DVI
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In Search of Certainty

In a recent national poll conducted by Bloomberg News only three of ten Americans say the value of their investment portfolio has risen since a year ago. Fewer high net worth Americans, those with incomes exceeding $100,000, say they have made money over the past year than those who say they have lost money.[1]

This is perplexing information to me, as we have experienced a strong resurgence in the capital markets over the past twelve months. Though not back to the market levels achieved in the fall of 2007, the market recovery has been strong, swift and broad based in terms of asset class participation. U.S domestic equity markets alone have recovered nearly 72% from their March lows, developed international markets have gained nearly the same and corporate fixed income markets, depending upon both credit quality and duration, have experienced returns at minimum in the mid-teens.

If this sentiment is halfway on target, it appears that many Americans and their trusted financial advisers have once again made poor decisions during what was admittedly an extremely difficult if not downright gruesome market environment.

It was apparent throughout most of 2009 that investors continued to seek out certainty in a world that appeared to them as being far less certain. As I have mentioned in the past, mutual fund flows in 2009 confirmed this mindset as a record $375.4 billion was placed into bond funds.[2] This insatiable appetite for fixed income securities and also a "cash is king" mentality was certainly a prevalent sentiment. This thought process, though maybe to a lesser degree, has carried into the first quarter of 2010.

In addition, investors have been attracted to investment vehicles that provide some sort of perceived floor of value or guarantee. We have experienced more than a few meetings with prospective clients in which a variable annuity contract with a death benefit and maybe even a market step-up provision held within an IRA Rollover was a topic of

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[1] Bloomberg News, March 23, 2010
[2] Wall Street Journal, March 31, 2010

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Economic Growth and the U.S. Debt Burden

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Senior Vice President

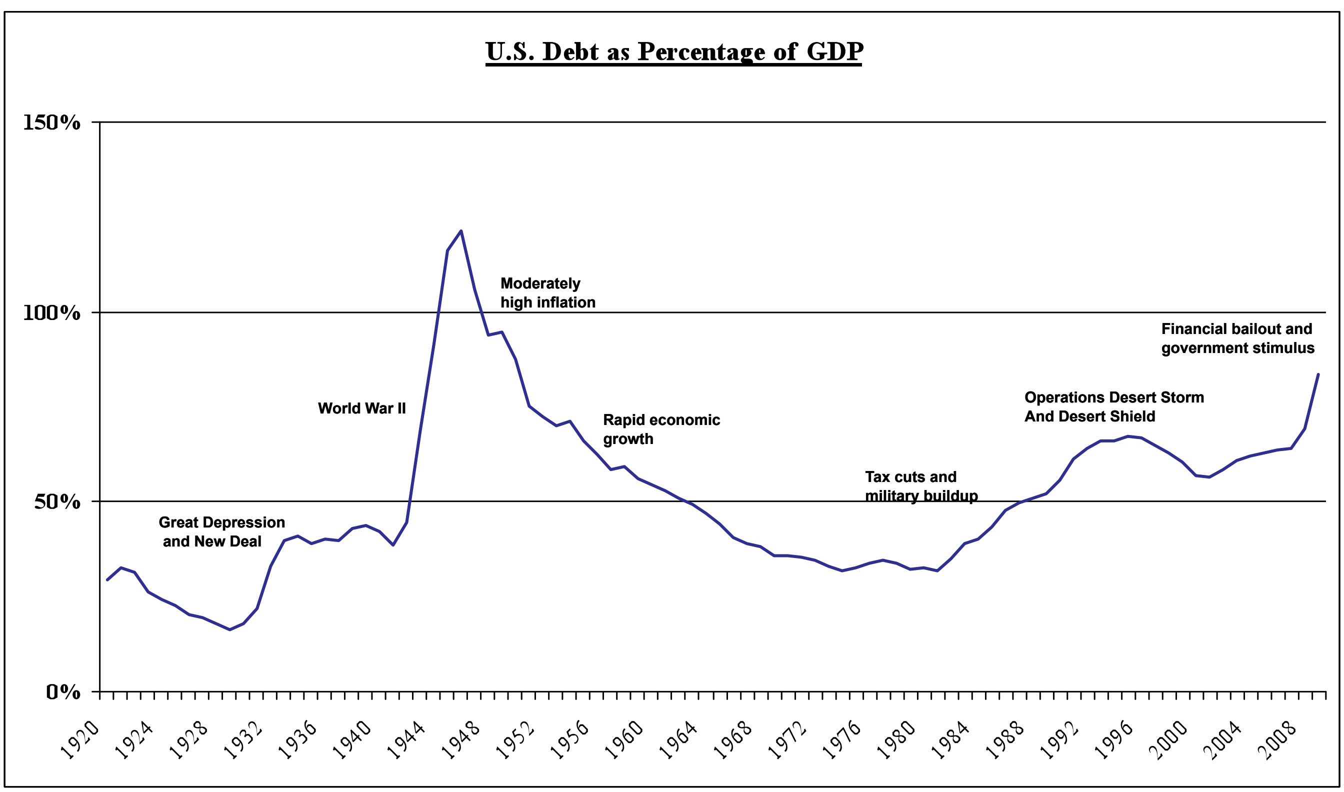
The nation's escalating debt burden remains a prominent issue for investors. Aid to the financial system, fiscal stimulus intended to jump start the economy, and the recent Health Care and Education Reconciliation Act of 2010 all are pushing the level of debt on the U.S. government's balance sheet to record levels. Additionally, in times of war, the level of public debt has risen substantially. The current military initiatives in Iraq and Afghanistan add further to the fiscal burden.

Undoubtedly, record levels of debt are not good. However, evaluating the data relative to our country's Gross Domestic Product - the output of goods and services produced by labor and property located in the United States - presents maybe a more palatable perspective. The chart below compares the level of U.S. debt as a percentage of Gross Domestic Product for the period 1920 through 2009.

As you can see from the chart, debt-to-GDP ratios are high. However, even higher ratios existed in the past, primarily during World War II. The impact of improved economic growth is evident following the war years driving debt-to-GDP to low levels in the late 1970's. Clearly, meaningful economic growth is the antidote for combating high levels of public debt.

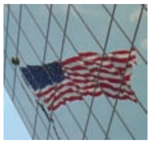
Since 1929, average annual GDP growth has been 6.6%. The GDP growth rate for the 1990 decade was 5.5% and for the 2000 decade the rate was 4.3%. Presuming we experience some reversion to the mean and GDP growth returns to levels more in-line with the long-term average of 6.6%, the debt burden will have less significance to our economy. The United States has faced these issues before. Often overlooked is the economic power of our country and the subsequent increase in tax revenues generated by higher sales, profits and investment, driven by higher demand for our products and services.

Recently, a client sent me a catalog listing antique stock and bond certificates that could be purchased as collectibles. As I flipped through the pages looking at certificates dating as far back as the 1840's, the origins of companies like Exxon Mobil, American Express and Pabst Brewing all came to life. In 1876, Standard Oil Company of Ohio had a market capitalization of $3.5 million. Today, Standard Oil's successor Exxon Mobil has a market capitalization of $316 billion – an increase in market capitalization of over 90,000 times. The evolution of these companies over the 134 years represented has experienced every type of war, conflict, scandal and financial crisis known to man and yet today are as strong as ever. Perhaps this is what the great financier J.P. Morgan had in mind, when he said, "The man who is a bear on the future of the U.S. will go broke!"



What is a Municipal Bond Doing in My IRA?

Drew Lister, CFA
Portfolio Analyst



The short answer is it's earning interest. The long answer requires a little more explanation…

The financial crisis of 2008 wreaked havoc on our nation's credit markets. The ability for issuers to bring new debt to market came to a grinding halt for all but the U.S. Treasury. Those who had to issue new debt to refinance obligations coming due, were forced to do so at abnormally high risk premiums, driving up their cost of financing and crippling otherwise economically viable business models. The municipal bond market was not immune to this, as investors worried the pending economic fallout would leave state and local governments without the tax revenue necessary to meet their financial obligations. This was quickly heading toward a self-fulfilling prophecy, as municipalities could not issue debt to viably fund new expansion projects in order to create jobs and spur economic growth. The system was malfunctioning, and something needed to be done to fix it.

Enter the American Recovery and Reinvestment Act of 2009, also known as the Obama Administration's Economic Stimulus Package. In addition to providing federal dollars directly to the states to fund shovel-ready construction projects, the Act created a new program to help the ailing municipal bond market: *the Build America Bond program.*

Build America Bonds (BABs), like traditional municipal bonds, are issued by state and local governments to fund essential capital improvement projects, such as infrastructure, transportation, and schools. **What makes BABs different than traditional tax-exempt municipal bonds are 1) the interest payments received by investors are taxable as ordinary income, and 2) the federal government directly subsidizes the cost of borrowing by reimbursing the municipal issuer 35% of the interest payments.** The structure allows municipal issuers to lower their financing costs (via the federal subsidy) and dramatically increases the number of potential investors. Traditional tax-exempt municipal bonds are usually purchased only by individuals and corporations in the highest marginal tax brackets, whereas BABs make economic sense for investors in lower tax brackets and more importantly in tax-exempt/deferred accounts such as pension funds and IRAs. These investors can now add municipal bonds at competitive taxable rates to their asset mix and benefit from additional portfolio diversification.

Not surprisingly, the program has proven to be extremely popular with the market. While BABs still represent a small fraction of the $2.8 trillion municipal bond market, they were by far the fastest growing segment of the market since their debut in April of last year. Data compiled by Bloomberg show BAB issuance exceeded $64 billion in 2009, and more than $27 billion came to market in the 1st quarter of 2010. These bonds have replaced much of the new issuance in the traditional tax-exempt municipal market. The scarcity of newly issued tax-exempt municipal bonds has caused an incredible turnaround in that market, cutting long-term borrowing rates by more than a third from the highs reached in 2008.

The success of the program, which is scheduled to expire at the end of this year, has Washington scrambling to extend it. President Obama's proposed budget to Congress sought to make the program permanent and lower the federal subsidy to 28%. The House of Representatives instead opted for a three-year extension with a gradual decline in the federal subsidy. H.R. 4849, which was passed on March 24, 2010, calls for a 33% subsidy for bonds issued in 2011, 31% for 2012, and 30% for 2013. As we went to press with this article, the bill was awaiting action by the Senate.

DVI was active in adding BABs to client portfolios in 2009, and we will likely continue to do so in 2010 (and beyond if the program is extended). Our investment process is simple; we invest only if 1) the bonds fit within the overall investment objectives of the client; 2) the bonds offer better value relative to other taxable fixed income products such as corporate and agency bonds; and 3) the bonds are issued by high quality state and local governments with either a general obligation pledge or a backing of essential services revenue such as water and sewer projects. This is the same prudent risk management approach we take when investing in traditional tax-exempt municipal bonds, and it's important because while the federal government is directly subsidizing the interest payments, it provides no additional credit support to the issuer to ensure the bonds are paid back at maturity.

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discussion. Certainty also meant for many asking the question, "What asset classes or investment vehicles have done well during the past year and a half?" With a rearview mirror in hand, they used this approach to construct a bullet proof investment strategy. In addition to purchasing fixed income, they acquired a hedge fund of funds, a commodity investment in a limited partnership or some other type of high expense ratio illiquid investment vehicle.

If the phenomenon I have described above is indeed true, it does not bode well for those millions of Americans who are preparing for retirement and have little margin for error. The onus is squarely on their shoulders, unlike in decades past where a trustee or corporation was responsible for prudently managing a retirement investment portfolio. Those days for the most part are over and it is now every person for him or herself.

With this in mind, I often think back to my many conversations with firm founder David Vaughan as we would discuss on more than a few occasions how to increase the probability of success for any investor. The following represents a handful of my recollections:

Basic Tenets of Financial Success:

- Save more than you spend.
- If it sounds too good to be true, it is.
- If you are told, "this time it is different." It definitely is not.

How to identify an outstanding investment advisor:

- Most people believe having a "wealth manager" in Zurich insures success. Actually the inverse is true…If London is good, New York is better, Chicago is better yet still and a town that most people consider a "fly over" is the best of all. If you can identify a firm that has experienced a modicum of success and is located in the perceived backwater of the financial industry – you have found a solid firm. Does Omaha come to mind or maybe Peoria?
- Make sure they believe in something and are confident in their beliefs – may it be dividends, relative value, quality of earnings or consistent cash flow. When opportunity presents itself, this provides the firm the ability to take action.
- Make sure they "eat their own cooking." If they genuinely believe in their investment process and philosophy, they will invest a substantial amount of their funds along with yours.
- Learn, Earn and ***Return*** – make sure the firm is generous to the community and charitable causes and maintains a stewardship mentality.
- Honesty, courage and integrity should never be taken for granted. Make sure they have a cupboard full of popcorn purchased from the Boy Scouts.
- And lastly, small children and pets can sniff out a fake a million miles away – take them to your first meeting.

Evaluating Investment Performance:

- Insist on an audited long-term track record and place more emphasis on long-term performance rather than recent success.
- Make sure to analyze risk adjusted return statistics. How much return did they achieve for each unit of risk?
- Low turnover should not be considered a "bad thing." Evaluate performance in the context of pre-tax and post-tax rates of return.
- Evaluate with a great deal of scrutiny performance in down markets. How one manages through adversity is far more important than how one navigates bull markets.

In closing, I do wish to once again praise the efforts of our hardworking investment, relationship management and client service teams during the past 18 months. I am proud not only of our results, but the manner in which they were achieved on behalf of our valued clients. Many thanks also to our clients and professional partners for trusting our judgment, heeding our investment advice and continuing to entrust us with your client referrals.

Will Williams

President

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