DVI
David Vaughan Investments

Summer 2014 | Vol. 21 | No. 3

All Quiet on the Western Front

The most accurate way to describe war as the old adage goes is hours upon hours of boredom punctuated by moments of sheer terror. Some have described high risk outcome occupations such as being an airline pilot or physician in a similar vein. I am not so sure you should not add portfolio managers to that list as well. For most of modern day history, the vast majority of quarterly equity market returns have been positive or just midly negative. As the table illustrates, nearly 84% of the time since 1926 you could have anticipated a return not to exceed -5%, with positive returns occurring nearly 68% of the time. However, there are those rare occassions when market volatility heats up, drawdowns are significant and the economic world as we once knew it seems destined to unravel. Fortunately if history is our guide, major losses of greater than 15% in a given quarter only occur roughly 4.5% of the time.

S&P 500 Quarterly Return Observations

% Decline	% of Time	Range of Outcomes	
> -20%	2.26%	-20.62	-37.68
> -15%	2.26%	-15.76	-18.59
> -10%	4.24%	-10.02	-14.68
> -5%	7.34%	-5.18	-9.95
< 0%	16.10%	-0.03	-4.93
	32.20%		
% Gain	**% of Time**	**Range of Outcomes**	
> 0%	24.58%	0.08	4.98
> 5%	25.99%	5.02	9.98
> 10%	11.58%	10.00	14.97
> 15%	3.39%	15.36	19.82
> 20%	2.26%	21.23	88.84
	67.80%		

Source: MS Direct - % Total Rates of Return (Q1 1926 - Q2 2014)

But despite the infrequency of these occurrences, reseachers have noted that investment behavior during these adverse conditions dictates much of your long-term investment performance. In fact, Vanguard has recently issued a White Paper attempting to quantify in basis points the value added contributed to investors by engaging an investment advisor who adheres to best practices. In this exercise they have determined what the average client experience or performance outcome looks like historically and then assigned additional performance based upon the adoption of each best practice. On a cumulative basis, Vanguard's research determined that an investment advisor could add up to 300 basis points (3 percent) annually in incremental performance. The most significant contributor, nearly 50% of the additional gain, is attributable to "Behavioral Coaching". What does that entail? It really is the recognition that most investors are unable to maintain discpline and adhere to a plan under times of market stress. They succumb to the natural instinct of self and capital preservation at the very wrong time and focus their thoughts on the here, now, and today, which is rarely if ever relevant over the long term.

| Continued on Page 4

Route To:

Smart Beta: New Name, Old Strategy

Brian Christensen, CFA
Senior Vice President

There is a new rage on Wall Street and it is called smart beta. Depending upon whom you believe, smart beta is either an inventive new sales tactic to capture assets from unsuspecting investors or a brilliant innovation which expands upon the academic work of Nobel Laureate William Sharpe. Sharpe first introduced the concept of beta as a measure of stock market risk into financial literature in the 1960's. Beta is used in portfolio management to measure a stock portfolio's sensitivity to market risk. The beta of the equity market (S&P500) is 1.0. A portfolio beta greater than 1.0 signifies risk greater than the market while a portfolio beta of less than 1.0 indicates the portfolio has less market risk. The Holy Grail for many portfolio managers is that point where a strategy maintains a beta of less than one while generating returns that exceed those of the comparable market index or benchmark. Smart beta advocates believe they have created strategies that are more optimal with a higher probability of excess returns.

Smart beta is essentially any quantitative (computer driven) investment strategy that is mechanized into an index and sold through mutual funds, exchange-traded funds or separate accounts. A strategy as simple as equal weighting the stocks in the S&P500 Index rather than capitalization weighting the index is considered smart beta. As the concept expands, portfolio weights or tilts toward value stocks, high dividend payers, small stocks, momentum stocks, or virtually any fundamental characteristic able to be explored and evaluated, can allow a strategy to be called smart beta.

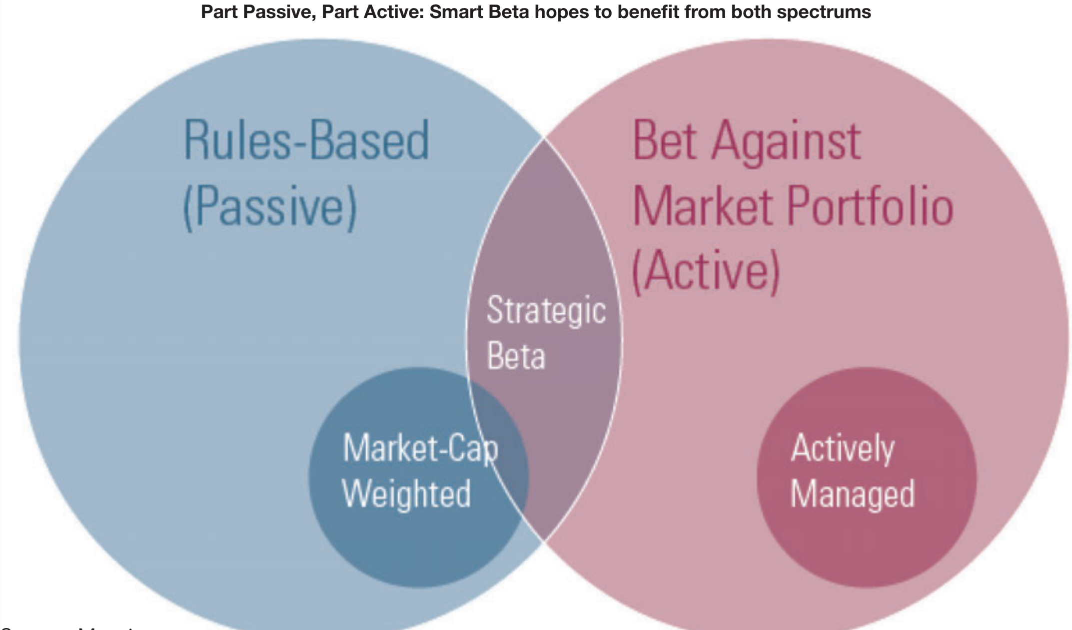
The diagram below, provided by Morningstar, reflects the blurred lines between active and passive management represented by smart beta strategies. (strategic beta in Morningstar vernacular)

According to Morningstar, there were 367 smart beta exchange traded products listed in the United States at the beginning of June. Assets under management totaled $346 billion, up nearly 30% in the twelve months prior. While similar concepts (fundamental indexing, enhanced indexes, quantamental indexes) have been around for nearly a decade, recent interest has exploded led by heavy promotion from the sales and marketing departments of Wall Street's biggest asset managers. The chart on the next page, provided by Morningstar, shows the enormous growth in smart beta assets under management during the past decade.

In its most complex form, smart beta is a multi-factor investment strategy, not significantly different than what many active managers are already doing. Ben Johnson, director of passive funds research for Morningstar states, "The layering of complexity adds to the due-diligence burden for investors. Investors' due-diligence processes for these funds need to be every bit as rigorous as those they would undertake in scrutinizing active managers." The reality of smart beta strategies is that they are not index funds, as some proponents express, but rather a rules-based investment strategy seeking to emphasize one or more fundamental investment factors. In a recent *CNNMoney* article written by Ben Rooney, Robert Deutsch, head of ETF business for J.P. Morgan Asset Management was quoted. Mr. Deutsch says "It's about two things: risk and return. The aim is to perform well throughout a cycle." Really? Isn't that what every investment manager seeks to achieve?

The term smart beta understates the increased risk inherent

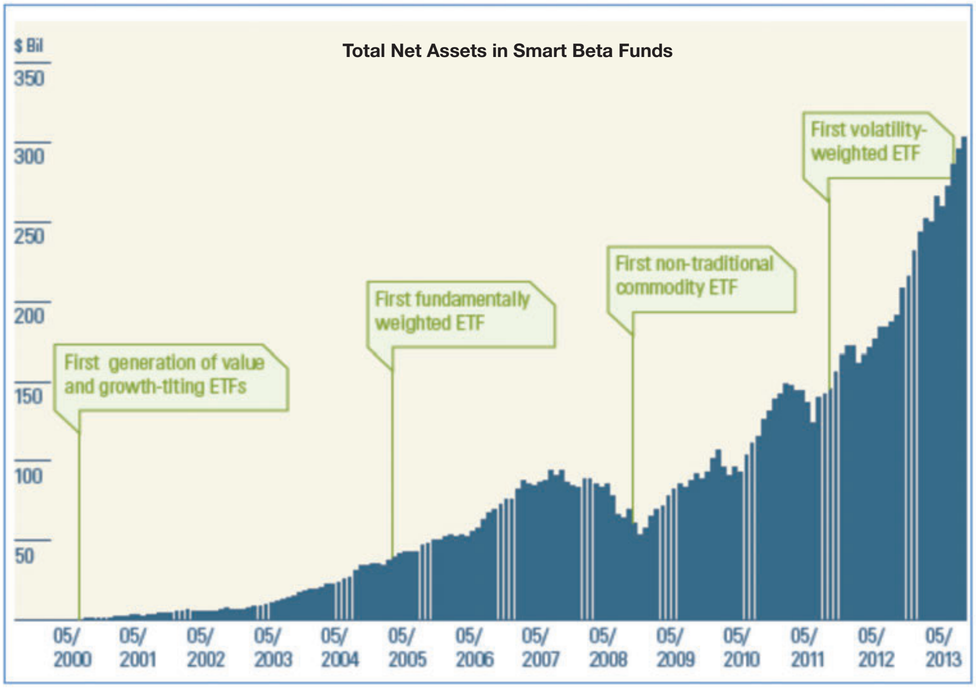
Part Passive, Part Active: Smart Beta hopes to benefit from both spectrums



Source: Morningstar

in such strategies and emphasizes the sales mentality of many large asset management firms. Interest in index investing and exchange-traded funds has grown rapidly and many investment providers want to be part of the trend. The outcome is a repackaged active investment strategy that tracks an index.

Research Affiliates, a $160 billion dollar investment manager is a lead dog in the smart beta pack. In a *Forbes* article dated June 5, 2013, Research Affiliates founder Rob Arnott was quoted as follows: "Our business model is one of creating new product and advancing it to the marketplace and, in effect, seeing what sticks. Every year we try new ideas, and half of them gain traction. The one I'm most optimistic about becoming our next profit engine is the marriage of low volatility strategies with fundamental indexing." Perfect – if you are a marketing firm. We at DVI will continue to be most optimistic about serving the needs of our clients and their profit engine.



Source: Morningstar

Associate Spotlight

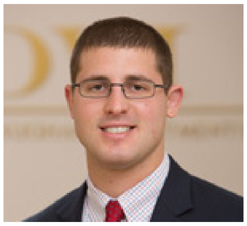
Michael A. Price
Chief Administrative Officer

Here at David Vaughan Investments, Inc. we are pleased to announce that Mike Price has joined the firm as Chief Administrative Officer (CAO). As CAO Mr. Price will be responsible for the behind-the-scenes infrastructure of the firm and will be directly responsible for all administrative support operations including Human Resources and Information Technology. In addition, Mike will spearhead the Strategic Planning and Implementation Process and will be the primary liaison working with DVI's Board of Directors.

The search for the CAO was quite extensive with more than 100 applicants from around the nation. For the first time, a case study method was implemented for the on sight portion of the interview process, which proved to be a valuable tool for discerning each candidate's capabilities and attitudes. When asked what made Mr. Price stand out as a candidate, Will Williams replied, "Throughout the process Mike demonstrated not only his business competency, but also a strong cultural fit with our organization which we viewed as essential." Will went on to say that "He has a wealth of experience in the financial services industry and we anticipate that he will make an immediate positive impact to our management leadership team."

Prior to joining DVI, Mr. Price most recently served as Chief Operating Officer/ Chief Financial Officer for Alliance Benefit Group of Illinois and held officer level positions with both National City Corp (now PNC) and RLI Corp. Mike received his Bachelor of Science degree in Finance from Illinois State University and his MBA from Washington University.

Mike and his wife Sandy reside in Peoria and have three sons. In addition to being involved with his kids activities and coaching, in his free time he enjoys travel, home improvement projects and sports of all types.



Dalton Mellon
Assistant Relationship Manager

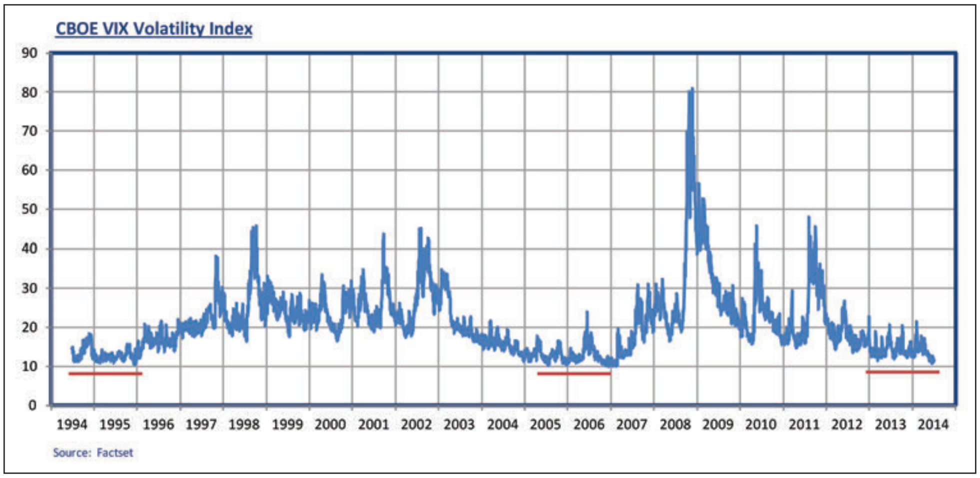
David Vaughan Investments, Inc. is pleased to announce that Dalton Mellon has joined the firm as an Assistant Relationship Manager. Originally from Bloomington, IL, Dalton is a recent graduate of the University of Illinois with a bachelor's degree in Finance. Dalton successfully passed the first level exam of the Chartered Financial Analyst Designation and recently sat for the June 2014 level two exam. He also holds a Series 65 securities license. At DVI, he is responsible for the coordination and execution of various tasks between the relationship managers and portfolio managers.

All Quiet on the Western Front

Continued from Page 1

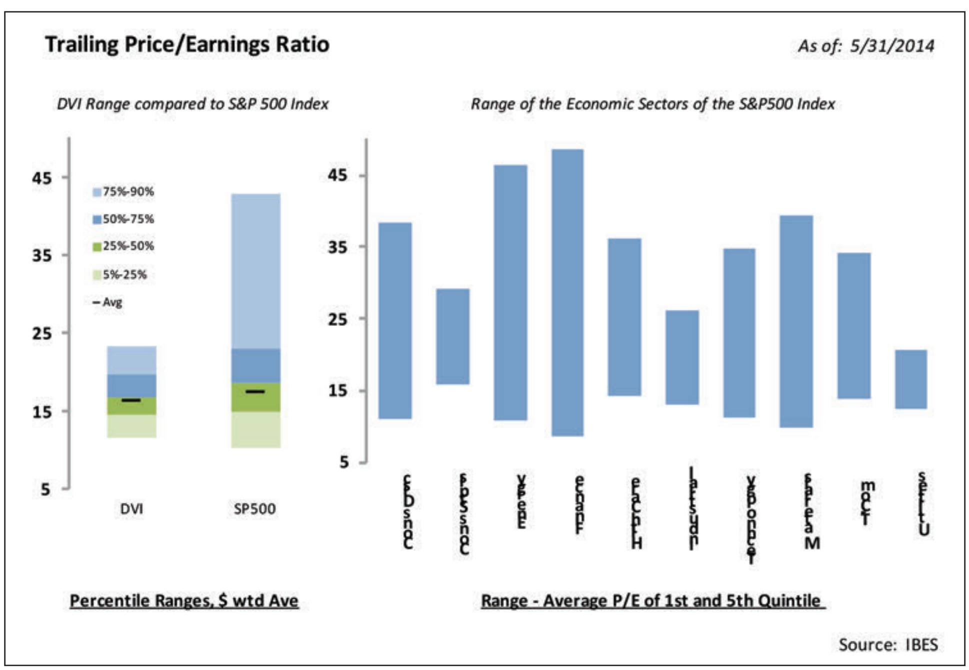
Quiet Before the Storm?

The stock market has been eerily quiet as the second quarter has come to an end, with the last 51 trading sessions in a row closing up or down less than 1%. The VIX Volatility Index, the market's measure of future volatility, has dropped back to levels not seen since 2005-2006 and prior to that time as far back as 1995. According to the *Wall Street Journal*, U.S. stock trading volume in the month of June was at its lowest level in eight years, with daily share volume averaging 5.8 billion shares a day. Share volume was down nearly 18% from the prior year time period. In this quiet backdrop, we have continued to experience a resilient equity market that has maintained its upward trajectory. Market analysts tend to express concerns after long periods of low volatility as it creates a false sense of security for equity investors. Lower volatility means investors can hold larger baskets of common stocks than they would hold otherwise as their perception of risk is heavily influenced by recent versus historical volatility. In the managed global economy that we are experiencing today and have been living through for the past number of years, modest controlled growth and stability are the primary objectives. Massive amounts of stimulus and liquidity have been injected into the system through coordinated intervention by the G-7 Central Banks. As an example of their unprecedented actions, the European Central Bank (ECB) instituted a new deposit facility rate in early June of -.10%, in effect charging institutions to hold excess reserves with the Bank to encourage additional lending by financial institutions.



We Don't Buy the Market

As the U.S. equity market continues to establish new all-time highs, market valuation has climbed as well. From the trough in mid 2011 to the end of the second quarter in 2014, the Price /Earnings multiple (P/E) has expanded from 11-12 times earnings to roughly 17 times earnings today. We have gone from an environment in which the market was clearly cheap to one in which the market viewed from a historical perspective is more fully valued. However, we remind our clients that at DVI, we are not buying the market as a whole, and as such, opportunities continue to exist to identify individual stocks with reasonable valuation and excellent dividend characteristics. As the chart to the right indicates, within each of the ten economic sectors there exists significant valuation difference among companies. Some are clearly at high valuation levels that are not attractive to DVI, however others continue to trade at a considerable discount to the market multiple. In practice, the pond we fish in is a much smaller valuation pond than the overall market. This is consistent with our firm belief that lower valuation does significantly reduce the risk in owning common stocks.



Will Williams

President