DVI
DAVID VAUGHAN INVESTMENTS

Quarterly Perspective

Fall | Vol. 18 | No. 4

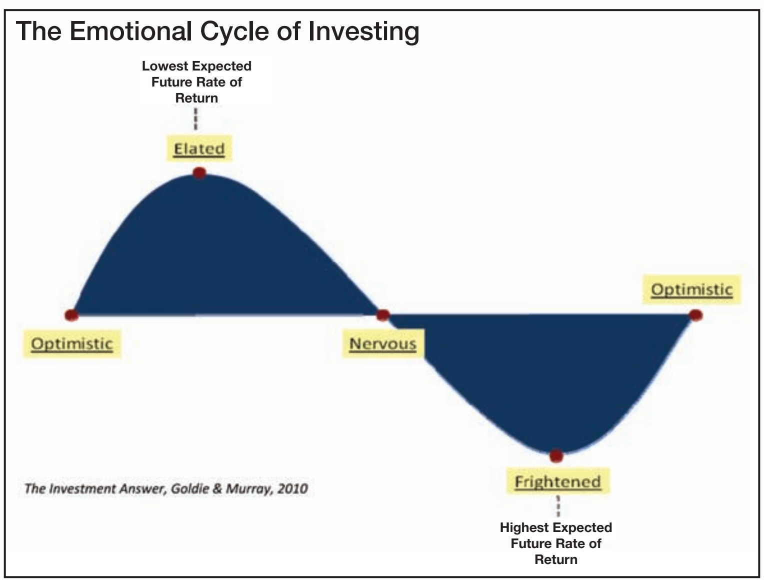
Risk-On / Risk-Off

The Macro investing theme over the past two months is in full Risk-Off mode. Look no further than the current yield curve of U.S. Treasury Securities to confirm that investors want little to do with assets that exhibit any financial risk. Thirty year bond yields have dropped by nearly 30% from the end of July to the end of September with rates hovering around 2.9%. Global and domestic investors have sought out the stability and liquidity of Treasury Securities as they reposition their once risk seeking financial assets. Despite a longer term view that questions the appeal of locking in rates of return that guarantee negative post-tax real rates of return, investors are convinced that this is an appropriate safe haven. The global equity markets have been battered as investors want little to do with the risks associated with the European Debt Crisis or a global economy that appears to be slowing. Many investors had sought out emerging market equity exposure as a way of reducing their portfolio risk, but once again discovered that emerging market economies are still significantly linked to the larger more developed countries and fell nearly twice as much as U.S. equity indices.

To me the current investment backdrop reinforces the importance of 1) adopting a reasonable, rational and time-tested investment philosophy and 2) believing in the merits of that philosophy during both good times and bad. Maintaining a framework of discipline in a financial market environment that wishes to challenge rational thoughtful behavior is a must.

I recently read a book entitled The Investment Answer, and the authors provided a wonderful perspective on what they described as the "Emotional Cycle of Investing."

In a very simple manner it addresses one of the greatest paradoxes in investment strategy. As you feel very good about your investments ("Elated") and the investment backdrop appears to be ideal and good news abounds, you are actually much closer to a future investing environment that will yield far lower returns and vice a versa. When the headlines are full of doom and gloom ("Frightened") and investor sentiment is very



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Route To:

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From Open Outcry to HFT: Negative Implications for Securities Markets

Brian Christensen, CFA
Senior Vice Pesident

The days when floor brokers and specialists at our nation's stock exchanges directed the majority of the equity trading volume in the U.S. are over. Scenes of men yelling orders and flashing hand signals across a trading floor are being replaced with high speed computers, algorithms and mad scientists of the financial kind. Rather than battling in the trading pit for the best location to see the action, firms now battle for office space that provides the shortest electronic link to the exchange's price and trade data.

Computerized trading first entered the scene in the 1970s when the New York Stock Exchange (NYSE) introduced its "designated order turnaround" (DOT) system which enabled electronic transmission of orders to the proper trading posts. NASDAQ became the first electronic stock market in the U.S. in 1971. In the late 1990s computerized trading moved from the exchanges to electronic communications networks (ECNs). ECNs became very popular after the Securities and Exchange Commission created a regulation (Reg. ATS) designed to promote alternative trading systems to the NYSE and NASDAQ. The electronic trading revolution was off and running.

ECNs allowed traders to enter orders into a system that was off-exchange and could be matched against other participants. ECNs reduced trading costs and errors significantly. The introduction of ECNs caused trade volumes to move from the NYSE and NASDAQ to many competing trading venues. Where the NYSE and NASDAQ once accounted for nearly 80% of trading volume in stocks they listed, today 60% to 70% of that volume is traded off-exchange.

In 2001, stock exchanges moved to decimalization of stock prices and began quoting prices in decimals rather than 1/8's and 1/4's. Market makers now had a much smaller advantage as the minimum spread between the price where they bought and sold went from 1/16th of a dollar (6.25cents) down to less than a penny. Following decimalization, transaction costs began to decline sharply and, not surprisingly, trading volumes rose significantly. While trading volumes continued to grow, so did the power of new technologies and high-speed computer systems. Add the brightest mathematical and computer programming minds of the world and you've created High Frequency Trading (HFT).

HFT now dominates the exchanges and is estimated to account for 70% of all stock trades in the U.S. HFT is a form of trading that exploits technological advancement and tick-by-tick data to execute trades as frequently as every few milliseconds. HFT strategies use computer models driven by sophisticated algorithms designed to identify small price differences in a market. The model triggers thousands of order messages per second to an exchange, buying and selling to gain profits of a penny or less per trade. It may seem like small change, but when done millions of times per day annual profits reach the billions.

The objective is to scan the stock exchanges order data and capture the tiniest of price differences between exchanges for the same security thereby locking in a profit. The worries of the fast money crowd are now about how quickly they can obtain and analyze the data rather than the more historically traditional trading concerns of valuation, commission rates and best execution. The market benefits, thus far, are quite debatable.

As one might expect, the HFT firms promote their activities as being beneficial to the markets by providing sources of liquidity and maintaining narrow price spreads. While this is hard to argue, these benefits occur only for a millisecond as the HFT system flashes orders to the market. More relevant, is the growing concern that 60%-75% of all equity trading in the U.S. is generated by computers reacting to market price data without human intervention. The "flash crash" on May 6, 2010 is a prime example of this risk. Automated trading strategies and unmanned computer systems are a bad combination. The SEC has stated that if it has to choose between the competing interests of long-term investors and short-term traders, it has a "duty to uphold the interests of long-term investors." Hopefully the growing concerns of traditional investors are addressed as the SEC and Congress seek to better understand the market and economic risks of HFT.

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low, expected returns from that point forward should be very high. I guess that is why Warren Buffet has been quoted as saying, "Be fearful when others are greedy and be greedy when others are fearful." However, taking a contrarian view is easier said than done. It is much easier to join the herd than to stand alone with your own convictions. Unfortunately, this ability to stand your own ground and be resolved and disciplined in your decision making is truly what defines a successful investor. Study after study has shown evidence of investors failing to generate reasonable long-term rates of return as they use the rear view mirror to evaluate the appropriateness of future investment opportunities. Chasing returns is quite simply a recipe for disaster.

The Further Unwinding of Tech Bubble Valuations

P/E Multiples

On a trailing four quarter basis, market multiples peaked in 1999 at around 29 times earnings as the technology bubble was in its frothy heyday (See "Elated" page one). Valuations have dropped significantly since then with market multiples ranging in the 10 to 11 times range depending upon the use of trailing or forward earnings. As such, market valuation is quite attractive from a historical perspective.

Corporate Earnings

Despite significant setbacks in 2008 and 2009, and a tepid domestic and global economic backdrop, corporate earnings have been quite resilient over the past two decades with new all-time Earnings per Share (EPS) levels forecasted for 2011.

Attribution of Returns

With such significant EPS growth over the past decade, how in the world can equity market rates of return be so meager? The answer is P/E multiple contraction.

In general, when investor confidence is high and interest rates are relatively low and stable, market multiples have a historical tendency to rise. The end result is higher stock prices as the market applies a much higher multiple to each and every dollar of earnings. Unfortunately the inverse of this effect can occur as well. When there is low investor confidence and interest rates are either high or rising, stock investors tend to reduce the price they are willing to apply to earnings to reflect their cautious attitude and the negative impact higher interest rates will have on future earnings.

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Associate Spotlight

In our previous newsletter we mentioned that DVI added several new associates to the firm in recent months. We would like to take this opportunity to spotlight those individuals who were not included last quarter, as well as spotlight and extend a warm welcome to the newest addition, AnneMarie Brinton, our new Administrative Assistant who joined our team last month. We look forward to you meeting these new associates.

Anne Ewers, CTFA, Investment Accountant

Anne joined David Vaughan Investments in May of 2011. She received her Bachelor of Science degree in Business Management and Administration from Bradley University. Anne came to DVI after working approximately six years at a local community bank performing trust administration. She successfully passed the Certified Trust and Financial Advisor (CTFA) exam in May 2010.

In her role as Investment Accountant with DVI, Anne's primary responsibilities include reconciling internal and external investment accounting systems, proxy voting, and researching and reconciling cost basis for clients.

Anne and her husband Tyler live in East Peoria with their dog, Cecil. In her free time Anne enjoys traveling and spending time with her family and friends.

Amy Mauser, Internal Accountant

Amy joined David Vaughan Investments in June 2011. She is a graduate of Milliken University with an accounting degree. Prior to joining DVI, she worked for Pricewaterhouse Coopers in Peoria, Illinois, for over 15 years in the areas of tax and auditing.

In her role as Internal Accountant, Amy prepares and files client securities class action claims, prepares client billing and assists with DVI website connectivity.

Amy is married and has two children. In her free time she enjoys spending time with her family and friends and is involved with her church.

AnneMarie Brinton, Administrative Assistant

AnneMarie joined David Vaughan Investments in September of 2011. She graduated from Illinois College with a Bachelors of Science in Mathematics and Theatre. Prior to joining DVI, she worked as a nanny for two small children. When she is not in the office, AnneMarie sings with the Irish band Turas, and enjoys spending time with her niece and nephew.

As Administrative Assistant, AnneMarie assists the Relationship Managers and the individuals in the Client Services office with their daily tasks and special projects. She is one of two DVI associates responsible for receiving client phone calls and greeting guests in the Peoria office.

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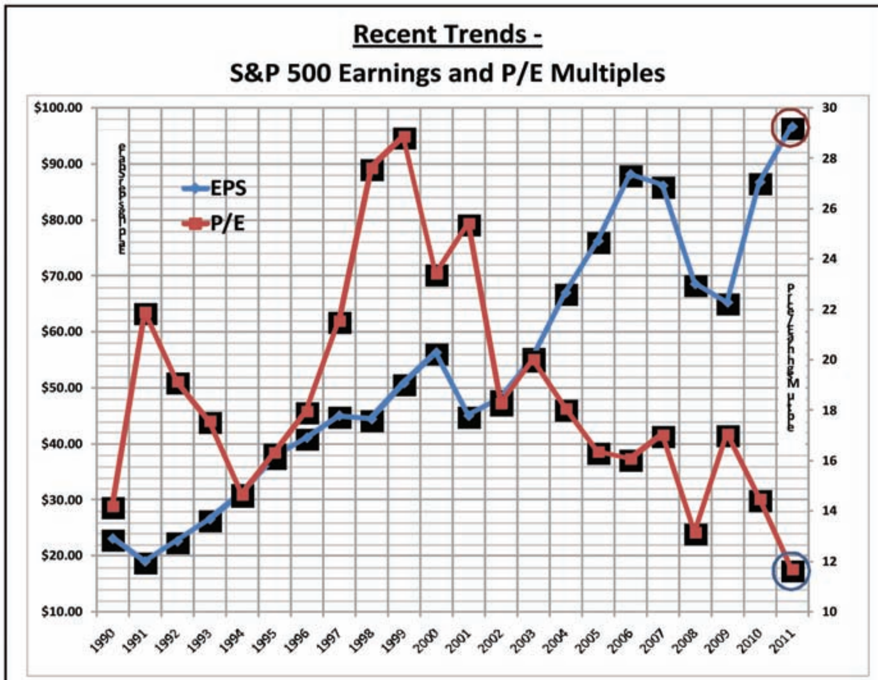
As the table below illustrates, what served as a tailwind for most of the 1990s, P/E multiple expansion (highlighted in green) has reversed course and has become a major obstacle to equity returns over the past nearly 12 years (see annualized figures highlighted in red). In recent months, despite a dramatically lower interest rate environment, evidence of continued multiple contraction has to be viewed as highly unusual, but it also has to be viewed as an indication of the extreme amount of fear and pessimism that is baked into current market prices.



Source: Standard & Poor's & Thompson Baseline

A Resolve to Be Opportunistic

In an environment that is emotionally charged, being unemotional, fact based and opportunistic is a successful mindset. Despite all of the chaos, there is much work to be done. In fact, it is the decisions that we make today, under less than ideal market conditions, that will be the foundation for future success. We cannot lose sight of the fact that certain estate and tax strategies are more attractive today than they were back in April when the market was establishing new recovery highs. We have to be diligent in monitoring capital gain tax exposure and mindful of asset allocation targets under circumstances in which DVI is managing a Balanced Strategy mandate.

Components of S&P 500 Index Return

	1990 - 1994	1995 - 1999	2000 - 2004	2005 - 2009	2010 - 09/2011
P/E Multiple Expansion	1.5	15.0	-8.5	-0.6	-19.0
Corp. Earnings Growth	3.9	9.8	5.1	-1.1	25.0
Total Capital Appreciation	5.4	26.2	-3.8	-1.7	0.8
Dividend Yield	3.3	2.3	1.5	2.2	2.1
Annualized Total Return	**8.7**	**28.5**	**-2.3**	**0.5**	**2.9**

Source: (1990 - 2009) Morningstar, Inc., Standard & Poors, FactSet. (2010 - 9/2011) Thompson Baseline, Morningstar, Inc.

Despite the current Risk-Off Mindset, there will come a day when investors are once again willing to accept a prudent amount of investment risk, and we need to make sure that our clients have not only weathered the current storm but that we also have positioned them to benefit as market conditions improve.

Will Williams
President

DVI Supports the Community

For the fifth consecutive year, this past August DVI teamed up with the South Side Mission to raise money to feed the less fortunate in the community. The Hike for Hunger, which began in the summer of 2007, is a morning of energetic hiking and fun filled games and activities for the entire family, held on the premises of DVI and the Forest Park Nature Center. Hikers pay a fee to participate and have the opportunity to take part in a silent auction and prize drawings. The DVI Hike for Hunger 2011 had a banner year with 275 hikers raising over $52,000 for the Mission. The five year total exceeds $200,000. The DVI Hike for Hunger 2012 is planned for the morning of Saturday, August 18th.

DVI has also had the privilege to sponsor numerous blood drives in cooperation with the Forest Park Nature Center. For three years this has been a semiannual event where employees of both DVI and FPNC, along with other scheduled and walk-in donors, have rolled up their sleeves for a worthy cause. The most recent drive was held on September 7, 2011 and brought in over 25 donors. According to the Red Cross, potentially 300 lives have been impacted by the blood donations that have been made during the 6 drives that have been held. If you have an interest in participating in our next blood drive, please contact Deanna Baele at dbaele@dviinc.com.

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