DVI
David Vaughan Investments

Quarterly Perspective

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The Fiscal Cliff (Act II)

The Debt Ceiling & Spending Cuts

No, it was not the "Grand Compromise" that we were hoping for, but at least the American Tax Relief Act of 2012 (ATRA) provides a more definitive roadmap to work with on the tax side of the equation. Part of the positive outcome from this legislation was the fact that many of these new tax rates have been made permanent (See Table 1). In contrast to the past few years, we can now look towards estate, capital gains, dividends, ordinary income and Alternative Minimum Tax rates with a sense of certainty and make rational long-term investment and estate planning decisions. The equity market's reaction to this last minute resolution, described by some as a "Bungee Jump off the Cliff" on January 1st, was more or less a sense of relief that everything was not going to be once again kicked down the road.

Table 1

2013 - New Tax Environment

	ATRA	Prior Law
Top Income Tax Rate		
Single Filers > $ 400,000 Joint Filers > $ 450,000	39.60%	35.00%
Top Dividend Rate		
Single Filers > $ 400,000 Joint Filers > $ 450,000	20.00%	15.00%
Top Capital Gains Rate		
Single Filers > $ 400,000 Joint Filers > $ 450,000	20.00%	15.00%
Top Estate Tax Rate	40.00%	35.00%
Estate Exemption Amout *(Inflation Adjusted)*	$ 5 million	$ 5 million
Affordable Care Act Taxes		
Investment Income		
> $ 250.000 Joint Filers > $ 200,000 Individual Filers	3.80%	0.00%
Tax on Earned Income		
> $ 250.000 Joint Filers > $ 200,000 Individual Filers	0.90%	0.00%

Source: CCH

The Budget Scoring of ATRA

The budget impact of this recent legislation can be viewed in two different ways. One way would be to compare the projected results over the next ten years versus what was to become law effective January 1st. This would include both the expiration of the Bush Era Tax Cuts and the spending cuts from Sequestration and no Alternative Minimum Tax inflation patch. Take this approach and the Congressional Budget Office (CBO) has calculated an additional $ 4 trillion in our nation's budget deficit through 2022. However, the U.S. Treasury has calculated the impact of ATRA with "Current Policy", using the status quo in 2012. This approach resulted in a positive $ 737 billion in additional revenue in the upcoming decade. According to this recent Treasury Report, nearly 85% of the revenue pick-up is attributable to the new top ordinary income tax rate of 39.6% and the new top estate tax rate of 40%. Of lesser impact is the roughly $ 12 billion in additional forecasted revenue from the early payment of taxes associated with the new ability to convert Retirement Plan Account balances to Roth Accounts.

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Route To:

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Why NOT to Invest in Gold

Brian Christensen, CFA
Senior Vice President

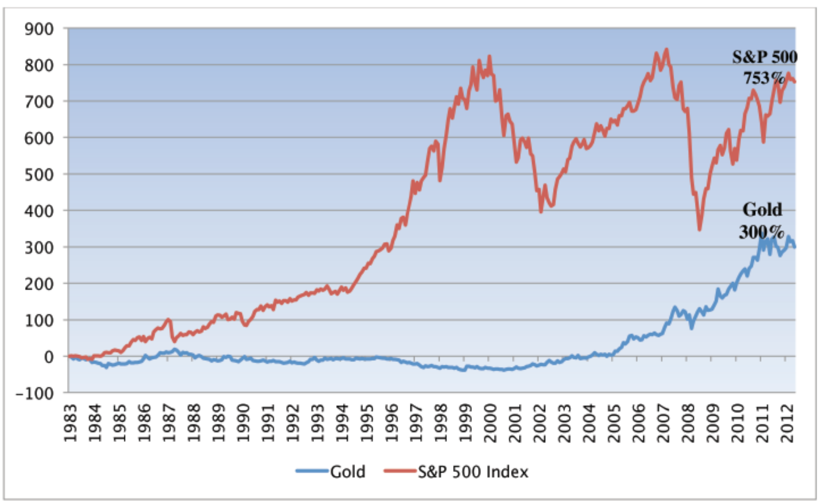
Radio and television commercials, full page ads in the local newspaper, and the cadre of sign wavers in front of your favorite strip mall beckon you to buy gold. Their approach is too similar to the "no money down" mortgage hawkers who died a painful death not so long ago. But what's an investor to do? Gold has risen more than 80% in the past five years while the price of the S&P 500 Index has been nearly flat. I have to get some… or not.

It's a common question from clients and at times my reply is rather flippant – if the world is going to collapse, I'd rather own a very large freezer and weapons. Warring factions in the Middle East aren't throwing gold coins at one another and while the largest consumer demand for gold is from India (mostly in the form of jewelry), the country still appears to have way too many starving citizens. Aside from my obvious personal bias, there are investment fundamentals to consider.

Investing in gold isn't like investing in stocks, bonds, or other securities. Gold has no yield, and because there are costs to owning gold, its yield is actually negative. There are no company financial statements or products to evaluate. Gold is purchased, in my opinion, out of either fear or greed – neither of which usually ends well. Gold's use as an industrial commodity is limited. According to the World Gold Council, only 12% of global demand comes from industrial applications and plays a minimal role in determining its value. As such, investor sentiment plays a very large role in price determination.

Viewed as a long-term investment rather than a hedge against Armageddon, gold has been rather uninspiring. Below is a chart showing the price movements of gold and the S&P 500 Index going back to 1984. Clearly it has only been in the past four years where gold has excelled.

At this writing, gold is trading at $1,657 per ounce. Is that a good price at which to buy? I don't know and honestly have no way of truly knowing. If it were a traditional security, I could evaluate the company's earnings, revenues, dividends, management, and the industry, among others. With gold, I have to estimate the price at which others are willing to pay me and that is based upon emotion and sentiment. How bad do things have to get for someone to pay me all-time high prices for my gold? In light of today's political and economic environment, and tremendous uncertainty in all of our minds, I'd like to think the worst is already factored into the price of gold. If one needs to own gold to maintain a high sleep quotient, by all means please do so, but be prudent with position size.



Plan, PROTECT and Prosper

Betty A. Corder
Client Services Associate

Protecting client assets is one of the three tenets that DVI is built upon. We strive to protect assets not only by emphasizing risk management in client portfolios, but, in conjunction with our custodians, Charles Schwab and TD Ameritrade, we also take steps to vehemently secure our clients and their assets from any act of fraud. There are three ways that we work with our custodians to provide this security: we help create awareness of email fraud, we use extreme precaution when wiring funds and we have incorporated a signature verification process.

Email Fraud: Email is an easy and convenient way to communicate. However, it is also used by criminals to deceive users into providing personal information or sending money. One common way email users become targets is by responding to emails that are sent as alerts, solicitations, or requests. These types of emails often entice people to act. We recommend that our clients closely evaluate the emails they receive and consider the following questions: Does the email request you to verify personal information or change your password by requiring you to click on a link within the email? Has the sender attempted to make the email look official but the email contains misspelled words? Is the email from someone or some organization that you have not done business with? For example, if you receive an email titled UPS, but you have not requested or used any UPS services, then delete the email.

A more sophisticated form of email fraud occurs when a perpetrator is able to access your email account by breaking your password. This provides an opportunity for the criminal to initiate communication and financial requests while posing as the client. Our custodians recommend protecting yourself from this type of fraud by evaluating your password and changing it on a regular basis. Some tips for creating a secure login ID and password include: (1) do not use passwords that contain personal information or words found in the dictionary, (2) do not use sequences such as abcde or 12345, (3) consider inserting a number in the center of your password to make the code more secure. Additionally, always logoff your email account, as well as any secure online website that you have used.

If you receive an email that appears to be from DVI, Schwab, or TD Ameritrade but you are unsure of its origin, please contact us. Remember, our custodians will never email or contact you by phone to request that you provide your account number, password, or personal information.

Wire Transfer Precautions: Wire Transfers are an efficient and sometimes necessary way of moving money, but there has been increased activity in wire fraud attempts made through compromised email accounts. At DVI, we partner with our custodians to take steps to prevent wire fraud. We will not initiate wire requests received via email without verbal confirmation from our client. Procedurally, we will contact our clients for verbal confirmation utilizing phone numbers that we have on record, rather than using phone numbers provided via email. We also provide clients with a wire authorization form for instruction, verification and signature. Once the request is submitted for processing, the form will be subject to signature verification prior to the release of funds. We work closely with our custodians to streamline this process, making it efficient and convenient, yet also ensuring the highest level of safety to our clients.

Signature Verification: Signature verification is another way we can help prohibit fraud. Signature verification is the process of comparing a submitted document against the client's known signature. The process is used not only for wire requests, but for address change requests as well. If your signature has changed dramatically over the years, we may consider submitting an updated signature comparison document.

DVI is committed to safeguarding your accounts and the privacy of your information. The highest levels of security are only possible when we work in conjunction with our custodians. The systems, policies and procedures that we have with Charles Schwab and TD Ameritrade are carefully developed and maintained to protect our clients' personal information and financial assets. These partnerships are further backed and evidenced by the Security Guarantee that we have with these providers. Rest assured that any losses due to unauthorized activity in any Schwab or TD Ameritrade account will be covered 100% by these custodians.

The Fiscal Cliff (Act II)

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Washington, We have a Spending Problem

What Congress and the President were unable to resolve in their last minute heated negotiations was what to do with the extension of the Debt Ceiling and the automatic $ 1.2 trillion in spending cuts over the next decade tied with the Sequestration. There has been a two month extension to the Sequestration and the U.S. Treasury estimates the Debt Ceiling limit will be met at approximately the same time. Some say we have tackled the hard part with the passage of our new tax policy, I would respectfully disagree. From a political standpoint, new income taxes on the upper 2 % of American wage earners seems a whole lot easier than reducing spending on entitlement programs such as Medicare, Medicaid and Social Security that represent nearly 50% of government outlays and would have such a widespread impact.

The ugly truth is that what was once was framed as a one-time $ 830 billion economic stimulus package back in 2009 in the wake of the banking crisis has become a permanent fixture in our Government's annual outlays and we have elected not to reduce this spending nor find ways to offset these additional costs. (See Table 2 located on page 4) The consequence is four consecutive years of trillion dollar plus deficits and it appears we are on the same path once again in 2013.

The CBO recently released their Monthly Budget Review for Fiscal Year 2013 for the period ending November 30th. We are only two months into the new Fiscal Year, but we have already recorded a deficit of $ 292 billion, a shortfall of approximately $ 57 billion from the prior year period. Receipts for the period climbed to $ 346 billion, an increase of $ 30 billion, but outlays climbed by $ 87 billion or nearly 16 % to $ 638 billion.

With this as a backdrop, everyone knows that we are facing the inevitable, we can no longer spend at the current rate and that which we elect to spend on, we need to find ways to pay for it. And everything needs to be on the table in this discussion, not only entitlement programs, but Military Spending as well. With interest rates so low, our net interest on public debt payments have actually decreased during this five year window despite our aggregate debt nearly doubling in size. Given interest rates of five years ago, our nation's annual interest expense alone would be nearly $ 500 billion! As Alan Simpson of Simpson-Bowles fame was recently quoted, "we appear to be the best looking horse in the glue factory."

The Congressional Budget Office

Since its founding in 1974, the Congressional Budget Office (CBO) has produced independent analysis of budgetary and economic issues to support the Congressional Budget process. The agency is strictly nonpartisan and conducts objective, impartial analysis, which is evident in each of the dozens of reports and hundreds of cost estimates that its economists and policy analysts produce each and every year.

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Table 2

U.S. Government Receipts & Outlays

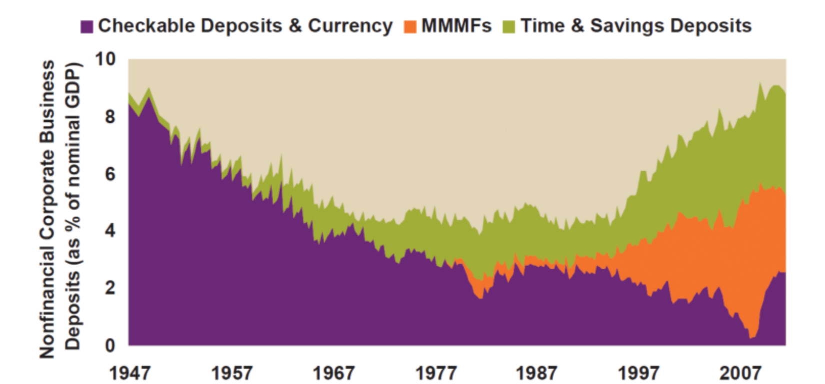
Fiscal Years (2007 – 2012)

	2007	2008	2009	2010	2011	2012
Total Receipts	2,568.00	2,524.00	2,105.00	2,163.00	2,302.00	2,449.00
Individual Income Tax	1,164.00	1,146.00	915.00	899.00	1,092.00	1,165.00
Estate & Gift	26.00	29.00	24.00	19.00	7.00	11.00
Total Outlays	(2,729.00)	(2,983.00)	(3,518.00)	(3,456.00)	(3,599.00)	(3,538.00)
Social Security	(586.00)	(617.00)	(683.00)	(707.00)	(731.00)	(779.00)
Health & Medicare	(641.00)	(672.00)	(764.00)	(821.00)	(859.00)	(847.00)
Military Spending	(551.00)	(616.00)	(661.00)	(694.00)	(706.00)	(716.00)
Net Interest on Public Debt	(237.00)	(253.00)	(187.00)	(196.00)	(230.00)	(225.00)
Deficit	(161.00)	(459.00)	(1,413.00)	(1,293.00)	(1,297.00)	(1,089.00)

Sources: Congressional Budget Office, Wall Street Journal 11.12.2012, Office of Management & Budget

2013 Equity Market Dynamic

Liz Ann Sonders, the Chief Investment Strategist for Charles Schwab & Co wrote "this has been the most unloved bull market I've witnessed in the nearly 27 years I've been in this business". Despite a nearly 120 % gain in the S&P 500 Index since March of 2009, it appears many investors have elected to sit on the sidelines waiting for better economic data or more encouraging news out of our nation's capital. All-in-all, as we have mentioned in prior commentaries, individual investors have been net sellers of common stocks throughout this entire period of time. In terms of overall confidence, the business community continues to err on the safe side as well. As the Chart below illustrates, corporate cash as a percentage of GDP has climbed to historical highs as business spending has declined in recent quarters and corporate profits remain robust.

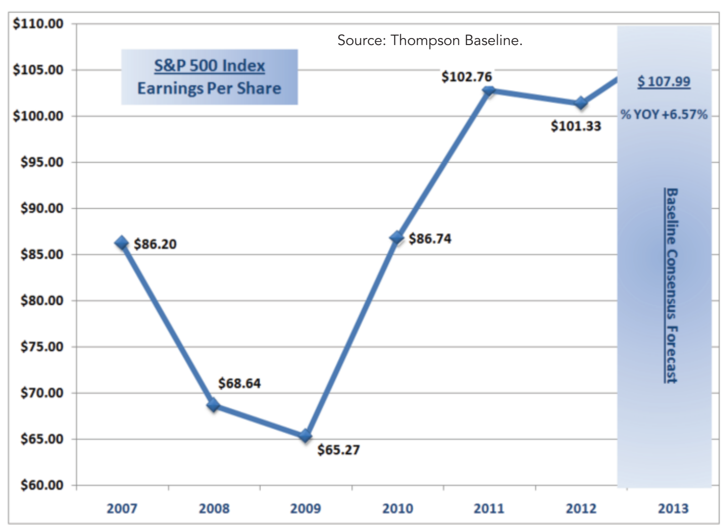


Source: Charles Schwab & Co.

With investor sentiment still skeptical, valuations remain reasonable with the S&P 500 Index forward price earnings ratio currently at 13.7 times 2013 earnings. As the Chart below depicts, earnings per share are forecasted to increase in 2013, with the consensus number of nearly $ 108 per share or an increase of nearly 7%. Lastly, worldwide credit markets appear to be positively responding to the massive amounts of Central Bank intervention in the global capital markets. Interest Rates at year end 2012 are historically low in most developed country economies.

So as one considers the prospects for 2013, with money supply worldwide in hyper accommodation mode, investor sentiment continuing to be in a show-me mode and valuations quite reasonable, expectations for 2013 are naturally somewhat positive.

However, the Fiscal Cliff (Act II) is likely going to be more contentious than Act I. This will potentially lead to increased market volatility and occasional market down drafts over the next 60 days as investors react to the threat of a government shut down or yet another Credit Ratings downgrade. The Republicans have already put a stake in the ground that the next round of negotiations will be all about spending reductions, while the Democrats are suggesting a more "balanced approach", focusing on both more revenue increases and spending reductions. Above and beyond the American Tax Relief Act, further fiscal measures will be absolutely required to put the U.S. Government on a sustainable financial path. As Erskine Bowles commented, "we have done all of the easiest stuff, all of the hard decision making lays ahead of us." As with ATRA, the solution does not have to be perfect, simply knowing what the future path is going to look like will remove investor uncertainty and provide overall support to the equity market.



Will Williams

President

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