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QUARTERLY PERSPECTIVE

DVI
DAVID VAUGHAN INVESTMENTS

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EXPECT THE UNEXPECTED

Will Williams *President*

As 2016 came to a close, I think most would agree that if there was a consistent theme for this past year it was to "Expect the Unexpected." Few, if any, in the analyst community accurately forecasted the outcomes of the two major political events of the year and the surprising capital market fall out. In late June, British citizens went to the polls and defied the oddsmakers by voting to exit the European Union, the so called Brexit. And in early November, U.S. voters not only maintained the Republican majorities in both the House and Senate, but elected Donald Trump as the nation's 45th President. As Warren Buffet has famously remarked, it pays to never try to predict the stock market, the economy or elections!

Investors as a rule have a tendency to invest their political beliefs rather than economic realities. As an example, recent interactions with conservative minded investors are revealing. With the outcome of the recent election as a backdrop, discussions generally reflect the anticipation that the stock market will rise from the ashes and finally perform well once again. It is a bit of an awkward moment for me as I have to remind them that over the past five years the broad stock market averages have nearly doubled in value. A very positive outcome, despite a languishing economic backdrop and anemic corporate earnings growth. It speaks to the power of global central banks, working in concert with one another, providing unprecedented liquidity to the capital markets.

The Economics Behind the Trump Bump

So here again, rather than getting caught up in the current day political theatrics of what is being framed as good versus evil, depending upon your political persuasion, the focus must continue to be on the economic facts. Are policies going to be put in place that will positively move the needle on both investor confidence and corporate earnings?

Business Friendly Pro-Growth Initiatives

- Corporate Tax Reform
- Individual Tax Reform
- Repatriation of Overseas Profits
- Infrastructure Investment
- Increase in Business CapEx
- Banking Deregulation
- Manufacturing Emphasis

1. Corporate Tax Reform -
The Trump plan would lower the statutory top rate to 15% from 35%. According to S&P Outlook, each one percent reduction in income tax rate would add $ 1.31 to anticipated 2017 S&P 500 earnings[1]. On a global basis, corporate tax rates have been trending lower for years. As an example, Japanese, German and United Kingdom corporate rates are nearly 10 percentage points lower today than they were a decade ago.

2. Individual Tax Reform -
The current 7 brackets will be reduced to 3, with the top marginal rate being reduced to 33% from the current marginal rate of 39.6%[2]. In addition, the Affordable Care Act 3.8% investment tax would be eliminated. The estate tax would also be eliminated, but going forward, appreciated assets would be handled in a different manner depending upon asset size.

3. Repatriation of Overseas Cash -
Some estimate as much as $ 2 trillion dollars has been accumulated overseas in an effort by U.S. corporations to reduce their corporate tax burdens. Incenting these corporations to repatriate their cash assets, pay tax, albeit at a lower rate and then possibly re-invest these monies in capital expenditures would result in an economic boost and additional tax revenue.

4. Infrastructure Investment -
It appears that both sides of the aisle agree on one thing, the alarming disrepair of our country's infrastructure and the need to prioritize funding for the repair or improvement of these assets. The question in practical terms is how to pay for these investments. Some estimates have suggested up to $ 100 billion or so could be made available over a period of ten years through a tax break on overseas profits.

Source: [1] *The Outlook, January 9, 2017, Volume 89, #1* [2] *Trump/Pence Tax Plan*

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Brian Christensen, CFA
Senior Vice President & CIO

YOU CAN'T SPEND PERCENTAGES

What would you prefer – a conservative portfolio that grows wealth predictably but generates a lower percentage rate of return or a more aggressive, volatile portfolio that generates a higher percentage rate of return? Instinctively, every investor seeks the higher percentage rate of return. But what if that higher percentage rate of return fails to grow wealth to the level necessary to meet your financial goals?

I'm guilty of saying, maybe too frequently, "Our clients don't spend percentages, they spend dollars." This gets to the core of how DVI manages your wealth. Conservatively and consistently, working with you to reach your financial goals. When we ask clients and prospects to define their financial objectives, the answers aren't in percentages, but rather goals. Retirement, college funding, charitable giving, a vacation home. Our personal lives are goals based – graduate from school, buy a home, build a family, have a successful career, give back, retire, travel, spoil the grandchildren, leave a legacy – live well. Our financial lives need to be goals based too.

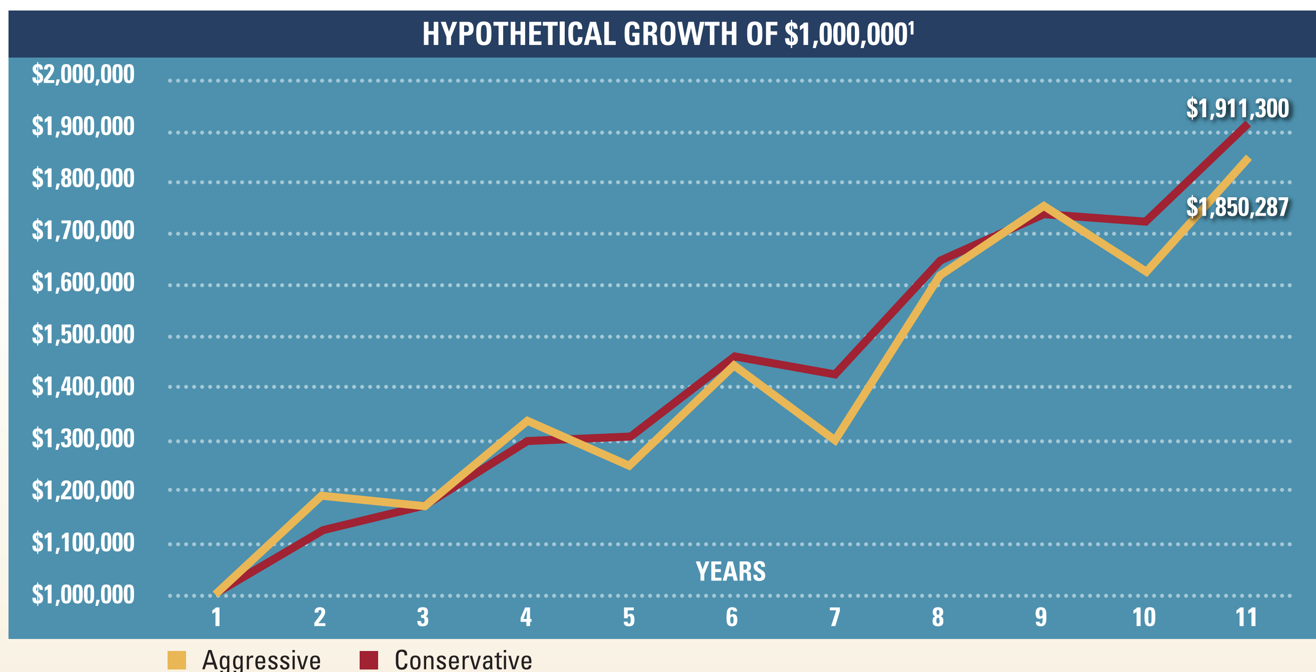
In the table shown below are hypothetical rates of return for two types of investors, Aggressive and Conservative. Despite the wide variability of annual returns, the arithmetic averages are nearly equal.

Year	Aggressive	Conservative
1	19.2%	12.2%
2	-1.5%	4.3%
3	13.7%	10.6%
4	-6.3%	0.7%
5	15.6%	12.2%
6	-10.3%	-2.6%
7	24.9%	15.5%
8	8.5%	5.5%
9	-7.5%	-0.7%
10	13.8%	10.9%
Average	7.0%	6.9%

The chart below graphs the growth of $1,000,000 for both the Aggressive and Conservative investor. One would expect the dollar value of the Aggressive portfolio to be greater than that of the Conservative portfolio given the slightly higher average return. As seen on the chart, this is not the case. Why? The Conservative portfolio preserved capital in declining markets which was then available to be compounded when markets recovered.

2016 provided solid investment returns and thus significant growth in portfolio market values for our clients. As a result, we are even more focused and motivated to manage risk in 2017 such that your dollars are secure and ready to meet your goals. Combining your goal of saving more or spending less (yes, it's possible), and our goal of building portfolios that provide solid risk-adjusted rates of return, we will build wealth together that meets or exceeds the needs of your long-term financial goals. Wealth measured in dollars, not percentages.

Source:[1] The hypothetical rates of return used in this graph are not indicative of actual composite results provided by DVI, but are hypothetical results used solely for investor education purposes.



DONOR ADVISED FUNDS VS. PRIVATE FOUNDATIONS

Is a private foundation the best way to steward charitable dollars or would a transfer of assets into a donor advised fund be a wiser decision? Both are powerful ways to give and they do offer some common advantages such as:

- **Formalizes giving**
- **Immediate tax benefit for future giving – leaves time for thoughtful decision making**
- **Easy to donate to several charities from one vehicle**
- **Can be used to help teach philanthropy to children**
- **Keeps charitable strategies easier to implement during recessionary times**
- **Can exist in perpetuity**

While both are excellent vehicles for philanthropic giving they do differ both structurally and operationally. A private foundation is a wholly distinct, tax exempt legal entity governed by its own sets of bylaws, board of directors or trustees, articles of incorporation, etc. A donor advised fund is a charitable giving account that is maintained and operated by a section 501(c)(3) organization, known as a sponsoring organization. These structural differences result in these accounts being created and operated very differently. While not an exhaustive list, some of the key differences between donor advised funds and private foundations have been summarized in the chart below.

The choice in which form to choose should first be consistent with your financial goals as well as tax efficient based upon your individual or family income circumstances. Further, it is entirely possible that a private foundation as well as a donor advised fund together could provide the optimum solution. If you are interested in pursuing or learning further about these philanthropic giving options, please contact us.

	PRIVATE FOUNDATION	DONOR ADVISED FUND
Set up and Start up Costs	Requires IRS application and legal assistance. Can take anywhere from a few weeks to several months to create.	Typically no start up fees and can be opened with an account agreement from the sponsoring organization.
Remains under legal and financial control of the family	Yes - if the board chooses, legal and financial control can remain with the family for unlimited generations.	No - family never has legal control. Control resides with the fund's sponsors and the donor can appoint a successor.
Required to file state and federal filings	Yes - must file an annual 990-PF with the IRS and comply with other filing requirements.	No state or federal filings required for these accounts.
Ability to make grants to for-profit businesses or tax exempt entities that are not 501(c)(3)	Yes - provided they are for a charitable purpose.	No - only grants to 501(c) (3) charitable organizations.
Required distributions	Yes - the IRS requires an annual 5% minimum distribution based on the previous year's net average assets.	No - there is typically no minimum distribution requirement.
Control of grants and assets	Donors can deliver grants by mail or in person, have complete control of grantmaking and investment decisions.	Delivering a grant check in person is not an option. Donor may recommend grants and investments but the sponsoring organization makes all final decisions.
Provide scholarships and choose recipients	Yes - with IRS advance approval may provide scholarships directly to individuals. May also choose the recipients.	No - prohibited from making grants to individuals. Grant may be made to an organization that administers a scholarship program.
Privacy	No - form 990-PF lists all assets, contributors and grantees.	Yes - the donor may remain anonymous.
Tax deduction limits for gifts of cash	Up to 30% AGI	Up to 50% AGI
Tax deduction limits for gifts of stock	Fair market value up to 20% AGI	Fair market value up to 30% AGI

Source: National Philanthropic Trust

CONTINUED FROM PAGE 1: EXPECT THE UNEXPECTED

5. An increase in Business CapEx - With global overcapacity in certain industries, it is less clear how this initiative will play out. The current strategy appears to encourage multinational companies that are producing products for the U.S. end market to invest in facilities that would allow the assembly of those products in the U.S. This is an additive strategy from the current state, but if the proposed border tax is part of this solution, it would be perceived by global markets as a form of protectionism.

6. Banking Deregulation - To provide a sense as to how beaten down financial service stocks were in general prior to the election, as a group they traded at the lowest multiple of book value relative to the broad market since the late 1960s[3]. It is speculated that rolling back much of the regulatory reforms contained in Dodd-Frank is on the Trump administration's agenda. Combined with higher interest rates, a steeper yield curve, and a perception that loan demand will finally pick up, the fundamental back drop for banks and financial service companies has materially changed for the better.

7. Manufacturing Emphasis - A renaissance back to a revitalized U.S. manufacturing sector is a key component of the Trump Plan. The primary driver behind this mindset is the creation of good paying jobs for the U.S. middle class. There is a statistical wage premium for these jobs, as much as 20% versus comparable service sector jobs according to a public policy piece recently issued by the Wharton School[4]. Auto manufacturers in particular: BMW, Ford, Toyota , GM and Fiat Chrysler have all been in the President's crosshairs as he encourages them all to move away from low cost facilities south of the border.

Source: [3] Fidelity Q1 2017 Market Update
[4] Knowledge @ Wharton, Can Trump or Anyone Bring Back American Manufacturing, November 30, 2016

Policy Uncertainty and Execution Risk

If you examined the overall economic dashboard post election, you would have to come to the general conclusion, that the prospects for an improving business climate is on the rise. Confidence measures of the consumer, small business owners and CEOs have all moved up sharply in recent months. Policies to stimulate economic growth such as lower taxes, less regulation and in general a business friendly environment in Washington has many people much more optimistic about future economic growth. However, this optimism has to be tempered somewhat with a reality check on execution risk. Most of the above stated reforms address policies that have been years in the making and cannot simply be reversed over night. Most of these initiatives are political planks that have yet to be converted into actual executable strategies. As they say, "the devil is in the details".

Do we continue to be optimistic?, indeed. But the duration of time in which many of these items can be successfully implemented may be far slower than the perception by the market. Frankly, there are a handful of companies whose valuation multiples might suggest that anything other than instantaneous reform will be a disappointment. As a value conscious investor, we will continue to maintain the discipline to assess company specific risk and take the necessary action steps required to maximize the long-term value of our managed portfolios.

On a Personal Note

Its been a decade now in which my leadership team and I have attempted to fulfill David Vaughan's aspirational dream of building a firm " Built to Last". We are materially larger now than in 2006; in assets under management, number of clients, staff size and resources, but our primary motivation remains the same. How do we continue to build a firm that has a sustainable economic model, but also leverages our private ownership status and local presence to unequivocally take care of our job number one, the needs of our valued clients? This is a dynamic process, but just know that is our top priority and shall always be.

We are extremely pleased that Pierce Timko joined DVI as of 2016. (Jonathan) Pierce Timko received a Bachelor of Science degree in Business Administration – Finance from Stetson University and holds his CFA, CFP® and CWS® certifications. Prior to joining DVI, Pierce worked for both Charles Schwab & Co. and KCM Asset Management, most recently excelling in his role as a Senior Portfolio Consultant. His background also includes experience in Investment Analyst and Relationship Specialist roles.

As a Portfolio Manager in the Winter Park, Florida office, Pierce is responsible for the daily investment management of client portfolios, providing analyst coverage on specific industry groups, and participating as a member of DVI's Investment Committee.

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