



2012 YEAR IN
REVIEW

DVI
DAVID VAUGHAN INVESTMENTS



From the Desk of: WILL WILLIAMS | *President* : David Vaughan Investments, Inc.

2012 YEAR IN REVIEW

BUILDING ON OUR TRADITION | *Daring to Be Different*

In 2012, David Vaughan Investments celebrated its 35th anniversary as a SEC registered investment adviser. After more than three decades in the investment business, one has the ability to look back over time and reminisce about the investment firms that have come and gone over these past three decades. When I began in the industry in 1986, firms such as Kidder Peabody & Co., E.F. Hutton & Co., Dean Witter Reynolds, Paine Webber & Co., Smith Barney, A.G. Edwards & Co., Lehman Brothers and Drexel Burnham Lambert, were all household names. Today they are all gone. Many were folded into our current day investment super markets, some were victims of poor management, and others simply went up in flames overcome by their own greed.

Most of these institutions started out as simple partnerships; then over time, as more capital was required to finance their operations, they sought external capital and morphed into public corporations. In that transition much was lost. No longer could these firms embrace and deploy a long-term strategy as the public markets demanded near term results. Risk was embraced rather than managed as the majority of their capital was no longer their own. Clients were only a means to a financial end rather than the sole reason why they were in business.

It seems like just yesterday we had \$60 million dollars under management, and everything was done on the back of an envelope. I am very proud of what we have accomplished over the past few years despite the most challenging investment backdrop that our

industry has faced in decades. Even with all of the advances that we have made evolving into a larger more professional institution, what I am the most proud of is the way we conduct our business. David Vaughan, without doubt, showed us the way and to this day he reminds us from above to never veer from "doing the right thing." I am always gratified when I am in conversation with one of my colleagues and they reference this very mindset. It is a common ground that we at DVI will never depart!

As I enter my 27th year in the industry, it is crystal clear to me that success in this business is all about surrounding yourself with the best and the brightest. I am most grateful to all of our associates that persevered and were able to work collaboratively to make thoughtful, prudent and sensible decisions throughout 2012. In the emotion filled environment of last year, without seasoned decision makers, we could have ended up down a very different path.

In effect, this emphasizes the greatest challenge to DVI as we move forward. We have a laser focus on working towards the development of the next generation of decision makers here at DVI. As the Board and shareholders have committed towards this vision of a firm "Built to Last," we must recruit and retain the highest caliber investment and support professionals in order for us to secure the financial future of our clients. As a firm that aspires to maintain its independent and private status, we feel we offer a unique and rewarding environment for young investment professionals that have a desire to "Dare to Be Different."



IMPORTANT DEVELOPMENTS

■ **We are extremely pleased that Wayne E. Baum, Chairman of CORE Construction joined the DVI Board in 2012.** In addition to growing his family owned business into one of the largest full service construction companies in the United States, Wayne has been one of the most active and generous supporters of the not for profit community in Central Illinois. Wayne's business acumen and understanding of the challenges facing privately held businesses have served as a tremendous resource to the DVI leadership team.

■ **As 2012 came to a close, the DVI Board of Directors, upon the unanimous recommendation of the Management Committee, authorized the company to add Stephen K. Hinrichs, CFA as a new shareholder.** Steve has been an associate with DVI since 1998 and currently serves as a Portfolio Manager. In addition to portfolio management and equity research responsibilities, Steve has served over a number of years as the principal liaison with many of DVI's largest institutional relationships.

■ **As DVI has continued to grow, our space needs have grown in lock step.** We faced a difficult decision in 2012 as we began to plan for the future and contemplated alternatives to staying in our beloved ivy covered brick building that has served as our home since 1993. Many thanks and gratitude goes to our friends at the Forest Park Foundation, our neighbors all along, who agreed to accommodate DVI and sell their floor to DVI for future expansion plans.

FINANCIAL MARKETS

Lessons Learned

■ **There continues to be a significant gap between perception and reality.** I recently asked a group of sophisticated investors what the annualized rate of return of the S&P 500 Index was over the past ten years. They shrugged their shoulders and suggested "Maybe zero?" In fact, the annualized rate of return was greater than 7% per year and the index nearly doubled over this time period. To understand the basis for this performance, one simply needs to reference U.S. corporate earnings that increased 111% during the similar period of time.

■ **One cannot underestimate the ongoing damage caused by the Bear Market that ravaged equity investors beginning in 2008 and ending in early 2009.** The nearly 50% decline of global equity markets during that time period has so shaken investors, that asset class exposure to common stocks has dramatically declined ever since. Furthermore, despite stock market returns that in recent years have erased all, if not most, of the economic damage, investors are either continuing to look towards innovative investment alternatives to provide downside market protection or are simply satisfied with fixed income securities despite historically low interest rates.

■ **In any given year, a market-weighted index such as the S&P 500 can be heavily influenced by the performance of just one stock.** For much of the year of 2012, Apple, Inc. [AAPL] was on a tear. At its peak of over \$700 per share, and a market capitalization in excess of \$600 billion, Apple shares alone represented nearly 5% of the overall Index value and contributed nearly one tenth of the total return of the market in 2012.

■ **The daily barrage from the financial press and the ongoing troubling news from both Washington D.C. and the European Union made 2012 one of the toughest, if not the toughest, year in my recollection.** Staying the course was not the easiest decision to make. It reinforced to me, once again, the importance of both conviction and a strong belief in the time tested investment strategies that we execute on behalf of our valued clients.



AN OUTSIDER'S PERSPECTIVE | *Firm Due Diligence*

Oftentimes, I try to take an outsider's perspective when gauging the progress we have made as an organization. I imagine I am walking into DVI for the first time with the task of evaluating the firm for a potential investment management engagement.

Here is my checklist:

■ **Governance** - Six member governing board of directors dominated by independent directors with both industry experience and intimate knowledge of the affairs of privately held firms.

■ **Management Team** - Management committee comprised of five members with collective investment industry experience of 121 years.

■ **Firm Ownership** - Widespread insider ownership with six shareholders maintaining the majority of voting stock of the company.

■ **Continuity & Succession Planning** - Firm ownership transition began in 2007 with initial issuance; further recapitalization was completed in 2010. Stock Appreciation Rights Plan for senior professionals was adopted in 2011. Additional shares were authorized for issuance in 2012 for recruitment and retention.

■ **Performance Track Record** - Independently verified firm investment performance dating back to 1992. Well-documented investment management and implementation process.

■ **Infrastructure & Technology** - Headquarters building owned by insider/family shareholders. Power generation back-up added in 2011. Fiber optic data feed added in 2012 for both data and disaster recovery data back-up.

As of December 31, 2012

Firm Wide Assets:
\$1.77 Billion

Discretionary Assets Under Management: **\$1.49 Billion**

■ **Financial Stability & Performance** - Record financial performance in 2012. Adequate reserves for ongoing re-investment back into firm, no debt.

■ **Regulatory Record** - Unblemished

LOOKING TOWARDS THE FUTURE | *Embracing the Partnership Mentality*

As we contemplate DVI's next 35 years, there are a few things we feel quite strongly about.

■ A successful investment management firm will always align its interests with its most valuable asset, its clients. They are the lifeblood of our organization, and we take the responsibility of serving them quite seriously.

■ We are much stronger working together than the strengths of any one individual. Our competitive advantage can be traced back to the collaborative effort among all of our associates and the ability to use DVI's collective tool box for the greater good of the organization and its clients.

■ A private and independent firm has the ability to adopt a long-term orientation. Management shareholders are not seeking instant gratification, but attempting to build an

organization that is "Built to Last." An organization that we can all be proud to have contributed to its success.

■ With our reputations and invested capital at risk every day, we are mindful that we cannot lose focus. The same patience, discipline and attention to detail that we utilize in our investment process has to be incorporated in the day-in, day-out management of the firm.

■ DVI associates, board members, and shareholders, we are all in this together. We are partners! Our job is to pave the way for future DVI associates, to insure the same opportunities are given to our successors as David Vaughan provided to us many years ago.

SHAREHOLDERS

Lawrence Williams IV
President & CEO
Tenure with DVI – 23 years

Brian A. Christensen, CFA
Senior Vice President & CIO
Tenure with DVI – 20 years

Patrick J. Smarjesse, CEBS
Vice President
Tenure with DVI – 18 years

Todd M. Sheridan, CFA
Vice President
Tenure with DVI – 13 years

James D. Sinclair, CPA
Treasurer & CCO
Tenure with DVI – 16 years

Stephen K. Hinrichs, CFA
Portfolio Manager
Tenure with DVI – 14 years

BOARD OF DIRECTORS

David J. Vaughan, Jr., MD ^{1,2}
Board Certified Physician
Board Chairman since 2007

John V.N. McClure ^{1,2,3}
Retired, Northern Trust Corp.
Director since 2007

Lawrence Williams IV ^{1,3}
DVI
Director since 2007

Brian A. Christensen, CFA ²
DVI
Director since 2011

Virginia Johnson Pillman, CPA ³
Retired, Duchossois Group
Director since 2011

Wayne E. Baum ^{1,3}
Chairman, Core Construction
Director since 2012



1. Compensation Committee | 2. Nominating Committee
3. Audit & Compliance Committee