DVI
DAVID VAUGHAN INVESTMENTS

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Five Years from the Brink

It is often said, "You cannot know where you are going, unless you know where you have been." For many of us in the asset management industry, Monday, September 15, 2008 will live on in infamy as that was the day the investment bank Lehman Brothers filed for bankruptcy and placed the global financial markets in further chaos. As the 3rd quarter of 2013 comes to a close, we mark the fifth anniversary of this historic event. Not only was Lehman our nation's largest bankruptcy filing, but was the final straw in a series of significant miscalculations by the banking industry relating to the use of leverage, the unintended consequences of financial engineering and in its ability to manage financial risk. It just so happened that the associates and Directors of DVI were hosting their biennial client appreciation event on the evening of September 14th and by evening's end we knew what was in store for us, and knew it was not going to be business as usual for some time. In fact, it was nearly six months before the stock market stabilized and began to claw back from its significant losses. By March of 2010, the market was finally in the black, but during those 18 months, seemingly a day did not go by without some major event or a difficult decision to make. The leadership team of DVI has at times been described as veteran or seasoned, with countless years of investment industry experience and perspective. Unfortunately, we all learned a great deal about internal fortitude and risk management during those difficult months.

As the market has continued on and not only met its 2007 peak, but recently established new all-time highs here in the 3rd quarter, I thought it made sense to look back and gain a bit of economic and financial market perspective.

Home Prices

One of the root causes of the Lehman collapse was its overexposure to real estate. Despite the Federal Reserve Board's decision to engage in quantitative easing, actually purchasing longer dated debt securities to drive borrowing costs lower, housing prices

	5 Year Anniversary Window				
	9/30/2008	Trough Level	2013	Description	2013 Data as of -
S&P Case-Shiller 20-City Home Price Index	159.06	136.87	159.18	Index that reflects Housing Price Trends in 20 Major Metropolitan Cities	07/01/13
10 Year U.S. Treasury Interest Rate	3.69%	1.53%	2.61%	10 Year Constant Maturity (% Yield)	9/30/2013
S&P 500 Index	1166.36	666.79	1681.55	Broad U.S. Domestic Stock Market Index	9/30/2013
U.S. Corporate Earnings (EPS per share)	$73.56	$59.37	$107.48	Est. Trailing 4 Qtrs Earnings of S&P 500 Cos	9/30/2013
Stock Market Valuation (P/E Multiple)	15.86x	12.7x	15.65x	Price/Earnings Ratio (Quarter End Prices)	9/30/2013
Total Non-Farm Payrolls	136.4 Million	129.3 Million	136.1 Million	# of Workers in the U.S. Economy, with certain category exclusions	08/01/13
U.S. Household Net Worth	$61.8 Trillion	$55.6 Trillion	$74.8 Trillion	Household Tangible & Financial Assets less Outstanding Liabilities	6/30/2013
U.S. Consumer Confidence Index	61.4	40.9	79.7	Index of Current as well as Future Expectations	9/30/2013
U.S Federal Debt as a % of GDP	73.55%	73.55%	101.58%	U.S. Total Public Debt as % of Gross Domestic Product	Q1 2013

Source: Federal Reserve Bank of St. Louis, Morningstar, Inc.

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Stocks, Dividends, and Rising Interest Rates

Brian Christensen, CFA
Senior Vice President

Over the past several months, market uncertainty has increased regarding when the Federal Reserve will begin to slow its quantitative easing program, thus signaling the start of a move to higher interest rates. While we expect the pace of this process to be slow, it will indicate that central bank monetary policy is moving to a less accommodative stance. The early stages of this process could prove to be quite volatile for the markets, but it ultimately should not be viewed negatively as we believe it will be a sign that the Federal Reserve has confidence in the strength of the economic recovery.

Chart 1

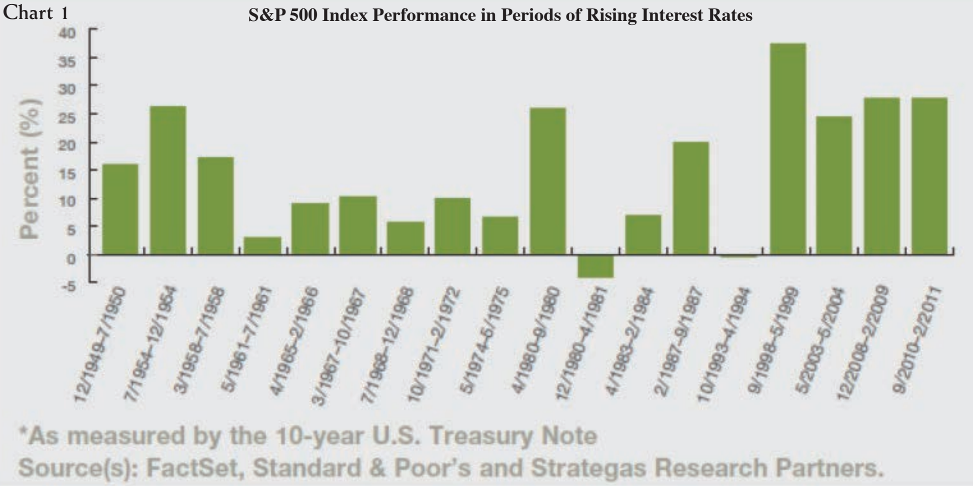


Table 1

Subsequent 12 Month Returns - S&P 500 Index
6/30/1927 - 12/31/2012

Change in 10 Year Treasury Rate	Non-Payers	Bottom 30%	Middle 40%	Top 30%	All Payers
1-Month Rise	6.90%	7.30%	7.70%	8.50%	8.00%
3-Month Rise	5.40%	6.40%	7.30%	8.50%	7.50%
6-Month Rise	5.90%	6.90%	7.70%	8.90%	8.00%
12-Month Rise	7.10%	7.80%	9.40%	10.90%	9.50%

Source: AFAM Capital

As interest rates begin to bump higher, a common concern is the impact this will have on stock prices. Many market observers expect rising interest rates to have a negative impact on stock prices. Outlined above is data that evaluates stock market performance during periods of rising interest rates, and as you'll see, history suggests the stock market should respond positively.

Since 1949, there have been eighteen time periods where long-term interest rates have risen, as measured by the 10-year U.S. Treasury Note. Chart 1 shows S&P 500 Index returns during each of those rising rate time periods.

As you can see, the S&P 500 Index increased during sixteen of the eighteen periods of rising long-term interest rates.

If we take the evaluation one step further and measure the performance of dividend paying stocks relative to non-dividend payers, the results become even more conclusive.

Table 1 identifies the performance of four different groups of stocks from within the S&P 500 Index: the Non-Dividend Payers, the Bottom 30% of Dividend Payers, the Middle 40% of Dividend Payers, and the Top 40% of Dividend Payers.

Clearly rising interest rates do not necessarily mean negative returns for the stock market.

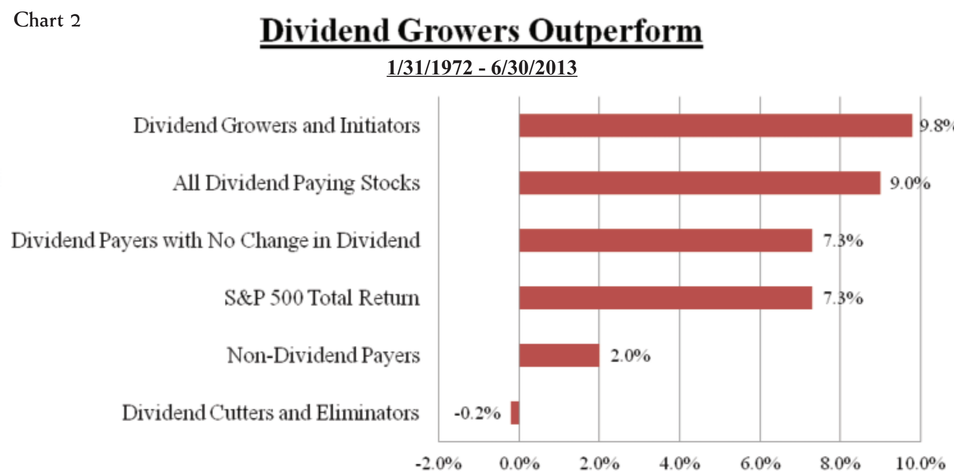
Ned Davis Research, Inc. analyzed returns for several different categories of dividend payers. Historically, companies with above average dividend growth rates and those having recently initiated dividends outperform other categories. The relative performance across dividend categories is shown in Chart 2.

So, what happens in rising interest rate environments to those stocks identified as Dividend Growers? Again using data from Ned Davis Research, Inc., the investment firm Lord Abbett published an article in June highlighting Chart 3 (see next page) which further documents the strength of stocks that exhibit consistent dividend growth.

And finally, what happens to the different dividend payers during various inflationary periods? We would expect higher interest rates to coincide with periods of higher inflation.

As seen in Table 2, clearly stocks that pay dividends and, more

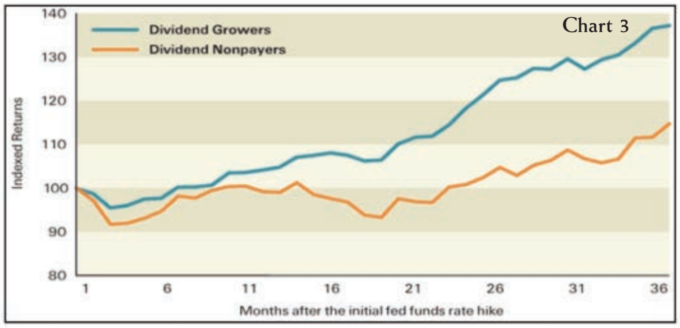
Chart 2



Source: Ned Davis Research, Inc.

Dividend Growers Have Historically Outperformed During Rising Interest Rates

Returns after an initial Fed rate hike in the S&P 500 Index (01/31/1972–12/31/2012)



Source: Ned Davis Research, Inc.

significantly, stocks that have above average dividend growth, outperform their peers. Even more important is the relative performance of these stocks during periods of rising interest rates and higher inflation. The DVI Model Portfolio currently has a dividend yield of 3% (versus the S&P 500 Index dividend yield of 2%) and over the past five years has experienced average dividend growth of 8% annually. The DVI strategy, which emphasizes owning companies with long histories of paying and increasing dividends, is well positioned to excel in an environment of rising interest rates and potentially higher inflation.

Table 2

Inflationary Environment	Change in CPI*	Non-Dividend Payers	Dividend Payers	Dividend Growers
Low to Moderate	0%-2%	3.82%	12.49%	13.33%
Elevated	2%-4%	5.17%	10.63%	11.60%
High	4%-6%	-20.17%	-5.16%	-2.62%

Source: Goldman Sachs Asset Management
*Consumer Price Index

Why Detroit Matters to the Municipal Bond Market and, More Importantly, Why it Doesn't

Drew Lister, CFA
Portfolio Analyst

On July 18th, 2013 the city of Detroit, Michigan filed the largest Chapter 9 municipal bankruptcy in U.S. history with over $18 billion in liabilities owed to more than 100,000 creditors. While the news headlines shocked the nation, the event came as little surprise to the municipal bond market, as Detroit's financial demise was long in the making. The city's credit ratings have crossed in and out of junk bond status numerous times since the 1980s and have been well into junk territory since early 2009. It's hard to believe, but Detroit was once one of the most vibrant economies in the U.S., and in 1960 it boasted the highest per-capita income in the nation.

Fast forward 50 years and this once bustling metropolis has become an urban wasteland. From its peak the city has seen its population shrink from over two million to 680,000 today, and its manufacturing job base has literally been decimated from 296,000 to around 27,000. As jobs and people left the city (some to the suburbs, some out of state), Detroit was left with a sprawling 140 square mile city infrastructure and an insufficient tax base to support it. The city went through decades of increasing taxes, and racking up debt, and cutting government services (40% of streetlights don't work, 2/3 of its ambulance fleet is out of service, average police response time is 58 minutes vs. 11 minutes for the national average, and over 90% of crimes go unsolved by police) to make fiscal ends meet, all of which exacerbated the mass outward migration of its tax base. Today, the average home in Detroit is worth only about $7,000 thanks in part to the over 78,000 structures that sit empty on its city streets; this negates property taxes as a meaningful source of funding for essential city services and debt obligations. Annual uncollected taxes run north of $130 million and public pension recipients now outnumber pension contributors 3-to-1. The city is (and has been for quite some time) in a fiscal death spiral.

So, how will Detroit's problems impact the rest of the country? More specifically, how will its bankruptcy impact the municipal bond market which is so vital to state and local funding? While there are a few issues that matter, the main answer is it won't.

The most interesting question facing municipal bond investors is how Detroit's general obligation (G.O.) bonds will be treated by the bankruptcy court. G.O. bonds are widely considered to be the safest types of municipal bonds, because they are backed by a pledge of the issuer's general taxing authority. In the case of Detroit, the city's emergency manager is proposing that tax pledge be removed and the bonds be treated as unsecured debt. The judge's decision on this issue (thus far untested in a bankruptcy scenario) will likely determine if Detroit G.O. bondholders ultimately receive full or near-full value on their investments or walk away with just pennies on the dollar. More importantly, the decision will impact how G.O. bonds are viewed by investors across the entire $3.7 trillion municipal bond market, which could impact the cost of local government funding from coast to coast. The other interesting issue will be how bondholders in general are treated relative to the city's other obligations, mainly retiree pension and healthcare benefits, which represent over half of the $18 billion owed and are protected by Michigan's state constitution.

These issues are of extreme importance and will be closely watched by the market. However, in whole, Detroit's bankruptcy filing matters very little to the overall municipal bond market for several reasons. The first reason has to do with the technical requirements for Chapter 9 municipal bankruptcies. In order to file Chapter 9, four criteria must be met: 1) the entity must be a local government (State governments cannot use bankruptcy to discharge claims), 2) state law must authorize Chapter 9 filings (only 24 states currently have laws on the books authorizing Chapter 9 filings, and 12 of those first require state approval before the filing can take place), 3) the entity must prove it is insolvent (not a high hurdle for Detroit, but this means other municipalities cannot voluntarily file for bankruptcy just to erase debt from their books), and 4) the entity must first negotiate in good faith with its creditors outside of bankruptcy to seek a resolution (a ruling on whether Detroit met this requirement is

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Five Years from the Brink

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today are nearly identical to where things stood five years ago. Though we have seen a 16% rebound in prices from the trough, household real estate holdings are still more than $ 3 trillion below their peak values registered in 2007.[1] An increase in housing values not only contributes significantly to consumer confidence but also allows for greater work force portability. Some have argued that job growth has been constrained by the inability of workers to move from one region to another.

Interest Rates

With both active intervention by the Federal Reserve and periods of strong investor demand it should come as no surprise that interest rates are lower today than back in the Fall of 2008. Rates have risen in 2013 with fears that the Federal Reserve might "taper" its open market purchases, (See Stocks, Dividends, and Rising Interest Rates for the impact of rising rates on equity prices); however, interest rates continue to be low from a historical perspective.

The Common Stock Market,
Corporate Earnings & Valuation

The ray of sunshine in this analysis is certainly the positive price trend of the common stock market over the past five years, supported by lock step growth in corporate earnings. With earnings per share climbing 46% during this period, market valuation has remained somewhat constant, though we have seen periods of P/E multiple expansion as we have rebounded from the trough, most specifically in 2013. Lower interest rates have not only contributed to Corporate America's bottom line as net interest expense has been significantly reduced, but have also made stocks a more attractive asset class relative to alternative fixed income vehicles.

Employment

Despite nearly 7 million new jobs from the lows in early 2010, job growth has yet to exceed levels established back in 2008. Most if not all of this job growth has come from the private sector as states and municipalities have been forced to downsize their payrolls during the economic contraction to right size their budgets. As mentioned earlier, job growth has been hindered by the inability for families to move, but also has been negatively impacted in recent times by the adoption of part-time workers to avoid the impact of the Affordable Care Act.

Household Net Worth and Consumer Confidence

In the second quarter of 2013, U.S. Household net worth increased to an all-time high, climbing over $ 20 trillion from the Fall of 2009. Most of this gain is attributable to rising financial asset prices, the equity market being the largest contributor, with marginal improvement on the liability side with an overall reduction in total household debt. Historically, there is a strong correlation between this statistic and consumer confidence and should bode well for overall consumer spending in the coming months.

U.S. Federal Debt

If the equity market was a ray of sunshine, the growth of outstanding U.S. Federal Debt is a significant dark cloud. As of the end of the 2008 Fiscal Year (Sept 30), outstanding Federal Debt was approximately $ 10 trillion; this figure now approaches $ 17 trillion or nearly a 70% growth rate. At this level, we now exceed 100% of our nation's total annual economic output, an all-time high.

As we look back, we can certainly point to areas of significant improvement over the past five years as the global financial system has been on the mend and balance sheet leverage, access to capital markets and overall financial liquidity have for the most part been resolved. Investor sentiment, though improving, continues to be well below historical averages as skepticism continues to rule the day on two matters: 1) Can the Federal Reserve successfully unwind their unprecedented intervention in the fixed income markets and 2) Can our nation's deficit be trimmed through higher receipts due to improving economic conditions and modest expenditure growth? I continue to be perplexed by the market's negative reaction to a "tapering" of version three of quantitative easing. If the economy is improving and the Federal Reserve deems the additional stimulus to be no longer necessary, it would seem to me that it would address the two issues that appear to be the primary obstacles towards improving overall investor sentiment.

Will Williams
President

[1]Source Alliance Bernstein 9.27.13 Economic Perspectives

Why Detroit Matters

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expected sometime this fall). These technical requirements make it impossible for many municipal governments to file bankruptcy and extremely difficult for those who can.

The other reason Detroit doesn't matter all that much to the rest of the municipal bond market is simply that the rest of the municipal bond market is not Detroit. Whereas Detroit has gone through a decades-long fiscal death spiral, the fiscal conditions for the vast majority of state and municipal governments are stronger today than they were prior to the recession. According to U.S. Census data, State tax receipts are at their highest level in 25 years and have seen 15 consecutive quarters of growth. Both the median general fund balance as a percentage of expenditures and days cash on hand for cities were higher in 2012 than they were in 2007 (both nominally and adjusted for inflation). County property taxes, while still struggling due to the slow-to-recover housing market, are back on a growth track. Nationwide average total tax collection rates are running around 98%. The list goes on and on. Basically, things are looking pretty good for state and municipal governments, and the market has taken notice. In the 2nd quarter, the credit rating agency Standard & Poor's upgraded 194 municipal issuers and downgraded only 94; this is the third consecutive quarter where municipal upgrades outweighed downgrades.

We at DVI are even less concerned by the Detroit bankruptcy (though we will be monitoring the situation closely) due to the types of municipal bonds we purchase for our clients. As a rule, we only invest in general obligation and essential service (water, sewer, utility, etc.) revenue bonds of highly rated states and municipalities (usually AA- and above). We also stay relatively short-term with our bond investments, as we never want to invest money beyond a reasonable timeframe of predictability. As with stocks, our investment philosophy with bonds places risk management as a top objective.

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