DVI
DAVID VAUGHAN INVESTMENTS

The DVI Approach to Asset Allocation

July 2010

White Paper

Introduction

While the last nine months of 2009 produced a very strong rally in equity markets, it did not change the fact that the decade from 2000 to 2009 went down as the worst decade on record for the S&P 500 index. Even the 1930øs, which included the Great Depression, produced a better 10-year result for equity investors. With that backdrop, we at *DVI* have received numerous questions from clients about how their portfolios should be positioned going forward.

The biggest question clients pose is what asset allocation, or mixture between stocks and bonds, is appropriate for their assets given the challenges facing our economy and the recent dismal returns from the stock market. This is a critical question for all investors to determine, as academic research has concluded that the biggest determinant of investment portfolio returns comes from the asset allocation decision, not the selection of investments within asset classes. As such, we at *DVI* wanted to share our thoughts on the issue as we start a new (and hopefully more prosperous) decade of investing.

Historic Stock & Bond Returns

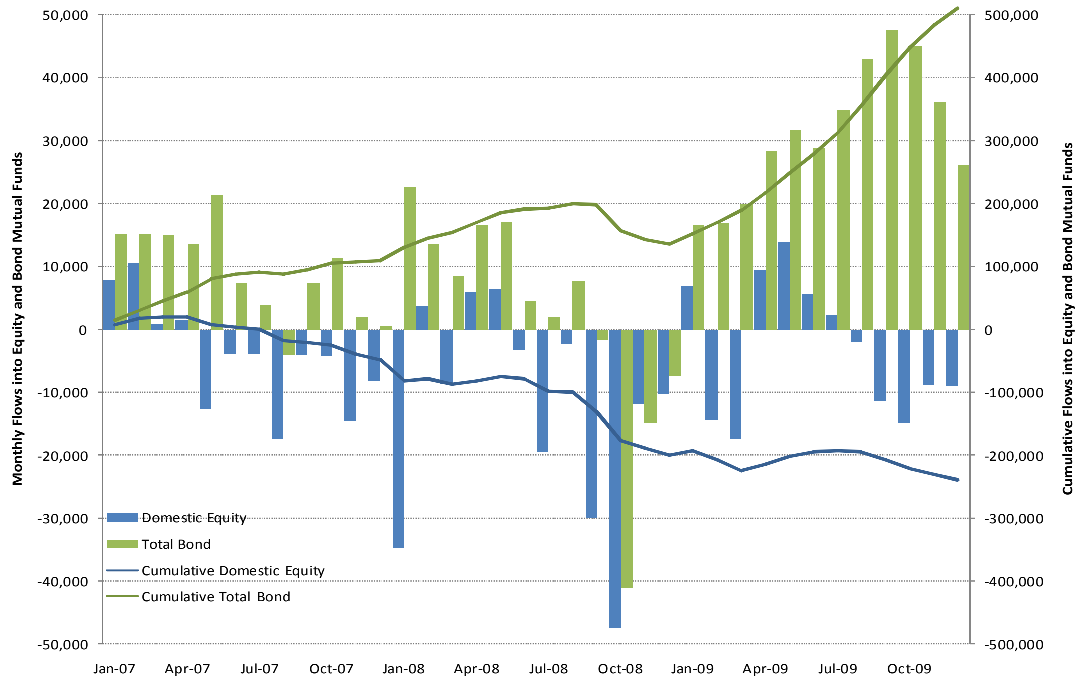
The recently completed decade has been referred to as the õlost decadeö for equity investors. As the table below shows, equity investors lost 1% per year in this time period as measured by the total return of the S&P 500 index.

Annualized Returns by Decade

	S&P 500 Index			Intermediate Term Gov't Bonds			
Decade	**Total Return**	**Income Return**	**Capital Gain Return**	**Total Return**	**Income Return**	**Capital Gain Return**	**Inflation**
1930-1939	-0.1%	5.4%	-5.3%	4.6%	2.4%	2.2%	-2.1%
1940-1949	9.2%	6.0%	3.0%	1.8%	1.2%	0.7%	5.4%
1950-1959	19.4%	5.1%	13.6%	1.3%	2.7%	-1.3%	2.2%
1960-1969	7.8%	3.3%	4.4%	3.5%	4.6%	-1.1%	2.5%
1970-1979	5.9%	4.2%	1.6%	7.0%	7.4%	-0.4%	7.4%
1980-1989	17.6%	4.4%	12.6%	11.9%	10.6%	1.2%	5.1%
1990-1999	18.2%	2.5%	15.3%	7.2%	6.5%	0.7%	2.9%
2000-2009	-1.0%	1.8%	-2.7%	6.2%	3.9%	2.2%	2.5%
Average 1930-2009	**9.4%**	**4.1%**	**5.1%**	**5.4%**	**4.9%**	**0.5%**	**3.2%**

Source - Ibbotson

The losses posted by stocks and gains posted by bonds over the last decade have led some investors to abandon stocks all together, in favor of all bond portfolios. Data from the Investment Company Institute presented in the following chart shows net inflows into bond mutual funds totaled about $500 Billion over the last three years, while equity mutual funds had a net <u>outflow</u> of over $200 Billion during the same time period. This is a much different scenario than we saw at the end of the 1990øs. Back then, investors were aggressively adding money into equity funds following the strong stock market returns of the 1980øs and 1990øs.



Time will tell if the recent move out of equities by investors is the right course of action in response to the nationøs high unemployment level and growing budget deficits. We at *DVI* have our own opinion on the prospects for future stock and bond returns given the current environment. In order to set expectations for potential returns though, we thought it made sense to first review what has driven historic returns from both asset classes.

The chart on the following page shows that stocks have returned on average about 9% per year since 1930, with significant contribution coming from both dividend payments and the capital gains generated from higher stock prices. On the other hand, intermediate term government bonds have returned on average about 5% per year, with almost all of the return coming from the interest payments received by the bond holders.

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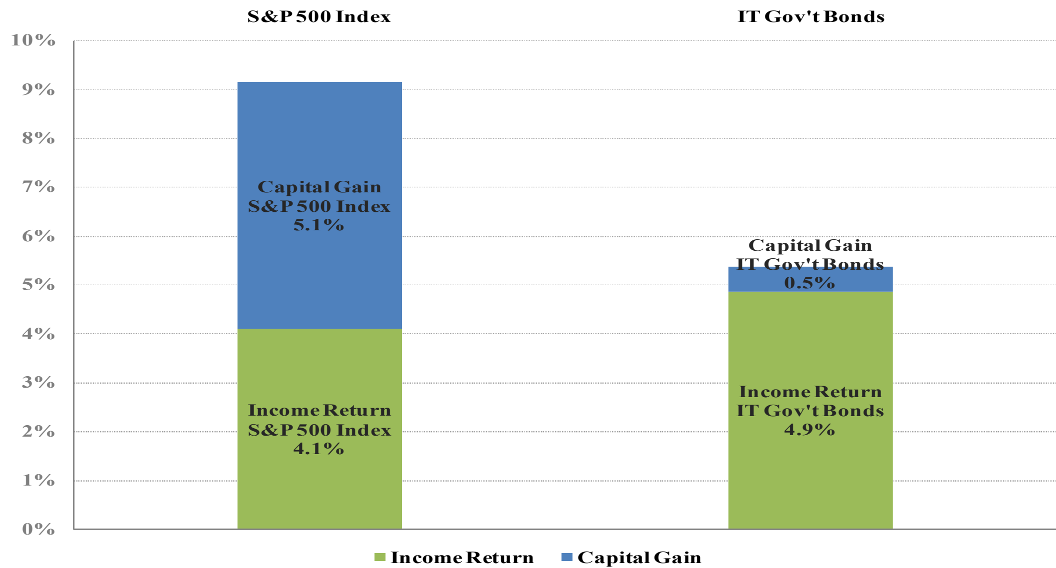
Composition of Stock & Bond Returns – 1930-2009



Source - Ibbotson

Future Stock & Bond Returns

With this historic framework in place, we can make a couple of observations about future returns. First, todayøs low interest rate environment will make it very difficult going forward for bond returns to keep up with their historic averages. A positive impact from the capital gains portion of total return is very unlikely for government bonds in the years ahead as interest rates are more likely to be moving higher than lower. The income portion of bond returns also remains under pressure, given the current very low interest rate environment.

Second, we believe equity returns are likely to outpace bond returns in the next decade. The biggest reason we are optimistic about future equity returns lies in the fact that the Price to Earnings multiple (a measure of how much stock investors are willing to pay for corporate earnings) of the stock market begins this decade at a much lower level than in 2000. As the chart on page 4 shows, investors ran stock market valuations up to very high levels with their enthusiasm for stocks in the late 1990øs. The P/E multiple for the S&P 500 ended 2009 at only 15 times 2010 estimated earnings, reasonable compared to the average multiple over the last 20 years. Assuming P/E multiples remain near historic averages, the key driver of stock market returns going forward will be corporate earnings growth. Corporate earnings typically track nominal GDP growth in the economy, which we expect to rebound as the economy expands from the latest recession. This should lead to earnings growth in the mid-to-high single digits, supporting higher stock prices.

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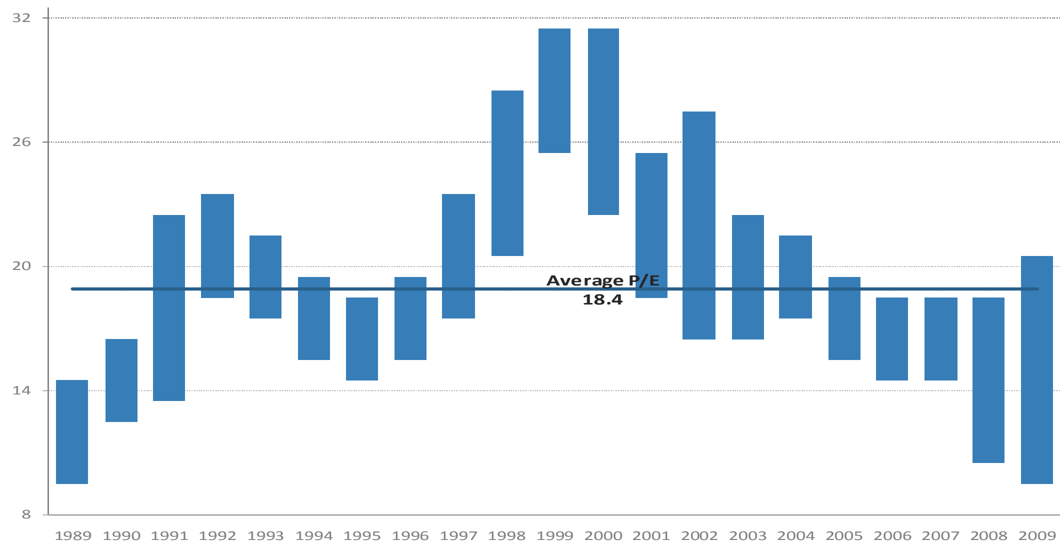
High and Low P/E Multiples of S&P 500 since 1989



Source ó Thomson Financial

Determining Appropriate Portfolio Asset Allocation

A forecast that stock returns will outpace bond returns in the next decade is not surprising, given stock investors are usually compensated over long term periods of time for the additional risk they are taking. It does not mean and would be unrealistic to assume that we will not see a significant decline in the stock market at some point in the next decade. That unfortunate fact reminds us that given the events of the past few years, everyone needs to re-examine their investment portfolio to determine if the current asset allocation is appropriate for them.

It is impossible to determine one asset allocation that would be appropriate for all of our clients. Every one of the individuals, families, and organizations we are fortunate enough to list as clients have unique circumstances that dictate a portfolio that is appropriate for them. We still have clients that have a long term investment time horizon, no cash flow needs from the portfolio and the risk appetite for us to recommend they build wealth through all equity portfolios. We also are seeing a growing number of clients who believe in the merits of equity investing, but given cash flow needs from the portfolio or a lower risk tolerance, we recommend a mixture of equities and bonds in their *DVI* managed portfolios.

For those clients needing a balanced approached, finding the right mixture between stocks and bonds can be difficult. On the one hand, the bond market historically offers a very low õreal returnö after factoring in taxes and inflation. Thus, a large allocation to bonds will lower the expected return of a portfolio, possibly to the point where there is a reasonable chance a retiree could outlive their assets due to low investment returns. On the other hand, recent volatility in the stock market has been much higher than many planned for when determining their portfolio asset allocation. The worst situation that can arise is when portfolio declines become so

extreme that investors eventually capitulate and sell equities at very low levels, thus missing the rebound from market lows. The ideal asset allocation is set so that the downside risk isnøt enough to cause investors to sell at market lows, but still offering growth potential as well.

The DVI Approach

To determine a particular clientøs appropriate asset allocation, *DVI* begins by using an asset-liability matching (ALM) process. This process sets aside certain assets in fixed income investments to prefund any known short-to-intermediate term cash flow liabilities such as living expenses, taxes, college tuition, or large asset purchases. This reduces the impact of short term market volatility on the clientøs wealth and allows the equity portion of their portfolio to remain invested for long term growth. Of great importance is that the client knows that all short to intermediate term cash flow needs are covered by their fixed income investments, regardless of what is going on in the equity market. This makes it easier for clients to remain committed to their asset allocation plan and not bail out on their equity investments at market lows.

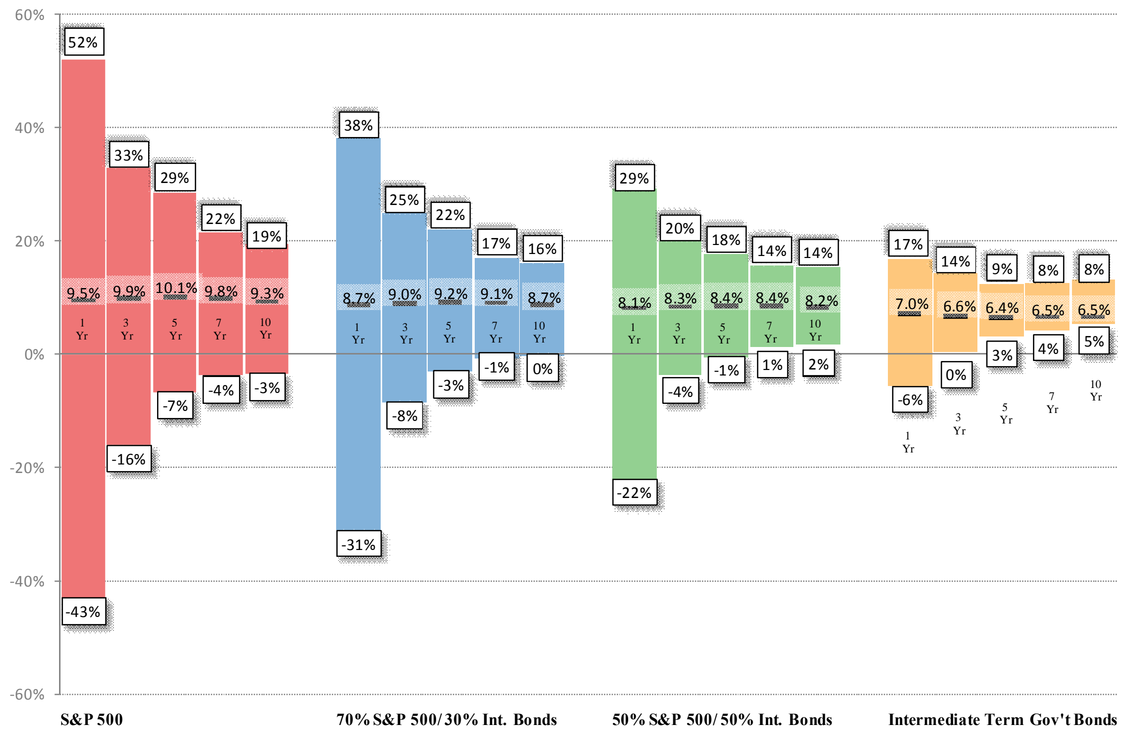
While this ALM approach has been used for risk management by managers of institutional assets for some time, the concept is less frequently used for high net worth clients. Even though the liabilities of an institution may be corporate pension expenses or large infrastructure investments, *DVI* believes the concept of ALM can still be extended to individuals whose liabilities are different in nature (living expenses, taxes, tuition). The idea in both instances remains the same: match up investments in low risk/lower return investments (bonds) to meet short to intermediate term financial obligations, while allowing the balance of the portfolio to be invested for higher returns (stocks).

Once the ALM process has been reviewed for a client, the appropriate asset allocation can be determined to cover expected liabilities. *DVI* views this allocation as the maximum amount of equity exposure a client should have, given their balance sheet. At this point, an examination of the clientøs risk tolerance needs to be done to see if this allocation needs to be further adjusted. While two clients may have the same dollar amount of assets and the exact same funding needs from their portfolio to cover liabilities, each clientøs risk aversion may be different enough to merit different asset allocations for their portfolios.

One of the tools *DVI* uses to gain knowledge of a clientøs risk tolerance is by examining historic range of returns for portfolios with different asset mixes. A chart like the following helps clients understand how adjustments in asset allocation impact their portfolioøs expected rate of return and level of risk. This chart examines the last 20 years of returns and shows the high, low, and average return for each asset mix assuming different holding periods. The highest historic return shows up at the top of each bar on the chart, the lowest historic return shows up at the bottom of each bar, while the average return of each time period shows up in the middle of each bar.

As you can see in the illustration below, the potential for loss is reduced as fewer equities (shown as the S&P 500) are held in a portfolio. But correspondingly, the potential upside and average return drops as more fixed income (shown as Intermediate Term Govøt Bonds) is added to the portfolio. Of particular importance is the significant reduction in the lowest return of the S&P 500 as the holding period becomes longer. This is why we believe investors need to view their equity holdings as long-term investments and to avoid the temptation to time when to get in and out of the stock market via short term holdings periods. Reviewing these holding period scenarios with clients provides *DVI* a much better understanding of how they will react to varying degrees of market volatility, with the ultimate objective of arriving at an asset allocation decision that the client can stick to during market downturns.

High, Low and Average Returns over Rolling Periods
20 Years Ending 12/31/09



Returns of Rolling 1, 3, 5, 7 and 10 Year Holding Periods

Source - Ibbotson
Returns annualized for periods > 1 Year

Conclusion

One of the ways *DVI* has transformed itself over the years is to take on more of an õinvestment counselorö approach to servicing our clients. This includes talking with both existing and prospective clients to understand their investment needs and help formulate an appropriate asset allocation that our portfolio managers will use to manage their portfolio. As we talk with clients in the year ahead, validating that their current asset allocation is appropriate will be our number one objective. If you have questions or concerns about how your portfolio is currently allocated, please contact *DVI* to discuss your situation. We value all of our client relationships and welcome the opportunity to sit down with clients to discuss their investment goals and determine an asset allocation appropriate for their portfolios.

About the Author:
Stephen K Hinrichs, CFA
Portfolio Manager
shinrichs@dviinc.com
(309) 681-4126

White Paper

Main Office

David Vaughan Investments, Inc.
5823 N. Forest Park Drive
Peoria, IL 61614

Tel: (309) 685-0033
Fax: (309) 685-3665

Florida Office

David Vaughan Investments, Inc.
222 W. Comstock Ave., Ste. 200
Winter Park, FL 32789

Tel: (407) 622-5133
Fax: (407) 622-5135

Email: dvi@dviinc.com

www.dviinc.com

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