DVI
David Vaughan Investments

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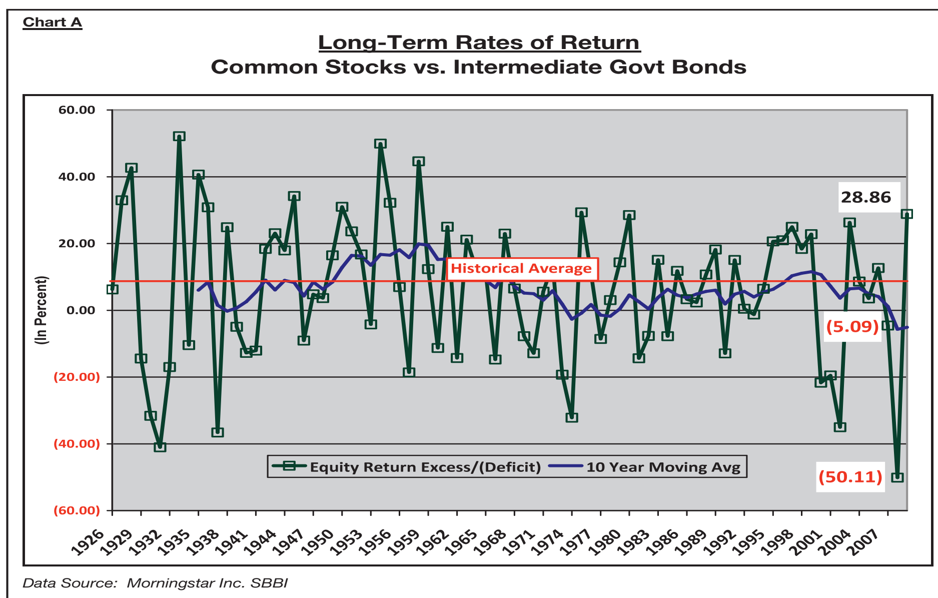
Old School Economics

Call me old fashioned, and you might not have too many people who would disagree, but I was always led to believe that if one assumed investment risk, over long periods of time the investor would be rewarded with returns in excess of risk free assets. It sure sounds logical - Why in the world would a rational investor assume risk unless there was an economic payoff? However, the end of the most recent decade has proven this economic relationship to be false. What I will term the "Lost Decade", referring to both the loss in the equity market and, more important to the Baby Boom generation, the loss of time, the last ten years has shown evidence that there are periods of time that go against economic history and conventional wisdom. Not only did the S&P 500 Index decline on average nearly 1% per year, but a defensive strategy, owning simply U.S. Government intermediate-term fixed income, outpaced stocks by nearly 5% per year. (See Chart A) This relative performance by stocks is the worst



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International Exposure in DVI Portfolios

Brian Christensen, CFA
Senior Vice President

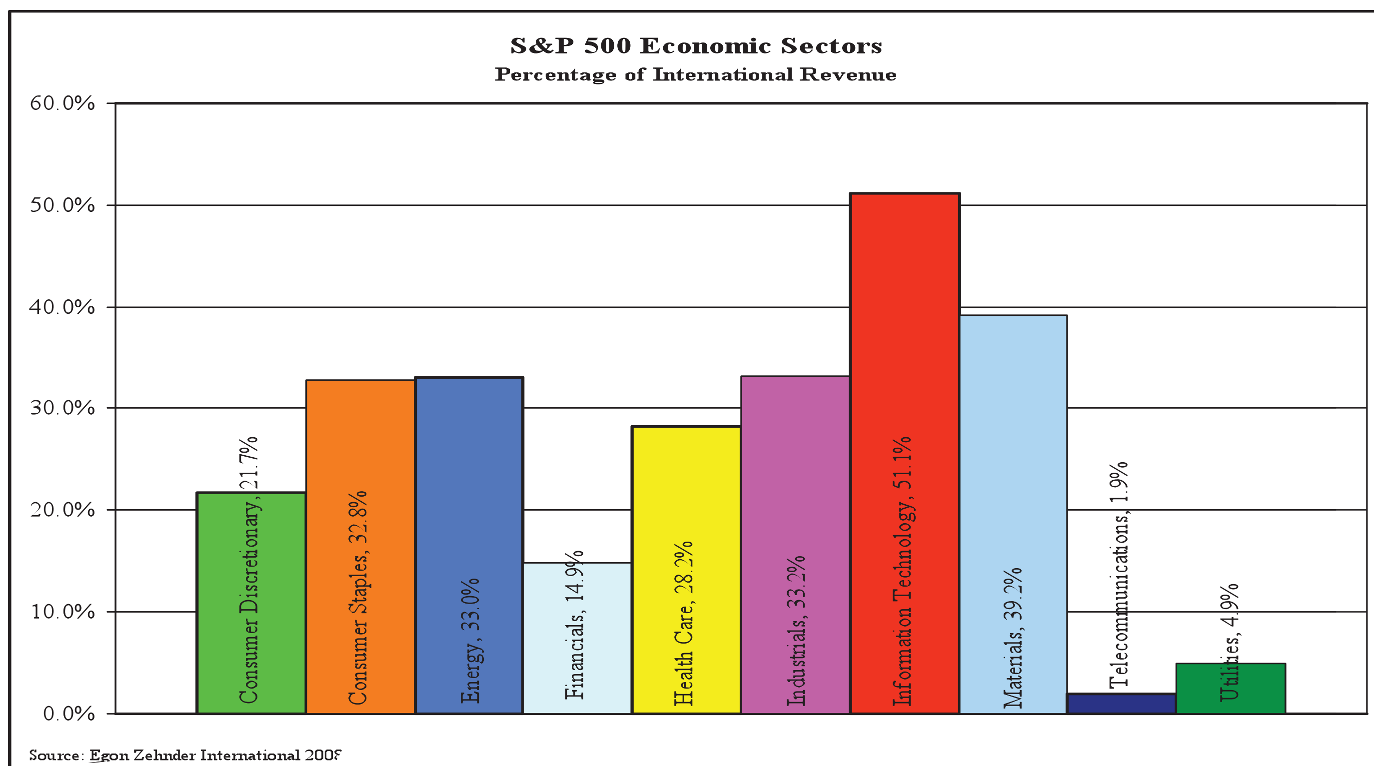
Some of the more frequent questions I get when meeting with clients relate to the merits of investing in international asset classes. With human nature being what it is, those questions become more frequent when international markets are outperforming and the fear of missing out becomes prevalent. International markets rebounded significantly in 2009. One widely held premise is that the global economic recovery will be led by both emerging and developed international markets, not the U.S. domestic market. If in fact that occurs, **DVI's** equity investment strategy won't be left on the sidelines to watch. Despite our emphasis on U.S. companies, our equity portfolios have significant international exposure.

In a recent Standard & Poor's article, 2008 sales revenue was evaluated in S&P 500 companies to determine what portion was foreign sourced. Standard & Poor's acknowledges the data is difficult to analyze as many companies do not fully report foreign data choosing to categorize sales by market or region. However, the results remain valuable in understanding the depth of international revenues found in S&P 500 companies. The chart below identifies the percentage of international revenues found in each of the S&P 500 economic sectors.

Using the data below, international revenues average 26.1% for companies in the S&P 500. Nearly 76% of the companies found in the S&P 500 have non-U.S. revenues.

If we take this evaluation one-step further and look at the composition of the **DVI** Equity Model we can tie the data to our client portfolios. The **DVI** Equity Model currently holds 78 companies. Of those 78 companies, 53 have international revenues. As a group, our Model companies have international revenues averaging 28.4%. Nineteen companies in our Model have international revenues greater than 50%. Names like Texas Instruments, Intel, Coca-Cola, Colgate-Palmolive, Pfizer, Chevron, General Electric, Caterpillar and IBM lead the list of U.S. based companies with significant non-dollar revenue.

As our world and its economies become more globally focused, it's only natural that the blue chip companies in which we invest seek opportunities to expand their businesses globally as well. Despite our emphasis on owning U.S. based corporations, **DVI** portfolios clearly have meaningful exposure to international markets and stand to benefit as the global economy continues to recover.



The Troubled Asset Relief Program – A Year Later

Stephen Hinrichs, CFA
Portfolio Manager

As TARP repayments have dominated the news from the financial sector of late, a review of who received funds from this program and who has paid it back is in order. But first, let's take a step back and review the origins and implementation of this program.

The Troubled Asset Relief Program was created by the Emergency Economic Stabilization Act in October 2008. It immediately became known as TARP but was also labeled the "bank bailout" bill when Congress granted then Treasury Secretary Paulson's request for $700 Billion to fund the program. TARP originally was designed to buy toxic mortgage assets from banks in order to cleanse the system of assets tied to souring mortgages. This original plan never got off the ground before the financial system deteriorated to the point that a simpler solution was quickly needed.

As a result, TARP was implemented as a way for the government to purchase preferred stock of banks to strengthen industry balance sheets in an effort to support lending. As banks received funds, there was a perception among some taxpayers that these funds would never have to be paid back. But in reality, these preferred stock investments were essentially loans from the government that paid 5% interest for the first five years and 9% thereafter. The government also received warrants for each preferred stock investment that allowed the government to purchase shares of common stock in each company, thus benefiting if stocks in these companies rebounded.

The largest banks in the country weren't given a choice and were forced to participate in the TARP program. With the stigma of receiving aid from the government then removed, many small and mid-sized banks also entered into the program. As time wore on though, bank management teams became disgruntled with government regulation of TARP recipients in areas of executive compensation and dividend payments. This led to many banks desiring to leave the program.

As markets improved throughout 2009, many of the largest institutions were able to sell enough new stock to private investors to raise the money needed to pay back the government with interest. As the table right shows, most of the larger banks have repaid their TARP funds. With December repayments totaling $45 Billion from Wells Fargo and Citigroup, the Treasury reports that repayments have now reached $164 Billion. You can also see from the table that aid from the TARP program has been extended beyond banks, with help going to insurer AIG as well as the struggling auto industry. The Treasury Department has also allocated TARP funds to mortgage modification programs designed to reduce home foreclosures.

The debate over whether the TARP program was good or bad will live on for years. On the one hand, the Treasury now expects a profit from its investments to shore up the banking industry. On the other hand, the Treasury still expects a loss of $141 Billion from the TARP program overall. Though this expected loss is $200 Billion less than earlier loss estimates, the government still expects significant losses from its support of AIG and the auto industry, as well as costs to fund mortgage modification programs.

Largest TARP Recipients

Company	Preferred Stock Purchased (Billions)	Repaid
Citigroup	$45.0	yes*
Bank of America	$45.0	yes
AIG	$42.7	no
JPMorgan Chase	$25.0	yes
Wells Fargo	$25.0	yes
General Motors	$20.7	no
Goldman Sachs	$10.0	yes
Morgan Stanley	$10.0	yes
PNC Financial	$7.6	no
US Bancorp	$6.6	yes
GMAC	$5.0	no
SunTrust	$4.8	no
Chrysler	$4.0	no
Capital One	$3.6	yes
Regions Financial	$3.5	no
Fifth Third	$3.4	no
American Express	$3.4	yes
BB&T	$3.1	yes
Bank of New York	$3.0	yes

* Repaid $20 Billion / converted $25 Billion into common stock
Source - Bloomberg

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10 year return since market data was produced back in 1926.

Over the last two years, there have been dramatic return swings in these two asset classes. In 2008, investors flocked to short-term treasury and government debt seeking liquidity and shelter from declining equity prices and struggling corporate and mortgage debt markets. Equity returns were 50% less than returns experienced in the U.S. Government debt market. In 2009, assuming investment risk paid off as those asset classes that struggled in 2008 recovered quite significantly. However, if one assumes a long-term historical view, one does get paid to assume risk, with the historical excess return of nearly 6% per year.

With interest rates maintaining nearly all-time lows, the sizeable flow of funds into fixed income versus equity mutual funds continues to amaze me. The Investment Company Institute produces a monthly table illustrating the movement into and out of various fund asset classes. In 2009, there was not one month in which redemptions exceeded new investment in the fixed income asset class. Inflows averaged nearly $ 37 billion per month. In contrast, U.S. domestic equity funds experienced net redemptions of nearly $ 10 billion per month since July. It is pretty evident to me that regardless of the rally from the March lows, most investors continue to be skeptical of the staying power of this recent rally and they continue to build rainy day funds in short-term debt and husband cash in both money market funds and CDs.

Despite requiring a strong stomach, or what David Vaughan would refer to as intestinal fortitude and loads of patience, I am convinced more than ever that we have not once again entered into a new economic paradigm. Notwithstanding a painful "Lost Decade", old school economics will once again rule the day, and savvy investors with staying power will be rewarded for assuming prudent amounts of investment risk.

Will Williams

President

DVI Associate Spotlight

Jesse L. Shaw, CFA

Relationship Manager,
Florida Region

Jesse joined David Vaughan Investments in November 2009 as Relationship Manager for our Florida Region. With an emphasis on portfolio strategy and manager selection, Jesse has experience serving as an investment advisor to both high net worth individuals and institutional investors. He will concentrate on serving the needs of current and prospective DVI clients within the Florida region.

He received a Bachelor of Science degree majoring in Finance from Lehigh University in 2000. In 2006, Jesse received his designation as a Chartered Financial Analyst and is currently a member of the CFA Institute of Orlando. Prior to joining DVI, Jesse was a senior member of the Manager Research and Selection Group at Lehman Brothers. His work focused on providing investment manager research to high net worth advisors and their clients within the Lehman Brothers Private Client Group and Neuberger Berman Trust Company. Prior to joining Lehman Brothers, Jesse worked as an Investment Analyst at Cambridge Associates, an institutional investment consulting firm residing in Washington DC.

Jesse spent his childhood growing up on St. Croix in the US Virgin Islands and later moved to New Smyrna Beach, Florida. Since returning home to Florida from Manhattan in 2009, Jesse has enjoyed the opportunity to be closer to family and friends. In his free time, Jesse enjoys surfing, going to the gym and an occasional round of golf. He looks forward to becoming actively involved with various charitable and professional associations within the Central Florida community.

Please feel free to contact Jesse directly at Jesse@dviinc.com or (407) 622-5133 on any of the matters listed above.

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