DVI
DAVID VAUGHAN INVESTMENTS

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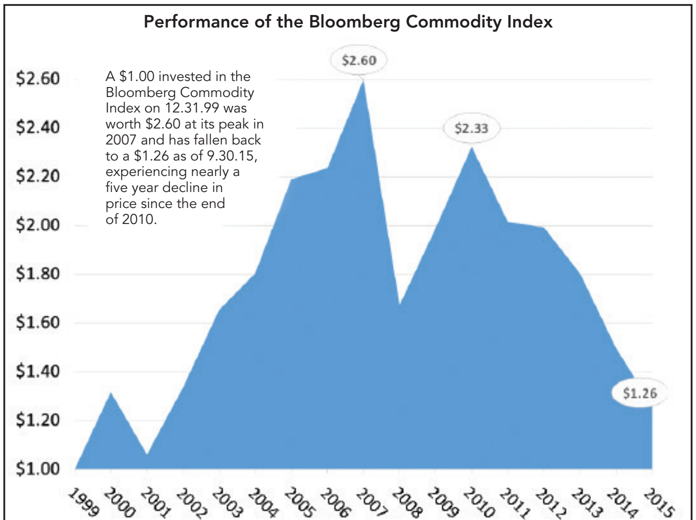
Connecting the Dots

As the old saying goes; when China sneezes, the rest of Asia catches a cold. Under the new dynamics in our global economy, apparently when China sneezes, the rest of the world could catch a cold. At least that is the fear that began to play itself out beginning in the middle part of August as the People's Bank of China surprised the international financial community with a 2% devaluation of the yuan versus the U.S. dollar. This, in combination with a rapidly deteriorating Chinese stock market and a decline of the Shanghai Stock Exchange Composite Index of nearly 40% from the record highs reached in June, led analysts to conclude that the Chinese economy was continuing to deaccelerate below their recently published growth rate of 7%.

Obviously it is meaningful that the second largest global economy is slowing, but it is of real significance for the global commodity markets that have been challenged with a prolonged bear market since 2011. One must not lose sight of the negative economic impact on the emerging market economies that source these raw materials. In fact, there are many commodity categories in which China's annual demand exceeds 40% of global consumption, such as Aluminum, Nickel, Zinc, Copper and Iron Ore.

Performance of the Bloomberg Commodity Index



Source: Bloomberg Commodity Index

Federal Reserve Interest Rate Glide Path

Because most commodities are priced in U.S. dollars, the recent strength in the U.S. dollar has placed greater pressure on commodity prices. It takes more foreign currency to purchase the underlying commodity, thus negatively impacting demand. So in general, there is an inverse relationship between the price direction of the U.S. dollar and the price of a diversified basket of commodities such as the Bloomberg Commodity Index. Investors have a tendency to seek out higher interest rates in stable or appreciating currencies. So in today's environment, there is keen interest in the timing and the magnitude of the interest rate hikes here in the United States. At least as speculated, we will be tacking in the opposite direction of the European Central Bank, Bank of Canada and the Reserve Bank of Australia and most developed market economies that continue to pursue loose monetary policy. The expectation was that our first interest rate lift-off was to be announced at the September 17th Federal Open Market Committee meeting. That announcement was delayed as "Recent Global Economic and Financial Developments" convinced the Federal Reserve that the systematic shock of higher U.S. interest rates might further destabilize the global economy.

A Double Whammy

So if you are an emerging market economy that is a net exporter of raw materials, you

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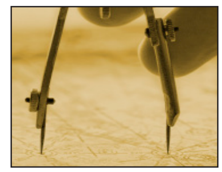

Route To:

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What's More Important – Outcome or Process?

Brian Christensen, CFA
Senior Vice President

I've written previously in past newsletter articles about the concept of Behavioral Finance – the idea that human psychology dramatically impacts a person's ability to make sound financial decisions. The psychology of human decision making sits front-and-center as businesses compete day-in day-out for both consumers' attention and dollars. Whether the goal is to encourage you to save more for retirement or to make sure you get your 10,000 steps in each day, consumers are eager to be manipulated.

Waves of Wall Street marketing dollars target the human tendency to focus solely on outcomes. The creation of new mutual funds and novel investment vehicles are quickly created and brought to market driven by past outcomes – best performing sectors, top fund managers, highest returning asset classes – not ranked by a repeatable process. No mention in the flashy advertisement about investment process, so we have no idea if the results were a one-time event, attributable to dumb luck, or actually a function of a well-documented investment process. You know the pitch. Buy this and get rich because that's what happened last year. Then next year rolls around and a whole different set of outcomes are in vogue, ready for more of your hard earned investment dollars. Outcome based selling is a Wall Street hallmark for only one reason – it rings the cash register.

The process oriented investor focuses on long-term strategies with proven, repeatable results. It's not sexy, but boring and rational. Discipline, patience, systematic savings plans, and periodic rebalancing should be the goal. But why are these time proven behaviors so difficult for investors to grasp?

In the early 1960's, the psychologist Dr. Walter Mischel used an experiment now referred to as the "marshmallow test" to examine self-control in children. Children were given the choice of a single treat they could immediately eat, or two treats if they could wait by themselves for fifteen minutes. As you would expect some of the children were able to wait while others had little self-control. The researchers conducted follow-up studies and tracked each child's progress for more than 40 years. The children who were able to patiently wait to receive the larger reward ended up with higher SAT scores, lower levels of substance abuse, higher grades in college, and generally better life experiences. These series of experiments proved that the ability to delay gratification was critical for success. The choice between the pain of discipline or the ease of distraction is a difficult decision for the human brain.

Bring forward the "marshmallow test" concept to today's world and add technology to the mix. The advancement of technology is playing a critical role in undermining our abilities to concentrate and focus for extended periods of time. Nicholas Carr, author of a noted article in *The Atlantic* titled "Is Google Making us Stupid?" which he expanded into his book "The Shallows: What the Internet Is Doing to Our Brains", sparked one of the more important debates of our time: As we enjoy the internet's bounties, are we sacrificing our ability to read and think deeply?

Carr believes that the Internet is a medium based on interruption — and it's changing the way people read and process information. We associate the acquisition of wisdom with deep reading and solitary concentration, and he says there's not much of that to be found online. In his book, Carr suggested his ability to concentrate wasn't what it used to be and his long reading spells were becoming non-existent. He wrote, "The very way my brain worked seemed to be changing. My concentration often drifts after two or three pages. I get fidgety, lose the thread, begin looking for something else to do." Carr continues, "And what the Net seems to be doing is chipping away my capacity for concentration and contemplation. My mind now expects to take in information the way the Net distributes it: in a swiftly moving stream of particles." Neuroscientists have known for years that the brain has plasticity in that it can be trained to change. Carr noted that the more we use the internet, the more we train our brains to be distracted, processing information very quickly but without sustained attention. It appears the natural result of spending many hours online in front of a computer screen is that our brains are creating new pathways. Pathways that are comfortable getting quick answers, endless distraction and seeking a wide variety of content from the internet. Scientists believe we have to actively work to train our brains to be able to think deeply. Today's online, constantly connected, fast paced data dump is teaching our brains to do exactly the opposite. Researchers find our tendency is to skim titles, review tables of contents, read one or two pages and then hop to another article. Study moves to an outcome driven process where we are seeking the quick bit of data to support our beliefs rather than willing to spend time reading about the process that led to the outcome.

By now, you're probably wondering how any of this is relevant to being a successful investor? As our brains become more affected by the manner in which data and information is communicated to us online, intellectual focus becomes increasingly more difficult to achieve. The patience and discipline necessary to be a successful long-term investor is challenged. The faster we search the Web, the more links we click and the more pages we view, the more difficult it becomes to concentrate for extended periods of time. Our interest in the outcome overrides our ability to be patient with the process. We become more likely to eat the first marshmallow rather than be patient and wait for the greater reward.

Make a Statement!

Stephanie Ricketts, CFP®
Relationship Manager

Why do you invest your money? The answers will vary: to sustain retirement over your lifetime, to fund children's college, to leave a legacy or to achieve some other financial goal. While it may be fairly simple enough to define a reason or a destination for your investments, what tends to be more difficult (particularly in volatile market environments) is laying a clear path to get there and establishing principles that will keep you from straying off the beaten path.

That's where a personal investment policy statement comes in. It's a pledge to yourself on how you will approach investing so when those white knuckle market gyrations occur, it will allow you to go back to the basics and remind yourself why you are investing and what your long term goals are. The investment policy statement will lay out the criteria you (or your advisor) will use when selecting individual investments, how the portfolio will be assembled with a target asset allocation as well as what you will look for on an ongoing basis as you monitor. The statement helps instill discipline in the investment process and can provide an additional check to ensure that you stick with your plan. Think of it as your compass to keep your investment portfolio on course to meet its goals even when the market and your emotions are telling you to abandon ship.

All clients of David Vaughan Investments, Inc. have an Investment Policy Statement. For some clients these statements may have been defined and executed in the past few months and for other clients, twenty years ago. Let's revisit a few important components of these statements that help provide us with a basis for consistent and disciplined decision making.

Asset Allocation Target

The asset allocation target defines the percentage weighting of the portfolio that will be invested in stocks and bonds and essentially attempts to ascertain risk, which is very critical. A sensible asset allocation framework takes into consideration both your capacity and tolerance for risk. What do we mean by this?

Capacity for risk, more or less, references your time frame. Are you currently drawing on your portfolio assets for your ongoing cash flow needs or are you years from retirement, still saving and have no intentions of drawing on portfolio assets for several years? In the case of the individual sourcing cash flow from their portfolio, their time frame is clearly shorter than the individual who plans on working for several more years. Note that time frame doesn't necessarily equate to age but rather time frame for needing portfolio dollars. For clients relying on their portfolios to support living expenses, we generally suggest that their portfolio contain enough fixed income to support annual withdrawals for the next five years. For some clients this could mean a 15% allocation to fixed income and for others this could mean 50%. The objective is to provide sufficient reserves so that when we experience a market decline, our clients have the fortitude to remain invested and prevail with minimum stress.

Risk capacity, however, is not interchangeable for risk tolerance. Tolerance is more a measure of how much risk can you stomach, or as David Vaughan would refer, your sleep quotient. You may have a huge nest egg and be able to withstand a lot of ups and downs in the market, but you may be the kind of person who just doesn't want to watch the size of your account shrink and grow dramatically. In these instances a fixed income allocation would be added in efforts at reducing portfolio volatility.

Approved Investment Vehicles

The approved investment vehicles lists the types of securities that will be utilized to obtain your financial objectives, as well as includes what vehicles or strategies will be prohibited. In the case of DVI, we prefer to keep it simple. Our approach is to invest in large cap, blue chip stocks for the equity allocation, (of which many of these companies you can easily identify), and investment grade corporate bonds, taxable / tax exempt muni bonds or U.S. Treasury and Agency securities for the fixed income allocation. We avoid overcomplicated strategies that are difficult to understand, as well as tactical market timing strategies. Our focus, rather, is to run a streamlined investment program that is easy to comprehend. It's particularly challenging to stick with a strategy when the going gets rough and you don't understand it! Unfortunately Wall Street really sells against this message and there are a lot of people talking throughout the day about stuff that ultimately does not make or break or affect your investment plan in one way or another. The ability to tune out this noise can also be a valuable attribute.

Continued Monitoring

The foremost winning habit in evidence-based investing is rebalancing, the process in which proceeds from the asset classes that have gained are shifted to those that have declined. Rebalancing forces you to buy low and sell high, which is the fundamental aim of any investment. Market declines offer the opportunity to rebalance and purchase equities at declined prices while strong market upswings offer the opportunity to recognize and harvest growth and reallocate to less volatile investments. Rebalancing provides discipline as many find it difficult to buy stocks when it seems like everyone else is retreating, or to sell stocks when it seems like everyone else is buying.

In addition to rebalancing, there may be instances where deviating from your investment policy statement may be justified. It's clearly a good idea to modify or update your statement for the right reasons. Life circumstances change for both good and bad and those changes will have an impact on your financial goals and objectives making it necessary to change how your portfolios should be invested. However, a market downturn or market volatility are not one of these reasons.

As it is with anything in life, when it comes to investing, don't feel as though sticking with the plan or making your statement is a solo venture. Like with Dr. Mischel's marshmallow test, sometimes just having someone there to remind you that in five more minutes, you can have two, is all the advantage one needs to achieve their goals. Accountability – and having someone coach or guide you, like a mentor, personal trainer or financial advisor – is the key to success for many.

Connecting the Dots

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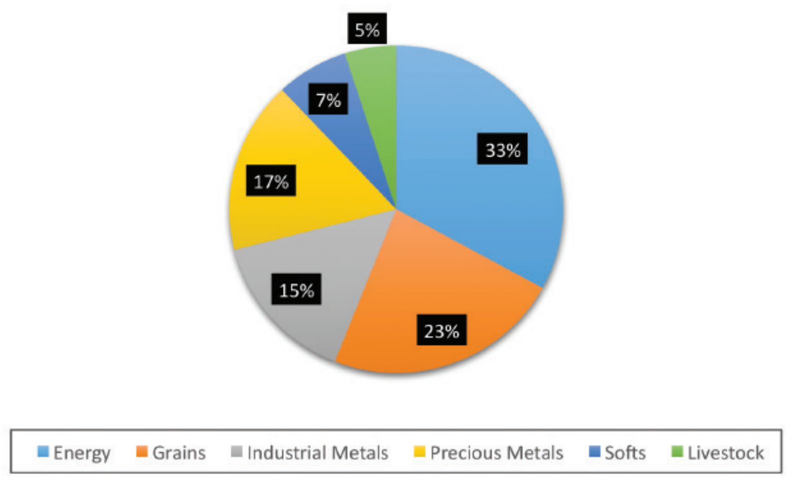
have been faced with a double whammy of sorts. First, one of your primary end markets, China, continues to grow, but at a deaccelerating growth rate. And then add to that, the strength of the U.S. dollar which places greater headwinds on global demand for raw materials.

Composition of the Bloomberg Commodity Index



Source: Bloomberg Commodity Index

The Growth of Emerging Market Debt

So how do these recent economic developments connect to the significant decline in the U.S. and global equity markets in late August? I would argue that it once again relates back to debt markets and in this case the growing concern over emerging market debt. According to J.P. Morgan, of the roughly $94 Trillion in global bond market debt as of the end of 2014, roughly 15% is tied to emerging market countries or in dollar terms approximately $14 Trillion. Debt outstanding in this sector now represents nearly 40% of the total amount of outstanding U.S. debt of $36 Trillion. This by far has been the fastest growth area of debt issuance over the past decade. Investors were convinced that emerging market economies would remain resilient, commodity process would remain stable and the higher interest rates earned on this debt would more than compensate for the assumed additional risk. Even better, much of this debt was issued in U.S. dollars, so currency risk was viewed as minimal.

Fast forward to today's environment. Many of the companies that issued out this debt are commodity based, so revenues are naturally down due to lower prices and the cost of servicing this debt has increased substantially as these same companies have to convert weakening home country currencies into U.S. dollars.

Global Risk-Off Trade

So as the events began to unfold beginning in mid-August, Bank Risk Managers, Asset Managers and Hedge Fund Managers alike all came to the same conclusion, that global economic risk was increasing and that it was time to shed risk based assets. The decline of the Chinese stock market was one indicator, the increasing credit spreads in the Fixed Income markets both High Yield and emerging market was another. The net result was a huge amount of selling pressure in a very short period of time for financial markets that were ill prepared for such an event. In the U.S., some securities experienced an almost "Flash Crash" on August 24th as the interaction between Exchange Traded Funds (ETFs), the individual security constituents of the ETFs and market circuit breakers created unintended consequences.

Time to Reassess

After times of market upheaval, there is a natural inclination to reassess. Fundamentally I do know that roughly 68% of U.S. Gross Domestic Product (GDP) as of the end of the second quarter was related to consumption. Developments like lower commodity prices, including crude oil, are still net positive for both U.S. manufacturers and consumers. This environment has historically resulted in both increased margins and greater economic activity. There are certainly company specific headwinds for multinational companies that rely on emerging market economic growth and/or strength in global commodity markets. Here at home, Caterpillar Inc. would be an example. But in general, for predominately a service based economy, I would prefer the current scenario versus an oil price shock that has consistently led to economic recessions.

Will Williams
President

Associate Spotlight

Margaret (Maggie) Rogers
Relationship Manager, Florida Region

In August of 2015, Margaret (Maggie) Rogers joined the firm as a Relationship Manager in its Winter Park, Florida office. With nearly 10 years of experience in the financial services industry, Maggie will serve as the primary day-to-day contact for many of the firm's Florida clients. Her responsibilities will include the oversight and coordination of all client-related tasks, including portfolio management, financial planning and investment reporting. In addition, she is taking an active role in representing DVI in the Orlando business community.

Prior to joining DVI, Ms. Rogers worked at both USAA and Merrill Lynch, excelling in Advisory and Management roles. Her background includes investment management, financial planning and insurance solutions. Maggie graduated from Emory University with Bachelor of Arts degrees in Economics and English Literature and University of Florida with a Masters of Business Administration. She is a Certified Wealth Strategist®, a licensed insurance representative and also holds FINRA Series 7, 24, 51 and 66 securities licenses.

When she's not in the office, Maggie enjoys fishing, hunting, traveling and running. Her last big adventure was an 8-day, 90 mile run across the vast terrain of Iceland.

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