DVI
DAVID VAUGHAN INVESTMENTS

Quarterly Perspective

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In Fear of Giving It Back

We have climbed back from the abyss; the S&P 500 Index has gained nearly 86% from the market lows reached in March 2009. So now how do you feel? Well in general it appears that the investing public does not feel a whole lot better than it did a year or so ago. The 2008 significant decline of virtually all asset classes, save that of ultra safe U.S. Treasuries, has scarred a generation of investors and has left them seeking safe haven strategies even as the equity market and economic backdrop continue to improve. Market participants continue to be net sellers of U.S. common stocks, albeit at a slower rate today than in months past and there continues to be strong interest for what some in the industry refer to as the ***Psychological*** asset classes.

- **Gold / Precious Metals -**
  The S&P Gold Exchange Traded Fund (ETF) is now the second largest of all ETFs, with a market capitalization of $ 58.3 Billion. Gold prices exceeded $ 1400 per troy ounce as 2010 came to a close, up nearly 30% for the year.
- **Emerging Markets -**
  Here again using popular ETFs as a guide, the third and fourth largest ETF funds are now both Emerging Market Stock Funds, iShares MSCI Emerging Markets [EEM] $ 48 Billion and Vanguard Emerging Stock [VWO] $45 Billion. The theory is that Developing Nations provide a superior Risk/Reward tradeoff versus Developed Nations as they are generally seen to have better growth prospects and less sovereign debt as a % of GDP.
- **Commodities -**
  As the year progressed and markets such as Cotton and the Grain complex began to capture headlines, investors gained access to these markets through commodity futures, ETFs and Structured Note products. With real demand growing in the developing world and investor demand growing as an inflation hedge, this asset class continues to gain attention.
- **Traditional Fixed Income -**
  Despite historically low yields for most of the year, investors continued to plow money into Bond Funds. Since the Lehman Brothers collapse in September 2008, nearly $ 1 Trillion has flowed into this asset class. According to the Investment Company Institute, nearly 25% of that total amount was achieved in 2010. It is clear that principal safety is the primary focus and the prospect of any future investment gain net of tax and inflation is of secondary consideration.
- **Variable Annuity Insurance Products -**
  The insurance industry has seized the current opportunity to sell the concept of growth with a safety net. Variable Annuities have always maintained a guaranteed death benefit, but recent iterations have also included "stepped-up" death benefits (locking in the highest achieved account value) and guaranteed minimum income and accumulation benefits. All of course with substantial fees associated with these added features.

After the trauma of a 37% market decline in 2008, it is completely understandable that investors are continuing to seek shelter and remain cautious. We are clearly not out of the

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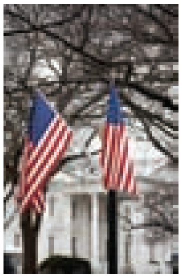
Presidential Terms and Stock Market Cycles

Brian Christensen, CFA
Senior Vice President

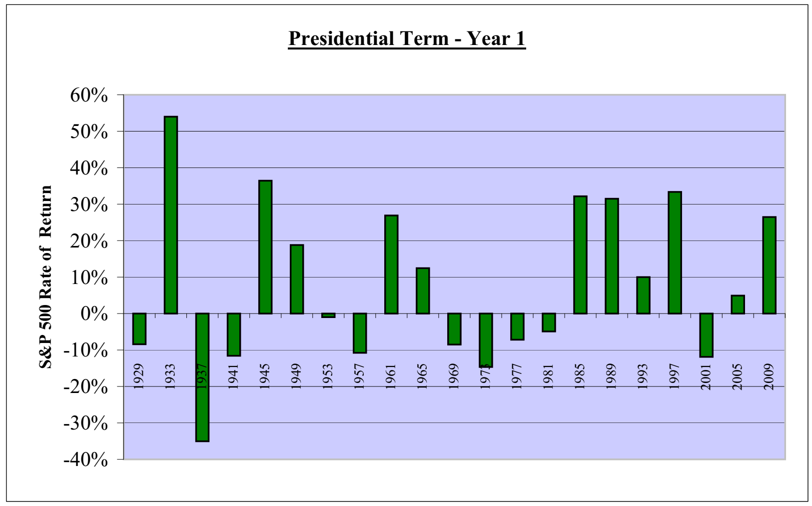


This time of year my inbox becomes filled with the latest forecasts and crystal ball predictions for what's to come in the New Year. Many are fundamentally based with sound economic logic while others lead to a review of the many wacky stock market indicators developed over the years by analysts who like to hear themselves talk.

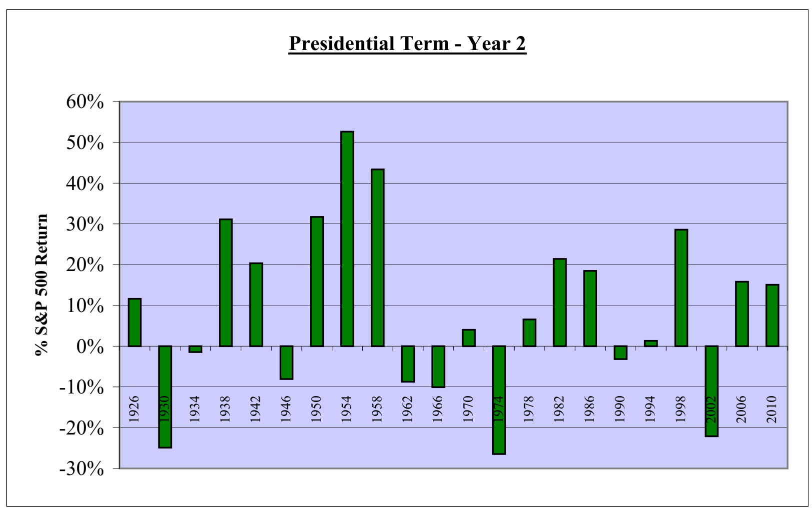
Among the more creative indicators you'll find the Boston Snow Indicator which states that if it snows in Boston on Christmas Day, rising stock prices will occur the following year. Yankee fans refer to this as the BS indicator. Another indicator revealed is the Skirt Length Theory suggesting that if skirts are short the markets are going up and if skirts are long the markets are headed lower. The idea behind this is that shorter skirts tend to appear when consumer confidence is high and the atmosphere is fun while longer skirts appear in times of fear and gloom. Further into finance and fashion trends is the Leading Lipstick Indicator which suggests that lipstick sales tend to increase during times of economic uncertainty. Not surprisingly, Leonard Lauder, the chairman of Estee Lauder, created this indicator. The theory is based upon the idea that in times of economic downturn, women change their shopping patterns and boost their moods with lipstick purchases rather than more expensive clothing purchases. Lauder's lipstick sales doubled in the months following the 9/11 attacks. For those of us more in tune with sports than fashion we have the Super Bowl Indicator which suggests you should always root for a team from the NFC to win. Over a 40 year period ending in 2008, in years where an NFC team wins, the market is higher about 80% of the time.

One indicator that appears to be more fundamentally based and maintains a significant track record is the Presidential Election Cycle Theory. This theory was advanced by Yale Hirsch of the Stock Traders Almanac and is based upon a pattern of market performance corresponding to the four year presidential election cycle. Hirsch notes that based on his research, "Presidential elections every four years have a profound impact on the economy and stock market. Wars, recessions and bear markets tend to start or occur in the first half of the term and bull markets, in the latter half."

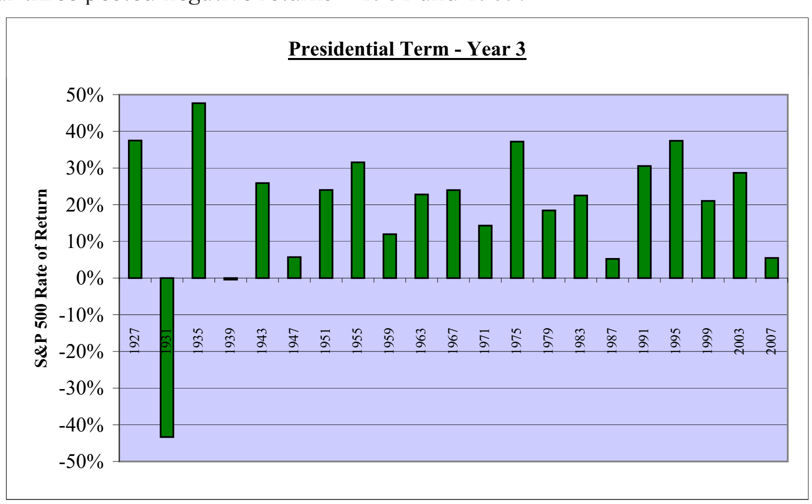
Year one of the presidency has historically been the weakest performer. Since 1926, the average S&P 500 Index return for year one has been 8.24%. More telling are the negative returns seen in year one of a presidential term. Year one occurred 21 times in the 85 years I analyzed and 10 of those 21 years posted negative returns.



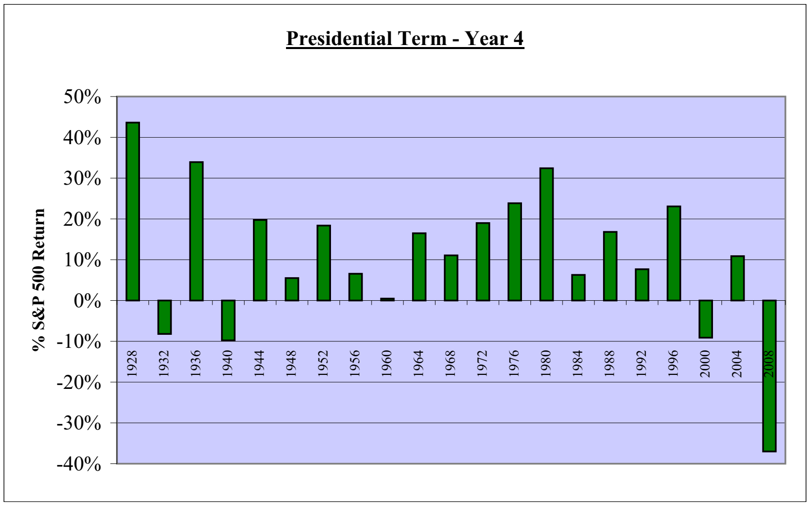
Year two of the presidency, or the mid-term election year, has also posted below average results. Consistent with Hirsch's research noting that wars, recessions and bear markets tend to start or occur in the first half of a presidential term.



Year three of the presidency has posted the strongest results averaging better than 19% annually since 1926. Additionally, there have only been two occasions where year three posted negative returns – 1931 and 1939.



Finally, in year four of the presidency, results have trended above average at an average of 11.03%. Year four is also a year with minimal declines having seen only four negative years - 1932, 1940, 2000, and 2008 – over a 21 year total.



In his 2004 article titled "Presidential Elections and Stock Market Cycles", Professor Marshall Nickles of Pepperdine University identified what he believes is a four year stock market cycle driven by "the consistency and predictability of administrative actions and campaign rhetoric and their anticipated influences on the economy". Nickles measured market returns from April 1942 to October 2002 and recorded 15 market cycles each averaging approximately 4 years in length. He found that during his measurement period 75% of the market lows occurred close to mid-year congressional elections or in year two of the presidential term.
The tendencies of our elected officials provide support for explaining how these presidential cycles are possible. In the first year after election the focus is on campaign promises and passing tough, unpopular legislation. These policies have the ability to be more restrictive or disruptive. The intent is that the voting public forgets about these actions by the time the next election occurs. In the second year of a term, as we've seen in 2010, tax cuts and increases in government spending are more prevalent. Our politicians hope to create a positive environment and optimistic outlook leading into the next election. The CFA Institute in a 2007 article titled "The Presidential Term: Is the Third Year a Charm", found that monetary policy was expansionary 65% of the time during the third year of a presidential term and only 48% of the time during the other years of a term.

Clearly, policy makers are reluctant to take more restrictive stances in the months prior to a presidential election. Given that stock markets tend to do well in times of loose monetary policy, it's not surprising the stock market has performed well during the third year of a presidential term.

While you'll not get many short-term market predictions from me or my colleagues, if the Bears win the Super Bowl and it snowed in Boston on Christmas Day perhaps the stars are aligned for a prosperous 2011. Certainly we are in the right year of a presidential term. Absent those events, we will continue to toil in our work to identify sound investment ideas using our time tested fundamental research processes.

Tax Relief, Unemployment Insurance Reauthorization and Job Creation Act of 2010

Stephanie Ricketts

Relationship Manager

With two weeks left to spare in 2010, President Barack Obama signed into law the "Tax Relief, Unemployment Insurance Reauthorization and Job Creation Act of 2010." This legislation, negotiated by the White House and select members of the House and Senate, provides for short term extension of tax cuts made in 2001. The tax bill's passage also brings clarity to estate planning, at least for a couple of years. We would like to take this opportunity to summarize some of the highlights that are most likely to impact our clients:

Income Tax Package

- ❖ For income tax purposes, the new law extends the Bush era tax rates for two years for all tax payers. Therefore, the following tax rates will remain in place through 2012: 10%, 15%, 25%, 28%, 33% and 35% (as opposed to 15%, 28%, 31%, 36% and 39.6%).
- ❖ Current rates have been extended for both long term capital gains and qualified dividends. Long term capital gains and qualified dividends will continue to be taxed at a maximum rate of 15%. Without passage of the new law, long term capital gains tax would have increased to 20% and dividends would have been taxable at ordinary income rates.
- ❖ The new law also provides for continued marriage penalty relief. The previous law had increased the basic standard deduction for a married couple filing a joint return to be twice the basic standard deduction for an unmarried individual filing a single return. This married standard deduction now remains in place and without passage, would have dropped to 1.67 times the standard deduction for single taxpayers.
- ❖ While the law extends several provisions for two years, there are a number of provisions that are only extended through 2011. One of these provisions includes the ability of taxpayers age 70 ½ or older to make tax free distributions of up to $100,000 from individual retirement plans for charitable purposes. In addition, individuals will be allowed to treat IRA transfers to charities during January of 2011 as if made during 2010.

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In Fear of Giving It Back

Continued from Page 1

woods yet; we simply have less significant problems to deal with today than we did two years ago. However, it has surprised me that investors have placed bets that either have been heavily influenced by a glance in the rear view mirror or have been made without an assessment as to the implications to their overall portfolio. Little consideration has been given to the merits of a high quality, dividend paying equity strategy as an answer to those that are looking for a conservative long-term investment solution.

A Strategy for all Seasons
Large Fortune 500 Multinational Companies
Industry Leaders with Pricing Leverage
P/E Multiples less than the S&P 500
Attractive Dividend Yields with Prospects for Future Increases

Strategy Advantages
Income - Predictable Future Cash flow
Favorable Tax Treatment versus Alternatives (Currently)
Inflation Hedge due to Pricing Power
Diversification - Access to Global Markets without Direct Foreign Currency Exposure.

Obviously this approach is squarely in the DVI wheelhouse, but as we assess the risk/reward trade off of alternative strategies, the current market environment appears to provide investors with a unique opportunity to do the right thing and be justly rewarded for that decision.

In the fall of 2010, we notified our clients and strategic partners of a pending change of control in the ownership structure of David Vaughan Investments, Inc. We are pleased to announce the conclusion of this process and the new role of the members of the DVI Management Committee. Thank you as well for the overwhelming and unanimous support of this transition and your continued confidence in team DVI.

Will Williams
President

Tax Relief, Unemployment Insurance Reauthorization and Job Creation Act of 2010

Continued from Page 3

Lastly, while not part of the recently passed legislation, the IRS has pushed back the filing date for those taxpayers that itemize. Taxpayers who claim deductions for home mortgage interest, gifts to charity and state and local taxes will have to wait until mid to late February to file their returns. The Internal Revenue Service attributed the late start of the filing season to the 2010 tax law changes and the agency needs extra time to put processing systems in place. These changes do not affect the April 15 deadline for filing tax returns.

Estate Tax Package

- ❖ The maximum estate tax rate for the next two years is 35%. This is 20% less than what the maximum rate would have been without passage of the new legislation.
- ❖ The applicable exclusion amount is $5 million for individuals ($10 million for married couples), which would have reverted back to $1 million under the previous sunset provisions.
- ❖ The new law also provides for the reunification of the estate and gift taxes, which creates a tremendous opportunity for high net worth individuals. A married couple may gift up to $10 million free of gift tax for the next two years.
- ❖ An additional significant opportunity of the new law is the portability between spouses of the $5 million applicable exclusion amount. This portability allows a surviving spouse to utilize any unused exemption of the deceased spouse, and as consequence provide the surviving spouse with an even greater exclusion amount. Married couples can essentially shield up to $10 million from estate tax effective with estates of decedents dying after December 31, 2010.
- ❖ The bill repeals the carryover cost basis rule and reinstates the stepped up cost basis for all assets included in the gross estate. For individuals who passed away in 2010, heirs can choose carryover basis rules under EGTRRA or the revived stepped up basis rules under the bill.

We look forward to incorporating this new legislation and the impact and opportunities it has for our clients during our review meetings over the course of 2011.

David Vaughan Investments, Inc. • Peoria, IL • Winter Park, FL • www.dviinc.com