DVI
David Vaughan Investments

Quarterly Perspective

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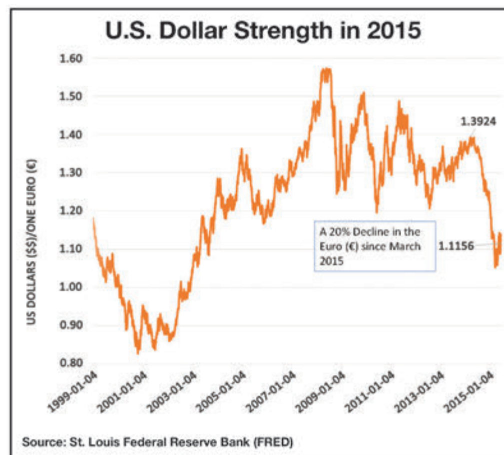
Battling Headwinds

Going into 2015, I had the suspicion that it would likely be a challenging year. DVI had the wind at its back for most of 2014, with the Utility sector in particular propelling us to strong investment performance results. The investment gods have an annoying tendency to instill a bit of humility into you when you are about to arrive at the irrational conclusion that you have it all figured out. Once again they have come through in spades! As we come to the close of the first half of the year, despite our well intentioned efforts to the contrary, we have very little to show for our efforts. As we go through the forensic exercise and survey what has worked and what has not worked, we can take some solace in the fact that most of what has worked is outside of DVI's traditional value and yield investment universe. As famed investor Ron Baron commented in his recent annual report, "We think our willingness to accept average performance or under performance on occasion by not investing in certain stocks which are most popular is an important reason we have outperformed over the long term." Under circumstances in which DVI loses its investment discipline and begins to chase securities with near term positive price momentum, but with little else in terms of conservative investment fundamentals, our firm's demise is inevitable. We certainly enjoy and appreciate the attributes of companies such as Netflix, Amazon.com and video game developer Electronic Arts, but over the years we have come to the conclusion to wish them well rather than to become owners.

Impediments to Success
Large cap multinational companies have both a real and perceived earnings headwind due to the rapid appreciation of the U.S. Dollar. [Exhibit 1 illustrates the nearly 20% gain in the U.S. Dollar versus the Euro since March of this year.] Many analysts have reduced S&P 500 earnings for 2015 by as much as $2.00 to $3.00 per share reflecting the negative earnings consequences of a strong U.S. currency. On the perception front, investors are leery of the non-dollar exposure and are raising cash in the multinational space and are seeking out companies, both small and midcap that are not faced with this uncertainty. Interestingly enough, there are some large multinational companies with significant non-dollar costs that will be aided by this recent currency development.

Exhibit 1



The combined effect of macro themes such as U.S. dollar strength, global crude oil price declines and continued weak public sector spending has all contributed to rather anemic earnings growth for S&P 500 companies. [Exhibit 2 provides consensus data on 2015 earnings per share for 2015 of $119.45, less than a 2% gain versus the prior year.] We have seen a nearly 7% downward revision to these full year estimates over the past six months as analysts have attempted to factor in these various economic developments.

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Value vs. Growth

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Senior Vice President

The decades old debate as to which stock investment style is the best, value or growth, is alive and well. Recent results suggest growth stock investors have the upper hand but a deeper dive into the investment pool is warranted.

Differences between the growth and value styles are well-defined. Growth managers focus on companies that are expected to experience faster than average growth as measured by revenues, earnings, or cash flow. Many growth-oriented companies are more likely to reinvest profits in expansion projects or acquisitions, rather than use them to pay out dividends to shareholders. While growth funds are expected to offer the potential for higher returns, they also generally represent a greater risk when compared to value funds. They tend to do better than the overall market when stock prices in general are rising, while underperforming the market as stock prices fall. As a result, investing in growth funds may require a slightly higher tolerance for risk, as well as a longer time horizon.

Exhibit 1

Total Returns as of June 30, 2015

Index	Year-To-Date	1 Year Annualized	3 Year Annualized	5 Year Annualized	10 Year Annualized
Russell 1000 Value	-0.61%	4.13%	17.34%	16.50%	7.05%
Russell 1000 Growth	3.96%	10.56%	17.99%	18.59%	9.10%
S&P 500	1.23%	7.42%	17.31%	17.34%	7.89%

Data: Morningstar Direct

Value managers focus on companies whose stock prices do not necessarily reflect the fundamental worth of the company. The reasons for these stocks being undervalued can vary. A poor quarterly earnings report or some external event can temporarily depress a company's stock price and create a longer-term buying opportunity. Typically, value managers focus on perceived safety rather than growth, often investing in mature companies that are primarily using their earnings to pay dividends. As a result, value funds tend to produce more current income than growth funds, although they also offer the potential for long-term appreciation if the market recognizes the true value of the stocks in which they invest.

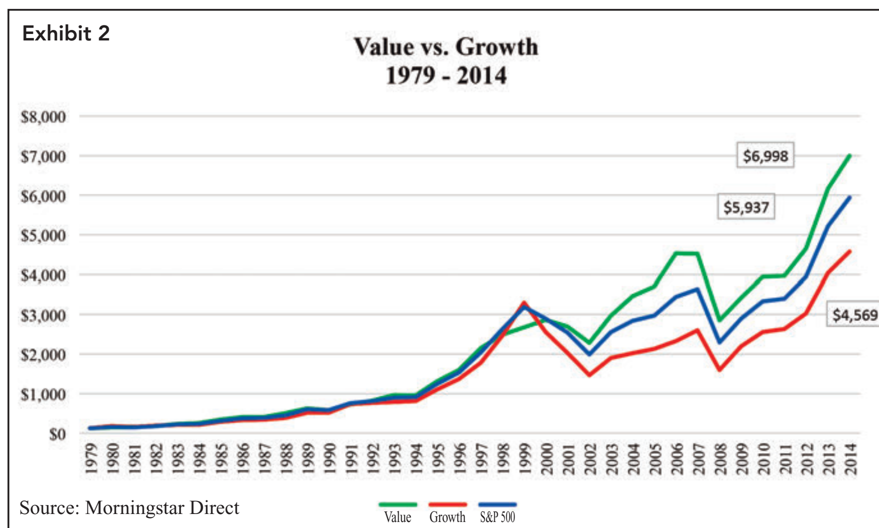
In 1997, renowned finance professors Eugene Fama from the University of Chicago and Kenneth French from Yale, published "Value versus Growth: The International Evidence". Data used in the study represented growth and value stocks from the U.S. and twelve other developed countries during the twenty year period ending December 1994. Fama and French differentiated between growth and value based upon a stock's price-to-book value ratio. Low price-to-book ratios reflected value stocks while growth stocks had the highest price-to-book ratios. Fama and French found that in twelve of the thirteen major markets measured, value outperformed growth by 7.6% annually during the twenty year timeframe.

More recent studies continue to indicate value stocks provide superior long-term returns. Russell Investments, recognized globally as a leader in investment consulting, evaluated growth stock and value stock returns for the twenty year period 1994 – 2013. During this time period, the Russell 1000 Value Index returned 9.7% annually as compared to the Russell 1000 Growth Index return of 8.5% annually. Further, the value index experienced lower volatility showing a standard deviation of 15.1% versus 17.5% for the growth index.

While one might immediately jump to the conclusion that value is better all the time, further research reveals windows where growth stocks have outperformed. Currently, growth stocks are on a ten year run of having outperformed value stocks by a considerable margin. The table below highlights recent performance data.

As evidenced in Exhibit 1, there are definitely periods of time when growth stocks outperform by wide margins and recent history is one of those windows. Exhibit 2 highlights the growth of a $100 investment made in 1979. Long-term, value stocks remain the preferred option.

The DVI investment process emphasizes value stocks as they have proven time and again to be the best vehicle for growing wealth conservatively. As supported by both the Fama and French study and the Russell data, value outperforms both in absolute terms and more importantly on a risk-adjusted basis too. We recognize there will be periods of time when the DVI investment philosophy and process is not in style and 2015 appears as if it may be one of those years. However, with nearly 40 years of firm history as our support system, we will continue to think independently, daring to be different from the herd on the street.



Wide Diversification: Does It Fit in Your Strategy?

Dalton Mellon
Assistant Relationship Manager

"Wide diversification is only required when investors do not understand what they are doing."
- Warren Buffett

Over the past several decades, a new school of thought has evolved into a strategy of its own, Asset Allocation, or as Buffett's quote might call it "wide diversification". Buffett and value investors alike are mainly concerned with selecting undervalued individual US stocks, holding, and eventually selling at a premium. Instead of investing solely in a U.S. stock and bond strategy, Asset Allocation combines a collection of asset classes (U.S. stocks, international stocks, emerging market stocks, small cap stocks, U.S. bonds, foreign bonds, real estate, commodities, etc.). It can be better thought of as a policy decision based on where to find the investments rather than individual selection between investments.

Correlation Matrix: 5 Year Average — Exhibit 1

Time Period: 1/1/2010 to 12/31/2014

	US Large Cap	International	US Small Cap	Commodities	Real Estate	Bonds
US Large Cap	1.00					
International	0.88	1.00				
US Small Cap	0.92	0.76	1.00			
Commodities	0.66	0.67	0.61	1.00		
Real Estate	0.73	0.68	0.71	0.43	1.00	
Bonds	-0.28	-0.13	-0.30	-0.21	0.16	1.00

Correlation Matrix: 25 Year Average

Time Period: 7/1/1989 to 12/31/2014

	US Large Cap	International	US Small Cap	Commodities	Real Estate	Bonds
US Large Cap	1.00					
International	0.75	1.00				
US Small Cap	0.81	0.65	1.00			
Commodities	0.17	0.25	0.20	1.00		
Real Estate	0.56	0.50	0.64	0.13	1.00	
Bonds	0.12	0.11	0.01	-0.01	0.18	1.00

Source: Morningstar Direct

The theory here is that any asset class with less than perfect correlation to any other asset class will add diversification benefits, and when combined together in a portfolio, they will reduce the overall volatility. The lower the correlations among asset classes, the greater the diversification benefits, and the lower the overall portfolio risk: sounds fairly straight forward.

Suddenly, your simple two asset class portfolio (stocks and bonds) has been split seven more times and displayed into a wonderful colorful work-of-art pie chart. It looks fancy sure, but are you really receiving the full benefit of the strategy? Here are a couple of points to consider:

- Over the last 15 years correlations among asset classes have come closer together, which means you are receiving less of a benefit from diversifying with other asset classes. As you can see from the darker shaded boxes in Exhibit 1 above, the last five-year average correlations have tightened closer to perfect correlation or "1", compared to the 25-year average correlations.
- One question that comes up is, "What's the right mix of asset classes?" Other than there being a multitude of complex models to choose from, correlations among asset classes change frequently and need to be constantly rebalanced to maintain that "optimal" mix. This can be time consuming and result in excessive fees from constantly trading. Looking at Exhibit 2 you can see how correlations move over time.

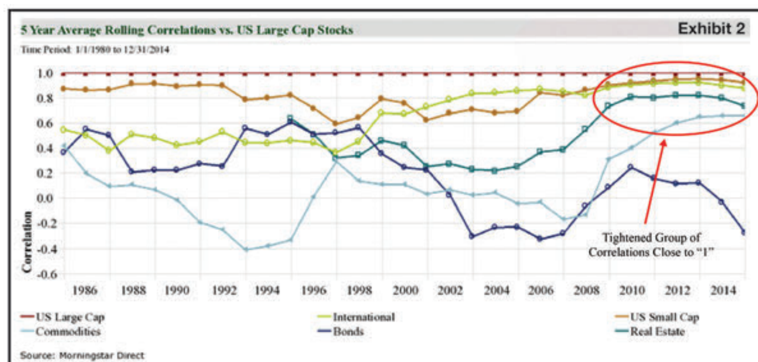
Many people may argue this could be a "phase" of higher correlations and they are bound to go back down. Well, here are few more points to consider:

- International stocks have moved steadily closer to U.S. stock correlations over time and are near all-time highs in the last five years. Many believe this is due to the globalization and connectedness of world economies. For example, what happens in China's stock market one day will likely cause a swing in U.S. markets. Another way to think of it is look at how many large U.S. companies rely on international sales as a normal part of business. It's possible, but hard to argue that our advances in globalization and technology will reverse in the future. Which, if true, means correlations should remain high for international stocks.
- Newer popularized asset classes such as REIT's (Real Estate Investment Trusts) and commodities have had wide swings in their correlations to U.S. stocks. Sometimes their low correlations have helped reduce risk, and sometimes not as much. For instance, Christine Benz, Director of Personal Finance at Morningstar noted that in the mid-2000's commodities were marketed as a great diversifier to reduce volatility and combat inflation. Despite their low correlations at the time, in 2007-2009 when commodities were supposed to add their most value during a market down-turn, they ended up performing very poorly: dragging poor portfolios down further.

This brings up a good point: even if an asset class has low correlations but also a high individual risk and low or negative returns, it can still raise the riskiness of your portfolio and reduce returns. Correlations aren't the only things to consider.

Benz also stated that through her correlation research "the one relationship that has held up through a variety of market environments has been the relationship between high-quality bonds and stocks of all stripes; we tend to see a good negative correlation there that will tend to reduce risk in investors' portfolios." In other words, the "old-school" strategy of stocks and bonds still proves to be efficient.

In conclusion, there is nothing inherently wrong with adding asset classes to your portfolio when they are in the right proportions and continue to match your risk/return objectives. However, this popularized strategy has drawbacks as evidenced by the last 5-15 years of rising correlations. Careful consideration should be given when adding more asset classes. Although it's possible to realize the desired risk/return profile through 10-15 asset classes, there might be a simpler way that delivers the same outcome.



Battling Headwinds

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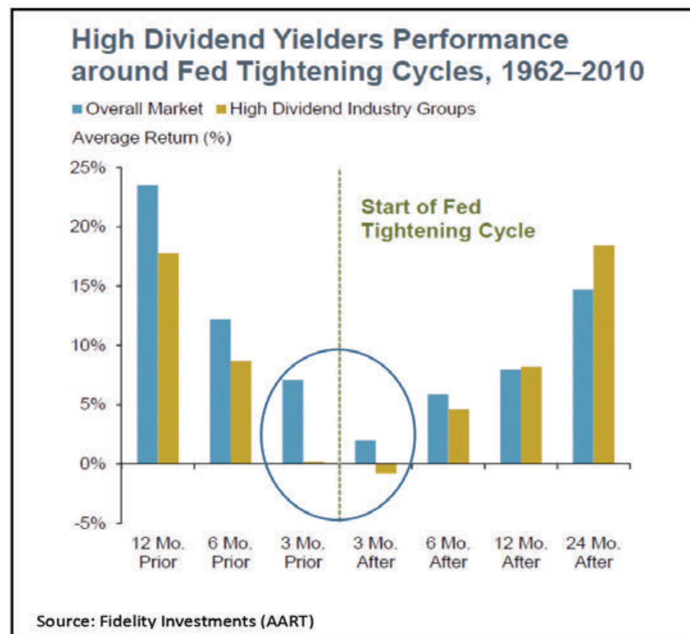
Exhibit 2

Stagnant Corporate Earnings Growth Rates

	CY '09	CY '10	CY '11	CY '12	CY '13	CY '14	CY '15
Q1 (Mar)	12.94	19.41	23.07	24.94	26.65	27.96	28.66
Q2 (Jun)	15.73	21.07	23.49	25.54	27.02	29.78	28.72
Q3 (Sep)	16.46	21.35	25.40	25.48	27.08	30.10	30.06
Q4 (Dec)	16.39	22.15	24.09	25.92	28.62	30.45	31.77
Cal. Year	59.92	83.75	95.43	102.97	108.90	117.20	119.45
EPS (YoY%)	-16.78	39.77	13.94	7.90	5.76	7.62	1.92
P/E Multiple	18.43	15.85	14.31	14.71	17.08	17.96	17.23
	Trough						Current

Source: Factset

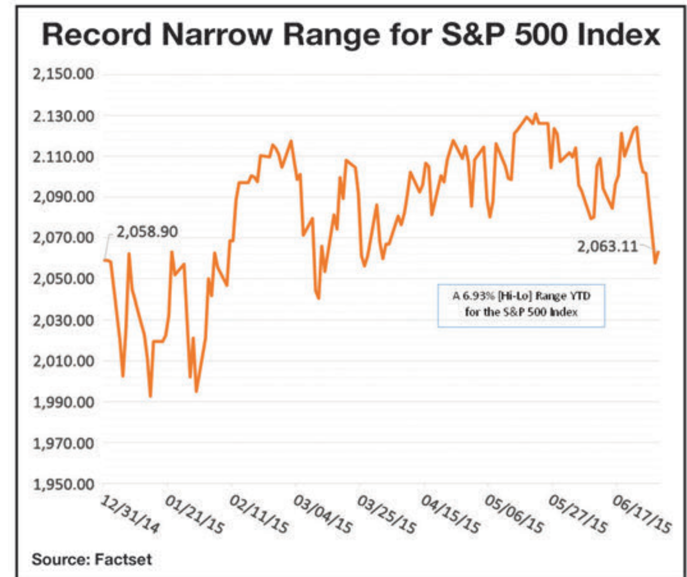
Exhibit 3



Source: Fidelity Investments (AART)

As we approached this year, most astute Fed watchers were predicting the first rate increase to occur in mid-June. With a rather soft economic backdrop in Q1, most of these predictions re-targeted the mid-September FOMC meeting for the first uptick in rates. The specter of rising rates has traditionally put pressure on high yielding industry groups such as Utilities, Real Estate Investment Trusts (REITs) and Telecom. [Exhibit 3 emphasizes the fact that most of the significant underperformance occurs within a three month window prior to and after the start of the first rate hike.] If indeed the rate liftoff does occur in September, 2nd Quarter price action for the Utility sector in particular moved in lock step with historical observations. While the overall equity market was virtually flat for the quarter, Utilities suffered a nearly 6% decline. Though I won't question the historical inverse relationship between interest rates and these equity sectors, one must ask the question, will moving off a nearly zero fed funds target rate have the same negative impact on the economic fundamentals of these companies? We continue to view the markets from a historical lens, but should that lens be calibrated a bit to adjust for extraordinary data points?

Exhibit 4



Lackadaisical Market Behavior

Despite a modest increase in intraday volatility of the S&P 500, all of this price action continues to take place in a trading range from high to low of approximately 7%. I have been told it is the narrowest year-to-date trading range for the Index in at least twenty years. On a price only basis, we started the year at 2058.90 and closed the 2nd Quarter at 2063.11, virtually no change. [Exhibit 4] And along those same lines, I guess it should come as no surprise then that roughly half of the constituents of the index are down for the year. Despite logging the 10th straight quarter of positive total return, albeit just barely, the overall large cap equity market is currently without conviction in a directional no man's land.

Despite the feeling here at DVI that after taking two steps forward we are taking one step back, we recognize that being out of sync with the current market drivers is ok. Investing is all about making choices. We have elected to place a stake in the ground embracing the concepts of risk management and attractive dividend yield. Our willingness to dare to be different has allowed investors to own a considerably larger share of common stocks than a more traditional approach would generally recommend. Over the long term this has provided a significant economic benefit to our valued clients. However, in the short-term, DVI's nose is back to the grind stone.

Will Williams

President

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