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QUARTERLY PERSPECTIVE

DVI

DAVID VAUGHAN INVESTMENTS

THE BEST OFFENSE IS A GOOD DEFENSE

Will Williams *Chairman, President & CEO*

Those outside the asset management industry might say that I have this famous phrase reversed, but in the financial markets, preserving capital is paramount. By maintaining a conservative yet prudent posture, investors maintain the ability to weather storms like we experienced in the 4th Quarter of 2018. Does that mean DVI portfolios were unscathed by the rapid equity market decline? Absolutely not. However, by minimizing the damage on the downside, we are now in a much better position to stay the course and benefit when equity markets regain their footing and return to normalcy.

As a long-term investor you are required to ride out these market disruptions, but it is always important to understand the real economic drivers of the current anxiety or fear. Gaining a better understanding of the fundamentals, versus subjecting yourself to the emotional roller coaster of the daily sensationalized headlines, has always proved to provide a bit more sleep quotient during these turbulent times.

U.S. Economic Slowdown?

The U.S. economy has been one of the bright spots on the global stage with GDP running along at a 3 percent year-to-date growth rate through Q3 of 2018, which is well above the 2 to 2.5 percent recent trend. The tax stimulus that was enacted at year end 2017 provided a great tailwind to the economy with a positive impact on both business capital expenditures and consumer confidence. The U.S. unemployment figure standing at 3.9 percent also supported the notion that the U.S. economic expansion, though long in the tooth, continued in expansion mode.

Earnings per Share Downward Revisions

Beginning in the early fall, we began to see the emergence of more downward earnings revisions from S&P 500 companies for calendar year 2019. It is speculated that earnings are beginning to face challenges due to a combination of 1) wage pressures from a tight U.S. labor market, 2) input cost pressures due to the ongoing trade disputes and 3) export end market demand softening, mainly from China. Analysts are becoming increasingly concerned that earnings

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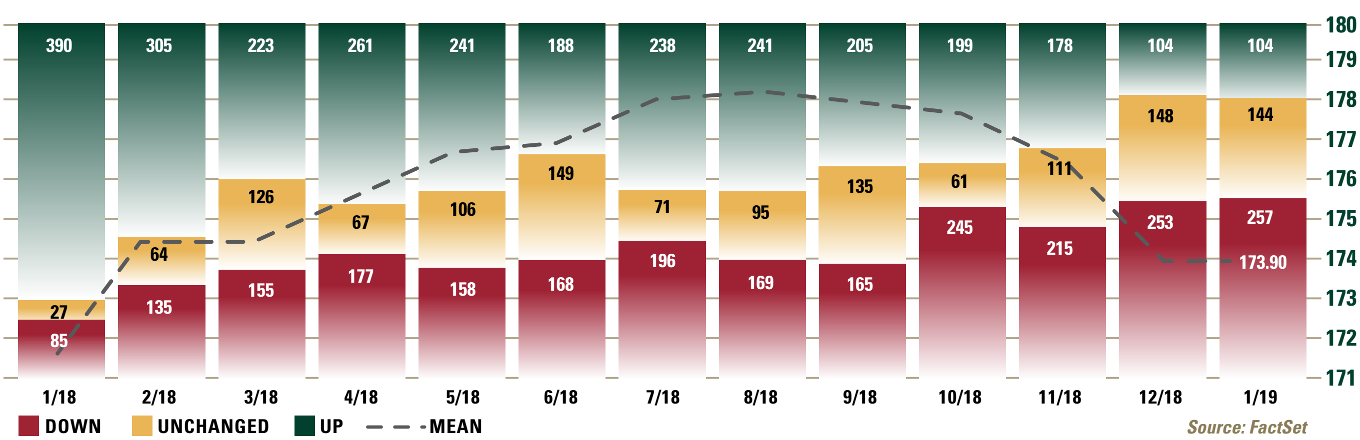
2019 S&P 500 Earnings Estimate History



A DECEMBER TO REMEMBER

As 2018 comes to a close, many will conclude that the stock market had an unusual year with more than its normal share of volatility. However, a review of historical market action will suggest 2018 was fairly normal in that regard.

As seen in the following chart to the right, a "normal" year experiences 62 trading days where prices swing up or down by at least 1 percent. This year was nearly average with 64 days, far from the 100+ days seen during the Tech Bubble in 2000 and the crash of 2008.

If we look at intra-year declines, 2018 again wasn't much beyond average with the largest intra-year decline registering 19.8 percent. The chart to the right provides the historical perspective going back to 1980.

Trading activity in 2018 feels excessive because relative to 2017 it was. However, 2017 was an anomaly to which you have to go back more than 30 years to even get close to replicating.

The Average Daily Range of the S&P 500, a measurement of the daily trading range as a percentage

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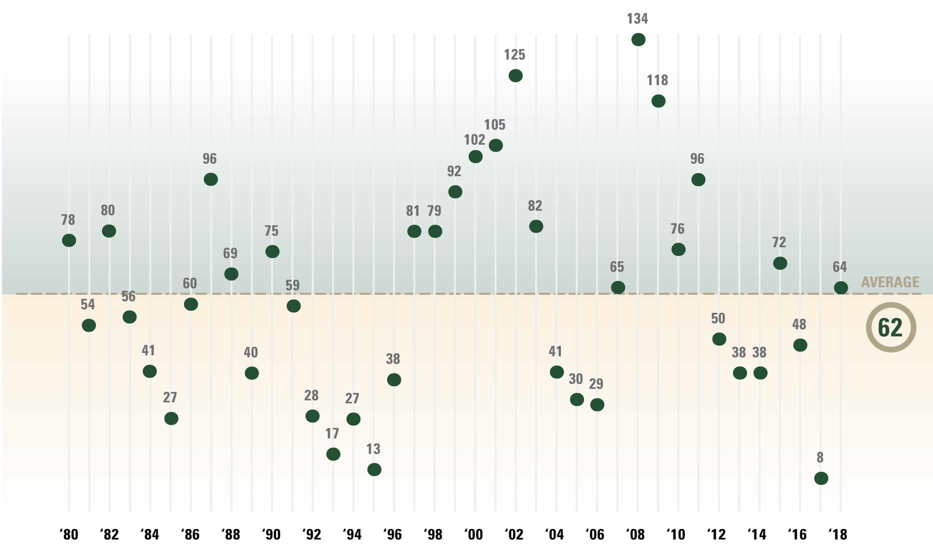
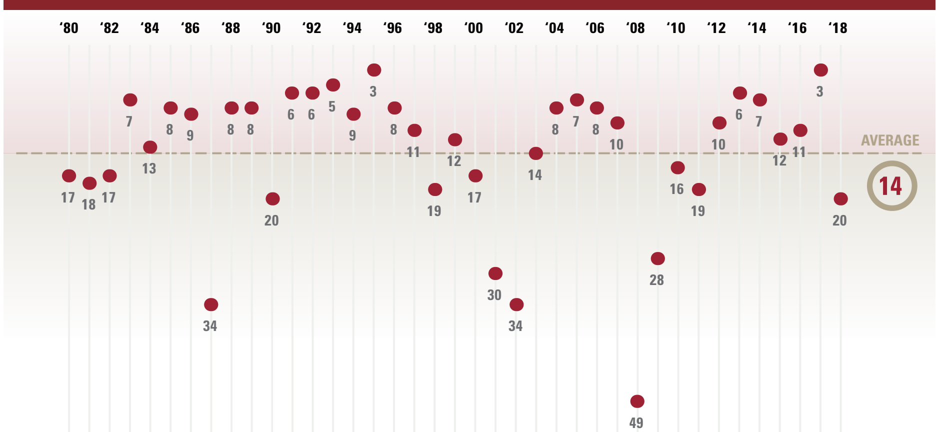
S&P 500 - TRADING DAYS WITH +/- 1% CHANGES



Source: FactSet

LARGEST INTRA-YEAR DECLINE



Source: JP Morgan

JEREMY HANSHAW, *IT Manager and Database Administrator*

DVI welcomes Jeremy Hanshaw as the new IT Manager and Database Administrator. Jeremy brings 8 years of IT Operations and Systems Administration experience including Microsoft Windows and SQL server administration, Microsoft Exchange and Office 365 management and maintenance and several programming languages. Jeremy graduated with a Bachelor of Science in Electrical Engineering from Northern Illinois University and a Master of Science in Engineering from Arizona State University.

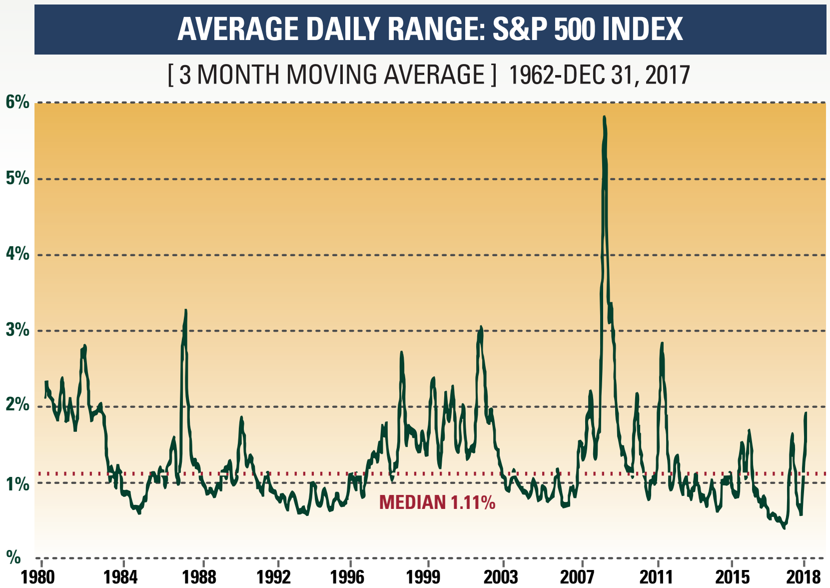
As the IT Manager and Database Administrator, Jeremy's primary responsibilities include analyzing complex business needs presented by DVI Associates and recommending technical solutions, providing expertise and assisting in the oversight and administration of all internal databases and overseeing all systems designed to protect the security of assets and information of the firm.

In his free time, Jeremy likes to play electric guitar and travel with his family.

CONTINUED FROM PAGE 2 : A DECEMBER TO REMEMBER

of the market index, suggests recent activity is below historical averages. Going back to 1980, the Average Daily Range has been about 1.11 percent. At today's index levels that means the daily trading range for the Dow Jones Industrial Average would be over 250 points. Despite what we experienced in the 4th quarter, the following chart indicates that recent action remains well within historical norms.

I'm confident volatility is here to stay regardless of how strong or weak the underlying economic fundamentals may be. The structure of the equity market is evolving. Passive investors and the computer models and momentum strategies used by short-term traders have grown while active investors have declined. As the algorithms driving the short-term momentum strategies initiate trades, they overwhelm the market and fundamentally focused active investors are unable to balance the order flow. This activity is magnified at times when light trading volumes are present – like holiday weeks. For the period 12/21/18 – 12/28/18 the Dow Jones Industrial Average had a trading range of over 1,500 points yet from the 12/21/18 open to the 12/28/18 close the difference was only 109 points.



As we move forward into a new year, it is ever important that you be comfortable with the zigs and zags of the market. DVI remains confident in our ability to manage risk and preserve capital in volatile markets. However, if the market action in December kept the sugar plums from dancing in your head, we need to talk. It's imperative that the strategy we've implemented for your portfolio continues to be one that provides you with a high sleep quotient.

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momentum for 2019 is contracting and year-over-year percentage gains will be limited to 7-7 ½ percent, which is down from double digit growth rates earlier in the year.

Anxiety over Leadership in Washington

Corporate decision-makers continue to face the challenge of determining how to navigate the ever-changing political landscape. With so much uncertainty surrounding global trade, the threat and now reality of a government shut-down and the headline risk attributable to the current administration, it is of no surprise that optimism is beginning to wane. The economic consequence? Businesses are beginning to pull in their horns and investment decision-making is either slowing or being put on the shelf until the dust settles. This is in stark contrast to year end 2017, when new tax policy contributed significantly to a more optimistic sentiment for 2018.

Inverted Yield Curve

Beginning in late summer, fixed income investors began to take notice of the narrowing spread between short-term (2-year U.S. Treasury Note) and long-term (10-year U.S. Treasury Note) interest rate yields. As the Federal Reserve continued its march towards normalizing the Fed Funds Target Rate (four interest rate hikes in 2018), short-term rates continued to rise but long-term rates remained stable to falling slightly from the 3 percent level it maintained for much of the year. The concern here is that an inverted yield curve (when short-term rates exceed long-term rates) has been a reasonably accurate early warning sign of economic recessions. In fact, this economic indicator has predicted with about 80 percent accuracy the last seven economic recessions since January 1962, with an average time from inversion to recession of 14 months.[1]

[1] *Source: J.P. Morgan Guide to Markets and St. Louis Federal Reserve Data*

Glass Half Full vs Glass Half Empty

If this represents the current equity market backdrop, are we convinced that the market declines we experienced in the 4th quarter of 2018 are indicative of what to expect in 2019? We tend to be optimistic to a fault, but here are a handful of developments that deserve attention:

- The decline in crude oil prices (>40 percent) has been material over the past three months which should act as a stimulus for consumers as they save money at the pump
- Much of the speculative excess, especially in the large cap growth space, has been deflated which bodes well for the overall health of the market on a going forward basis
- Fed Watchers were originally calling for an additional three interest rate increases in 2019, but recent polls would now suggest we might see only one in the first half of the year
- Investor bearish sentiment is on the rise and valuations are once again becoming attractive on a historical basis

As we position client portfolios for 2019, we never lose sight of the fact that managing risk is our primary occupation. We recognize the significance of the decisions that we make during these trying times. If past is prologue, our convictions will be tested, but we recognize the significance of our responsibility. Our ability to make the right decisions on behalf of our clients will define their financial success in future years.

AMY APA, *Investment Accounting Team*

We are pleased to announce that Amy Apa joined DVI as a member of our Investment Accounting team this fall. Amy comes to DVI with 8 years of experience in the financial services industry. In addition to her investment accounting experience, Amy has process change and reporting experience along with a Trust Banking and Client Service background. Amy received her Bachelor of Arts in Economics from Southern Illinois University - Edwardsville.

As an Investment Accountant, Amy's primary responsibilities include reconciling internal and external investment accounting systems, researching and reconciling cost basis and market values for clients, reconciling proxy votes and calculating monthly returns for composites.

Amy is an avid traveler and her recent favorite destination spots are the Galapagos Islands and Thailand. She also enjoys softball, pheasant hunting and creating her own greeting cards.