DVI
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Investor Sentiment Has Not Yet Turned the Corner

Because of my position and as a consequence of the DVI client service delivery model, I am fortunate to have direct access and daily interaction with a significant portion of the individual clients that we serve. This benefits me in several ways, but specifically on the investment management front; it provides me a front row seat to the current sentiment of high net worth individuals. Despite investment returns over the past three years that have been robust, the meager returns over the past five years and the market volatility along the way has left investors both weary and skeptical about the future.

According to Bloomberg, the S&P 500 Index has experienced daily price swings of greater than 2 percent for almost 40 percent of the trading days in the time period of August through September last year. For the full year, nearly a third of the trading days exhibited that type of price volatility, similar to the erratic price behavior that we suffered through in 2008.

Source: Bloomberg

As of Mar 2012:	3 Years Annual	3 Years Cumulative	5 Years Annual	5 Years Cumulative
US Intermediate Fixed Income [1]	6.84	21.94	6.25	35.39
US Large Cap Stocks [2]	23.42	87.99	2.01	10.48
US Balanced Strategy Portfolio Return [3]	16.91	59.80	4.15	22.52

[1] BacCap Agg Bond Index, [2] S&P 500 Index, [3] 60% S&P 500 / 40% BarCap Agg Bond
Source: Morningstar, Inc.

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Does Quality Matter?

Brian Christensen, CFA
Senior Vice President

Unprecedented increases in stock market volatility during the past several years have led investors to seek out higher quality common stocks hoping for a smoother ride and more consistent investment returns. Intuitively it makes sense to believe higher quality stocks would perform better in times of market turmoil. Ideally, high quality stocks provide capital preservation in declining markets yet also participate broadly in market rebounds.

Standard & Poor's (S&P) began publishing Quality Rankings in 1956, measuring the growth and variability of a company's earnings and dividends. S&P uses a computerized scoring system measuring results over the most recent ten years. Companies get classified into one of nine categories, ranging from highest of A+ to lowest of Liquidation. To enable tracking of performance of the S&P 500 companies based upon their Quality Rankings, S&P created two indices: the S&P500 High Quality Rankings Index and the S&P 500 Low Quality Rankings Index.

So, does quality matter? In the July 2010 research article titled Is High Quality Always Better?, S&P evaluated the Quality Rankings indices exploring the relationship between high and low quality stocks in a variety of market environments. The quality premium, defined as the difference in investment returns of high quality stocks versus low quality stocks, was the measurement factor.

For the Quality Rankings indices, S&P used thirteen years of data, ranging from May 31, 1997 to May 31, 2010, that evaluated quarterly investment returns. The chart shown below left reflects their findings.

Consistent with widely held investor beliefs, high quality stocks do provide capital preservation in declining markets. High quality stocks have less earnings variability which supports share prices in times of market turmoil. However, the trade-off appears to be a lower capture rate of up market performance.

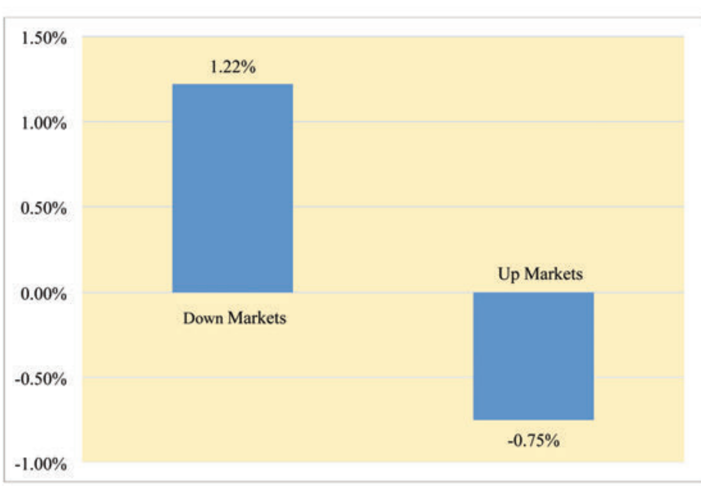
T. Rowe Price performed a similar analysis using Return on Equity (ROE) as the measure of quality. ROE is defined as a company's earnings as a percentage of shareholder equity and measures how well a company uses its assets to generate profit and earnings growth. T. Rowe Price measured the results of the 1,000 largest U.S. stocks, and their study results can be seen in the chart below right.

The T. Rowe Price study saw similar results as S&P, but also validated that the capital preservation generated in declining markets resulted in high quality stocks outperforming across the entire time period. Preserving capital in declining markets allows for greater compounding of assets when markets recover.

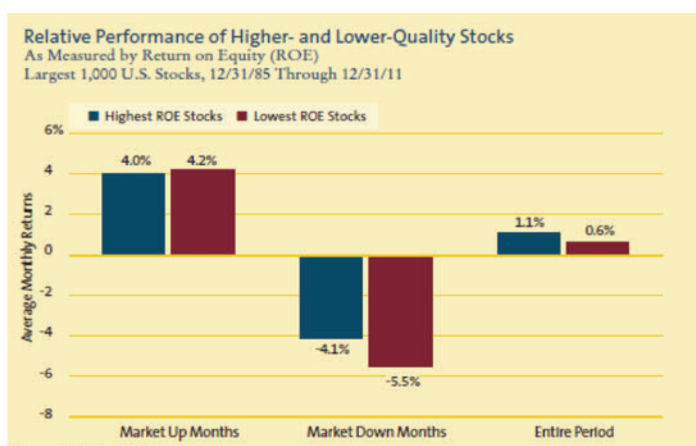
Further evaluating the data, T. Rowe Price broke out the 1,000 stocks into quintiles based upon ROE. Rolling 12-month returns were calculated for each group, and the data is presented in the chart on page three.

As you can see in the chart on page three, those stocks with the highest ROE outperformed all other quintiles

S&P Quality Premium During Up Markets and Down Markets



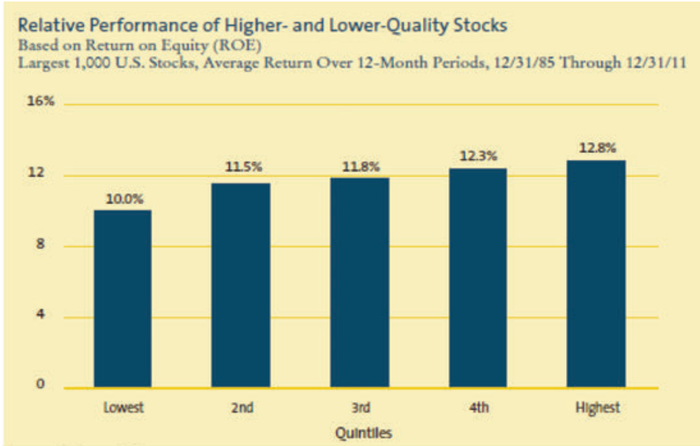
Source: Standard & Poor's data from 5/31/97 – 5/31/2010 on a quarterly basis.



Source: T. Rowe Price

and exceeded the lowest group by 2.8%. Clearly, there is a benefit to owning high quality stocks.

In recent years, the DVI Investment Committee has expanded our research process to include a quantitative ranking system. This system allows us to evaluate balance sheet metrics, dividend trends and profitability measures, like ROE, in search of high quality stocks. Our traditional approach of bottom-up fundamental analysis, which focuses on a company's products and services, market position, and management team, among other items, continues to be the foundation of our process. The combination of a quantitative and fundamental approach to our research process has broadened our ability to find high quality companies. Ultimately, our goal is to build portfolios with excellent risk–reward profiles that meet your investment objectives. Focusing on quality does matter.



Source: T. Rowe Price

2012 Update to the Illinois Estate Tax

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Since 2011, the Illinois estate tax exemption has not been set at the same amount as the Federal estate tax exemption. For deaths occurring in 2011, the Illinois exemption was $2 million (compared to the Federal exemption of $5 million). For deaths occurring in 2012, the Illinois exemption is $3.5 million (compared to the Federal exemption of $5,120,000).

Like the Federal exemption, the Illinois exemption can be used for lifetime gifts or transfers at death. Unlike the Federal exemption, any portion of the Illinois exemption not used at a person's death is lost; it cannot be carried forward for use by the surviving spouse. Illinois does allow an unlimited marital deduction for assets left outright to the surviving spouse and for assets left to the surviving spouse in certain qualifying trusts.

A typical estate plan for a married couple postpones payment of any estate tax until after the death of the survivor, and minimizes the estate tax to be paid at the survivor's death. It does this by directing that at the first death, assets equal to the unused Federal estate tax exemption are to be held in a "credit shelter" trust for the benefit of the surviving spouse. Assume a person dies in 2012 with assets of $5,120,000, and his Will directs an allocation of assets equal to the Federal exemption to a credit shelter trust. No federal estate tax will be due. However, since that allocation exceeds the $3.5 million Illinois exemption, Illinois estate tax of $364,245 will be due, even though the surviving spouse is the trust beneficiary. To avoid this result, the credit shelter trust should include language which allows the trustee to elect to qualify a portion of the credit shelter trust for the Illinois marital deduction.

If the value of your and your spouse's assets, including retirement accounts and life insurance death benefits, exceeds $3.5 million, in order to avoid unexpected payment of Illinois estate tax, your estate planning documents and the allocation of assets between you and your spouse should be reviewed with your financial advisor and legal counsel.

Lifetime gifts will remove asset appreciation from your taxable estate. In the calculation of both the Federal and Illinois estate tax, certain lifetime gifts are added back to determine your taxable estate. Because of the unique method by which the Illinois estate tax is calculated, higher levels of lifetime gifts will lower the Illinois estate tax beyond the asset appreciation. The Illinois Attorney General provides an on-line Estate Tax Calculator at www.illinoisattorneygeneral.gov.

The current Federal exemption will expire at the end of 2012, so as the year winds down, pay close attention for any extensions or other changes passed by Congress, and any reaction to those changes by the Illinois legislature.

Investor Sentiment Has Not Yet Turned the Corner

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So why should it come as a surprise that despite surging equity market performance we continue to see positive investment flows into fixed income mutual funds and outflows from U.S. domestic equities? In economics the term that is often used is utility; in the investment world we have adopted the term sleep quotient. It simply is the fact that investors today value the insurance policy of owning fixed income securities (despite record low yields) greater than the potential reward of higher rates of return from the equity market, and frankly over the past 10 years, this insurance policy has not cost investors a dime. In fact, during this time period, adding fixed income exposure to your overall portfolio has not only reduced your portfolio's downside, but has provided greater rates of return than a pure equity solution. Even though this "Lost Decade" outcome contradicts capital market theory and is not consistent with longer time periods, the facts are the facts and investors are responding accordingly.

The Baby Boomer Mindset

In a recent survey of Baby Boomers conducted by the Pew Research Center, nearly 80 percent of those surveyed greater than the age of 46 were dissatisfied with the way things were going in this country today. The 79 million member Baby Boomer generation represents approximately 25 percent of the total U.S. population. They also represent a significant portion of the total retirement assets that are invested in the financial markets today. As we sit across the table from our current clients, their high level of dissatisfaction comes across loud and clear. If the global geopolitical environment doesn't have them down in the dumps, the future direction of individual tax rates does, or the staggering national budget deficit, or the future of entitlements such as Medicare and Social Security. There is so much negative sentiment, it just feels like it will be baked into the markets forever.

An interesting question was recently raised in a BNY Mellon advertisement, "Are you well positioned if something goes right?" I thought this was an intriguing question. As discussed earlier, investors continue to re-position themselves into more defensive asset classes. Under circumstances in which there would be a surprise positive development, it certainly would catch investors off guard. We have been on the defensive for what now seems to be an eternity. Can we maintain a sustained move towards taking on more equity risk? Is it possible to experience price earnings multiple expansion once again versus contraction? For now it might seem unfathomable, but is it totally out of the question? I continue to believe that a high-quality dividend-focused equity strategy makes great sense as a core investment strategy for those that wish to prepare for the worst and hope for the best. Under circumstances in which investors wish to incrementally move up the risk scale from fixed income, but lose very little if any current income, I can think of no other reasonable alternative.

Will Williams
President

The recent New York Times Editorial written by a former Goldman Sachs Vice President particularly resonated with me as he described his old firm. It speaks very succinctly as to the type of organization we strive to be here at DVI.

<u>Culture</u> - It revolved around teamwork, integrity, a spirit of humility and always doing right by our clients.
<u>Leadership</u> - It was about ideas, setting an example and doing the right thing.

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