DVI
DAVID VAUGHAN INVESTMENTS

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The Road Less Traveled

Two roads diverged in a wood, and I– I took the one less traveled by, And that has made all the difference. – Robert Frost

As I look back and reflect upon 2014, I must admit that many of the tailwinds that led us to superior results for our clients this year were fundamentally baked in our firm's DNA at least 25 years ago or more. As I have commented in the past, one of our key attributes is to "dare to be different" and I am convinced that we must maintain this very mindset to insure future success.

Risk Management

The tack that we take in our portfolio construction process relating to the use of utility stocks as a risk management tool is certainly evidence of thinking outside the box. No one could ever suggest we are a closet market index fund as our current overweight to the utility sector is nearly 18 percent relative to the S&P 500 Index. It just so happened in 2014, yield hungry investors re-discovered this economic sector with both attractive yields and consistent earnings characteristics and drove prices to all-time highs. The irony of course is that we own utilities for their attractive risk/reward characteristics and their significant contribution to DVI's low historical downside market capture ratio. Extensive research and validation of these key attributes is an ongoing focus and a high priority at DVI. (DVI Chief Investment Officer Brian Christensen is in the process of releasing a white paper on the Utility industry and its historical performance during varying market and economic backdrops.)[1]

Tax Efficiency

DVI is a buy and hold manager favoring a five year holding period… or longer. It really is the utmost form of discipline and almost unheard of in this age of high frequency trading on Wall Street. Until years like 2014 emerge, one doesn't recognize the virtue of embracing an ownership mentality, buying a piece of an operating company versus simply owning a financial piece of paper. The uproar has not begun yet, but as tax accountants begin to sort through client tax information, they will find an extraordinary amount of mutual fund capital gain distributions, both short and long-term. The five year rebound from the market lows of over 200 percent and high portfolio turnover leaves fund managers with no place to hide from the taxman. The historical advantage of using individual securities versus pooled investment vehicles will once again become apparent.

[1]www.DVIinc.com – Media/White Papers

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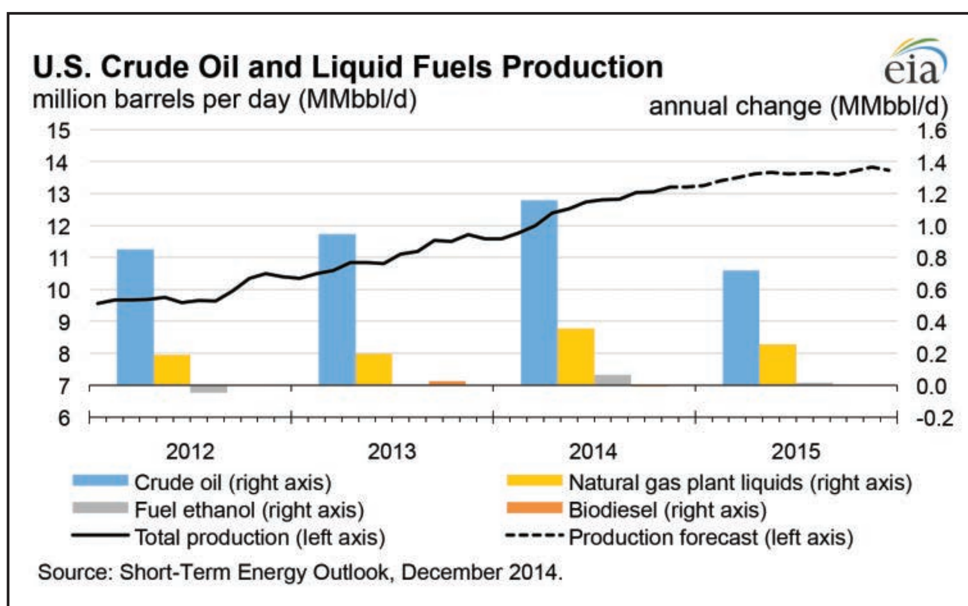
Route To:

Collapsing Crude

Brian Christensen, CFA
Senior Vice President

Oil prices have been plunging. Why? Global oil supply has outstripped global demand growth. The U.S. energy renaissance has seen American oil production (see chart below) grow from 6.5 million barrels per day in 2012 to 9.3 million barrels per day at the end of 2014. This significant increase in U.S. supply, combined with increased production from the likes of Mexico, Russia, Argentina, and most Middle East countries has created a supply shock.



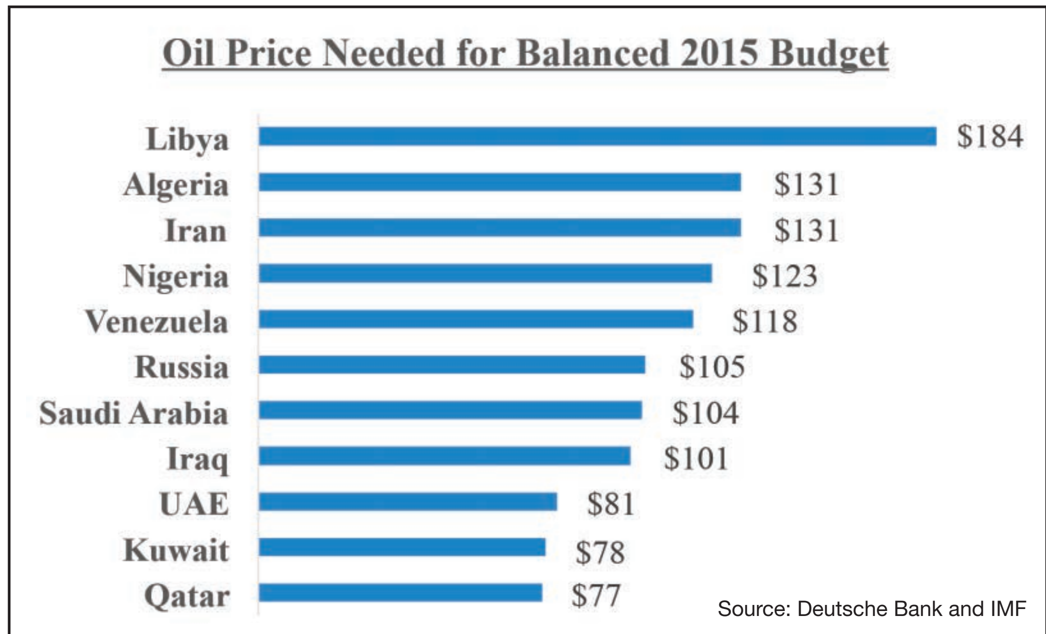
Further, stalled economic recoveries in Europe and Japan and weaker demand from China have been blamed as reason for a slowdown in the global demand for oil. The International Energy Agency (IEA) cut its global oil demand growth forecast to 700,000 barrels per day in 2014, from a prior estimate of 1.3 million barrels per day. China, which over the past 12 years has accounted for about one-third of annual global oil demand growth, is the main contributor to the demand slowdown. Leading up to the 2008 financial crisis, average annual growth rates in China were approximately 800,000 barrels per day. In 2014, Chinese growth is likely to come in at a significantly lower 200,000 to 250,000 barrels per day.

So, who will be the real winners and losers from the recent plunge in oil prices? First, the U.S. consumer is a clear winner. Gasoline represents about 5% of a household's annual expenses per the Consumer Price Index. According to AAA, consumers saved $14 billion on fuel in 2014 compared to 2013 and they estimate the savings in 2015 could be as much as $75 billion. Many analysts consider the decline in gasoline prices to be like a tax cut for consumers. The Brookings Institute has stated that the recent decline in gasoline prices equates to a $500 "tax cut" per household. I think it's a safe assumption that consumers will spend the savings on discretionary items like dining out, travel, and even household goods. Consumer spending represents 68% of the U.S. Gross Domestic Product (GDP). Oil and gas industry capital expenditures represent about 1% of GDP. The benefits of lower energy prices to the consumer clearly outweigh the costs to the energy industry relative to their GDP contributions.

Liz Ann Sonders, Chief Investment Strategist at Charles Schwab, says "Lower energy prices also hold down overall inflation, which is a plus for both the U.S. economy and stock market. Lower inflation has historically meant higher equity valuations." According to Bespoke Investment Group, during all oil bear markets since 1985, the S&P 500 averaged a gain of 2% with positive returns occurring slightly more than two-thirds of the time. Additionally, during 84% of all days that crude oil was in a bear market, the S&P 500 was in a bull market. Globally, winners and losers can almost be synonymous with whether a country is an oil importer or exporter. According to the U.S. Energy Information Administration (EIA) China became the world's largest net importer of oil in 2013 surpassing the U.S. It is estimated that every $1 drop in oil prices saves China an annual $2.1 billon. Cheaper oil should also support the Chinese government's efforts to reduce energy subsidies. Japan, India, and South Korea round out the top five largest net oil importers.

On the export side, Saudi Arabia, Russia, United Arab Emirates, Kuwait, and Iraq make up the top five largest oil exporters. Saudi Arabia's Prince Alwaleed bin Talal has called lower oil prices a "catastrophe" for

his country. If oil prices remain at current levels, it is estimated that Saudi Arabia will see revenues cut nearly in half from $360 billion annually to under $200 billion annually. The biggest losers are likely to be Venezuela, Russia, and Iran - all who have 2015 budgets based upon oil prices well above $100 per barrel as well as the known geopolitical issues at hand. Shown at right is a chart detailing budgeted oil price assumptions for many of the larger exporters. Clearly, there is a significantly greater risk of default for many of these countries under these scenarios.



In the aggregate, we think lower oil prices will be a positive to the U.S. economy driven by a pick-up in consumer spending and confidence. Morgan Stanley estimates that a 15% decline in gasoline prices equates to $60 billion in consumer spending power. Specific industries where this additional spending power should benefit include specialty retailers, apparel, restaurants, credit card companies, and airlines. Aside from the obvious pain in the energy industry, basically any industrial or financial company with a significant energy industry customer base is likely to be challenged. It is within this group that being patient and opportunistic may prove to be the most rewarding.

Associate Spotlight

Jeff Huizenga, CFP®, ChFC

David Vaughan Investments, Inc. is happy to welcome Jeff Huizenga to the firm. Jeff joined DVI in November 2014 as a Relationship Manager. He is a graduate of Dubuque University where he received his Bachelor of Science degree in Business Administration. He is a Certified Financial Planner®, a Chartered Financial Consultant, a licensed insurance agent and also holds FINRA Series 7, 24 and 63 securities licenses.

Jeff brings to DVI over 20 years of experience in the financial services industry, which includes thirteen years with CliftonLarsonAllen, the last ten of which have been in Peoria as a Senior Wealth Advisor. His background includes investment management, financial planning and insurance solutions.

As a relationship manager, Jeff's responsibilities will include the oversight and coordination of all client-related tasks ranging from portfolio management to investment reporting. In addition, Jeff will introduce ancillary services to clients that will enhance their overall experience with DVI.

Jeff and his wife Vickie have two children, Bryan and Bridget, and in addition to being involved in their school and community, they are active members of New Castle Bible Church. Jeff serves as board member and Treasurer of Lifeline Pilot's and is a board member of the Peoria Leadership Prayer Breakfast Committee, where he has previously served as board President.

The Road Less Traveled

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Valuation and Dividends

Constructing portfolios with attractive (lower) valuations, and (higher) dividend yields have been the key ingredients of DVI's success over the past nearly four decades. As historically low interest rates have become an almost permanent state of mind in the U.S. capital markets, yield hungry investors have bid up prices in industry groups that have traditionally provided rich pockets of these types of opportunities. Utilities as an example, are trading on a trailing price/earnings basis of nearly 20 times, versus their 20 year historical average of nearly 15 times. As this is not a "set it and forget it approach", it will be a natural extension of the DVI research process that we mine for opportunities in other industry groups (as well as other asset classes for that matter) that provide the greatest income and risk/reward combination.

Despite recent successes, our passion to formulate innovative solutions to manage risk within the equity market is as strong as ever.

2015 – Looking Forward

As 2014 came to a close, the nearly 50 percent decline in crude oil prices was the most unexpected development for the year. Who would have thought that a decline of this magnitude would have come from a commodity that most analysts considered to be in a stable range between $90 and $110 per barrel? I use this as an example that highlights the unpredictable nature of the markets. Price volatility is more of a steady state in the world in which we live in today than price stability.

Over the past 2 years, the equity market has been in a very quiet upward trend with intra-year declines no more than 7 percent. Over the past 25 years, intra-year declines have averaged closer to twice that amount. Though I feel like I have cried wolf on this topic before, I think it is a natural development that price swings increase in both range and volatility in the coming year. This is not a negative view towards the market, but simply an assessment that investors should continue to focus on risk, their willingness to assume it and a re-assessment of their ability to withstand normal market behavior.

25 Years at DVI

I used to tell David Vaughan when he asked me a complex question, David, "I am just 26 years of age!" Well those days are long over. However, I am still as excited today as I was back then to get to the office in the morning and to work with my colleagues, friends and partners to solve the issues of the day on behalf of our valued clients. Though DVI's success may not be a traditional success story, it was achieved because we were encouraged to take the road less traveled. Thank you.

Will Williams
President

Mutual Fund Investors – Buyer Beware

The year 2014 will be remembered as one when mutual fund investors were insulted twice. As of December 19th, Morningstar reported that more than 79% of U.S. Stock funds failed to beat their market benchmarks for the year. Adding insult to injury is the fact that many investors will also be on the receiving end of large capital gain distributions. If you own mutual funds in taxable accounts, these large capital gain distributions can translate into significant tax bills.

Mark Wilson, founder of website CapGainsValet.com, tracks taxable distributions in the mutual fund industry. Mr. Wilson's database contains information on 225 mutual fund firms. As of December 15th, 210 firms had posted their estimates for 2014 capital gain distributions. From those 210 firms there were 453 mutual funds with estimated distributions over 10%, 52 funds with estimated distributions over 20%, and 12 funds with estimated distributions over 30%. Many industry experts believe that annual distributions in excess of 10% of your account value signals a problem.

DVI's preference for building portfolios with individual securities allows us to better manage the realized capital gains and losses for our taxable portfolios. Further, the low turnover tendency of our strategy allows a higher percentage of post-tax return to accrue to our client's benefit.

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