DVI
DAVID VAUGHAN INVESTMENTS

Quarterly Perspective

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Challenging Current Day Conventional Wisdom

Study after study reinforces the fact that individual investors continue to struggle to earn reasonable investment rates of return despite the recovering capital markets in recent years. Most research results indicate returns of approximately 50% less than either a passive index comparison or a compilation of investment fund returns. Most of these studies highlight several common themes that are driving these disappointing results and reinforcing the economic reality that most investors are simply not acting in their own best interest.

Investing Behaviors

- Trend Following – waiting for trends to be well established prior to investing, pulling the trigger close to market tops, leaving them unable to withstand the loss from the inevitable market correction.
- Performance Chasing – constantly switching between investment managers, seeking out the highest rated managers when their investment philosophy, theme or asset class is at its very peak of performance.
- Investment Complexity – in the age of asset class diversification and financial engineering often times investors don't really know what they own and how it is supposed to perform in varying investment climates. As such, the tendency is to sell investments like these when they are underperforming rather than to stay the course.
- Lacking a Long-Term Investment Strategy – the investment industry is constantly encouraging investors to embrace "non-traditional" thinking, to re-shape their investment strategy and to incorporate the latest investment craze or fad into their mix.
- Contrarian or Opportunistic Thinking – our educational system and the investment industry in general, have both failed to highlight the significance of a contrarian mindset. At the end of the day, it might be the most significant attribute towards long-term financial success.

Defensive Strategies, Now on the Defensive

As the second quarter of 2013 comes to a close, there is going to be all kinds of soul searching among investors as they examine the disparate results of various asset classes both on a year-to- date basis as well as over the past twelve months. Investment categories that had been viewed as safe havens to the deteriorating fundamentals here in the U.S. such as Gold and Emerging Market Stocks have experienced significant declines so far in 2013. Inflows into these two asset categories in recent years have been robust, with investors frequently using large ETFs (Exchange Traded Funds) to gain exposure. Gold has declined nearly 30% for the year and Emerging Markets have followed suit, down nearly 11% year-to-date. The pain of those declines is made worse when plain old U.S. domestic stocks have produced positive results across the board, with the broad market up nearly 14%.

Certainly not to the same extent but as a consequence of the recent backup in interest rates, fixed income securities and fixed income mutual funds will most likely show brackets for both the YTD and one year periods, though losses so far have been relatively modest. This is in stark contrast to the nearly 6% annualized rate of return produced by the Barclay's Aggregate Bond Index over the past five years for the period ending 12.31.12. If the year ended today, this would be the worst showing for the Aggregate Bond Index since 1999.

These results, both absolute and relative, will

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What You Don't Know About Bonds Might Hurt You

Brian Christensen, CFA
Senior Vice President

The yield on the 10 Year U.S. Treasury Note increased nearly 60% when it rose from 1.63% on May 1st to 2.61% on June 25th. This volatility in interest rates was experienced across the curve leaving even the shortest maturities impacted. The table below provides more detail:

On the surface these increases may not appear to be a big deal as interest rates are still relatively low.

Change in Interest Rates
May 1, 2013 - June 25, 2013

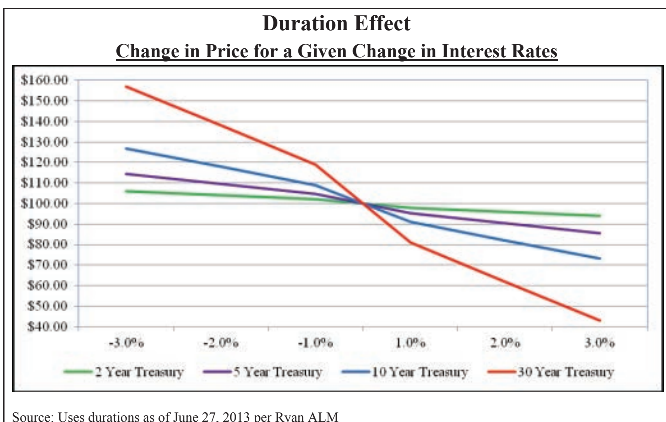
	Yield on May 1	Yield on June 25	% Change
2 Year Treasury Note	0.20%	0.41%	105%
5 Year Treasury Note	0.65%	1.49%	129%
10 Year Treasury Note	1.63%	2.61%	60%
30 Year Treasury Bond	2.82%	3.62%	28%

However, the impact of this sharp increase has surprised many bond investors—not surprised by the fact that interest rates are beginning to increase given there is ultimately no other direction to go, but rather surprised by the impact on their portfolios.

If you own bonds or have money invested in bond mutual funds, there is a statistic you need to know. That statistic is called duration. Duration, for investments that consist of fixed cash flows (interest and principal payments) like a bond, is the weighted average of the time until those fixed cash flows are received. Duration also measures how sensitive a bond price is to interest rate changes.

In its most basic form, the higher a bond's duration the greater its price sensitivity to interest rates. Keep in mind that bond prices and interest rates move inversely. To estimate how a change in interest rates can affect a bond price, simply multiply the duration by the change in interest rates. If a bond or bond fund has an average duration of 2.5 years, a 1% rise in interest rates would lead to a 2.5% decline in the bond price. Inversely, if interest rates decline by 1%, the bond price will increase by 2.5%. Obviously higher duration implies greater price risk.

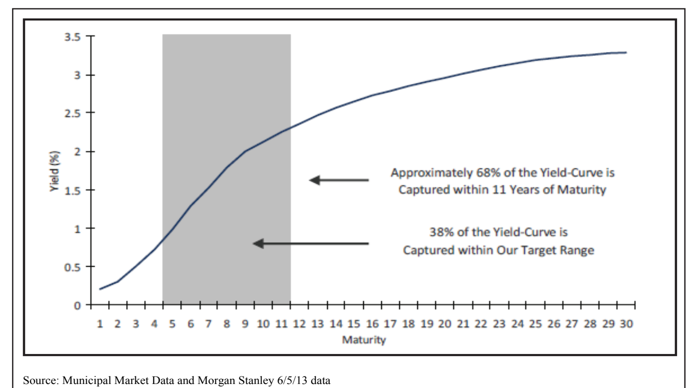
The chart shown below provides additional perspective as to how bond duration and changing interest rates impact prices.



Source: Uses durations as of June 27, 2013 per Ryan ALM

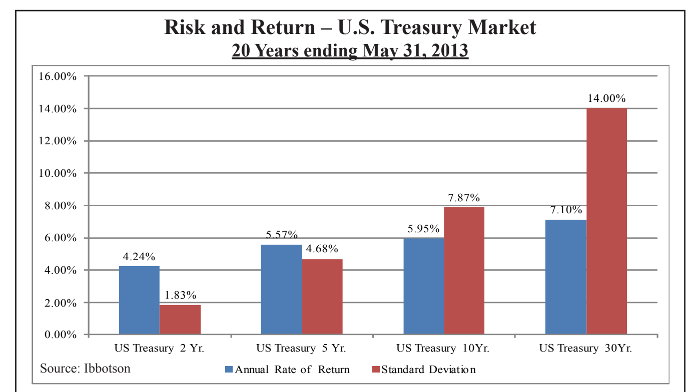
Duration in a bond portfolio can be managed to minimize the portfolio's sensitivity to interest rates. At DVI, we build bond portfolios using short and intermediate term securities with investment grade credit ratings. We also seek to ladder maturities such that a portion of the portfolio matures each year. A laddered bond portfolio typically performs well relative to other bond strategies and does not require any reliance on interest rate forecasts. The ladder allows for cash flow from principal and interest receipts to ideally be reinvested into new bonds carrying higher coupon rates. This reinvestment process works to counteract the price depreciation experienced by rising interest rates.

Our preference for short and intermediate maturities is supported by the chart below which indicates a significant portion of the yield curve is captured in these maturity ranges.



Source: Municipal Market Data and Morgan Stanley 6/5/13 data

Further, when investors extend portfolio maturities they assume greater risk which is not sufficiently rewarded. As seen in the chart below, the 5 Year U.S. Treasury Note captured nearly 80% of the return of the 30 Year U.S. Treasury Bond while enduring only one-third of the volatility.



Source: Ibbotson

While many individuals perceive fixed income investments as safe and with little volatility, not all bonds or bond funds are the same. A portfolio's duration, credit quality and tax exposure all play a factor in the outcome. The role of active management is to minimize these risks while capturing a significant proportion of available market return. Bond fund investors would be well served to evaluate exactly how much risk they have assumed in the ever present chase for higher yields.

Drowning in Paper: How to Stay Afloat

Jim Sinclair, CPA
Treasurer & Chief Compliance Officer

Within the last two years, my wife and I moved my parents into a nursing home and her parents passed away. In both cases we found ourselves drowning in the paper documents stored in their respective homes. It was a long, methodical process to wade through the documents (much less furniture, etc…) to determine what to keep, what to shred, and what could be simply thrown out before we could put their homes up for sale. Let me share the steps we followed to simplify this process for our children when we die.

First, categorize your documents into five groups – tax and business, net worth, legal and insurance, sentimental, and other. Documents that support income and expenses for a personal or business tax return should be organized by calendar year. This includes everything from last year's return to W-2's, 1099's, cancelled checks, letters from charitable organizations, property tax receipts, realized gains and losses reports, and any other receipt to support a deduction. Certain documents will support a future tax year such as taxable account security trade confirmations, non-deductible IRA contribution, and major home improvements. These should be filed by custodian account or type of asset.

All net worth documents should be separated by custodian account, bank account, piece of real estate, mortgage institution by account, annuity, etc… If you receive more than annual statements, these should be separated by calendar year.

Any currently enforceable legal documents (trusts, annuities, mortgages, investment advisory agreements, etc…), product warranties, and insurance policies should be separated from prior documents that have expired (i.e. cell phone plans) and filed by type of agreement such as insurance policies, cell phone agreement, etc...

Virtually everyone keeps sentimental items from their childhood, accomplishments along the way, children and grandchildren drawings, school papers, etc… If these documents exist throughout your house, we suggest you gather them in one location to be reviewed by you and your children with serious consideration for what can be purged. We are now down to one or two storage tubs per each of our four children and ourselves.

The final group includes all remaining paper documents not included in the above four groups.

(A more complete list of the wide variety of documents can be found on the Resources page of the DVI website at www.dviinc.com.)

Second, relevant documents should be kept for required periods of time. The Internal Revenue Service (www.irs.gov) expects you to keep relevant records of your income, expenses and deductions, including retirement account contributions, charitable contributions, and mortgage interest for three years after you file your return (6 years is the statute of limitation if income is underreported by more than 25%). Internet guidance ranges from 6 years for the support documents of a given return, to permanent retention of your actual tax return.

Net worth documents typically show the market value at a given point in time and transactions since the last statement. A good rule of thumb for most statements would be to keep the December 31st statements for prior years and all statements for the current year until you verify that the 1099 received agrees with the year-to-date total, and the tax return is filed. If you are reinvesting dividends in a taxable account, the monthly statements reflecting the number and cost of shares purchased should be kept until the securities are sold. This is the only record of these transactions.

Legal document retention ranges from the duration of the contract to permanent retention. Unless you have a claim, outstanding under a prior contract plan, the expired documents can be destroyed. Birth, marriage, and death certificates, home and car titles, savings bonds, estate documents, funeral arrangements, etc… should be kept permanently or until they are replaced by an updated version.

Retention time for sentimental items is your choice. The general rule of thumb "less is best." These can be the most difficult items to throw out because many children or grandchildren might be interested in looking through them momentarily but not want to continue to store them after you die. It can be a fun family gathering (laughs and tears flowing) to bring these documents out and let everyone review them with the goal that you keep a few, they keep what they want, and the rest will be destroyed.

Group five items should NOT be kept at all unless there is a compelling reason to maintain them for a certain amount of time. Bottom line – check with your tax and legal professionals for final guidance.

Third, find the right storage option for the documents you keep. There are three choices – paper at home, paper in the safe deposit box, or electronic. Originals of documents such as birth certificates, estate documents, real estate and auto titles, savings bonds and other negotiable instruments that cannot be transferred to a custodian for safekeeping, and other key original documents should be stored in a safe deposit box. Create a list of these items to be filed with your home documents for easy reference.

The remaining documents can either be stored as paper or scanned and stored electronically. Many of them like custodian and bank statements, cancelled checks, credit card statements, trade confirmations, tax forms, etc… are available electronically on the appropriate institution's website. Others can be scanned at home with a relatively inexpensive scanner and retained on your home computer. Some of the safe deposit documents should be scanned for quick reference.

We would recommend you file the documents – paper or electronic – similar to what we described above and limit your paper copies to the current year. At the end of the year, verify that year-to-date totals agree with the monthly statements, scan the documents necessary to support your tax return and other documents you want to keep, and shred the rest. Most custodians and banks will maintain electronic copies of documents for multiple years back. If you would prefer to keep them on your own computer, they can be downloaded.

The biggest risk of electronic filing on your home computer is losing the files after a system crash. We recommend that you backup your home computer through very reliable internet companies for a minimal fee per year. These systems will automatically backup all new and changed files as they occur. Simply enter "home computer internet backup" in your web browser to see several options.

Fourth, dispose of what is not being kept. You have two choices – shred or throw out. Any documents which have any personal data about you or your family (i.e. social security and

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Challenging Current Day Conventional Wisdom

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challenge modern day investors. What they have experienced to date is not what they had expected nor what they were told to expect and now they have to decide to either ride it out or once again go to Plan B. This is a terribly difficult decision, especially in light of the circumstances and in my own mind, an exercise that one should attempt to avoid at all costs.

Key Components of Defensive Investment Management

If there is one overarching theme that I consistently hear from investors, it is simply the idea that the financial markets and related investment vehicles have become far too complex. With complexity, there is a lack of understanding and conviction which generally leads to poor decision making.

Building off of themes outlined in Benjamin Graham's well known book Intelligent Investor, I have attempted to piece together a series of basic and simple to understand guidelines that might prove beneficial to investors as they evaluate investment strategies. Obviously, DVI has come to the conclusion that a core equity-income investment strategy should be the cornerstone of defensive investment management. However, I think one can apply these principles to other investment strategies and still achieve a positive outcome.

- Elevator Speech – if you cannot explain the strategy to an adolescent child with a few brief sentences, the strategy is either too complex or is a marketing gimmick of Wall Street.
- Access to Liquidity – with alternative investment strategies (Private Equity, Hedge Funds) gaining traction, making sure you have an efficient, liquid and timely way out of an investment is essential.
- Investment Cashflow – periodic dividends, interest payments or shareholder distributions depending upon the structure are key as they provide ongoing transparency as to the health of the investment and allow for further investment diversification.
- Reasonable Valuation – oversubscribed investment themes tend to push up valuation on both an absolute and relative basis. Maintaining a keen eye on valuation will force you to maintain both disciplined and a contrarian mindset.
- Stable Earnings Growth – may it be corporate earnings, real estate rent or lease payments from a gas pipeline, as long as earnings increase over the long-term, price improvement will follow.

In my own mind, taking this approach is more or less just practicing good common sense and constructing a sound decision making framework. This appears to be at odds with the current day conventional wisdom on Wall Street that is increasingly emphasizing alternative strategies and other complex investment vehicles as a substitute for low-yielding fixed income. In a recent poll conducted by the Center for Applied Research, when institutional investors were asked to describe their largest challenge, complexity stemming from increased investments to alternative strategies was the #1 ranked response. If institutional investors are troubled by the increasing level of complexity, I cannot even imagine how Main Street investors are going to comprehend the risk and reward benefits of the products being sold to them. And at the heart of this, most of these vehicles are being sold under the pretense that they should provide superior downside protection. When one experiences a quarter like we just experienced, now what does one do?

Top 5 Survey Results -

What investment firm capabilities will become increasingly important to you over the next 10 years?

- *Performance*
- *Unbiased High-Quality Advice*
- *Client Service Excellence*
- *Transparency*
- *Reputation and Integrity*

Source: Center for Applied Research (November 2012)

Will Williams
President

Drowning in Paper: How to Stay Afloat

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account numbers, etc…) should be shredded. The first time you go through this process, you will have a lot of materials to shred. We recommend you take these to a commercial shredder for a minimal fee. Going forward, a home shredder is recommended. The remaining documents can simply be recycled or thrown out.

My wife and I began this process after her father died earlier this year. We were amazed how much paper can accumulate after 35 years of marriage and four grown children. Through organizing the documents into groups, determining which ones need to be kept and for how long, and selecting a storage method, we have reduced the paper in our house significantly. We are not done, but in the end it will simplify the process for us, our children, and our trustees and executors.

NOTE: This process is relevant for business. DVI will implement this process as a business in the near future.

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