DVI
DAVID VAUGHAN INVESTMENTS

# Quarterly Perspective

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## Safety at All Costs

Investors continue to be shaken by the market turmoil that occurred in the 2008 early 2009 time period in which there was no place to hide other than U.S. Treasury Securities and long-term asset classes lost half their value or more. They are also frequently reminded by the financial press that what we experienced during those dark days is likely to re-occur. Economic futurists have suggested that we have entered into a new era of investing in which so called Black Swan events, unexpected economic or geopolitical developments of great significance, will rock the status quo as we know it today. In what has been called the "New Normal", capital market activity that would be statistically expected say once every hundred years, will now occur with much more frequency.

Investor psychology and behavior has always been dominated by the current investing environment and human nature tends to extrapolate that environment and project the status quo out well into the future. It has now been over two years since the market low and notwithstanding a robust rally in most asset classes, investor behavior continues to be dominated by the theory that the next financial catastrophe is right around the corner.

Therefore, it should come as no surprise that as investors allocate assets their predominant concerns are risk, and how to reduce price volatility as much as possible. The other R word, return, is of secondary importance.

As mentioned in previous articles, market statistics continue to confirm the fact that investors are fleeing from U.S. domestic stocks to investment opportunities with less perceived risk. Fixed income securities, alternative investment strategies, commodities and precious metals have all attracted billions of dollars of new capital. Alliance Bernstein recently described this phenomenon as a "Stampede to Safety". Disregarding the fact we have been told that this is the future of investing, most advocates have been using the rear view mirror to support its legitimacy.

**Exhibit 1**

**Economic Forecasts Are Generally Off Target**


Source: GMO LLC, Federal Reserve Bank of Philadelphia

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Route To:

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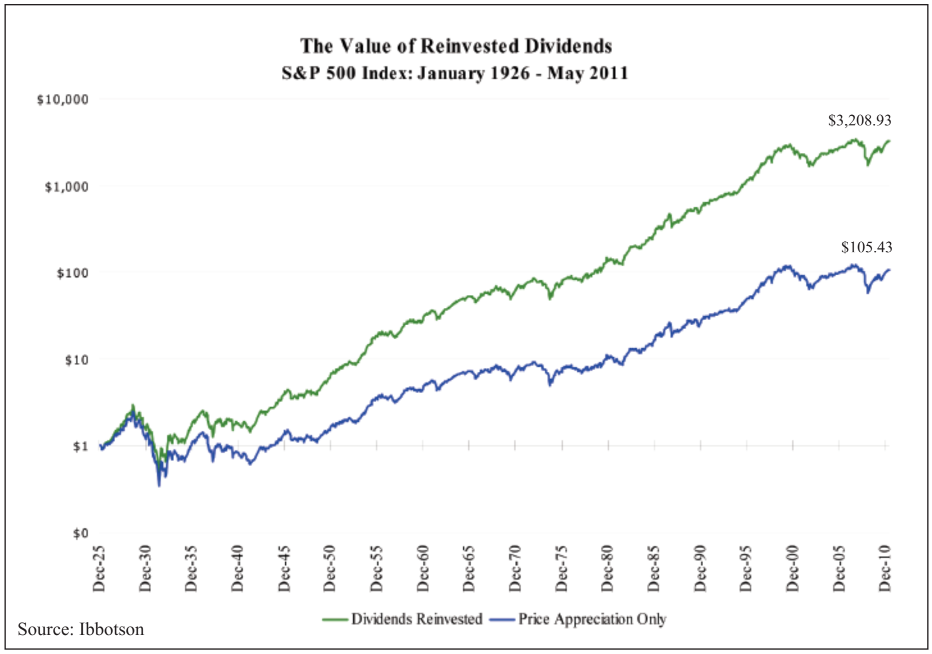
# Dividends: What's Old is New Again

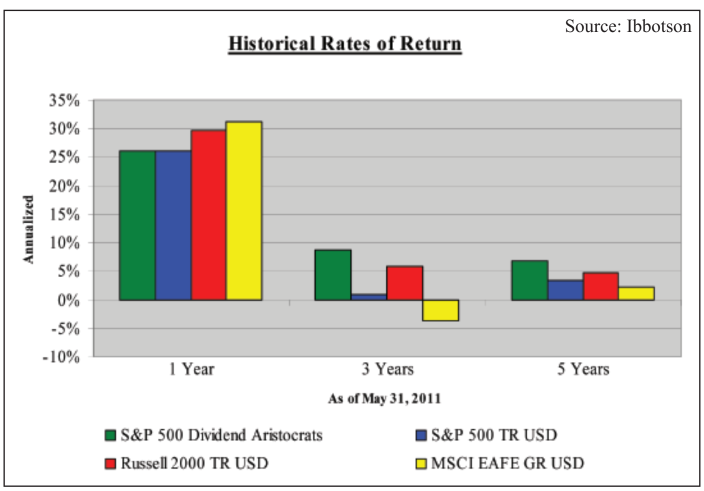
Brian Christensen, CFA
*Senior Vice Pesident*


In recent months, there has been a steady flow of data from a variety of mutual fund companies and Wall Street research firms touting the benefits of owning dividend paying stocks. I suspect the growing investor demand for income in a low interest rate environment has reignited the discussion. Much of what is being touted by the analysts and strategists is old news to *DVI*. Our emphasis on owning companies that pay above average dividends which also have attractive dividend growth rates has been a core component of the *DVI* stock selection process for decades.




Source: Ibbotson

Predictably, investment performance is first on most investor's minds. Standard & Poor's has created the S&P 500 Dividend Aristocrats Index which measures the performance of large cap, blue chip companies within the S&P 500 that have followed a policy of increasing dividends every year for at least 25 consecutive years. Currently, this index has 42 constituents. Below is historical investment performance relative to several other recognized equity indices.




Source: Ibbotson

As you can see, the Dividend Aristocrats have either met or exceeded returns from other equity categories.

Albert Einstein has been attributed with calling compound interest the greatest force in the universe. The next chart validates the power of reinvested dividends and the compounding impact on investment results. The appreciation in the reinvested S&P 500 Index is more than 30 times greater than the index experiencing price appreciation only.

Ned Davis Research initiated a study of S&P 500 Index stock returns beginning in 1972 specifically measuring results based upon companies' dividend policies. Below are results for the period 1972 through November 2010.

| Category | Annual Return | $100 Became … |
|---|---|---|
| Dividend cutters or eliminators | -0.7% | $75 |
| Non-dividend-payers | 1.5% | $182 |
| S&P 500 | 7.1% | $1,449 |
| Dividend payers with no change in dividends | 7.2% | $1,471 |
| Dividend growers and initiators | 9.5% | $3,349 |

Source: Ned Davis Research, Inc. and Columbia Management

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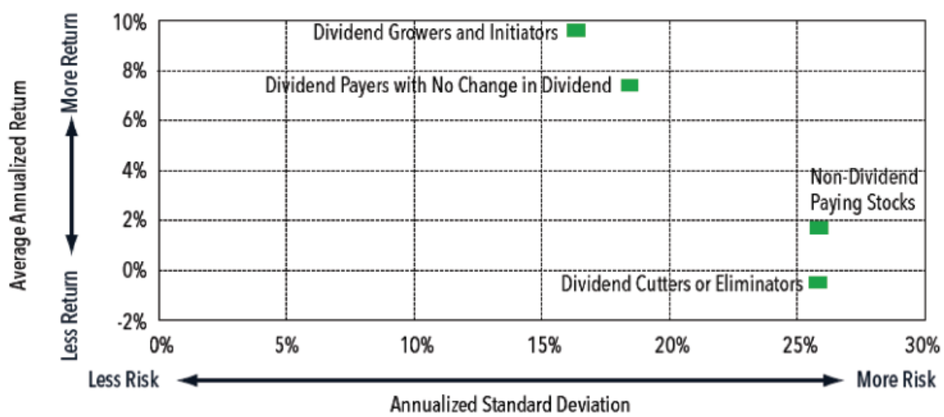
Clearly, dividend paying companies, and those who also have a regular practice of increasing dividend payments, provide greater long-term returns to investors. But is there a trade-off in terms of having to assume greater portfolio risk for higher returns? The chart below indicates the answer is "No". The stocks of companies who pay dividends exhibit lower volatility as measured by standard deviation, than the stocks of those companies who pay no dividend or have cut or eliminated a dividend.




Source: Ned Davis Research, Inc. and Nuveen Investments

Beyond volatility, Ned Davis Research also identified that dividends can be an indicator of business strength and financial health. Companies whose stocks paid dividends posted higher return on assets and higher return on equity than non-dividend paying companies.

The merits of owning high quality, dividend paying stocks are stronger than ever. Beyond the favorable characteristics described above, the current environment also offers tax-advantaged income relative to fixed income securities and inflation protection. It's easy to see why Wall Street is revisiting a topic that has and will continue to be a cornerstone of the *DVI* investment philosophy.

# Associate Spotlight

Over the past several months, DVI has added four new associates to the firm: Chris Downs, Building and Grounds Maintenance Coordinator; Betty Corder, Client Services Associate; Anne Ewers, Investment Accountant; and Amy Mauser, Internal Accountant. The additional staff has also led to some recent renovation of the second floor to accommodate our growth. Our new associates look forward to meeting you.

**Chris Downs**

Chris joined DVI in December of 2010 as Building and Ground Maintenance Coordinator. He is responsible for maintaining and supervising our beautiful facilities inside and out and in addition he makes deliveries for our staff and clients. Prior to joining DVI he worked at a local dental lab for 10 years as Janitorial Supervisor and later in the Building and Grounds Maintenance Department. He also held positions as a construction laborer and delivery driver for an office supply company for 8 years.

Outside of work, Chris enjoys spending time with his wife, two sons and daughter. He has been involved with coaching his sons' baseball teams and his daughter's traveling softball team for over 15 years. He enjoys getting out on his motorcycle with his wife, getting together with friends for cookouts and traveling to Michigan to see his son and daughter in-law whenever they get the chance.

**Betty Corder**

Betty joined David Vaughan Investments in January 2011. She brings to DVI over 15 years of banking and financial industry experience. Just prior to joining DVI, she worked as a trust administrative assistant where she worked with trust and investment clients to secure documentation to open new accounts, managed disbursements from client portfolios, coordinated the transfer, sale or purchase of assets as directed, and performed account research, including assistance with cost basis information. Her previous customer service experience also includes positions in both private banking and commercial lending, where she assisted high net worth clients and small business owners.

As a Client Service Associate, Betty is responsible for new client account registration paperwork, the timely and accurate transfer of assets, assisting with various client requests, and maintaining the quality of our client database.

Betty lives in East Peoria with her husband and two children. She enjoys reading, flower gardening, and spending time with her family. She is a graduate of Pekin Community High School and is in the process of completing her Associates degree through Illinois Central College.

# *Safety at All Costs*

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**A Contrarian Mindset**

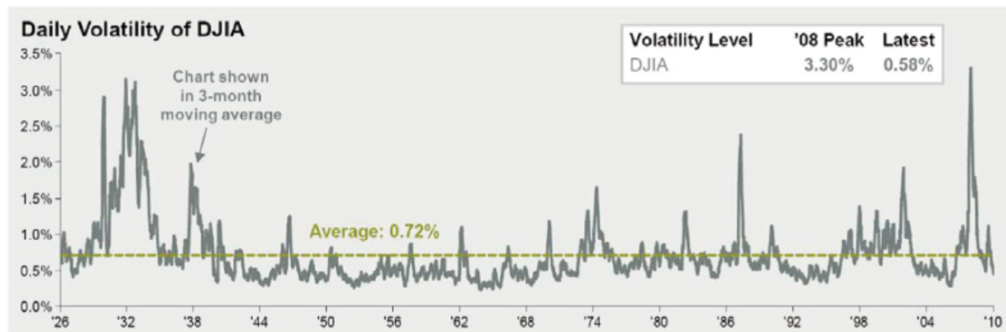
When there appears to be strong groupthink on a certain topic, the contrarian in me suggests that the consensus view is wrong or at least flawed. Despite all of the brilliant people out there, consensus forecasts are inevitably off target. Exhibit 1 (on page 1) supports that position as economists continue to struggle with forecasting economic growth rates despite supercomputers and ever complex macroeconomic models.

**Risk Status of U.S. Domestic Stocks**

As Exhibit 2 suggests, we did experience historically high market volatility during the recent financial crisis, but we have gradually worked our way back to volatility levels below the long-term average. It remains hard for me to adjust my perspective that 100 point swing days up or down on the DJIA is not unusual market volatility, but with a Dow at 12,500, this is well within the range of normal historical volatility on a percentage basis.

Exhibit 2

**Volatility has Dropped below Long-Term Average**




Source: JP Morgan Asset Management, Dow Jones as of 6.30.2011

Intra-year market declines are unfortunately to be expected. In the second quarter of 2011 we experienced a correction in the S&P 500 Index from high to low of 8.21 percent, the average intra-year decline over the past 31 years according to Standard and Poor's is 14.3 percent. Are these market corrections pleasant? Of course not! But somehow we have to focus on the fundamentals, keep things in perspective and recognize that every market drop is not the beginning of another Black Swan event.

Higher price volatility is inherent in asset classes that over long periods of time provide rates of return greater than those that demonstrate less volatility. In seeking out investment opportunities that are less volatile, I am terribly concerned about two possible outcomes:

1. The asset classes that have been advertised by Wall Street as safer, in effect are not and investors have set themselves up for yet another financial disappointment.

2. Investors have lost sight of the negative effects of both inflation and taxes and as a consequence of becoming too defensive, will win the battle and lose the war as they fail to maintain purchasing power parity.

Will Williams

*President*

# *Reminder: Payroll Tax Reduction Lasts Six More Months*

The employee portion of the social security tax was reduced from 6.2% to 4.2% effective January 1, 2011 under the "Tax Relief, Unemployment Insurance Reauthorization, and Job Creation Act of 2010." This lower payroll withholding tax is currently set to expire on December 31, 2011.

The limits on wages subject to Social Security tax is $106,800 for 2011 and if you make up to that taxable earnings cap, this reduction translates into a tax savings of $2,136. While the employee is benefiting from a 2% reduction, the employer portion however, remains at 6.2%. Additionally, Medicare taxes remain unchanged at 1.45% each for employers and employees.



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