DVI
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Circle of Competence

In the investment management world, the response "I don't know", generally speaking does not gain you a whole lot of fame, celebrity or frequent headlines in the Wall Street Journal. However, as I get longer in the tooth, I am always interested in the thoughts and ideas of those that can honestly and humbly suggest "I don't know", and even more so if they go on to say, they will look into it and circle back with their findings. What a refreshing approach! It leaves you with the understanding that when they do have something to say, it has been thoroughly researched and will be expressed in a thoughtful and meaningful manner.

2013 Nobel Laureate and Yale economics professor, Robert Shiller, was recently being interviewed by the Wall Street Journal and he commented on his new exalted status, "I have a sense that you expect me to come up with answers to every one of your questions, but maybe I should say, 'I don't know' more often." Shiller expressed his admiration for University of Chicago economist, father of the efficient-markets theory and also Nobel Prize winner, Eugene Fama, who frequently responded to interviewer questions at the Nobel ceremony with the comment, "I simply don't know." These are two academics that know a great deal, but over time have developed a mature ego whereby they simply know what they know.

Billionaire investor Warren Buffet is known for his witty insights into common stock investing and his commonsensical approach. He too is an advocate of the concept of recognizing one's limitations and openly acknowledges that most of his success is attributable to the fact that he recognizes his "circle of competence" and stays well inside of it. In fact, in his published criteria to acquire a business, he specifically states he looks for simple businesses, because if there's lots of technology, he won't understand it. He also is an optimist—a fundamental key trait of all successful equity investors. Regarding the financial panic that occurred in late 2008 Buffet remarked, "Could anyone believe the earth was going to swallow up the incredible productive assets and unlimited human ingenuity existing in America?"

In Berkshire Hathaway's recent Annual Report, Buffet commented on certain fundamentals of investing. The Oracle of Omaha made several derogatory comments aimed at market forecasters and television commentators. "Because there is so much chatter about the markets, the economy, interest rates, price behavior of stocks, etc., some investors believe it is important to listen to pundits – and, worst yet, important to consider acting upon their comments." He references Mickey Mantle's quote "You don't know how easy this game is until you get into the broadcasting booth." Buffet goes on to say, "forming macro opinions or listening to the macro or market predications of others is a waste of time, indeed it is dangerous, because it may blur your vision of the facts that are truly important. Games are won by those focusing on the playing field, not by those whose eyes are glued to the scoreboard." And in conclusion on this topic, "In the 54 Years we (Charlie Munger and I) have worked together, we have never forgone an attractive purchase because of the macro or political environment or the views of other people."

The Dilemma

With the technology boom and bust of the late 1990s, the devastating impact of the 9-11 tragedy, the fall out of the Enron bankruptcy, and worst yet, the financial meltdown beginning in the fall of 2007, it has been quite a roller coaster ride over the past 15 years. Yet despite the economic turmoil, bouts with both volatility and heightened emotion, the S&P 500 market index provided a positive rate of return of roughly 4.5% per year. This figure dims in comparison to the prior 15 year period of time, when the index achieved rates of return of nearly 18.50% per year from the summer of 1984 through the spring of 1999. During that time period investment portfolios

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Route To:

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The Multiple Faces of Risk

Brian Christensen, CFA
Senior Vice President

Risk comes from not knowing what you're doing – Warren Buffett

As we enter the sixth year of the current bull market, I thought it would be timely to revisit the concept of risk. By no means is this to sound alarms or forecast a market correction but rather a simple reminder that even in good markets, risk is prevalent. The market environment is not easily defined by a single risk metric or even a single type of risk. The magnitude of market risk varies broadly across time and can change quite quickly. Mr. Buffett, as expressed above, has a knack for simplifying the complex. At DVI, risk management is but one hallmark of our investment process yet it permeates our culture.

Probably the most familiar risk measure used today is volatility or market risk. Volatility is simply the day-to-day fluctuation in prices. In general, expected volatility is the best summary of the risk of an asset. Volatility is most often measured by tracking the standard deviation of asset returns. This process captures the range of returns, or dispersion, over a given time period.

In 1993, the Chicago Board Options Exchange (CBOE) introduced the CBOE Volatility Index, or VIX, and it quickly became the benchmark for stock market volatility. Since volatility often signifies financial turmoil, VIX is often referred to as the "investor fear gauge". Not surprisingly, VIX can be traded just like a traditional security.

Portfolio risk is a second type of risk we monitor and strive to manage. Diversification, or the absence of diversification, is a key element to portfolio risk. The interrelationships between assets in a portfolio are measured by correlation. Correlations can change dramatically over time driven by investor preferences for different asset classes. Occasionally you might hear market participants suggest we are in a "stock pickers" market. This implies that correlations across stock market sectors are low such that portfolio managers can add value through superior research and stock selection. Other times correlations may be high and a majority of stocks are trending similarly regardless the economic sector. Correlations vary between -1 and 1. A correlation of 1 implies perfect synchronization between the asset classes being measured. A correlation of -1 implies that the assets are mirror opposites of each other. A correlation of 0 implies no relationship exists between the assets.

Provided below is a correlation matrix measuring data across various assets classes for the last 23 years ending 12/31/2013. The degree of diversification in a portfolio is measured by these asset class correlations. The farther a correlation is away from 1, the greater the diversification.

Valuation risk measures asset prices and the degree to which securities are rich or cheap. Abnormally priced securities can be risky simply because of valuation regardless of their volatility. Understanding this can be critical in terms of properly positioning a portfolio. Stretched valuations generally indicate elevated risk in a market. However, quantifying any relationship between valuation and return is difficult. Our approach in measuring valuation risk is driven by analyzing historical data and normal valuation ranges then look to identify where current prices are trending outside the normal range.

Event risk or systematic risk is prevalent across all markets and asset classes. Many of the risks investors face relate to specific events that may or may not occur. An international conflict, a central bank changing monetary policy, or inflation are all examples of systematic risk. Systematic risk is considered to be "undiversifiable" as it is the uncertainty inherent to the entire market. Beta is the statistic we use to measure systematic risk. The S&P 500 has a beta of 1.0. Since its inception, the DVI Equity strategy has had an average beta of 0.70. This implies our strategy is approximately 30% less volatile than the S&P 500.

Unsystematic risk or specific risk is inherent in any given company or industry. The risk of a company experiencing a labor strike is an example of unsystematic risk. Contrary to systematic risk, unsystematic risk can be managed through diversification. By building a portfolio with representation across a wide range of industries and companies, investors can minimize unsystematic risk in their portfolios. The DVI equity philosophy emphasizes broad diversification as part of our risk management strategy as reflected by the 80 different companies currently held in our Model Portfolio.

Credit risk and interest rate risk are of more particular concern to bond investors. Credit risk is the risk that a company will be unable to repay the interest and principal on its debt obligations. We manage credit risk in balanced portfolios by limiting our bond investments to those securities carrying investment grade credit ratings as these securities have a lower probability of default. Interest rate risk is the risk that an investment's value will change as a result of changes in interest rates. Again, this risk is more directly a concern of bond investors. We manage interest rate risk by adjusting the maturity structure of a bond portfolio.

DVI has invested significantly in systems to support our risk management objectives. From the installation of our proprietary DVI Quantitative Factor Model three years ago, to the recent addition of the FactSet suite of market analytical tools, we continue to seek improvements in our processes. Whether a client opts for an equity, fixed income or balanced portfolio, the goals are always similar: consistent returns, lower volatility, downside protection.

Correlation Matrix

Time Period: 1/1/1990 to 12/31/2013
Source Data: Total, Quarterly Return

	1	2	3	4	5	6	7	8	9
1 DVI Equity Composite (Net of Fees)	1.00								
2 S&P 500	0.92	1.00							
3 Russell 2000	0.84	0.89	1.00						
4 International Equity (MSCI EAFE)	0.76	0.84	0.76	1.00					
5 Barclays US Aggregate Bond	-0.04	-0.12	-0.20	-0.09	1.00				
6 Barclays US Corporate High Yield Bond	0.63	0.66	0.67	0.59	0.05	1.00			
7 US 30 Day Treasury Bill	0.02	0.02	-0.08	-0.10	0.23	-0.12	1.00		
8 S&P GSCI Gold Spot	-0.18	-0.18	-0.17	0.07	0.09	-0.06	-0.17	1.00	
9 Real Estate (S&P US REIT)	0.68	0.60	0.69	0.57	0.09	0.62	-0.07	-0.05	1.00

Source: Morningstar Direct

Planning with Execution

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Financial planning has become a generic term. You find it mentioned across media channels from banks to brokerages to accounting firms to personal finance. While the term itself may be diluted, planning is the first step in securing your long-term security. But this security is only realized when the plan is implemented.

Your various needs, anxieties, and aspirations fuel every step and define how you measure the plan's results. The actual method is best defined as "Planning with Execution" for the obvious truth that you won't get results unless the plan is put into action. As a single, flowing process, results present themselves as solutions to your needs and requirements. In other words, your income is more stable and certain; your spending matches your priorities; your taxes are less; you know what to do with your property; your loved ones are protected; your physical care is assured.

Key Takeaways:

- Like anything worth achieving, a formal planning process is necessary to secure your long-term financial stability.
- An essential element of every plan is the inventory of your needs, anxieties, and aspirations.
- Your needs and requirements serve as the plan's objectives and determine the value of results.
- In order to achieve your desired results, an array of targeted investment, insurance, and trust solutions is instituted that generates net benefits to the costs incurred.

Why We Plan

We plan with these objectives in mind: 1) to avoid wasting time and money, 2) to prepare for future uncertainty, 3) to minimize consequences, and 4) to seize opportunities. These objectives sit passively until the planning process begins.

The table below identifies eight planning tasks under the general umbrella term, "Financial Planning." For any given situation, several of these tasks will be active during the planning process, and if you are a successful small business owner, all eight may be in play.

Each task serves as a container filled by your specific circumstances, needs, anxieties, and aspirations; this is detailed in the right column

What you need to know:

Through the planning process, whether you have one or eight containers filled with your needs and requirements, this inventory sets in motion action steps to bring the fruits of this planning into reality.

Implementing for Results

A common tool kit for implementing a plan includes mutual funds, ETFs (Exchange Traded Funds), individual stocks, and insurance products (noting that more complex circumstances may include private stock, hedge funds, real estate, collectibles, and other specialized investments). These tools exist alongside your other wealth sources such as employment compensation, property, and business-ownership interests.

Trusts, in their various forms, are excellent in solving financial and wealth needs and requirements. In fact, trusts provide an enveloping structure wholly compatible with common investment and insurance tools as well as your other wealth sources, and enhance what otherwise could be attained.

Trust Solutions Meeting Needs and Requirements

Financial and Wealth-Management Need Categories

- More stable and secure income
- Lower income taxes
- Lower capital gains taxes
- Efficiently diversifying concentrated stock ownership
- Protecting wealth from liability-based lawsuits
- Elimination of legal expenses from liability-based lawsuits
- Reducing end-of-life fees and expenses
- Directing wealth to specific purposes and passions
- Productive investing based on values and beliefs
- Protecting wealth from undesirable uses
- Replacing wealth used to support lifestyles

Planners operate within a band of expertise such that they use the strategies they know and understand. This natural inclination to stay in one's comfort zone, though, may lead to limitations in which other tools beyond one's expertise may do a better job. Trusts are a clear example: Trusts' technical nature and imposing acronyms (e.g., CRUTs, GRATs, QPRTs, IDGTs, etc.) have built a barrier to understanding that constrains their broader use in producing more robust planning.

What you need to know:

No one can be an expert in every one of the eight financial planning categories (see table below). Therefore, advisors operating in a team of experts leap over technical barriers

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Financial Planning Tasks	Underlying Need/Requirement
Income Planning	• Controlling spending • Lifestyle budget support • Developing new income sources • Annual shortfall management
Retirement Planning	• Controlling spending • Retirement lifestyle budget support • Distribution planning • Wealth conversion to income • Long-term care anxiety • Shortfall risk anxiety
Insurance Planning	• Income protection • Wealth replacement • Property loss protection • Health deterioration fear • Lawsuit liability protection
Tax Planning	• Federal and state income tax efficiency • Capital gains tax efficiency
Charitable Planning	• Wealth purposing/passion investing • Enhanced charitable tax benefits
Estate Planning	• Beneficiary support • Lifetime dependent support (special needs?) • Low or no probate costs • Federal/state estate taxes • Wealth transfers • Fear of misuse of transferred wealth • Avoiding family disputes • Minimizing family hassle at death • Use of wealth according to values • Controlling end-of-life outcomes
Investment Planning	• Wealth protection • Wealth creation • Diversification • Fee minimization • Protection against liability-based lawsuits
Private Business Planning	• Controlled and efficient transfers • Protection against liability-based lawsuits

Circle of Competence

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grew like Topsy and were doubling nearly every four years. Making a few costly errors might have trimmed your results to 10% per year, but even at that rate, it seemed likely if not probable that you were going to get to the finish line. That has changed over the past 15 years, where an ill-timed decision or two might not only have exacerbated your losses in any given year, but quite likely impacted your long-term performance in a material way as well. Saving for a comfortable retirement at age 65, a task that at one time appeared quite achievable, has now morphed into something that at times seems almost unattainable. Under these circumstances, everyone is naturally seeking out those so called experts to guide them through the financial mine fields, as one can ill afford to make any more mistakes.

It appears to me that in this world that appears to be turned upside down, the best and the brightest, those that you can trust, those that have demonstrated good judgment over time, are increasingly saying, “I don’t know.” They don’t emphasize tactical shifts that need to be made over the next three to six months, a practice that Mr. Buffet equates to flipping a coin with a known statistical outcome, but stress the importance of tactics that simply increase your probability of success. Sometimes the best decision is not what you have elected to take action upon, but the process that you embrace that encourages you to discard those ideas that do not have any merit.

At DVI, we continue to emphasize certain fundamental financial truths that have spanned the test of time. Have these concepts gone in and out of favor? Yes. Do we continue to probe and research and validate the merits of these fundamentals? Absolutely! And undoubtedly, the success or failure in implementing this approach has more to do with the patience and discipline of those that execute the strategy than the actual concepts themselves.

A brief sampling of some of our basic beliefs….

- There are two R words, Risk and Reward. Spend most of your time on Risk and the Reward will take care of itself.
- Sometimes, it is not so much what you own, but what you pay for what you own. Valuation is important.
- A high relative dividend yield is good, a growing high relative dividend yield is even better.
- Understand the post-tax rate of return from a taxable portfolio; the negative impact of high portfolio turnover is significant.
- Embrace an unemotional contrarian mindset. As Buffet would say, “A climate of fear is your friend when investing; a euphoric world is your enemy.”
- Follow corporate earnings, if there is growing cashflow, increased dividends and stock prices will surely follow.

Despite the simple and understandable nature of most of these concepts, you rarely hear much talk about them at all. They are certainly not a get rich quick scheme, maybe that is why they have lost their luster and appeal. I simply don’t know.

Will Williams
President

Planning with Execution

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and define comprehensive and efficient solutions. In this multidisciplinary approach, a trust attorney works alongside financial or other advisors and assists in using trusts’ unique characteristics not only to generate true net savings (i.e., the dollar results > the dollar costs) but equally significant quality-of-life benefits.

The Protective Cure

We buy many things that give us mental or emotional rewards whereby we proclaim that the costs were “worth it.” Every day examples are vacations, education, and luxuries. Similarly, paying insurance premiums to protect against potential losses frees us mentally to enjoy driving a car, leaving our house empty while on vacation, and getting medical treatment for an injury or illness.

With this context, you should expect that solid planning shifts anxiety to comfort, turmoil to peace, and complexity to understanding. Trusts further deliver a protective cure against these possible hits to your mental and emotional quality of life:

- the pain felt if loved ones aren’t protected financially;
- the worry that wealth will not last;
- the possibility that a family will be left with hassle and discord after a loved one’s death;
- the risk that a family will dissolve into disharmony arguing about wealth;
- the anxiety that a life’s work could be lost to litigation;
- the anguish if wealth isn’t used according to one’s values and beliefs;
- the frustration that money could be wasted unnecessarily.

What you need to know:

Although trusts offer various net financial benefits, removing anxieties and fears about your wealth may in and of itself enhance your quality of life. Considering these beneficial financial and mental or emotional results alongside a plan’s set-up costs represents a balanced evaluation that leads to a more informed decision; you can proclaim, “It was worth it.”

Actions to Consider:

- Build a complete needs/requirements inventory.
- In considering what is important to you for your future, list your fears and anxieties since if these are left untouched by your financial plan, joy may be sapped.
- Set up a table in which you identify in the left column the costs associated with planning and the plan’s execution, and in the right column you enter the financial and mental/emotional value you expect.
- Judge the net results. If the net results are greater than the costs, you are richer than if you had done nothing.
- Set your standard as “Planning with Execution” and monitor the actual results to those that were expected.
- “Planning with Execution” is not a transaction but a process that makes ongoing adjustments as your needs/requirements inventory changes.

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