DVI
David Vaughan Investments

Quarterly Perspective

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The Next Leg Up

Despite the fact that the S&P 500 Index posted its seventh straight quarterly gain at the end of the Third Quarter and the market reached an all-time high back on the 19th of September, much of the client feedback I receive these days is filled with probing questions, economic and political concerns and in some instances frustration and despair. Fatigue is the best way that I can describe it. The daily barrage of negative headlines ranging from the Russian military intervention in Ukraine, the emerging impact of ISIS on the Middle East, the slowing of the Chinese economy and the recent Ebola virus outbreak, have all contributed to a mindset that nothing appears to be going right. As one client expressed to me, "it is giving me a headache." As a consequence of historically low interest rates, the challenge for all investors today is the requirement that they assume risk, be it equity, credit, commodity, or economic risk to achieve positive post-tax, post-inflation rates of return. The absence of a source for safe, reliable and most importantly reasonable annuity streams from traditional fixed income securities and bank deposits continues to leave investors on edge when market volatility begins to heat up.

Common questions we receive at DVI are "what is going to hold this market up at these lofty levels?" or "aren't we due for a nasty correction?" In essence, what are the catalysts going forward that will fundamentally support the next leg up in the common stock bull market that started over five years ago? The best way to address this is to back track to determine how we got to where we are today and what reasonable scenarios exist that will support higher stock prices down the road.

The Past Five Years

Things have been turned so upside down since the Great Recession back in 2008 and 2009 that many analysts are skeptical of the fundamentals that we relied on in the past, concerned that they have been manipulated with smoke and mirrors. Dividends on the other hand, and Free Cash Flow remain rather transparent proxies for the health, growth and future prospects for a company. In calendar year 2009, S&P 500 companies generated $61.05 per share in Free Cash Flow, by year end 2014 that figure should reach nearly $93.00 per share. Dividends have followed a similar strong growth trajectory. In calendar year 2009, S&P 500 companies paid out $21.88 per share in dividends, with a quarter remaining in 2014, that figure is projected to be $39.33 per share or nearly an 80% increase. Despite a relatively slow growth economic recovery, Corporate America through both cost reduction and productivity gains have managed their businesses quite effectively to provide substantial shareholder value. Investors once shell shocked by the events related to the financial crisis have also taken notice and have slowly but surely placed funds back into the equity market and have increasingly been willing to pay higher and higher multiples of free cash flow to own equity securities. The combination of the underlying superior growth of cash flow and the appetite from investors to pay higher and higher multiples to own these companies has resulted in the bull market results to date.

Possible Future Catalysts

Companies will only be able to go so far with cost cutting and productivity gains and

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Route To:

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Financial Markets and a Strengthening U.S. Dollar

Brian Christensen, CFA
Senior Vice President

The U.S. dollar is currently trading at levels not seen since mid-2010, and is up nearly 20% since the May 2011 lows. Most recently, we've seen a sharp 8% increase in the value of the dollar just during the 3rd quarter of this year. The natural questions are "Why?" and "What are the implications for financial markets?"

As for "Why?", we see the primary drivers being an improving U.S. economy and the Federal Reserve acting to increase interest rates while central banks in Europe and Japan are aggressively cutting rates. Despite our historically low interest rates, the current 10-year U.S. Treasury yield is now trading above global fixed income alternatives. The demand for dollars should accelerate under a strengthening U.S. economy and higher interest rates, which create a more attractive investment environment relative to other global economies.

As for the impact on financial markets, historically asset classes have responded differently to changes in the dollar's value. S&P Capital IQ measured 12-month rolling correlations going back to December 31, 1986. Correlation ranges between -1 and +1. Perfect positive correlation (a correlation co-efficient of +1) implies that as one security moves, either up or down, the other security will move in lockstep, in the same direction. Alternatively, perfect negative correlation means that if one security moves in either direction the security that is perfectly negatively correlated will move in the opposite direction. If the correlation is 0, the movements of the securities are said to have no correlation; they are completely random. The results of the S&P Capital IQ study are shown in the table below.

Rolling 12-Month Correlations with the U.S. Dollar Index

Since 12/31/1986

12-Month Correlations	S&P 500	Russell 2000	MSCI EAFE	MSCI Emerging Mkts.	Barclays Aggregate Bond	Gold	WTI Oil
Current	0.52	0.03	-0.13	0.48	0.46	-0.46	-0.67
Average	0.03	0.12	-0.2	-0.06	-0.11	-0.41	-0.27
% Negative	48%	40%	59%	53%	55%	79%	70%
% Positive	52%	60%	41%	47%	45%	21%	30%

Source: S&P Capital IQ, Russell, MSCI, Barclays

Not surprisingly, the most significant negative correlations are seen in oil, gold and bonds implying that when the dollar's value increases, these asset classes decline. Positive correlations were seen only in domestic equity asset classes indicating that historically a rising dollar has been good for stock prices.

In a recent Charles Schwab study, they too found a positive relationship between a stronger dollar and rising stock prices. The table below details their research results.

S&P 500 Performance - Dollar Bull & Bear Markets

Dollar Bull/Bear	Dates	Days	U.S. Dollar Index % Change	S&P 500 % Change
$ Bull	10/30/78 - 2/25/85	2,310	100.7%	88.5%
$ Bear	2/25/85 - 12/31/87	1,039	-48.2%	37.9%
$ Bull	12/31/87-6/14/89	531	23.7%	31.1%
$ Bear	6/14/89 - 2/11/91	607	-23.2%	13.8%
$ Bull	2/11/91 - 7/5/01	3,797	-50.2%	230.8%
$ Bear	7/5/01 - 4/22/08	2,483	-41.0%	12.9%
$ Bull	4/22/08 - 3/5/09	317	24.9%	-50.4%
$ Bear	3/5/09 - 11/25/09	265	-16.7%	62.7%
$ Bull	11/25/09 - 6/7/10	194	19.0%	-5.4%
$ Bear	6/7/10 - 4/29/11	326	-17.5%	29.8%
	Average Dollar Bull Market		43.7%	58.9%
	Average Dollar Bear Market		-29.4%	31.4%
Recent $ Bull	4/29/11 - ??	1,232	15.4%	45.6%

Source: Charles Schwab

Schwab's research suggests that a stronger dollar is likely to be both an economic and market positive. As the data in the table indicates, during periods of a rising dollar, the stock market has outperformed by a nearly 2-to-1 margin over periods of a falling dollar.

Additionally, Schwab measured S&P 500 Index returns relative to the volatility of the dollar. They found that S&P 500 gains were the highest during times of dollar stability. However, S&P 500 gains were higher in a rising dollar environment than during a falling dollar environment.

Clearly U.S. stock prices are affected by a variety of factors and the value of the dollar is but one. However, the current global economic environment is favoring dollar denominated investments which under the realm of an improving U.S. economy should con-tinue to support our markets longer term.

Corporate Inversions: A Brief Overview

Stephanie Ricketts, CFP®
Relationship Manager

Even though corporate inversions have been taking place for over 3 decades, a surge of them this year has thrown the term and its associated consequences in the political spotlight. So what exactly is a corporate inversion, why is this a political hot topic and, most importantly, what are the consequences to investors?

In its simplest form, an inversion is the process by which a corporate entity, established in another country, "buys" an established American company. The transaction takes place when the overseas entity purchases either the shares or assets of a domestic corporation. Essentially, the legal location of the company changes through a corporate inversion from the United States to another country but typically does not change the operational structure or physical location of the company.

If structured properly, the inversion allows companies to move some of their profits to their new homeland and pay less in taxes to the U.S. Treasury - but nothing else moves. It's business as usual for their American operations, employees and customers. In order to be structured properly, 25% of the merged company's revenue, employees and assets must be derived and maintained in the foreign domicile. In order to achieve this structure, American companies pursuing an inversion are identifying acquisition targets of 25% their size, with similar businesses in complimentary foreign markets.

The primary reason corporations are pursuing re-incorporation overseas is to reduce their effective tax rate on income earned from foreign sources. The United States corporate income tax rate is 35% on most corporate income, which is relatively high by international standards. Corporate America cites a market driven rationale: domestic firms need lower taxes to keep them competitive with international business rivals. Many U.S. firms also tout projections of long-range growth, lower taxes and higher earnings per share – benefits that could make the transactions a good deal for shareholders in the long run.

The Obama administration, however, says that companies that pursue inversions are unpatriotically "gaming the system" and potentially eroding the federal tax base while continuing to take advantage of the U.S. economy and domestic services. The White House estimates the Treasury could lose out on as much as $20 billion over the next decade. Amid continued Capitol Hill gridlock in a congressional election year, Treasury Secretary Jacob Lew recently announced new restrictions that are expected to make corporate inversions harder to complete and less profitable, including a requirement of companies that claim they are no longer American to be more than 50% owned by foreigners.

In contrast to the heavy national focus on the broader inversion issue, somewhat less attention has been devoted to the tax impact on shareholders. An inversion that reduces the corporation's tax bill can increase income taxes for the firm's shareholders. Because the inversion is the sale of the U.S. firm to a foreign company, stockholders in the U.S. firm are deemed to have sold their shares in the U.S. firm in exchange for shares in the new foreign-based company. They receive no cash, but rather a stake in the new company. In nearly all cases, inversions prompt the realization of capital gains on the difference between the cost basis and fair market value of the new shares.

When an investor owns stock of a company pursuing inversion, the tax consequences can be readily determined with accurate cost basis records. Some investors who hold shares of inverting companies through mutual funds may not yet realize they could face capital gains taxes. Mutual fund investors typically will not know until the end of the year, when mutual funds complete their annual reports. Further, because mutual fund shareholders ultimately bear the burden of the subsequent tax liabilities, mutual fund managers reap disproportionate upside from corporate inversions. This can create a possible conflict of interest between the fund managers objective of strong pre-tax returns ahead of client interests.

So what is an investor to do if one holds stock of a company that is undergoing an inversion (in a taxable portfolio)? There is no magic bullet to eliminate the capital gains. Some stockholders may be able to offset their gains with capital losses on other investments. Others may give some consideration to gifting the shares ahead of the merger to a charity or to individuals in lower tax brackets. DVI is here to assist and consult with our clients who may be experiencing this situation to determine what may be best for them based upon their individual circumstances.

Hike for Hunger

Thank you to everyone who supported and participated in the 2014 Hike for Hunger! This year's event resulted in a record breaking fundraiser for the South Side Mission.

The 2014 David Vaughan Investments Hike for Hunger surpassed $73,000, bringing the lifetime event total to $409,000. This fundraiser, held August 16th, supports the food ministries of South Side Mission and helps to underwrite the three food pantries and the meals that are served to the women and children who live in the shelter at South Side Mission.

Corporate sponsors underscore the grassroots effort along with the donations and participant fees from nearly 360 hikers. We hope to see you at the 2015 Hike, which will be held the third Saturday in August.

The Next Leg Up

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investors will come to a point when they will no longer pay up for future earnings growth. What other developments are out there that are reasonable and could contribute to a positive market backdrop over the next 12 – 18 months?

Source: S&P Capital IQ

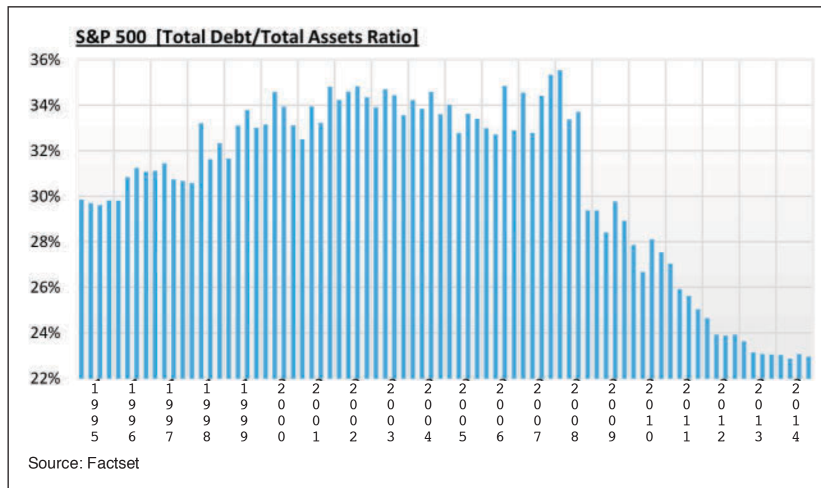
S&P 500 Index Foreign Sales as a % of Total Sales	46.29%	46.29%
	2013	**2010**
Africa	3.55%	3.00%
Asia	7.71%	6.07%
Australia	0.11%	0.12%
Europe	6.80%	13.48%
North America (ex USA)	2.72%	1.94%
South America	2.60%	2.14%
Foreign Misc.	22.80%	19.54%

GDP Growth Rate

Stabilization of the European Economy

As the table illustrates, nearly 50% of the sales for the S&P 500 Index are foreign sales, a constant since 2010. However, a dramatic shift has occurred within Europe as its economy has slowed and the percentage of S&P 500 companies growing sales has been cut in nearly half.

Any renewed economic strength coming out of Europe would contribute to Global GDP growth and would provide top line sales growth for U.S. companies.



Source: Factset

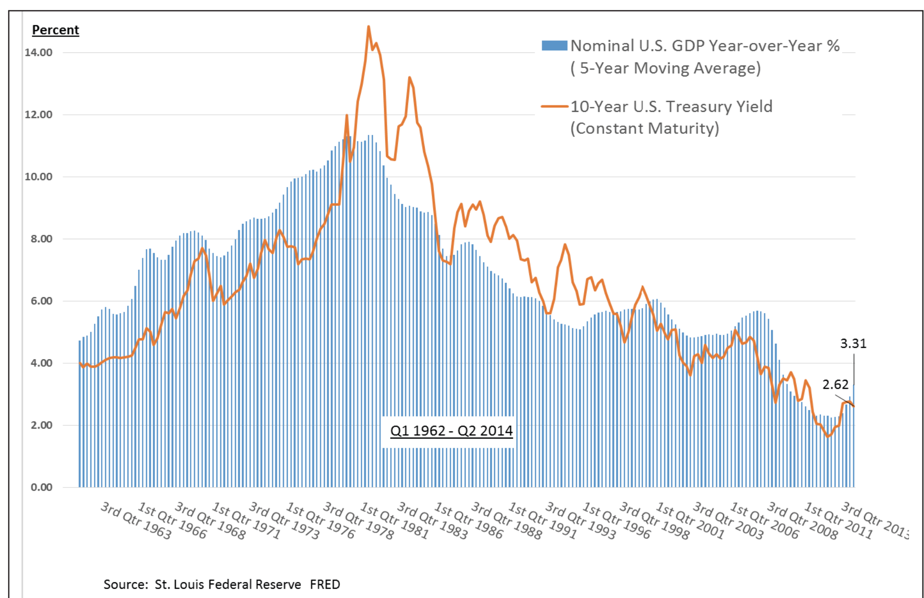
Redeployment of Corporate Capital

Companies have elected to maintain conservative balance sheets and have been in a deleveraging mode in recent years. They are fundamentally in a great place to deploy significant capital to invest in projects to grow their top line. If they elect to use this capacity, this too should have a positive impact on overall GDP growth.

Interest Rates Rising in the U.S

When long-term interest rates rise, it is generally highly correlated with nominal GDP growth. When long-term rates are unusually low, below four to five percent, JP Morgan research has determined that rising rates actually have a positive correlation to rising stock prices as well. This is in contrast to the widely held perspective that a rising rate environment is negative for the stock market.

Being optimistic or constructive on the equity market for the long-term is not a new or recent development here at DVI. However those factors that we are monitoring to determine the overall health of the market continue to change and evolve. We acknowledge that the backdrop of 15 % plus annualized rates of return that we have enjoyed over the past five years is more reflective of an oversold market getting back to equilibrium rather than a sustainable pace going forward. We continue to believe a healthy investing environment is in place when you match persistent skepticism by investors with improving economic fundamentals. This combination has historically provided a catalyst for the market to slowly but surely climb this wall of worry.



Source: St. Louis Federal Reserve FRED

Will Williams

President

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