DAVID VAUGHAN INVESTMENTS, INC.

QuarterlyPerspective

Spring 2008 • Vol. 15, No. 2

IT COMES DOWN TO CONFIDENCE IN THE FUTURE

Time is running out in this decade for the U.S. equity market to recover from what is becoming the worst performance period since the 1930s. If you take into account inflation, real rates of return are now running negative for the decade-to-date, suggesting investors are losing purchasing power to the tune of about 2.44 % per year. (See Table 1)

Table 1

An Evaluation of Real Rates of Return

ANNUALIZED % RATE OF RETURN

	S&P 500	US Inflation	S&P 500 (Inflation Adjusted)
1930s	-0.05%	-2.05%	2.00%
1940s	9.17%	5.41%	3.76%
1950s	19.35%	2.20%	17.15%
1960s	7.81%	2.52%	5.29%
1970s	5.86%	7.37%	-1.51%
1980s	17.55%	5.09%	12.46%
1990s	18.20%	2.93%	15.27%
2000s	0.40%[1]	2.84%[2]	-2.44%
1/1930-3/2008	9.76%	3.27%[2]	6.49%

[1] For Period Ending 3.31.08

[2] For Period Ending 2.29.08

Source: Morningstar, Inc.

Those that have adopted a pessimistic view might suggest this performance is indicative of a domestic economy in shambles or caused by the perceived declining stature of the United States in the global economy. What is interesting however, despite news reports to the contrary, is that both corporate earnings and Real GDP growth for the decade to date are not materially different than what we enjoyed in the prosperous 1990s. **Corporate earnings** for the constituents of the S&P 500 Index are currently running at an annualized rate of approximately 7% per year versus nearly 7.50% per year in the prior decade[1]. The nation's economy grew at a rate of approximately 3% per year in the 1990s, while in this decade, through the end of 2007, **Real GDP** growth has come in about 2.9% per year[2]. So if it isn't the underlying economics, what is causing this long period of underperformance?

In recent years, there has been much hoopla and substantial dollar flows into foreign markets predicated on several factors: 1) the growing percentage of economic growth outside of the U.S., 2) a strong consensus that the U.S. dollar will continue to weaken and 3) recent strong performance in excess of other equity market alternatives. What came as a surprise was the fact that international equity market returns, as represented by MSCI EAFE (Europe, Australia and the Far East) in local currency terms provided a rate of return nearly identical to that of the S&P 500. The decline in the dollar only provided a modest return advantage to U.S. investors. (See Table 2)

(continued on page 4)

Table 2

International Equity Markets - % Annualized Rates of Return

	MSCI EAFE (Local Currency)	Impact of $ Decline	MSCI EAFE (in $US)
2000s[1]	0.64%	3.55%	4.22%

[1] For Period Ending 3.31.08

Source: Morningstar, Inc.

ROUTE TO:

☐

☐

☐

INSIDE

DVI Associate Spotlight

LISA C. PROCTOR
Accounting & Operations Assistant

Lisa joined David Vaughan Investments in June 2007. She is a graduate of Pekin Highschool and has taken general studies classes at Illinois Central College.

Prior to joining DVI, Lisa was Lead Teller and Personal Banker at BankPlus. As Lead Teller, she supervised the tellers, oversaw day to day operations of the bank's teller department, handled transactions and customer concerns and was responsible for vault and ATM balancing. Lisa also has several years of experience as a casino dealer and dual rate supervisor, where she was responsible for large monetary transactions and enforcing strict casino policies and procedures according to Gaming Board regulations.

Lisa's extensive experience in banking and regulatory policies, as well as her commitment to customer service has been valuable to DVI in her role as accounting and operations assistant. She is fundamental to the investment accounting process where she posts and reconciles accounts on a daily, monthly and quarterly basis. She also is responsible for generating client reports for meetings and our clients' quarterly report packages. In addition to these duties, she also assists with various firm sponsored client events and educational forums and provides back up support to our front office with client and prospect interaction.

Lisa lives in Peoria with her husband and young daughter. In her free time she enjoys decorating her home, entertaining and spending time with family and friends. She also is very involved with her daughter's activities, which include soccer and t-ball.

Please feel free to contact Lisa directly at Lisa@dviequity.com or (309) 685-0033 x31 on any of the matters listed above.

Federal Reserve Intervention in the Financial Markets

The month of March proved to be a very active time for Federal Reserve intervention in the financial markets. The table below lists recent steps taken to improve market sentiment and begin the process of resolving the current credit crisis.

Recent Government Actions

March 11:	Fed announces the Term Securities Lending Facility (TSLF), a swap of Treasuries for other collateral with primary dealers.
March 16:	Fed announces the Primary Dealer Credit Facility (PDCF), a lending facility for primary dealers, accepting various types of collateral, including mortgage- and asset-backed securities.
March 18:	Fed cuts the fed funds rate by 75 basis points, to 2.25%
March 19:	Fannie Mae and Freddie Mac capital surplus requirements are cut to 20% from 30%.
March 24:	The Federal Home Loan Banks' leverage requirements are increased.

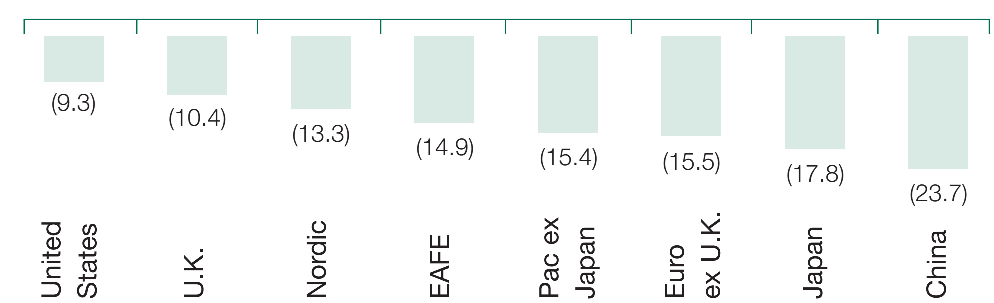
Not surprisingly, the underlying theme of the above is housing and mortgage related. Is the crisis over? Probably not. But, the change in Fed policy to allow primary dealers to use mortgage and asset-backed securities as collateral was significant. I sense risk aversion has started to normalize as implied by yield spreads between various fixed income securities moving toward more typical ranges.

As seen in the chart above, the U.S. equity market has outperformed most other developed markets in the first quarter. Is this a vote of confidence in the Fed's ability to manage the crisis and restore normalcy (whatever that might be) to U.S. markets? Probably so. The central banks of our foreign trading partners have not been as proactive as the Fed in easing credit conditions in their economies.

Economist Ed Yardeni of Yardeni Research identified sixteen financial crises between 1960 and today where the Fed responded with reductions in the Fed Funds target rate. Those events included the Cuban Missile Crisis in 1962, the failure of Franklin National Bank in 1974 (the 20th largest U.S bank at that time), Mexico debt default in 1982, failure of Continental Illinois in 1984 (the 7th largest U.S. bank at the time), the S&L crisis in 1990, Long-Term Capital Management collapse and Russian debt default in 1998, World Trade Center attacks in 2001 and today's sub-prime mortgage meltdown. In each instance, the Fed took proactive steps to reduce interest rates and provide the necessary liquidity to the financial markets. No question the process is painful, but historically the outcome has been rewarding. Over the time period examined by Mr. Yardeni, the S&P 500 Index returned an annualized 10.51%. One more example of why you "Don't Fight the Fed."

Brian A. Christensen, CFA
SR. VICE PRESIDENT AND CIO

Equity Market Year-to-Date Performance (Local Terms)



Note: Total returns from December 31, 2007 to March 31, 2008.

Source: MSCI Inc., FactSet Research Systems Inc.; Bear Stearns & Co. Inc.

The Dreaded R Word

Recession. If you are like us at DVI, you probably heard the word mentioned from time to time last year as the U.S. housing market showed signs of weakness. During the first quarter of this year, it became virtually impossible to turn on the news without hearing a political candidate or news anchor bemoaning the fact that our economy is either in or headed toward a recession. As we've been fortunate to only have had two recessions in the United States over the last 25 years, many investors aren't clear on how one in 2008 would affect the stock market. An examination of historic stock market returns in other periods of recession should help guide our expectations.

To begin with, many people are confused as to what a recession truly is. The most widely accepted definition of a recession is a period of two or more consecutive quarters of negative economic growth as measured in the country's Gross Domestic Product (GDP), or better said a decline in the value of all goods and services produced in the country. Given that GDP growth came in at +4.9% in the 3rd quarter of 2007 and +0.6% in the 4th quarter of 2007, it is still not definitive that we are currently in a recession. Even so, weakness in economic data throughout the first three months of this year has many predicting we will see a U.S. recession in 2008.

If that is the case, what does that mean for the stock market? Looking back through history, there have been nine official recessions in the U.S. since 1953 as determined by the National Bureau of Economic Research (NBER). The table below lists these nine periods and the performance of the S&P 500 around these times. You can see in the second line of data in this table that the average peak to trough loss in the S&P 500 around each recession is about 25%, while the median loss is about 20%.

But as you can see in the first line of data in the table, it is important to remember that the stock market usually begins to discount a possible recession well before it occurs. In fact, over the last nine recessions, the peak in the stock market had typically occurred four to five months before the recession officially began (as judged by the NBER). Thus, if we do see a recession in 2008 and the typical stock market peak to trough decline, one would not expect a 20-25% drop in the stock market from current prices. Rather, one would expect a drop from the prices at the peak of the market in October of 2007. As we've already seen a 20% drop in the S&P 500 from the peak on October 11th to the low on March 17th, there is a reasonable chance that we've already seen the worst of the market's decline this year even if the economy does indeed slip into a mild recession in 2008.

The obvious risk the stock market faces from current levels is if we see the type of peak to trough declines that occurred around the 2001 (36.5%) or mid 1970's (48.2%) recessions. Our view is that a mild recession similar to 2001 won't lead to the market losses of that period because stock valuations back then were much higher following the infamous technology bubble that mounted prior to that recession. We also believe a long, drawn out recession similar to the mid 1970's is unlikely given the government's aggressive actions to stimulate the economy in response to the recent weakening conditions. □

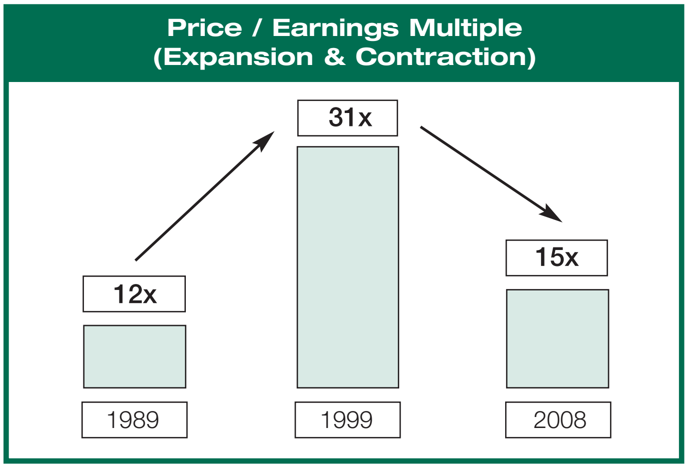
Stephen K. Hinrichs, CFA
PORTFOLIO MANAGER

Recession Dates	Aug '53- May '54	Sept '57- Apr '58	May '60- Feb '61	Jan '70- Nov '70	Dec '73- Mar '75	Feb '80- Jul '80	Aug '81- Nov '82	Aug '90- Mar '91	Apr '01- Nov '01	Average	Median
# of Days S&P 500 Peaked Prior to Recession	147	38	188	160	225	2	170	12	145	121	147
% Loss from S&P 500 Peak Prior to Recession to S&P 500 Low During Recession	-14.8%	-20.5%	-13.9%	-34.7%	-48.2%	-14.7%	-27.1%	-19.9%	-36.5%	-25.6%	-20.5

Source: Citigroup

CONFIDENCE *(continued from front page)*

Chart 1



If the economic fundamentals and global markets march in lockstep with the U.S., what else can explain these trying times? I would argue that you should look no further than investor confidence as the primary culprit, and the easiest way to gauge investor optimism or pessimism is to monitor the Price/ Earnings (P/E) multiple of the market. As the chart above depicts, investors were willing to pay 12 times earnings for stocks at the end of the 1980s and by the end of 1990s investor optimism had increased so substantially that market valuation had expanded 2.5 times to nearly 31 times earnings. Since the market peak, we have experienced the Enron bankruptcy and other corporate scandals, the Terrorist Attack on September 11th, the War in Iraq and just recently the housing related banking crisis. All of these events have one by one shaken investor confidence and as such, market multiples have contracted by over 50% to 15 times 2008 earnings. It appears that most of the excess of the late 1990s has been removed from the market and we are now back to more reasonable valuation levels.

In the current market environment, it might be viewed as overly optimistic to forecast future rates of return that would once again approach the nearly 10 percent average annualized return experienced over the past nearly eight decades. However, with dividend yields now hovering around 3 percent and if we can achieve a reasonable earnings growth rate, a 7 to 8 percent return assumption, as David Vaughan would say, is "not so wild a dream". ☐

Will Williams
PRESIDENT

[1] Assumes Forward S&P 500 Earning in 2008 of $ 93.90. Source: Baseline
[2] Source: Decision Economics

Supreme Court Ruling on Investment Advisory Fees Will Impact Trusts and Estates

Karl Kuppler
Hasselberg, Rock, Bell & Kuppler LLP

In a January 2008 unanimous ruling, the United States Supreme Court held that investment advisory fees paid by a trust or estate are deductible only to the extent that they exceed 2% of the trust's adjusted gross income (AGI). The ruling and the regulations which the IRS is in the process of issuing on the subject will change the way many professional trustees charge their fees and will increase the tax burden on many trusts and estates and their beneficiaries.

By way of background, the Internal Revenue Code allows a miscellaneous itemized deduction only to the extent that the total of such deductions exceed 2% of AGI. This rule, which makes such expenses largely nondeductible, has applied to individuals for several years. The rule also applies to trusts and estates, but does not apply to costs incurred in the administration of the trust or estate which wouldn't have been incurred if the property wasn't held in the trust or estate. Most tax preparers had previously taken the position that investment advisory fees were fully deductible against the trust's income, and this was the taxpayer's argument before the Supreme Court.

In its decision, which involved a trust created by a gentleman named Rudkin, who was the founder of Pepperidge Farm, the Court held that the exception applies only to costs which would be uncommon or unlikely for an individual to incur. Trustee or executor fees are the obvious example. Since many individuals pay investment advisory fees on their investments, the Court found that such fees are not uncommon and therefore are subject to the 2% floor.

In 2007, the IRS issued proposed regulations which held that investment advisory service fees are subject to the 2% floor. Under the proposed regulations, trusts or estates which pay a single fee that includes both trustee fees and investment advisory fees (as has been common under most bank trust company fee schedules) would be required to use a reasonable method to allocate the single fee between the two types of costs. It has been suggested that banks and trust companies will be forced by these regulations to change (unbundle) their fees. The IRS is expected to issue final regulations consistent with the Rudkin decision. The Service has recently issued a Notice (2008-32) that it will not require unbundling of fees for tax years beginning before January 1, 2008. Therefore, tax returns for 2007 and before do not need to address the issue. However, it appears that for 2008 and beyond, investment advisory fees will need to be unbundled in order to provide clarity in determining the fully deductible portion. ☐