DVI
DAVID VAUGHAN INVESTMENTS

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Moving in Lockstep – For Now

For many investors, all stocks are viewed in the generic, each one sharing the same risk and reward characteristics. If one invested in the stock market, there was a uniform perception as to what that experience was going to be like. We on the other hand have argued for decades that all stocks are not alike, as with automobiles, there are racy sports cars and dull four door sedans. Both provide transportation, but the ride along the way for each is considerably different. In the equity market, there are companies that participate in emerging fields, are constantly requiring funding from the capital markets, cannot afford to pay a dividend and trade at high multiples of future earnings. Contrast these companies to those that are in mature industries, are market leaders, create excess capital used to repurchase company stock and pay dividends and trade at a discount to various market multiples. Fundamentally, the more conservative stock should zig and zag in the market place with much less volatility than the growth stock that is more vulnerable to the vagaries of the economy. This very concept is the rationale for constructing individual security portfolios, attempting to provide a return stream that exhibits a significantly different pattern than provided by an equity index such as the S&P 500.

In today's high anxiety investment environment, traditional long only equity investors are increasingly being replaced by those investors who are much more focused on macroeconomic trends. These top-down investors are reading the tea leaves of economic statistics and are implementing short-term trading strategies based upon their forecast of a myriad of economic factors. These are investors who quite frankly do not care about the fundamental differences between say Microsoft and Ford Motor Co. The success or failure of their investment strategy is not based on what individual stocks they own, but the price direction of the basket of stocks they own in the form of passive index funds or increasingly exchange traded funds (ETFs) Stocks have in effect been turned into a commodity, no different than gold, crude oil or pork bellies. And at least for now, the correlation statistics that have supported our long held view that all stocks are not created equally, would argue that they are increasingly becoming generic.

As the chart on page 4 illustrates, over the past 24 months, correlation statistics between the S&P 500 Index and other primary equity indices has been in excess of .90 (1.00 being perfectly correlated). Intentionally, this is not an apples-to-apples comparison as these indices vary quite significantly. Not only did I include small and mid cap indices, but also indices that vary based upon the growth or value nature of the companies represented. And in the case of the MSCI EAFE, this international equity index has both a different geography and a multitude of home currencies.

What has caused this phenomenon?

1) Investors no longer trust long term capital market statistics, the "lost decade" has

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Route To:
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Inflation and Stock Prices

Brian Christensen, CFA
Senior Vice President

Recently, a frequent topic of discussion with clients has been about the potential impact of high inflation on the equity markets. No doubt the concern arises due to the fiscal challenges faced by our country and the ongoing effort by the Federal Reserve to stimulate economic growth with historically low interest rates. Much of the world today is awash in liquidity. Thanks to this increase in liquidity and extended period of low rates, the risk of higher inflation will surface as the economy gains strength.

Inflation can be measured in many ways but for the purpose of this study I used the Consumer Price Index for All Urban Consumers (CPI-U). The U.S. Bureau of Labor Statistics produces monthly data on changes in the prices paid by urban consumers for a representative basket of goods and services. CPI-U is the index most often reported by the national media.

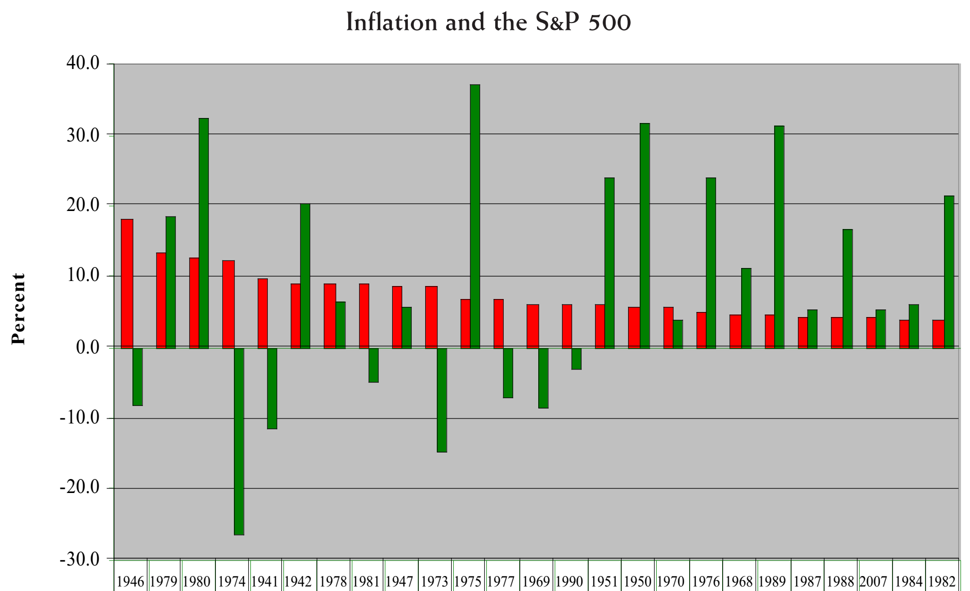
The chart below identifies the 25 years of highest inflation during the 83 year period of 1927-2009. As you can see the chart is dominated by the 1970's and 1980's when year-over-year U.S. inflation ran as high as 13.3% in 1979. Also shown on the chart is the return of the S&P 500 Index during those same years. You'll note that in 14 of the 25 years the return of the S&P 500 Index outpaced inflation providing real economic gain. The average CPI-U inflation rate for these 25 highest years was 7.55% while the average S&P 500 Index return was 8.70%. It appears stock returns can and have kept pace with inflation even in the most significant years.

Further confidence is gained from looking at the worst 10 year period for inflation (1973–1982). The table above highlights the period when CPI-U averaged 8.7%. The S&P 500 Index matched the inflation rate also averaging 8.7%. Maintaining some degree of purchasing power during extreme periods of inflation is meaningful. The data also suggests investors must have conviction and staying power as short time periods show higher volatility in returns.

Year	CPI-U	S&P 500 Index Return
1973	8.7%	-14.7%
1974	12.3%	-26.5%
1975	6.9%	37.2%
1976	4.9%	23.8%
1977	6.7%	-7.2%
1978	9.0%	6.6%
1979	13.3%	18.4%
1980	12.5%	32.4%
1981	8.9%	-4.9%
1982	3.8%	21.4%
Average	8.7%	8.7%

Given the current economic environment and analyst forecasts, I don't believe we are soon headed toward periods of runaway inflation comparable to the 1970's and 1980's. Year-to-date ending August, actual CPI-U was 1.1%. The Organisation of Economic Cooperation and Development, the leading source for global economic and social statistics, forecasts U.S. inflation at 1.9% for 2010 and 1.1% for 2011. Clearly there is room for the economy to expand without fear of runaway inflation.

While current data is not worrisome, the future risk is in how well the Fed manages the recovery process. In their paper titled "Inflation, Monetary Policy and Stock Market Conditions", Michael Bordo of the Rutgers University Department of Economics, Michael Dueker of Russell Investments and David Wheelock from the Federal Reserve Bank of St. Louis, conclude that it's inflation and disinflation shocks that create the greatest market turmoil. To the extent the Federal Reserve responds in the coming months with monetary policies that minimize unanticipated fluctuations in inflation, equity markets should respond favorably and in a more stable manner.

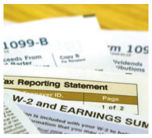


	1946	1979	1980	1974	1941	1942	1978	1981	1947	1973	1975	1977	1969	1990	1951	1950	1970	1976	1968	1989	1987	1988	2007	1984	1982
Inflation	18.1	13.3	12.5	12.3	9.9	9.0	9.0	8.9	8.8	8.7	6.9	6.7	6.2	6.1	6.0	5.9	5.6	4.9	4.7	4.6	4.4	4.4	4.1	3.9	3.8
S&P 500	-8.1	18.4	32.4	-26.5	-11.6	20.3	6.6	-4.9	5.7	-14.7	37.2	-7.2	-8.5	-3.2	24.0	31.7	4.0	23.8	11.1	31.5	5.2	16.8	5.5	6.3	21.4

25 Years of High Inflation

Cost Basis Legislation – Part I

James Sinclair, CPA
Treasurer and Chief Compliance Officer



The Emergency Economic Stabilization Act passed Congress on October 3, 2008. This legislation requires custodians to report adjusted cost basis for taxable accounts to the IRS and account holders via Form 1099-B starting with tax year 2011. Final IRS guidance is not expected until the end of 2010 and as such, some of these provisions as outlined may be subject to change.

Today, custodians report ONLY the "Proceeds from Broker Transactions" on sales for taxable accounts to each account holder and the IRS on Form 1099-B. The custodian's new Form 1099-B must document the sale of "**Covered**" securities and if the resulting gain or loss is short- or long-term, as well as if there are any amounts of loss disallowed under wash sale rules.

The legislation defines "**Covered**" securities as securities acquired on or after the following effective dates:

- January 1, 2011, for equities
- January 1, 2012, for mutual funds, ETFs and dividend reinvestment plans (DRIPs)
- January 1, 2013, for other securities (including fixed income and options)

The Results Are In...

Nearly 200 DVI clients responded to our Client Audit survey conducted last month. The goal of this survey was to gain a better understanding of your needs and to ensure that the service that we provide meets or exceeds your expectations. We are very pleased and honored that our clients gave us an overall satisfaction rating of 4.8 out of a possible 5 points! You can count on DVI to continue to work diligently on your behalf and identify ways to improve our offering. You will be receiving more detailed information related to this initiative in the near future. Thank you for your participation!

"**Uncovered**" securities consist of those securities purchased prior to the above dates. Bottom line - The custodian will be the IRS's official record keeper of both "Proceeds from Broker Transactions" on all transactions and cost basis information for "**Covered**" securities beginning on January 1, 2011. The account holder is and will still be responsible for reporting the cost basis to the IRS on their tax returns.

Changes Affecting Account Holders
First, under the new rules, specified lot selections (doing something other than what is the account holder's default method) must be made for tax purposes prior to the securities' settlement date (three days for equities). It appears that custodians will generally use the First In First Out (FIFO) cost basis method as the default unless account holders, with guidance from their tax advisers, have instructed them otherwise. Registered investment advisers like *DVI* will make sure that the proper method is selected for our client accounts.

Second, account holder's January 31, 2011 statements for taxable accounts (and for some custodians all accounts) may, for the first time, reflect tax lots unless this information had previously been requested.

Finally, the Form 1099-B received in January/February 2012 will include the information indicated above and will be reported to the IRS for the first time.

Changes Affecting Custodians
Custodians have several changes occurring. First, most are working with registered investment advisers (like *DVI*) to synchronize the tax lot cost basis for all accounts. Second, they are working to allow daily reconciliation of this information after January 1, 2011. Third, they are making changes to their systems to ensure that both "**Covered**" and "**Uncovered**" securities are properly treated and reported on the monthly statements sent to account holders as well as the information available on their secure website. Finally, they are making the necessary changes to accurately report all of this to the IRS on Form 1099-B.

Changes Affecting Registered Investment Adviser's (RIA)
RIA's like *DVI* will be synchronizing their investment accounting system with their custodians. This will ensure that RIA quarterly reports to clients will match the custodian statements. Additionally, they will ensure that the proper cost basis method is setup for each client's account based on discussions with their tax adviser. This will also include making sure that the correct tax lot is used upon sales of securities from client accounts. They will also ensure their processes are setup to handle daily reconciliation of cost basis information. And lastly, they will review the new Form 1099-B's to ensure the information being reported is accurate.

Rest assured that a great deal of work is being done by both the custodians and registered investment advisers to ensure that the information is correct and that the process from the account holder's perspective is seamless. Client's can anticipate numerous communications from both the custodians and *DVI* over the next year or so to keep you informed about the changes as to how your account information is captured and reported. Please contact me if you have any questions.

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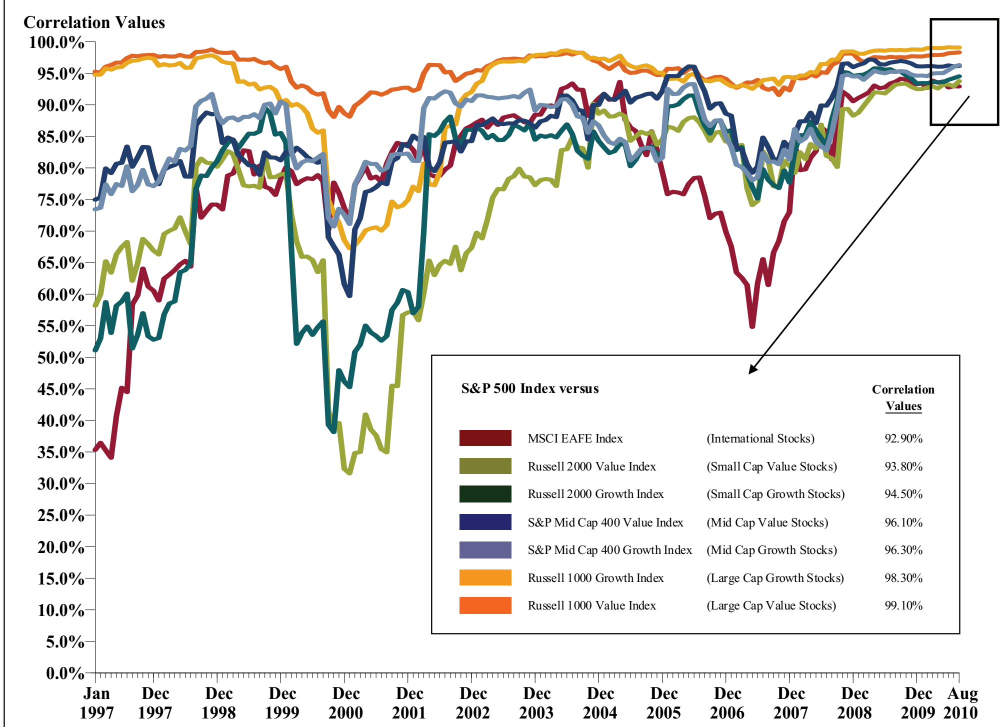
forced them out of traditional investments into Top-Down market timing and theme investment strategies. They are searching for strategies that will be effective in all seasons.

2) Hedge Funds have replaced large institutional equity managers as the daily movers and shakers in the equity market and have embraced the use of ETF strategies.

3) The continued development and roll out of ETFs that slice and dice the market into now almost 1,000 different investment baskets.



Source: Morningstar, Inc (24 Month Rolling Correlations)

Risk Management Implications –

Not only are many of the broad equity market indices being painted with the same brush, but under the hood of many of those same indices, individual economic sectors are being treated in the same sort of indiscriminating fashion as well. Here at DVI, these are troubling developments as we rely on the risk reduction attributes of electric utility and natural gas companies in addition to traditional low volatility sectors such as telecommunication and energy. If these sectors increasingly become more highly correlated to the market as a whole, we lose the desired low down market capture ratios that have been our pride and joy. At DVI risk management is as important as asset management and portfolio downside protection is a major theme.

Our current assessment is that this is a temporary development and that over time we will revert back to an environment in which lower correlations will once again exist. We are still of the mindset that fundamentals will eventually win out and common sense would reinforce our intuition.

Will Williams

President

DVI Hike for Hunger 2010

On August 21, 2010 approximately 260 hikers joined us on the DVI and Forest Park Nature Center grounds for the 4th annual Hike for Hunger to benefit the South Side Mission. Over $46,000 was raised to feed the poor and hungry of our community and over the life of this event, more than $150,000 has been raised. With these funds, more than 6,000 food baskets will be prepared and distributed and over 100,000 hot meals will be served to the poor, elderly and homeless of our community. The South Side Mission has seen a record need in food ministry this year, so a tremendous and sincere thank you to all who participated and supported this great annual event.

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