DVI
David Vaughan Investments

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A Reality Check

As we interact with clients either in formal review meetings or in informal daily communication, there is no subject that creates more anxiety about the future than the current status of the U.S. Budget Deficit. Not only does it raise concerns about the long-term prospects for their respective children and/or grandchildren, but also stirs up near term apprehension on a number of fronts. What is the future of the U.S. Dollar as a reserve currency? What control do we have over our own destiny when nearly a third of our national debt is owned by foreigners? Can we continue to keep the printing presses running and not incur runaway inflation?

As they say, one's action speaks louder than words. According to the Investment Company Institute, mutual fund investors in 2009 and 2010 sold U.S. stock mutual funds to the tune of $ 135 billion and have reinvested $ 90 billion into Foreign Equity Funds. Not a great vote of confidence in the U.S. Dollar or American business.

For those doomsayers out there, there is no shortage of ammunition to argue that the decline of the United States is upon us. The U.S. National Debt now amounts to approximately $ 14.3 trillion. This national IOU has grown by nearly $ 5 trillion since June 2008 or by over 50 percent. The net interest expense alone will run well in excess of $ 400 billion on an annual basis in FY 2011. Can you imagine what this number would be if we were experiencing a normal interest rate environment?

This government deficit spending put a floor in the economy in the midst of the financial crisis and according to the National Bureau of Economic Research, the U.S. recession ended in the second quarter of 2009. Since that low water mark for our nation's economy, Real GDP growth has increased on a cumulative basis approximately 5.2 percent. Despite an economy on the rebound and the prospect for tax receipts on the rise, the projected 2011 budget deficit will reach approximately $ 1.7 trillion according to White House estimates and will shrink to $ 1.2 trillion in FY 2012 with the current administration's proposed budget. Mind you, that amount is twice the budget deficit experienced back in 2008. As a percentage of projected GDP, the 2012 deficit would be nearly 7 percent of our nation's Gross Domestic Product. Over the past thirty years, that figure has averaged about 3 percent, with the highest rate achieved in 2010 of about 10 percent and an actual surplus of 2.4 percent was recorded in 2000 during the Clinton administration.

As we at DVI have a natural tendency towards viewing the glass half full not half empty, we don't believe the deficit is an insurmountable challenge. We believe that this is not a partisan issue, but an American issue. This is not a political issue, but an economic issue. As Alan Simpson, Co-Chair of the Presidential Debt Commission remarked "Time to go for facts. Everybody's entitled to their own opinion, but nobody's entitled to their own facts." Realistically, the solutions are going to be painful, everyone's ox will be gored to some degree. However, by not addressing this problem today, we will only increase the severity of the measures required to provide a solution in the future.

Smoke and Mirrors Again??

In addition to the mounting U.S. budget deficit problem, we once again face crude oil prices in excess of $ 100 a barrel with prices at the pump on the verge of $4.00 a gallon. The Middle East and North Africa are in political turmoil with seemingly no end in sight. The Japanese Earthquake/Tsunami was not only a human tragedy, but also caused supply chain disruptions for the global economy.

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Route To:

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It's Time for Spring (Financial) Cleaning!

Stephanie Ricketts
Relationship Manager

The Spring thaw has begun. The days are getting both warmer and longer and the anticipation of getting to spend time outdoors is felt by all. Many of us also feel compelled to get our Spring cleaning underway. Once the more traditional cleaning is complete, it may be worthwhile to pursue a financial spring cleaning of sorts as well.

So what might a spring financial cleaning session entail? While each of our client's circumstances and goals are unique, there are a few similar discussion topics that we often encounter with many clients and feel that the following areas are a good starting point.

Estate Planning Opportunities for 2011 and 2012
Given the new developments in the estate, gift and GST tax laws as passed under the Tax Relief, Unemployment Insurance and Job Creation Act of 2010, we believe this is a logical and important time to review your estate plan and consider the effects of the rules that will be in effect for 2011 and 2012.

<u>Make Substantial Gifts:</u> Estate and gift tax exemptions have been "reunified" for 2011 and 2012 so that the total lifetime gift tax exemption available to an individual for these years is $5,000,000. The $5,000,000 gift tax exemption allows clients to make substantial taxable gifts and take advantage of certain estate planning techniques during this two year period without having to pay any gift tax.

Making current gifts that use your gift tax exemption removes from your estate not only the gifted property, but more importantly any future income or appreciation related to that property, and therefore reducing future estate tax exposure. Also, if you make current gifts that exceed your available gift tax exemption and incur gift tax, and you survive for three years after making the gift, the amount of the gift tax will also be removed from your estate. Lastly, in addition to reducing the size of your estate, paying gift tax now may be advantageous because gift tax is imposed in a more favorable way than estate tax. Gift tax is imposed on a tax-exclusive basis (meaning only on the net amount of the gift the donee receives). Estate tax, on the other hand, is imposed on a tax inclusive basis (meaning on all of the estate's assets, including the assets that will be used to pay taxes), leaving less for your heirs.

<u>Portability of Estate Tax Exemption Between Spouses</u>: Estate tax exemptions are portable between spouses for 2011 and 2012. This means that if, for any reason, the estate of the first spouse to die is unable to use the entire amount of the deceased spouse's estate tax exemption, the executor of the deceased spouse's estate may elect to transfer any "unused" estate tax exemption to the surviving spouse. The surviving spouse, in turn, may use the transferred exemption in connection with his or her own lifetime gifts and / or to offset estate taxes imposed at the surviving spouse's death.

<u>Continue to Utilize GRATs</u>: We have had numerous clients create and fund Grantor Retained Annuity Trusts over the past year and a half. With the 7520 rate (IRS interest rate) continuing to be quite low (current rate is 3.0%) clients should continue to utilize GRATs as a viable, tax-effective estate planning option. Clients should consider the potential impact of increasing interest rates on GRAT planning in the near future, including whether it might make sense to create a longer term GRAT now to "freeze" today's lower interest rates for an extended period of time.

Change in Life Circumstances / Life Events
All too often changes in life circumstances or life events can disrupt the best-intended estate plan. In light of this and the changes as outlined above, now is as good a time as ever to ensure that Wills and Trusts are executed and current, and further, that your trust is funded so that all assets that belong in the trust are properly titled to reflect this ownership.

Additionally, life changes often warrant a new look at accounts with beneficiary designations. Accounts such as IRAs, 401(k)s and various qualified plans should be checked periodically to ensure that those assets will be passed to the heirs that you want them to go. And lastly, another often overlooked issue is the titling of personal property. Whether property is held in trust, in joint ownership or whatever form, this too should be checked periodically to verify that it will indeed pass to the intended recipient.

Planning for Educational Expenses
Individuals planning to help pay for a child's or grandchild's education expenses face numerous options. In addition to deciding how much to save, they must also determine the best vehicle for those savings. Education funding decisions should include anticipated rising costs of education, alternative sources of education funding, as well as tax implications and varying characteristics of funding vehicles such as 529 plans, custodial accounts or state pre-paid plans. Other issues that must be taken into consideration include income and gift tax implications as well as limitations of some of the structured education savings plans. And lastly, these options must be balanced against the fact that some clients are best suited to simply pay for these expenses directly to the educational institution on behalf of the child or grandchild.

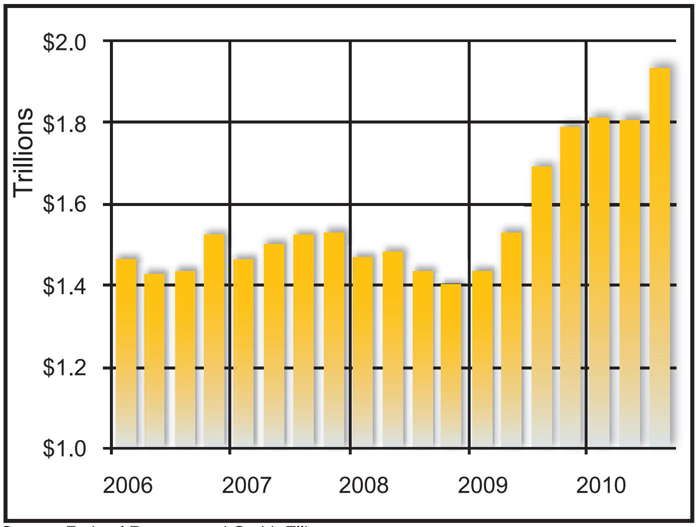
So, after you have washed the windows, cleaned the patio furniture and stained the deck, take some time to relax and let DVI assist you with how you may be able to incorporate some of these "spring (financial) cleaning" tools into your plan.

Trends in Corporate Cash Levels – Another Reason For Optimism

Brian Christensen, CFA
Sr. Vice President

The U.S. Federal Reserve reported cash and other liquid assets on the balance sheets of nonfinancial businesses totaled a record $1.93 trillion at the end of the third quarter 2010. This equated to 7.4 percent of their total assets, the highest share since 1959. Standard and Poor's identified cash and short-term investment accumulation of more than $1 trillion in the S&P 1500 companies. In response to the recession and financial crisis in 2008 and 2009, corporate America has built a significant safety net. The chart below identifies the trend in cash accumulation over the past several years.

Cash and Liquid Assets – Nonfinancial Corporate Business



Source: Federal Reserve and Grubb Ellis

Now that the smoke appears to have cleared and the recession is past, corporations are aggressively putting the accumulated cash and short-term investments to work. In 2010 and continuing into this year, share buybacks, merger and acquisitions and dividend increases all are being implemented.

Standard & Poor's reported share buyback activity in the S&P 500 companies increased 117 percent in 2010 to $299 billion versus $138 billion in 2009. Additionally, the number of companies participating in share repurchases is slowly increasing, growing from 251 at the start of 2010 and finishing the year at 270 companies. The Technology sector continues to dominate the buyback market within S&P 500 companies accounting for more than 22 percent of all activity in the fourth quarter of 2010. The table to the right highlights the 20 largest share repurchases by companies in the S&P 500 during the fourth quarter of 2010. Thirteen companies on the list can be found in the DVI Model Portfolio.

20 Largest Share Buybacks

S&P 500 Companies – 4th Quarter 2010

Company	$ Millions
Exxon Mobil	$5,758
Microsoft	$5,052
Wal-Mart	$3,800
IBM	$3,601
Coca-Cola	$2,958
ConocoPhillips	$2,608
Hewlett-Packard	$2,290
Cisco Systems	$1,849
The Travelers	$1,557
DIRECTV	$1,550
Intel Corp	$1,514
General Electric	$1,354
Johnson & Johnson	$1,285
Amgen	$1,192
Phillip Morris	$1,167
Goldman Sachs	$1,095
WellPoint	$1,015
Lowe's Corp.	$1,002
Kohl's Corp.	$1,000
MedcoHealth Solutions	$ 963

Source: Standard and Poor's

Merger and Acquisition (M&A) activity grew significantly in 2010 and appears to be accelerating so far in 2011. Global M&A activity rose 23.1 percent in 2010 to $2.4 trillion. Volume in the United States rose 14.2 percent to $822 billion. In addition to the large corporate cash stockpiles, cheap credit is providing further incentive to dealmakers. Energy and power related businesses were the dominant sector for deals in 2010 seeing volumes nearly double from 12.5 percent to 28.1 percent. While final data for 2011 won't be known for some time the growing list of deals already in process suggests continued improvement in deal volume. According to Bloomberg, year-to-date deal global volume sits at $682 billion versus year ago of $546 billion. Whether it's AT& T acquiring T-Mobile or Diamond Foods buying Pringles chips from Procter & Gamble, corporate M&A is indicative of improved market sentiment.

Finally, a growing trend in dividend payments is also bolstering investor confidence. In S&P 500 companies, the indicated dividend rate is up 7.4 percent from year-end 2010 and up 15.4 percent on a year-over-year basis. First quarter 2011 payments are up 12.9 percent versus first quarter 2010. On a dollar basis, first quarter 2011 increases were $16.6 billion versus $5.6 billion for first quarter 2010 and decreases of $38.8 billion during first quarter 2009. Listed in the tables on page 4 is historical dividend data for the S&P 500 companies.

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A Reality Check

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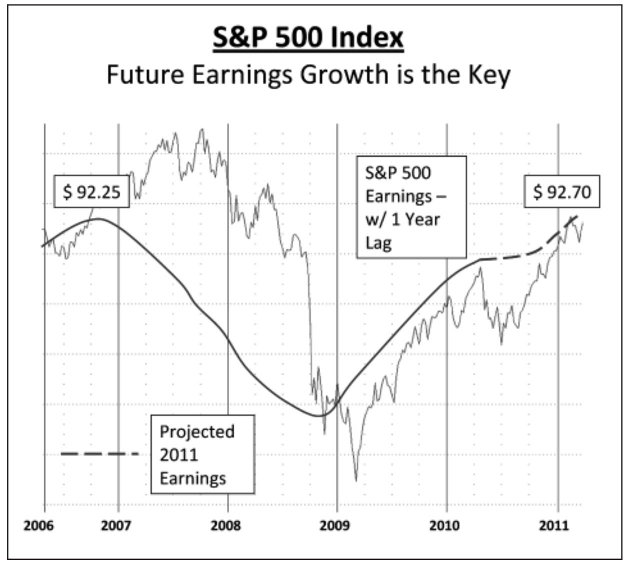
Commodity prices are off to the races again, with the grain complex particularly strong. And lastly, according to the Case-Shiller housing price index, home prices continue to soften back to the levels of the summer of 2009 as foreclosures still weigh on the housing market. With this as the backdrop, the market appears to be incredibly resilient. Is this all smoke and mirrors or are there fundamental reasons that we have enjoyed positive rates of return in the first quarter of 2011?

I would argue that there are two primary factors at work that have provided the equity market a boost:

1) Corporate Earnings
Credit must go to the leadership teams of Corporate America who successfully maneuvered their companies through the severe economic decline and then were able to position them to profit substantially as the economy eventually rebounded. For seven straight quarters, companies have responded with earnings releases that consistently exceeded analyst expectations. Earnings per share growth for the S&P 500 were up 33 percent in 2010 and earnings are poised to reach $ 92.70 per share in 2011, an all-time high. Save that of those companies that will be negatively impacted by the Japanese crisis; there is a general expectation in the marketplace that first quarter earnings should continue this positive trend.

2) Return of Capital to Shareholders/Mergers & Acquisitions
As companies have returned to profitability and their coffers have become flush with cash, there is evidence that a portion of this excess cash will be put to better use. It will be spent to provide larger cash dividends, to fund share re-purchase programs or to be used to acquire other companies. The recently announced $ 6.5 billion cash acquisition of National Semiconductor by Texas Instruments would be an excellent example of this anticipated behavior.



Source: Thompson Baseline

Despite the economic headwinds we face, a boost in confidence by Corporate America that leads to an increase in capital expenditures and a greater return of capital to shareholders should provide solid underpinnings for the equity market for the balance of 2011.

Will Williams
President

Trends in Corporate Cash Levels – Another Reason For Optimism

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S&P 500 Dividend Actions - Historical First Quarter Data

Time Period	Dividend Increases	Dividend Initiations	Dividend Decreases	Dividend Suspensions
2011: 1st Quarter	107	10	1	0
2010: 1st Quarter	70	8	1	1
2009: 1st Quarter	54	1	40	6
2008: 1st Quarter	92	3	7	5
2007: 1st Quarter	102	1	1	1
2006: 1st Quarter	109	2	3	1
2005: 1st Quarter	110	6	3	1
2004: 1st Quarter	88	2	2	1

Source: Standard and Poor's

S&P 500 Dividend Actions - Historical Annual Data

Year	Actions	Positive Actions	Negative Actions
YTD 2011	118	117	1
2010	261	256	5
2009	235	157	78
2008	303	241	62
2007	310	298	12

Source: Standard and Poor's

Growing optimism in their respective market segments clearly is the driver for corporations beginning to open the purse strings and invest accumulated war chests of cash. Low short-term interest rates, attractive market valuations and improving global economic growth have been additional catalysts to increased investment activity. As my colleague Will Williams opines in his page one commentary, the glass is half full, not half empty.

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