DVI
DAVID VAUGHAN INVESTMENTS

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A Changing of the Guard

Tactical Investment Decision Making is Becoming Widespread

Investors have embraced the practice of managing downside risk through ongoing active portfolio decision making. The concept of tactical decision making is very appealing. Who wouldn't want their cake and eat it too? If executed to perfection, portfolio assets would be directed towards risk seeking asset classes and higher beta stocks when the market environment is positive, and assets would be re-positioned into gold, fixed income, and other defensive risk-free assets when storm clouds are seen forming on the horizon.

This practice is no longer described as market timing because statistics prove that very few active managers, if any, can add value through that approach. It really is being framed as a sophisticated risk management technique, leveraging both technology and complex economic databases to provide portfolio management direction. Investors are quite frankly clamoring for this type of solution. The psychological and financial damage that occurred to investors in 2008 and early 2009 is still fresh in their minds. They can ill afford another roller coaster ride of that proportion. They claim they are willing to forego some of the capital market's upside to be assured that they have significantly less downside risk.

(As an aside, I am always skeptical when Wall Street firms embrace strategies that: (1) have a receptive audience in battle weary investors and (2) result in high portfolio turnover and correspondingly greater revenue for Wall Street.)

What interests me is how investors will react when all of the advantages of tactical decision making in concept do not come to fruition in practice. 2012 may just be the year in which we find out. As analysts take stock of performance by active equity managers in 2011, it is clear that managers were caught off guard by the August market decline. They pared back their risk exposures at that time and as the market regained its footing in the final months of the year, they elected to maintain their bearish stance. As a consequence, they failed to capture the market's upside going into yearend and fell well short of their performance benchmarks. As tracked by JP Morgan and Bloomberg, they determined that 48% of active managers missed reaching their benchmark performance by at least 2.5% and 31% failed to achieve benchmark like returns by at least 5%.

Despite all of the hype and fanfare behind tactical decision making, DVI continues to maintain its historical position that strategic decision making over longer periods of time is often more effective, certainly more tax efficient and typically much more cost effective in managing capital market risk. In full recognition, this conservative time tested approach more or less softens portfolio volatility rather than eliminating it altogether.

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Route To:

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Is Diversification Dead?

Brian Christensen, CFA
Senior Vice President

During 2011, one of the more prevalent investment topics written about in financial publications has been the increase in correlations between asset classes and market sectors. Financial theory suggests portfolio diversification is achieved by holding investments that react differently to fundamental market data. When investment A zigs, investment B must zag if a portfolio is to be diversified. A consistent conclusion in many of those articles may best be summed up by David Kostin, chief U.S. investment strategist at Goldman Sachs. In a research note published last August, Kostin stated, "Record high S&P 500 and sector correlation poses a challenge for fundamental investors. Elevated correlation is generally considered a poor environment for long-only fundamental investors. In highly correlated sell-offs, the market does not discriminate based on company fundamentals, reducing the value of stock picking." Maybe so if your perspective is from 35,000 feet, but were Mr. Kostin to examine specific portfolio holdings and not generic asset classes his opinion might be different.

Table 1 shows correlations between several of the more recognized equity market indices for 2011. This is the 35,000 foot perspective. As you can see, the coefficients between all categories are close to 1 suggesting a high degree of correlation between each pair. Greater diversification exists when coefficients are closer to zero or, better yet, negative.

Table 2 looks at 2011 data from the sea-level or individual stock perspective. Clearly correlation coefficients between stocks at the portfolio level show meaningful diversification. Iona College professors Jeffry Haber PhD and Andrew Braunstein PhD, in their paper titled Examining the Role of Short-Term Correlation in Portfolio Diversification, conclude, "Individual products within an asset class are not created equal. Treating the returns of an asset class as representative of the returns of the underlying components could be erroneous. To be relevant, correlation should be calculated based on the returns of specific portfolio holdings, not generic asset class returns."

Table 1

	Russell 2000	MSCI EAFE	MSCI Emerging Markets	Goldman Sachs Commodity Index	S&P 500
Russell 2000	1.00	0.89	0.90	0.81	0.98
MSCI EAFE	0.89	1.00	0.82	0.76	0.94
MSCI Emerging Markets	0.90	0.82	1.00	0.87	0.84
Goldman Sachs Commodity Index	0.81	0.76	0.87	1.00	0.80
S&P 500	0.98	0.94	0.84	0.80	1.00

Data Source: Morningstar EnCorr

Table 2

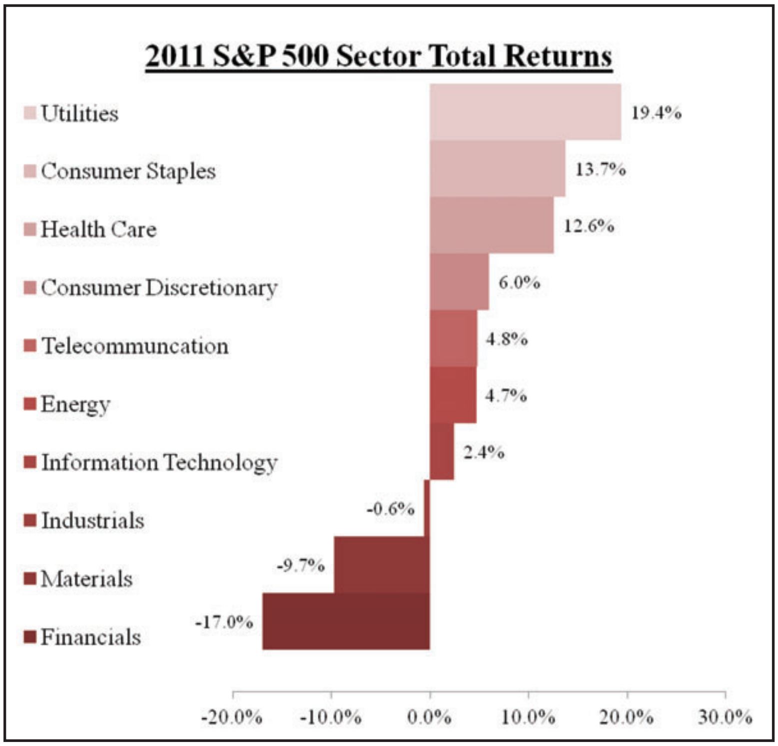
2011	AT&T Inc	American Electric Power	Baxter Int'l	Caterpillar	Colgate-Palmolive	General Electric	Exxon Mobil	Microsoft	Wells Fargo	McDonald's	S&P 500	Russell 2000	MSCI EAFE
AT&T	1.00	0.11	0.60	0.51	0.58	0.33	0.14	0.09	0.23	0.06	0.49	0.60	0.42
American Electric Power	0.11	1.00	0.11	0.09	0.75	-0.04	-0.12	-0.04	-0.13	0.63	0.15	0.13	0.04
Baxter International	0.60	0.11	1.00	0.04	0.38	0.27	0.08	0.02	-0.04	0.02	0.22	0.27	0.35
Caterpillar	0.51	0.09	0.04	1.00	0.22	0.68	0.66	0.53	0.66	0.20	0.93	0.95	0.82
Colgate-Palmolive	0.58	0.75	0.38	0.22	1.00	0.03	-0.22	0.09	-0.05	0.48	0.20	0.25	0.13
General Electric	0.33	-0.04	0.27	0.68	0.03	1.00	0.82	0.62	0.81	-0.36	0.85	0.76	0.87
Exxon Mobil	0.14	-0.12	0.08	0.66	-0.22	0.82	1.00	0.30	0.56	-0.32	0.76	0.68	0.75
Microsoft	0.09	-0.04	0.02	0.53	0.09	0.62	0.30	1.00	0.68	0.05	0.62	0.56	0.72
Wells Fargo	0.23	-0.13	-0.04	0.66	-0.05	0.81	0.56	0.68	1.00	-0.23	0.73	0.69	0.66
McDonald's	0.06	0.63	0.02	0.20	0.48	-0.36	-0.32	0.05	-0.23	1.00	0.10	0.19	0.00
S&P 500	0.49	0.15	0.22	0.93	0.20	0.85	0.76	0.62	0.73	0.10	1.00	0.98	0.94
Russell 2000	0.60	0.13	0.27	0.95	0.25	0.76	0.68	0.56	0.69	0.19	0.98	1.00	0.89
MSCI EAFE	0.42	0.04	0.35	0.82	0.13	0.87	0.75	0.72	0.66	0.00	0.94	0.89	1.00

Data Source: Morningstar EnCorr

Financial theory (and Mr. Kostin) has concluded that absent the ability to diversify an investment portfolio, active stock selection and portfolio management offers little value over indexing. Table 3 provides a glance at economic sector returns of the S&P 500 for 2011, a 10,000 foot perspective.

Again, a deeper evaluation into the components of an asset class return reveals a different conclusion. When the range of equity sector returns spans more than 35%, opportunity for value added by active management remains alive and well. Long live diversification and the value of active portfolio management.

Table 3



Data Source: Thomson Baseline

2012 Tax Law Changes and Pension Plan Limitations

Effective January 1, 2012, personal exemptions and standard deductions will increase slightly, tax brackets will widen, and workers will be able to save more for retirement, thanks to inflation adjustments by the Internal Revenue Service. By law, the dollar amounts for a variety of tax provisions must be revised each year to keep pace with inflation. As a result, several tax benefits, affecting virtually every taxpayer, are being adjusted for 2012. Some of the highlights include:

- Elective deferral (contribution) limits in 401(k) and 403(b) plans increased from $16,500 to $17,000
- The amount of each personal and dependent exemption is $3,800, up $100 from $3,700 in 2011.
- The standard deduction is up slightly. For singles, the basic deduction amount for this year is $5,950, up from $5,800 last year. For married couples, it is $11,900, up from $11,600 in 2011. There are additional amounts for those who are 65 or over, blind, or both.
- Federal income tax bracket thresholds increase for each filing status. To give an example, for a married couple filing a joint return, the taxable income threshold separating the 15% bracket from the 25% bracket is $70,700, up from $69,000 in 2011.
- The contribution amount allowed for Roth IRAs begins to phase out for joint filers with incomes exceeding $173,000 (up from $169,000) and $110,000 (up from $107,000) for singles and heads of households.
- The annual contribution limit for most defined contribution plans rises to $50,000, up from $49,000 in 2011.
- The limitation on the annual benefit under a defined benefit plan is increased from $195,000 to $200,000.

Other limitations that remain unchanged include:

- The deductible amount for an individual making qualified retirement contributions remains unchanged at $5,000.
- The catch up contribution limit for those ages 50 or older remains at $5,500 for 401(k) and 403(b) plans and $1,000 for individual retirement accounts.
- The limitation regarding SIMPLE retirement accounts remains unchanged at $11,500.

Source: Internal Revenue Service

A Changing of the Guard

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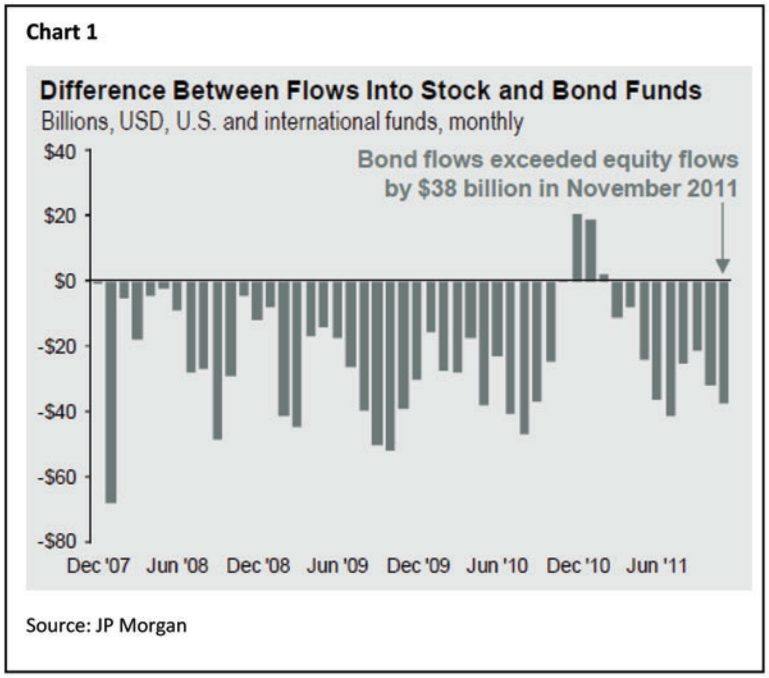
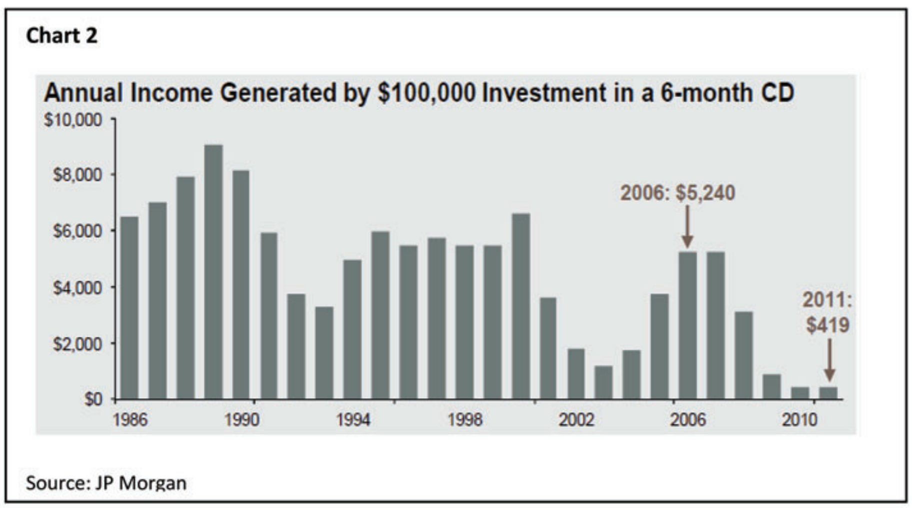
Investors Continue to Shy Away from Traditional Equity Markets



Over the past three years, the S&P 500 Index has achieved double digit rates of growth, generating annualized rates of return in excess of 14% per year. Traditionally, in the past, investors with money sitting on the sidelines would become increasingly dissatisfied with money market and/or fixed income rates of return and would slowly work their way back into the common stock market. As evidenced by Chart 1, other than a brief window of time in late 2010 and early 2011, investors continue to prefer fixed income investment vehicles over common stocks.

Historically Low Short-Term Interest Rates Should also be a Catalyst for Change

Chart 2 graphically depicts the meager amount of income being generated by short-term cash investment vehicles. The 2011 figure of $419 is 92% less than what was paid just 5 years ago. Also, many would suggest, based upon the current mindset of the Federal Reserve Board, that though rates might creep higher we should not anticipate any material change in the near future. It is hard for me to believe that investors will continue to maintain large balances in safe haven investment vehicles if capital markets show signs of being on the mend.



Dividend Paying Common Stocks

Though the merits of investing in large capitalization, high quality, dividend paying common stocks is not new to DVI, this approach is reappearing once again on the radar screens of investment strategists on Wall Street. It is one solution that not only addresses the real income needs of investors, but it also recognizes the necessity to propose strategies that maintain a lower risk profile. It is nice to see that a strategy that was once viewed as old-fashioned, conservative and out of sync is now once again being viewed as a prudent approach towards managing long-term assets. However, at DVI our comfort level is much higher when we are being described as "behind the curve, investment dinosaurs, stuck in our ways" as that generally means we are once again well positioned for the future. 2011 certainly demonstrated to our clients the merits of staying the course and sticking to our knitting and we aim to replicate this success in 2012.

Will Williams
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