates lower while driving investors to other asset classes. Powell embarked on the reverse of this policy, dubbed quantitative tightening.

The almost immediate result of quantitative tightening was a collapse in global asset prices, including a decline of 20% in the U.S. stock market by December of 2018. I believe it is important to understand what this quantitative tightening was. Until this policy announcement, the Fed had been in the habit of buying every month billions of dollars in bonds, with a balance sheet of nearly $5 trillion dollars. Powell proposed to reduce (not eliminate, simply reduce) the size of the Fed's balance sheet to $2.5 trillion to $3 trillion over a period of 4 years.

Prior to the Financial Crisis, the Fed's balance sheet was nearly $900 billion. Powell inherited a balance sheet roughly 5 times that size. But markets made it clear that his plan would not be taken lightly. And so he relented.

We now live in a world where fiscal (government) and monetary (central bank) policy focus on maintaining asset prices. So it is good to be an asset owner. One day, there will be another Paul Volcker, or perhaps a politician with courage, that will move to break the back of inflation. When that happens, asset prices will deflate. And it won't be pretty.

In the meantime, stocks can remain expensive for a very long time without the market caring. When stocks are the best alternative, their valuations matter little. Demand will be plentiful enough to send prices even higher. There just aren't enough shares of FAANG or enough bitcoins to satisfy demand.

We will remain cautious with how we commit your capital. Our Commentary in January 2020 spoke to the importance of staying invested. Indeed, staying invested is the key to ultimate investment success. But staying invested can be challenging when markets move lower. By seeking to limit our exposure to the companies most vulnerable when the downside comes, we hopefully help you stay invested for the long run. Trying to time entries and exits is as foolhardy as trying to prognosticate.

As we have pointed out countless times, it is important that we take stock of the amount of risk we take on to realize the gains in the market, and to determine if that risk is appropriate. We don't get out of the market. We get out of the stocks that don't justify the risk, in our view. Stocks are expensive. That doesn't mean the market is. Yet.

John Carew is a shareholder, the President and Chief Investment Officer of Tandem Investment Advisors, Inc. Mr. Carew began his investment career in 1985 and founded Tandem Investment Advisors, Inc. in 1990. He is a graduate of the University of Virginia with a Bachelor of Arts degree in Economics.

John B. Carew
President, Chief Investment Officer
Tandem Investment Advisors, Inc.

The opinions expressed are those of the Fund's Sub-Adviser and are not a recommendation for the purchase or sale of any security.

As of December 31, 2020 the Fund did not hold a position in the following companies mentioned in this report — Tesla, Inc., Zoom Video Communications, Inc., General Motors Co., Facebook, Inc., Apple, Inc., Amazon.com, Inc., Netflix, Inc., or Alphabet, Inc.

The Standard & Poors 500 Index (S&P 500) is an index of 500 stocks. The Dow Jones Industrial Average is a stock market index that tracks 30 large, publicly traded companies. The Nasdaq Composite Index is a market-cap weighted index of more than 2,500 companies listed on the Nasdaq stock exchange.

The Fund's investment objectives, risks, charges and expenses must be considered carefully before investing. The prospectus contains this and other important information about the Fund, and it may be obtained by calling 1-877-743- 7820 or visiting www.castleim.com. Read it carefully before investing. Distributed by Rafferty Capital Markets, LLC Garden City, NY 11530.

The risks associated with the Fund are detailed in the Fund's Prospectus. Investments in the Fund are subject to common stock risk, sector risk, and investment management risk. The Fund's focus on large-capitalization companies subjects the Fund to the risks that larger companies may not be able to attain the high growth rates of smaller companies. Because the Fund may invest in companies of any size, its share price could be more volatile than a fund that invests only in large-capitalization companies. Fund holdings and asset allocations are subject to change and are not recommendations to buy or sell any security.