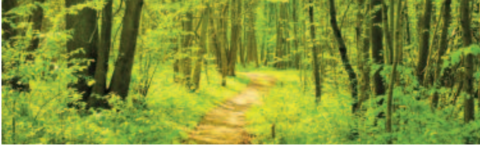

SUMMER 2017 | VOL. 24 | NO. 3
QUARTERLY PERSPECTIVE

DVI
DAVID VAUGHAN INVESTMENTS

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2. Index Fund Investing: Concentrated Risk Few Recognize
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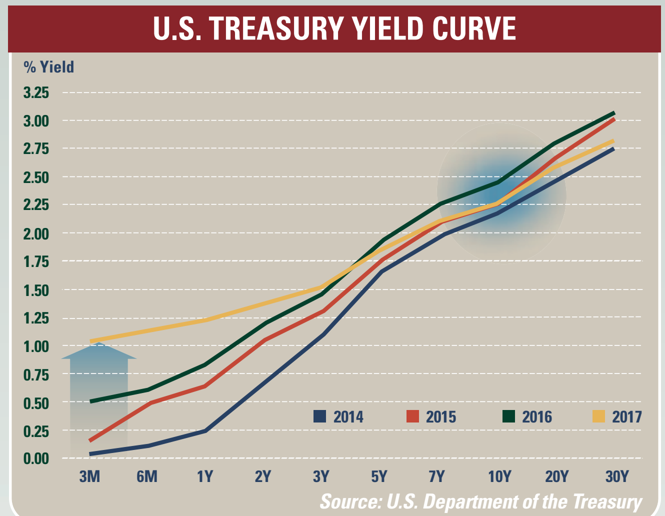
STANDING AT THE 50 YARD LINE

Will Williams *President*

A number of years ago, DVI hosted our annual Fall Forum in which our guest speaker was Norm Orenstein, a resident scholar of the conservative think tank the American Enterprise Institute and contributing writer for The Atlantic magazine. He had been in Washington since the mid-1970s and a professional congressional watcher for well over thirty years. What Norm went on to describe was the complete dysfunction of Congress and the inability for Washington to get anything meaningful done. He used the analogy of a football field and how in decades past most politicians were pragmatic, practical, for the most part moderate and were squarely standing at the fifty yard line. As you can just imagine, he went on to provide a narrative of recent times in which most if not all members of Congress were standing squarely in both end zones – Democrats holding court at one end and Republicans in the other. The fifty yard line as the story was told, was left deserted except for a few lost crickets.

I share this story only as a means of pointing out that gridlock in Washington is certainly not new and it appears to be firmly entrenched in the 115th U.S. Congress. Legislative initiatives that were designed to jump start our economy such as corporate tax reform, infrastructure initiatives and bank regulatory reform all appear to be on hold as both parties wrestle with proposed amendments to the Affordable Care Act. As the current administration rolls into its 160th day, post-election optimism has now lessened a bit as the realities of an entrenched gridlock continues to have a strangle hold on the legislative process.

With fiscal reform now on hold and Federal Reserve monetary policy moving short-term interest rates higher, financial markets are beginning to suggest the bounce in U.S. economic activity that was once viewed as a certainty, might be at risk or at minimum pushed out further into 2018. There are several indicators pointing to this conclusion. One that has received recent attention in the financial press is the shape of the U.S.



Source: U.S. Department of the Treasury

Treasury Yield Curve. U.S. short-term rates have risen in sympathy with the higher Federal Funds target rates (1.00-1.25 percent) recently revised by the Federal Reserve. Short-term rates have risen to exceed one percent. However, longer-term interest rates have dropped since year end 2016, as lower expectations for economic growth and future inflation are now factored into fixed income prices. In fact, 10 year note yields today (2.27%) are nearly identical to rates back in 2014. This phenomenon often referred to as the flattening of the yield curve, is generally an early indicator of a benign or uninspired economic environment. The potential consequence of a stalled macroeconomic

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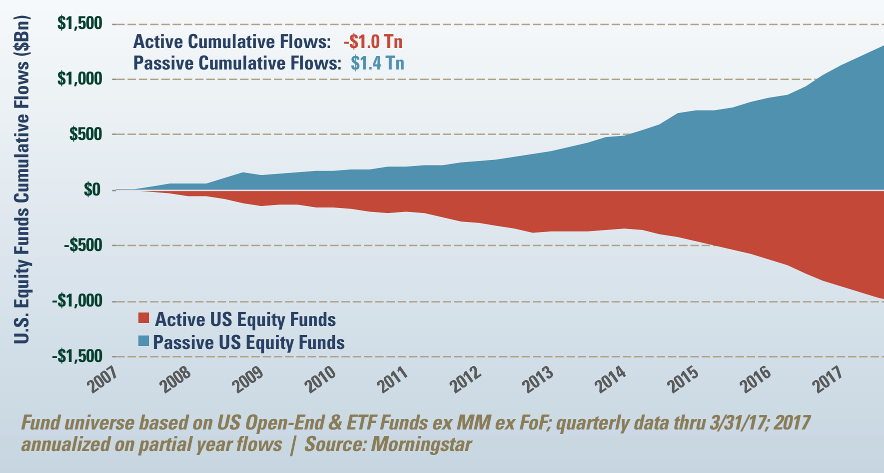
Brian Christensen, CFA
Senior Vice President & CIO

INDEX FUND INVESTING: CONCENTRATED RISK FEW RECOGNIZE

Over the past 10 years, there has been more than $1 trillion in assets shifted out of actively managed equity funds and into passively managed equity funds. The growth has occurred in both traditional mutual funds and exchange traded funds (ETFs). Driven by lower investment fees, a period of index outperformance relative to active managers, and sizable fund company marketing budgets, interest in index investing (that's a lot of "ins") has exploded.

ACTIVE VS. PASSIVE CUMULATIVE EQUITY FLOWS SINCE 2007



Fund universe based on US Open-End & ETF Funds ex MM ex FoF; quarterly data thru 3/31/17; 2017 annualized on partial year flows | Source: Morningstar

According to the Investment Company Institute 2017 Factbook, total U.S. mutual fund and ETF assets as of December 31, 2016 were $18.8 trillion. Of that total, ETFs represented $2.5 trillion or about 13%. Further analysis reveals more than 35% of all mutual fund assets are now index funds, and 98% of ETFs are indexed. The sheer size of indexed assets are creating market risks not fully understood by investors. David Vaughan regularly pointed out that there were "Two Rs in this Market – Risk and Reward." People often overlook the first R especially when markets are steadily moving higher.

The dominant index fund managers today are Blackrock, State Street and Vanguard. Combined, these three firms manage nearly $11 trillion in assets. If you look at the top holders of any S&P 500 company, you will find these firms. For example, Apple Inc. is the largest company in the S&P 500 comprising 3.5% of the index. Blackrock, State Street and Vanguard own a combined 15.06% of Apple shares. Together, these three firms are the largest shareholder in 40% of all publicly listed firms in the U.S. As a group, they are the largest single shareholder in 88% of the S&P 500 companies.[1] So, why is this risky? There is a huge potential for corporate governance standards to be weakened. Active managers have a vested interest in the underlying company, its success, and the actions of company leadership. Passive managers own their shares by index default thus there is no underlying fundamental tie to the company's success. The process of voting for things like corporate directors, mergers and acquisitions, and executive compensation potentially becomes diluted. Further, you will rarely see an index fund manager take an activist role in a company – it's contrary to the basic definition of being a passive investor.

ETFs, which again are 98% indexed, are clearly increasing the volatility in stock prices during times of market stress. ETFs originally were intended to create a more liquid, flexible alternative to traditional mutual funds. Mutual funds are priced daily, at the end of the market session, with transactions valued after the market closes. ETFs are priced continuously throughout the market session with transactions valued as they occur, like a normal stock trade, thus providing better liquidity and flexibility to investors. The share price of the ETF is supposed to trade in lockstep with the stocks held in the fund. However, a significant problem occurs when individual share prices fall quickly and ETF investors rush to the exits.

On May 6, 2010 a series of events caused a "flash crash" in the U.S. stock market. Market makers tasked with valuing the underlying stocks held in ETFs were unable to do so as prices fell dramatically. Nearly 25% of the Russell 3000 Index dropped by more than 10% in a matter of minutes. As a result, those same market makers chose to back away from trading and further reduce the liquidity in the market. The end result was a collapse of market prices. At the end of the day, the exchanges determined that any trades executed in excess of 60% away from the price of the security at 2:40pm EST were to be cancelled. The New York Stock Exchange essentially said everybody gets a do-over. Nothing gained, nothing lost. Two-thirds of the trade cancellations were in ETFs.

Of course, this "flash crash" led the Securities and Exchange Commission to call for greater structural reforms and mechanisms to curb extreme pricing volatility. On Monday August 24, 2015, U.S. stocks were again under pressure. The S&P 500 had ended the prior week in decline and foreign markets were plunging. In the

Continued on page 4

INDEPENDENTLY UNITED

(Part I) A Successful Succession Plan

In late June of 2017, DVI announced the partnership of David Vaughan Investments and Morton Community Bank. Independently United, is the first among a series of articles to provide further insight into DVI's thought process supporting this new corporate initiative.

Developing a succession plan is a daunting task. It explains why most privately held business owners avoid the pain and suffering of the process, especially in the investment management industry. But at DVI, we never believed we had a choice. Our clients were far too important to us – not just the current generation, but the next generation as well. It was essential that we develop and execute a well-thought-out glide path with a sufficient timeline that would allow us the ability to tweak and refine the strategy. We knew we had to get it right for the long-term!

Rather than focus on the beginning, the DVI leadership team spent most of our time focusing on what the end should look like.

We resolved that we must -

- **Continue the partnership culture and maintain a privately held company status**
- **Prioritize our clients' interests above those of others**
- **Harness financial resources to both weather storms and opportunistically invest in the business**
- **Construct a governance structure that is dominated by an independent fiduciary Board of Directors**
- **Recruit the absolutely best and brightest investment talent to provide continuity of service**
- **Develop innovative resources and services that would further enable our clients to achieve their financial goals and objectives**
- **Embrace a servant leader mindset that recognizes our efforts should be focused on the greater good**

Succession planning for some is another way of describing a planned financial exit, monetizing your life's work and moving on. Succession Planning for DVI is a strategic exercise not a financial end game. It is the painstaking process of looking into the future and determining the best path forward. We came to the conclusion that our future success was predicated on identifying a like-minded private organization, a trusted partner, to build a strong future together. Some call this outcome unconventional, we call it the "Power of Two."

Through personal commitment to their clients' goals, David Vaughan Investments and Morton Community Bank have established themselves as leaders in their respective fields. Now, they will leverage their histories to create a partnership built to last.

Learn more at DVIandMCB.com

BETH SALMON, CPA | *Director of Business Operations*

David Vaughan Investments, Inc. is pleased to announce that Elizabeth "Beth" Salmon has joined the firm as Director of Business Operations. With nearly 30 years of experience as a finance, management and operations decision-maker, Beth worked in the education, healthcare, information services and public accounting industries. Beth graduated with a Bachelors of Business Administration degree from St. Mary's College, Notre Dame. She is a Certified Public Accountant.

As the Director of Business Operations, Beth's primary focus is on administering, expanding and overseeing the Human Resources and Career Development programs.

CONTINUED FROM PAGE 1 : STANDING ON THE 50 YARD LINE

environment is the negative impact on corporate earnings which in turn has a substantial influence on stock market prices and valuation. Positive developments out of Washington, in effect moving back to the fifty yard line, are going to be necessary to support the earnings growth forecasted in the 2nd half of 2017.

The most counterintuitive phenomenon that has occurred in the first six months of the year is the continued lack of price volatility in the equity market. In absence of perceived market risk, investors continue to pursue higher risk strategies without a clear understanding of the potential downside risk. If history is a guide, this fact pattern generally does not end well, but predicting the timing of that life lesson is anyone's guess.

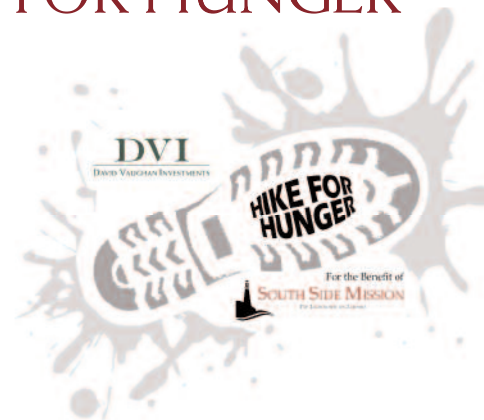
CONTINUED FROM PAGE 2 : INDEX FUND INVESTING

opening minutes of trading that day, the S&P 500 Index was down 5.3%. Comparatively, the iShares Core S&P 500 ETF tanked 26%, or nearly 20% below its fair value. The Vanguard Dividend Appreciation ETF and the SPDR S&P Dividend ETF plunged 38% apiece while the S&P 500 Low Volatility ETF dropped as much as 46%.[2] Investors and market makers howled. The SEC again called for greater structural reforms and mechanisms to curb extreme pricing volatility. Oh, and they also created an Equity Market Structure Advisory Committee to study the problem…. The problem hasn't been resolved.

I understand the need for liquidity, efficiency and being cost effective as was intended with the first index funds. But I don't understand why it makes sense to have a class of equity securities (ETFs) that in 2016 represented 30% of all trading value and 23% of all trading volume in the U.S. A class of securities that have been implicated in the last two stock market "flash crashes," have enabled three investment companies to become the dominant shareholder in nearly every publicly traded stock in the U.S., and allows lousy companies to increase in value simply because they are part of an index. In a Financial Times editorial dated May 30, 2017, Renaud de Planta, Chairman of Pictet Asset Management, concludes, "Much like antibiotics, if passive funds are overused, they will create more problems than they solve."

Source: [1] Fichtner, Heemskerk and Garcia-Bernardo, CORPNET, University of Amsterdam. 2017
[2] Barron's, The Great ETF Debacle Explained, September 5, 2015

DVI HIKE FOR HUNGER



Save the date! The 11th Annual DVI Hike for Hunger is Saturday, August 19, 2017. David Vaughan Investments is a dedicated, long-term supporter of South Side Mission and its dozens of transformational ministries. DVI's Hike for Hunger will be at the Forest Park Nature Center on Saturday, from 8:30 am to 11:00 am featuring family-friendly trail hikes, Fun on the Run inflatables, prizes, snacks and a silent auction. On the day of the hike, parking and registration will take place on the grounds of DVI and Samaritan Ministries. The event will take place rain or shine!

Registration is $20 for individuals and $50 for families. Registration includes hiking, a t-shirt, a backpack and the opportunity to earn trail tickets for prizes.

Register online at: southsidemission.org or at DVI on the morning of the hike.

MARYANN SPROUT, *Front Office Associate*

David Vaughan Investments, Inc. is pleased to announce that Maryann Sprout has joined the firm as one of our Front Office Associates. A lifelong Peoria resident and a graduate of Illinois Central College, Maryann brings 15 years of reception and assistance experience in the real estate, banking and legal fields.

As the Front Office Associate, Maryann contributes to the overall success of the firm by performing a wide variety of administrative duties, and acts as the initial point of contact for many clients and vendors.

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