

# KIELY WEALTH ADVISORY GROUP, INC.



From Left To Right: Joe Kiely, Scott Below, Katie Burr, Brownie Cordell, and Kellie Kiely

## BEHIND THE SCENES

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### OPENING THOUGHTS

Although this probably isn't news to you at this point, the third quarter of 2011 was the worst quarter in nearly three years—and for most investors the extreme volatility over the final few weeks probably made it feel even worse than it really was. The quarter began innocently enough, with a mild rally in July that brought the indexes close to yearly market highs. But as July wore on, the prospects of a possible U.S. default and the acute political dysfunction on display in Washington over the debt ceiling were foremost in the minds of investors, leading to rising volatility and a modest downturn in stocks. Frankly, we were surprised how well the stock market was behaving at the time, given the ominous tone of many news reports. Strong corporate earnings reports no doubt played a role, as they continued their trend of outpacing analyst expectations.

August ushered in new challenges on several fronts, beginning with an extremely hostile political battle over the debt ceiling, which ultimately led to the controversial S&P downgrade of U.S. debt. After adding renewed fears of a potential default in Greece into the mix, it became too much for a number of short term oriented investors to withstand, and we experienced a broad sell-off across the globe along with a sharp spike in volatility. Even so, the second half of August saw a nice rally in both large and small cap stocks, serving to partially offset earlier losses. Given the continued encouraging news regarding corporate profitability and the fact that the debt ceiling was finally raised (as promised), we hoped the worst was behind us.

#### A Bloody September

The financial news in September was primarily focused overseas, on four interrelated items. Specifically, market participants were concerned about:

1. The conflict and dysfunction being exhibited in the European political system.
2. Europe's anemic and fragile recovery and the prospect of economic contraction.
3. The surprising lack of European exports to growing economies.
4. The potential for default by Greece and the group of countries known by the intentionally unflattering acronym "PIIGs" (i.e. Portugal, Italy, Ireland and Greece).

The troubles in Europe were compounded by a few weaker-than-expected economic reports out of the states. Midway through September, the major stock indexes were essentially unchanged, which we again attributed to the encouraging earnings numbers U.S. corporations continued to post. Then, as we noted in our September monthly update, an

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interesting thing happened. The news out of Europe actually improved...while the global securities markets began a dramatic sell-off.

### **The Numbers**

Overall, the S&P 500 index (large stocks) was off 7.2% for the month of September, while the Russell 2000 index (small stocks) was down 11.4%. Over the quarter, the S&P fell 14.3% and the Russell 2000 dropped 20.6%. Year-to-date, through October 31, the S&P 500 was down 10% while the Russell 2000 was down just over 16%. The third quarter's sell-off was seemingly as ubiquitous as it was painful, with every one of the 33 equity fund sectors tracked by Lipper finishing in negative territory for the quarter (including gold funds). The average U.S. stock fund lost 17.9% during the quarter and of the 8,222 U.S. stock funds tracked by Morningstar, only nine finished the quarter in positive territory (with the largest quarterly gain among them being just 0.4%). Although we know such drops are concerning to many investors, we couldn't help but feel like the sell-off was driven more by fear and computer flash trading versus something more fundamental, like earnings.

Given the problems in Europe, it's not surprising that foreign markets generally fared even worse. Just 3 of the 94 country-specific indices tracked by Bloomberg reported positive returns for the quarter (Venezuela, Tunisia and Jamaica) and the average international stock fund on Morningstar (3,900+ funds in all) lost 20.3% during the quarter. The sell-off clearly sent many panicked short run oriented investors clamoring for the exits, with more than \$60 billion pulled out of U.S. stock funds, which simply added more fuel to an already sizable conflagration.

### **Looking Forward**

Amid all of the negativity at the end of the quarter, many investors are left wondering whether the markets can find the road back into positive territory? Given current (and expected future) corporate earnings and cash flows, we believe it's not so much a matter of "if" we'll return to the highs we saw last April, but "when." So while we hate to see our clients (and their portfolios) go through periods like this, we recognize that markets are sometimes emotionally driven in the short-run. When one includes computer trading into the mix, it's clear that rapid sell-offs, like we saw over the latter part of September, are now an inevitable part of the stock investing landscape. For long term investors, these inevitable dips (which are exacerbated by computer driven flash trading) provide great opportunities. Think about this logically: If corporate earnings and cash flows are growing,

does it make sense that every sector of the stock market went down and the average stock lost 17% over the course of a few months? Of course not! This is why we believe valuations are currently quite favorable for stock investors and why we feel the long-term prospects remain excellent. This may seem counterintuitive to many market observers. However, we'd like to provide a gentle reminder about what we're actually purchasing on behalf of our clients, which often gets lost amid all of the negative noise during these inevitable volatile times. Let's be brief...

1. We are NOT investing in a dysfunctional government.
2. We are NOT investing in our governments deficit.
3. We are NOT investing in an unemployment rate.
4. We are NOT concerned with short run price changes.
5. We ARE investing in profitable companies.
6. We ARE doing so through the use of the best managers.
7. And, we ARE long term investors.

So, for those of you who are concerned, please try not to lose sight of what we're investing in. We're buying profitable companies...not negative headlines. That said, we believe it's likely that there will be more volatility ahead because, as we've seen in the past, once fear and panic enter the picture they generally like to stick around a while.

### **Good News?**

The good news is that sell-offs driven by investor emotions (i.e. fear and panic) are always temporary in nature, thereby creating unique investment opportunities for patient investors. Even though the past quarter was a difficult one for our portfolios and our clients, it certainly doesn't mean we will revisit the lows of March, 2009. Nor does it mean we are abandoning our prudent, research-driven investment strategies which work well over time.

To provide some perspective, if we look back to the lows experienced in March, 2009 (including the most recent third quarter correction) the S&P 500 is still 70% above its previous low and the Russell 2000 is up over 90%. It should be clear that the key to weathering corrections like the one we've just been through is to avoid getting caught up in the emotions of the moment.

As we've said from the outset of the mortgage crisis, economic recoveries from credit-driven recessions are typically long, drawn-out affairs with numerous setbacks. However, even with the inevitable setbacks that have occurred over the last few years, the general direction continues to be up. With today's computer-driven stock exchanges, significant moves (in both directions) occur more rapidly than ever before, meaning increased volatility (in



both directions) is here to stay. However, as we have stated a number of times, we can largely mitigate the effects of the volatility and even use it to our advantage, if we: 1) Remain patient, 2) Stick to our long term investment plans, 3) Use dips wisely, 4) Keep our emotions in check, and 5) Look for the inevitable new opportunities that volatility creates.

In this newsletter, we'll explain why we believe long term investors need to keep a significant portion of their portfolios in equities and why we think increasing our exposure to equities at this juncture is a more sensible response than decreasing it. Look, we recognize that the third quarter was a difficult one, and we are well aware that the volatility unsettled many investors. However, as is generally the case, volatility also creates some very attractive opportunities that savvy long term investors can capitalize on.

Of course, there is also a reason why we build diversified portfolio's that include a fixed income component. During these inevitable volatile periods, we use our bond funds to provide a stable stream of income and stability to our overall portfolio mix. At the end of this newsletter, we'll examine the bond funds we use; fixed income opportunities that exist; and the overall bond market. In the meantime, the biggest opportunities today exist in the stock market - so take a minute to get settled into a comfortable chair, mix up your favorite drink, and enjoy the next section on market opportunities.

## OPPORTUNITY KNOCKS

At Kiely Wealth Advisory Group, we believe significant value can be gained from looking at a diversity of opinions and research on any given economic topic. To that end, we seek out as many different views on important topics as we can find—in order to both challenge our own views and to gain as broad a perspective as possible. Given our alliances with both practitioners and academics in the investments field, we have access to a wealth of high-quality research and a wide variety of disparate viewpoints, and we seek to leverage these to their utmost for the benefit of our clients.

What follows is our aggregate view of the data, research, and opinions we've been both generating and analyzing, across a wide range of important topics in finance and economics. The subjects range from macro views of the global economy, to more narrow examinations of

corporate America's prospects. Please recognize that this analysis is generally presented from the perspective of long term equity investor which, when it comes to equities, is what we are. Please also recognize that a long term perspective can differ greatly from the one you might get from the media, which generally focuses on the "crisis" of the moment.

### The Economy

Over the last few months there has been a great deal of speculation over a potential double-dip recession. We believe much of this is based on a worst-case scenario of how the European debt crisis, domestic GDP growth, and unemployment situation will play out. However, at the risk of annoying our readers by repeating ourselves, we know that credit-driven recessions tend to be long, drawn-out affairs characterized by sluggish economic growth, and are subject to numerous setbacks over their lifecycle. Thus, periods where the economy sputters are to be expected and should therefore come as no surprise. In fact, you may recall that just last year we experienced a third quarter slowdown and market correction, only to see it followed by an uptick in economic activity in the fourth quarter and a nice year-end rally in the stock market.

Based on our analysis, the data suggests that the economic expansion continues to progress and, in some cases, even exceed expectations. For example, the Chicago Purchasing Managers Index (PMI) surprised significantly on the upside (again) in September. Estimates had called for a dip from 56.5 to 55.4, but the index rose to a fairly robust 60.4, where a reading of 50 is the threshold between expansion and contraction. Separately, spending on construction projects rose unexpectedly; retail sales surprised on the upside; and durable goods orders once again came in stronger than expected. In addition, non-defense capital goods orders, considered a proxy for business investment, increased 1.1% in September. This all comes on top of a new GDP report which revised the previous quarter's GDP growth upward, with exports, government spending, and the consumer collectively driving the gains.

In addition, consumer spending and saving have both continued to expand this year, which may seem implausible to many, given the high level of unemployment. However, we've been experiencing steady gains in both total hours worked and personal income levels for several years. This is because, while the unemployment rate remains stubbornly high, temporary jobs, the number of hours worked, and income levels have all continued to grow steadily, and this is a trend we think will continue for some time.



As a result, we believe the data suggests that it is unlikely the U.S. will enter a recession anytime in the near future. We believe the economy, while far from robust, is not as weak as many believe. That said, it also seems doubtful economic growth will be strong enough to reduce the unemployment rate in any meaningful way for quite some time, which is especially troublesome for those looking for work. Overall, we think the economy will probably continue to muddle through for several more years, as we continue to transition away from an economy that was once driven by the expansion of debt. Winding down debt levels is a slow process and there are no magic bullets or quick fixes. We are making progress, however, and continue to be headed in the right direction. For example, we already know corporate balance sheets are pristine. However, many people will be surprised to learn individual balance sheets have improved almost every month for almost two years now.

### **The Federal Reserve's Operation Twist**

After a few weeks it appears the Federal Reserve's "Operation Twist" may be much more powerful than what we originally expected. In fact, many strategists now believe the Fed's new tactic may provide more punch for both the bond and stock markets (long term) than QE2, its predecessor. The Fed's plan is actually quite basic and straightforward, aiming to sell \$400 billion of shorter term Treasuries (maturing in anywhere from in three months to three years) and using the proceeds to buy longer term Treasuries. The increased demand on long term Treasuries will raise their price, thereby driving long term interest rates down. The net effect is that since the announcement of the plan, long term rates have fallen across the board. For example, 30-year mortgages now stand below 4% for the first time on record, which has stimulated a rush of refinancing. This is a significant positive for the economy because with lower monthly mortgage payments, consumers who have refinanced will have more money to spend on other things. When you combine this with steadily increasing income levels, it's clear consumer spending will slowly grow over time.

Another aspect of lower long-term rates is an increased incentive for businesses to borrow and expand at a lower cost of capital. In fact, many analysts initially thought operation twist would have a relatively limited impact on the economy, however Barclays, Credit Suisse, and Goldman Sachs all now estimate that its financial impact will be equal to or greater than that of QE2, which spawned a significant stock market rally. Even though the plan has not been implemented yet, we've already seen long term rates

move down significantly in anticipation. As the Fed begins to actually buy up longer term debt, the expectation is that long rates could go even lower.

A final impact of operation twist can be thought of as the financial market equivalent of osmosis, whereby money tends to move from lower yielding assets to higher yielding ones. Just like those molecules you learned about in high school biology, over the last few weeks investors have been buying fewer Treasuries (with lower yields) while increasing their purchases of corporate bonds, municipal bonds, mortgage bonds, and stocks. This is precisely the reaction the Fed was trying to achieve, and based on the rally we've seen over the first few weeks of October, it may be working even better than expected.

### **Insider Buying**

One of the best leading indicators of future stock performance has long been insider buying activity. Insider buying occurs when corporate insiders - who include officers, directors and the largest shareholders - buy shares of stock in their firm. Insider buying (not to be confused with "insider trading", which is illegal) must be reported to the SEC, making the activity public information that non-insiders can then use in making their own investment decisions. To keep corporate insiders from having an unfair advantage over ordinary investors, they are required to hold the newly acquired shares for a minimum of six months and usually hold them for much longer. We first saw corporate insiders begin to step up and buy heavily during the sell-off this past August and they became even more bullish throughout the September sell-off, which is a positive sign.

According to Vickers Weekly Insider Report, the ratio between insider selling and insider buying over the last four decades has averaged somewhere between 2-to-1 and 2.5-to-1, with ratios below that point considered bullish indicators for the stock market. The average ratio over the last eight weeks (multiple week ratios are used to smooth out the week-to-week volatility) is now down to roughly 1-to-1. This is the lowest level since early 2009, just before the bull market run that saw the market averages essentially double in less than two years. In other words, the "smart money" has doubled the amount of their buying (versus selling), which clearly indicates they believe the shares of their own firms are significantly underpriced.

So unlike individual investors, who have been running away from equities in recent months, insiders are buying instead. Not only that, but our research indicates they are concentrating their buying activity on the days when the



market is down by the largest margins, which is “Basic Investing 101” in practice—buy low, sell high. We think all those investors who have been bailing out of stocks recently should maybe take a harder look at what the best informed investors on the planet, (i.e. the corporate insiders), are doing. After all, no one has a better handle on what their companies are actually worth than they do. Research shows that paying attention to what the “smart” money is doing has generally been a wise move—and it just so happens that the smart money, including Warren Buffett, has recently been indicating stocks are really cheap.

**Investor Sentiment is at Panic Levels**

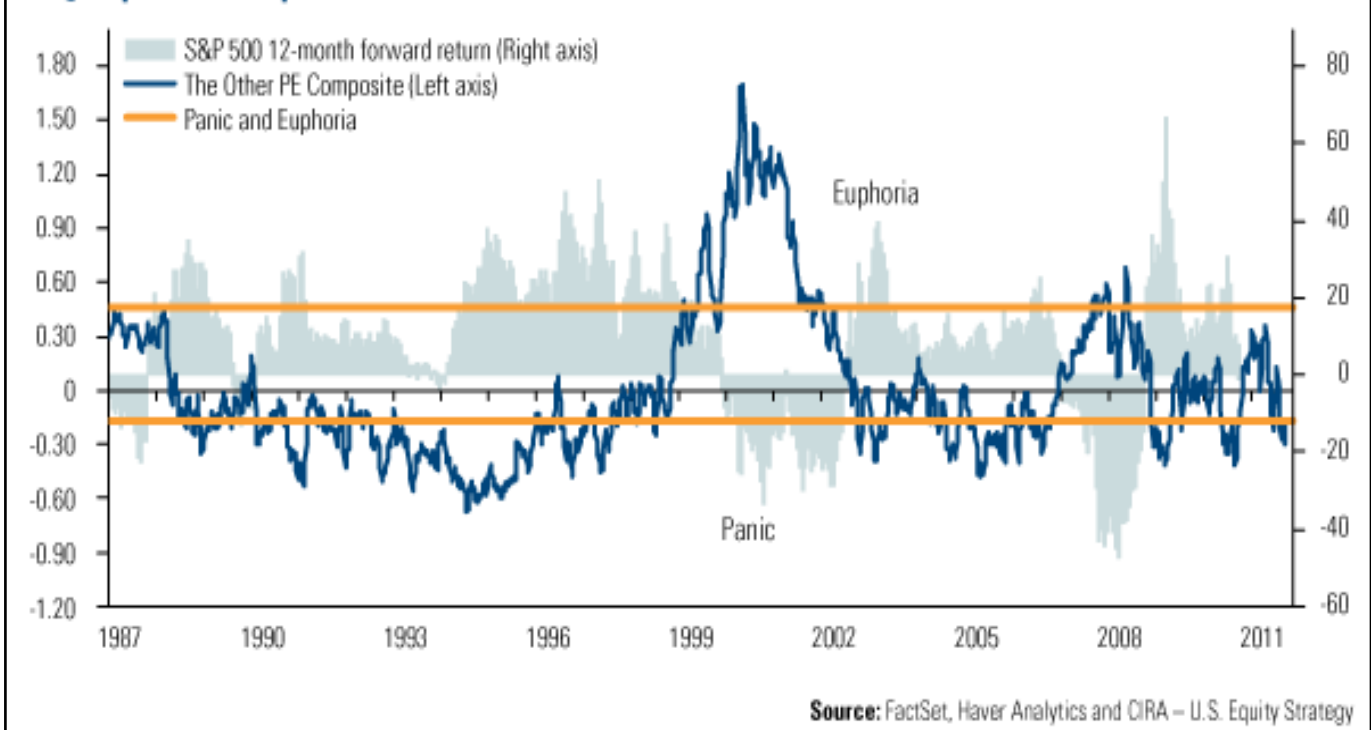
Investors are always looking for leading indicators to help predict future market moves and we think one of the more interesting ones is the indicator developed by Citigroup, which attempts to measure the levels of fear and greed in the market. They call it the Panic/Euphoria model, and it’s a proprietary combination of nine measures of investor psychology and fund manager actions. Historically, overly bullish territory (Euphoria) has generally signaled an impending market correction, while excessive pessimism (Panic) has generally preceded strong market rallies. As you can see in the chart below, the indicator has been in “panic” territory since mid-August.

According to Citigroup, the current level of panic, “... generates a near 90% chance of higher equity prices in six months and a 97% probability of teen-like gains in the next 12 months.” On average, the market bounce in the six months following the indicator reaching the panic stage has been 8.9%, and in the subsequent 12 months the market has gone up an average of 17.3%. It’s worth pointing out that gauging investor sentiment isn’t an exact science. However, Citigroup says the current level does send a “fairly clear contrarian message of opportunity.”

In the past, we have also commented on a similar indicator—consumer confidence. In a handout provided at our 2009 client dinners, we showed how the markets tended to rally when consumer confidence is at or near its lowest point. Over the past few months, we’ve seen consumer confidence approaching levels last seen in late 2008, and just recently it has started to look like it’s starting to rise. Putting these two indicators together, we think they sends a pretty strong signal that emotions have helped drive the market to oversold levels, suggesting we may well be due for an upswing.

Psychological indicators, like the ones above, aren’t the only bullish signals out there. Financial ratios have also long been used as leading indicators, and at present they seem to be pointing in the same direction as the psychological indicators.

**Citigroup’s Panic/Euphoria Model Shows Markets in a Panic**





### Price-Earnings Ratios

Investors seeking evidence that the stock market is on sale have long used financial ratios as their primary guide. Since we know the current “price” of an asset is one of the most important determinants of what the future “return” of an investment will be, it follows that an asset’s relative price should be an informative metric for investors, and a significant body of research bears this out. As a result, we examined the historical record to see what we might reasonably expect as a “rate of return” going forward from here, given current stock market valuations. We used the S&P 500 index for the analysis because it’s the index for which we have the most complete historical data (going all the way back to the 1930’s).

Specifically, we analyzed the 10-year forward-looking returns for various 12-month trailing Price/Earnings (P/E) multiples. As of the end of September, the P/E ratio for the S&P 500 stood at 12.9 times earnings, which is well below the long-term historical average of 16.9 times. Historically, we also found that the S&P500 index has tended to generate above average returns in the following 10-year periods where the P/E ratio was in the 12-14 times range. In fact, the average annual return for the subsequent 10-years following these periods was 12.9%, with the minimum average annual return being 5.2% and the maximum 19.0%. Not too bad! For comparison purposes, exactly one decade ago the S&P 500 P/E multiple stood at 36.8 times, and over the ten years ending Sept. 30, 2011, the index delivered a decidedly anemic 2.8% average annual return. Ouch...now you know why we diversify into small and mid caps.

At this point, it should be clear that lower valuations generally lead to better returns going forward, but the analysis goes beyond that. We believe today’s price levels are such that the upcoming decade for U.S. equities could be far superior to the last decade. Wouldn’t that be nice?

For those of you who tend to be more concerned about the near term, it’s important to point out that we’re entering what has historically been the best quarter for stocks. In fact, since 1970, the two best months for stocks have been November and December. Interestingly, the worst month for stocks over the same period has been September. Don’t ask us to explain why this anomaly has occurred—we can’t. In theory, the average monthly returns should all be about the same, but that’s clearly not the case. Maybe the results have something to do with the changing moods of investors as the seasons change - or - maybe it has to do with the way the stars and the moon align in certain months. Whatever the reason, we can only hope history repeats itself one more time as we close out 2011.

### Discounted Cash Flow Models

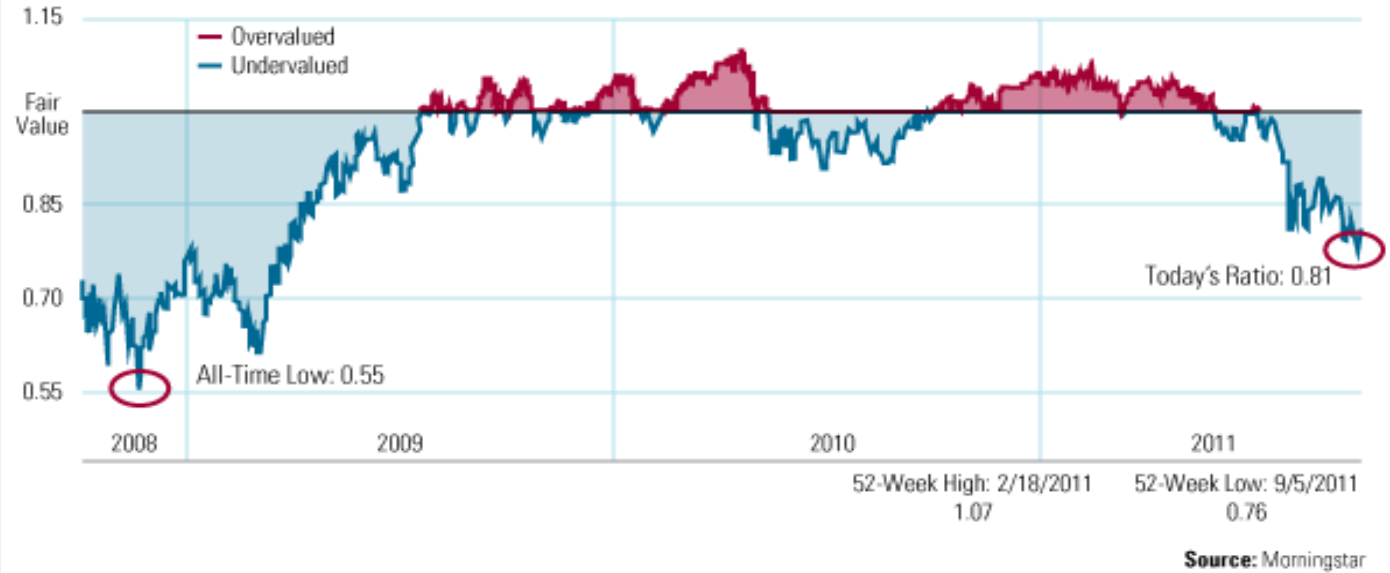
Many investors seem to forget that when they invest in a publically traded company they are purchasing a share of that company’s expected future earnings, or cash flows. As we saw in the previous analysis, the current level of prices relative to corporate earnings is fairly low, and thus appears to provide a nice opportunity for investors. However, earnings (i.e. the level of net income reported on firm’s income statement) can sometimes paint an inaccurate picture of how a firm is doing. This is because earnings are an accounting number and don’t technically represent true cash flows. For investors, the biggest problem with net income as reported on the income statement is that it includes non-cash expenses like depreciation and accruals and excludes some other types of cash flows. This, in turn, makes it difficult to tell how much cash flow the firm actually generated. Additionally, net income is easier for managers to manipulate than cash flows are, making them less reliable. As a result, many investors favor operating cash flows over earnings.

The chart on the following page (Page 7) uses expected cash flows (based on analysts’ projections) and a financial model called a “discounted cash flow model” to estimate the fair value of the roughly 1,300 U.S.-listed stocks covered by Morningstar. A ratio of one indicates a company is trading at fair value, with anything above one implying the stock is overpriced and anything below one implying the stock is underpriced. As you can see in the aggregate view below, today’s ratio for the 1,300 firms in the sample is 0.81, and this is lower than it’s been since early 2009. Also note that the all-time low for the measure was reached in late 2008, during the worst of the financial crisis. The current level of the ratio doesn’t necessarily mean equity prices have bottomed, but even the most pessimistic investor can see that companies are currently trading at a significant discount to their fair value...which usually indicates it’s a good time to buy.

*See chart “There’s Value in the Market” on Page 7*



**There's Value in the Market**



**Dividend Yields**

As is usually the case during most selloffs, the last few months have brought with them an increasing opportunity to invest in high-quality assets at attractive prices. One such opportunity can be found in dividend paying stocks, where dividend yields (or returns) on many blue-chip stocks now exceed the yield (or return) on 10-year Treasury notes. This is an extremely rare occurrence and provides a rare opportunity for long-term investors, who can invest in high-quality companies that have stable, growing dividend streams, at prices that translate into yields above what they could get on long-term bonds! As we stated earlier, we know stock prices will eventually bounce back but we don't know exactly when. One of the advantages of dividend paying stocks is that, even if it takes a while for the market to recover, the dividend income generated from these stocks will still exceed the interest income you could have earned in Treasury bonds or cash. Unlike bonds, companies consistently raise their dividend payouts, so the dividend income you receive on a stock portfolio grows over time! In addition, when the market does eventually bounce back, you will not only be receiving the dividend payments, you'll also get to enjoy the capital gains from the stock price increase. It is also encouraging to note that every time dividend yields have exceeded long-term Treasury yields in the past, a significant stock market rally has ensued. The rally may not happen immediately, but we think it's a pretty safe bet that over the long term stocks will be worth more than they are today. If that's the case, then you'll be much better off in stocks than long term Treasuries.

**DATA SUMMARY**

After the quarter we just had, we understand why people are concerned about the financial markets. Some mild concern is normal. However, our analysis indicates the sell-off was overdone, and we believe the volatility we've been experiencing will also gradually abate. To this point, our clients seem to concur, as the vast majority of you have been amazingly calm and patient in our conversations with you. We hope some of this has to do with our educational efforts and our continued focus on the core tenets of long term stock investing. However, if you have the slightest concern, do not hesitate to contact us immediately, as we want you to fully understand what we are trying to accomplish over time.

One of the biggest issues we're going to have to contend with going forward is that we live in a very complex, global economy, where it's becoming increasingly difficult for anyone to connect all the dots. Ten or fifteen years ago the financial problems in Greece would have been a tiny blip on the radar screen and many of us would have been blissfully unaware that Greece was even in trouble. This was because ten or fifteen years ago when Greece had similar problems—what happened in Greece largely stayed contained in Greece.

**New Connections?**

Today, however, the euro zone countries are intertwined in a new common currency, and disparate economies the

(Continued on Page 8)



world over are increasingly interconnected via the burgeoning global economy. As a result, what happens in Greece no longer stays there, because Greece's woes are now also the woes of the European Union. Since we're still all so new to the "new normal" intertwined global economy, we don't have history as a guide. In other words, we don't have the luxury of having been through situations like this before...because we haven't. We know how to handle one country's financial issues...it's the 17-country issues that add a different layer of complexity. The added uncertainty and anxiety this creates has been clearly evident in global financial markets over the past few months.

Just in case you didn't think all the uncertainty over the new global economy was enough to deal with, we're also seeing dramatic increases in intraday market volatility due to computer-driven flash trading, which now represents 70% of all trades placed each day. Now, every bit of news, good or bad, can result in wild swings in intraday stock prices worthy of the most daunting amusement park roller coasters. No wonder people are concerned!

However, given all of this, the thing that's most critical for stock investors to understand is that it is now more important than ever to stay focused on the long term. All that day-to-day and week-to-week volatility we've been seeing is irrelevant to the long term investor, who should be focused on cash flows and earnings...not headline news. This means that today, more than ever, investors need a well thought-out investment plan that incorporates how to respond to periods of increased volatility—because we can almost guarantee that periods of volatility will become increasingly common going forward.

### **Some Perspective**

For some perspective, let's step back and take a look at what's happened over the past several years. In 2008, the financial markets sold off dramatically and the global financial system experienced a near meltdown. At that point we had a REAL credit crisis. In 2009, even after the crisis had been averted, investors continued to panic and their indiscriminant selling drove asset prices down to the most absurd levels we've ever seen. Yet, in less than two years small and mid-cap stocks were hitting all time record highs.

In 2010, we continued dealing with a frustratingly stagnant domestic economy and saw the situation exacerbated by worries over the European debt issues. Even though corporations continued posting record profits and cash flows, individual investors sold off stocks from late April to early July, resulting in a peak-to-trough decline of 16% in roughly two months. Over the next six months the market

once again rallied, closing the year more than 23% above its July lows. Hmm, are you sensing a pattern here?

Our point is, this year has been more of the same and the indicators suggest that the market has probably once again overreacted on the downside. As a result, we think a nice opportunity exists for patient, long term investors and have based this conclusion on the following:

- Based on an analysis of the overall macroeconomic data, we believe the economy is stronger than many think and is unlikely to fall into a recession anytime soon. The stock market, on the other hand, appears to have "priced in" a recession and a failure of the European Union to get their act together. We think both are unlikely.
- Corporate insiders support our view, both on the overall economy and on the oversold nature of the stock market, by investing their own hard earned money to prove it. In addition, the increased level of merger and acquisition activity would indicate they believe their peers are underpriced as well.
- Panic levels are high and consumer confidence is low, which historically have both been reliable "buy" signals for investors who remain unemotional.
- P/E ratios are at levels which, based on our analysis, have historically generated returns well above the long run market averages for long term investors.
- Applying "discounted cash flow" analysis to expected corporate cash flows suggests that the market is currently trading approximately 20% below fair value.
- Dividend yields currently exceed long-term Treasury yields, which is an extremely rare occurrence, thus providing a nice income opportunity even if stocks should take a little longer than expected to recover. Historically, any time you could generate more income from stock dividends than from long term bonds, it's been an great time to buy stocks.
- Finally, we have an accommodative and very capable Federal Reserve that is providing another "goose" to the economy via their innovative "operation twist."

Of course, we've yet to delve into many specifics about the European situation, which at this point seems to be Wall Street's metaphorical "elephant in the room."



## THE EUROPEAN DEBT CRISIS

The European situation is messy and complex, as we've touched on briefly. However, we also believe the concerns should be directed predominantly toward the European nations and less so toward the U.S., as Europe, while still an important trading partner for the U.S., only accounts for about 25% of our overall exports. Yet, judging solely from the virtually identical sell-offs in the European and U.S. stock markets, one would assume the U.S. was part of the European Union. In other words, we think the sell-off in the U.S. markets relative to the European debt crisis was an overreaction. What happens in Europe does impact us here in the U.S., obviously, but not to the extent that recent market gyrations would seem to have indicated. For more perspective on the overall situation in Europe, the following presents a look at 1) how the crisis has unfolded, 2) what we think is likely to happen next, and 3) what it might all mean from an investor's perspective.

### A Timeline

- **May 2010:** In response to growing concerns about the ability of several European countries to meet their sovereign debt obligations, the European Union (EU) created the European Financial Stability Facility (EFSF). In concert with the EU and the International Monetary Fund (IMF), the EFSF can provide up to €750 billion (more than \$1 trillion U.S.) in financial assistance to euro-member countries facing trouble with their sovereign debt loads. The EFSF's first customer was Greece, which received a financial rescue package totaling more than €110 billion (\$155 billion).
- **November 2010:** Ireland, struggling with fiscal problems stemming from the government's decision to guarantee all debt incurred by the country's troubled banking sector, received an €85 billion (\$120 billion) rescue package from the EFSF. A newly elected Irish government implemented some fiscal austerity measures, which have helped, but Ireland's fiscal viability hinges primarily on a banking sector recovery.
- **May 2011:** Almost one year to the day after the initial bailout of Greece, Portugal received €78 billion (\$111 billion) in rescue funding from the EU and IMF. Portugal relies heavily on foreign creditors to raise capital, and when they are reluctant to lend—which has been the case as the country's fiscal woes have worsened—Portugal's economy grinds to a standstill.

- **June 2011:** Facing a stagnant economy, growing social unrest, an inability to meet fiscal deficit reduction targets, and a potential default on its maturing debt, Greece requested a second bailout package from the EU.
- **July 2011:** The EU, IMF, and Greece reached an agreement on a second bailout package. In addition to providing additional loans to Greece, the EU forced the country to adopt more stringent fiscal austerity measures. The agreement also called for a voluntary debt exchange, in which Greek bond investors have several options to exchange bonds maturing in the next few years for new bonds with longer maturities, effectively extending the maturities of Greek bonds to avoid a near-term default. Separately, the EU sought to expand the role of the EFSF to buy bonds on the secondary market and provide funds to euro-member countries to recapitalize banks.
- **August 2011:** The EU took steps to prevent the contagion from spreading to larger but fiscally vulnerable European countries, such as Italy and Spain. Toward that end, the European Central Bank began buying Spanish and Italian bonds on the secondary market, and Italy approved new fiscal austerity measures.

### What to Watch for Next

Two major developments related to Greece are set to take place over the next six weeks and will have a significant effect on how the sovereign debt crisis unfolds.

- **The first is ratification of the second bailout package,** which as we write this has officially been accomplished, with Slovakia being the last of the 17 currency bloc nations to pass the proposal. The ratification also includes increasing the size and power of the EFSF. But the process is fluid and will remain so for some time as the countries try to figure out how best to maximize the fund's firepower without requiring nations to contribute further funding or guarantees. France, for example, has proposed using the bailout pool of funds to insure bonds from euro-zone countries, but exactly how things will play out is impossible to know at this point.
- **Greek debt exchange.** The details have yet to be fully worked out, but under a current proposal advanced this week by the former head of the German central bank, bondholders would exchange their claims on low-rated Greek debt for wider claims on the euro area. Under the proposal, European banks would have to forego some principal for better debt. One of the main sticking points at present is how steep the bank write-downs should be. Germany, whose banks are generally stronger



and less exposed to sovereign Greek debt, is pushing for steeper write-downs (perhaps in excess of 60%). France, on the other hand, whose banks hold more Greek debt, is pushing for more modest write-downs. Regardless of the final details, the losses from the Greek debt swap will require some banks to be recapitalized, especially weaker ones.

### **Our Take**

In spite of all the posturing and bickering, ratification of the second bailout package is a sign that the euro zone nations can find common ground and work together to solve this crisis. Details of the package still need to be worked out, but the biggest hurdle to the process, initial ratification, has been successfully navigated, which is reassuring.

### **The Longer-Term View**

The second bailout package is just one in a series of challenges facing the EU that will play out over the long term. From a historical perspective, we are in unprecedented territory, and the ultimate outcome is uncertain. But here are some things to keep in mind as the situation develops:

- Confidence is key. Debt markets depend heavily on confidence. It is difficult to access the capital markets for funding if potential bond investors lack confidence in your ability to repay your debts. Fortunately, the euro zone countries understand this and are trying to find the best ways to use the bailout funds to reassure investors, such as insuring new debt issued by some of the fiscally troubled countries.
- Focus on the economy. The economic environment in Europe can make a big difference in achieving these fiscal targets. Weak economic conditions create headwinds for restoring fiscal strength because government revenues will fall, but if economic growth recovers, it will make the process considerably easier.
- Moving toward a fiscal union. One factor that gives us encouragement is the resolve among EU member countries to keep the union intact. We expect to see more assertive action from the EU to unite eurozone countries fiscally as well as monetarily. The creation and expansion of the EFSF, an insistence on fiscal austerity measures in exchange for financial aid, and a push toward balanced budget amendments in euro-member constitutions represent a meaningful shift toward a fiscal union. This not only bodes well for the long-term stability of Europe, but it just makes sense—as a whole, the EU is in better fiscal shape than the U.S., and a single fiscal entity would make it much easier to withstand and

overcome the current debt problems.

- Making the rational choice. It is in everyone's best interest to solve this crisis in an orderly fashion. No one wins if countries default on their debt and/or the eurozone falls apart. The ramifications would be severe and far-reaching—debt-laden countries would suffer significant economic damage, the financial system would destabilize, and international trade would come to a halt. Financial markets have been known to act irrationally, and the herd mentality is difficult for even the most experienced investors to avoid, but we think cooler heads will prevail and the rational choice will win the day.

## **STOCK MARKET RETURNS**

As we alluded to in previous updates, the stock market recovery from the lows in March 2009 has been quick and powerful...but not without a few bumps. During the first quarter of 2011, this recovery continued, with the S&P 500 index (large-cap stocks) increasing more than 5%, and the Russell 2000 index (small-cap stocks) increasing more than 7%. Over the second quarter of 2011, the S&P 500 gave back most of the first quarter gains but then recovered quickly to finish the quarter down just under 1%. The Russell 2000 followed a similar second quarter pattern, finishing the quarter down just under 2%. The third quarter experienced a sell-off much like we saw last year at the end of the summer. For the quarter, the S&P declined 14.3%, while the Russell 2000 fell 20.6%. Year-to-date through October 31<sup>st</sup>, the S&P 500 is off 10.0% while the Russell 2000 is down a little more than 16.0%. However, if you go back to the lows experienced in March, 2009 - and include the most recent quarterly correction - the S&P 500 is still 70% above its previous low point and the Russell 2000 is up over 90% from its low. This should provide some much needed perspective, especially for those prone to getting caught up in the emotion of the moment. As we've said from the outset, recoveries from credit-driven recessions are typically long and slow, with numerous setbacks, so periods like we're facing now are no surprise.

### **The Style Index Numbers**

Looking at the twelve months preceding the end of the second quarter, five of the nine style boxes were in positive territory. Overall, large cap stocks performed better than their small and mid cap counterparts, while the difference between value and growth stocks was slanted in favor of growth. In terms of the individual indexes, large cap growth led the way, due largely to tech stocks, which is a reversal of the longer term trend.

(Continued on Page 11)



### 1 yr. Russell Style Index Performance Ending 09/30/2011

Value	Blend	Growth	
-0.03%	3.12%	6.36%	Large
-0.76%	1.23%	3.44%	Mid
-4.79%	-1.69%	1.38%	Small

Since the lows reached on March 9, 2009, the pattern of performance remains typical of an economic recovery, with small and midcap stocks outperforming large caps by a fairly substantial margin. In fact, the average return across the six small and mid cap style boxes since the 2009 low is 103%, compared to the 80% return averaged across the three large cap style boxes. Large caps have fared better YTD, but as the market recovers from the recent decline, we would expect small and midcaps to regain leadership.

### Post-Crash Recovery of the Russell Style Indexes 03/09/2009—09/30/2011

Value	Blend	Growth	
81%	82%	77%	Large
112%	109%	106%	Mid
93%	98%	102%	Small

Examining style box performance over the last ten years, a similar pattern emerges, with small and mid-cap stocks outperforming large caps by a significant margin. As we keep reminding everyone, this pattern of performance, with smaller companies outperforming larger ones, is not new and is in fact typical of the stock market over time. However, it's also clear that the returns of the past decade have been positive, but below the long term historical averages, which is largely because the time period encompasses the last part of tech bubble, two recessions (including the most severe recession in history), the post 9/11 market drop, the real estate bubble and subprime mortgage crisis, and the recent third quarter dip. Going

forward, we believe stability will return to both the economy and the financial markets and that long term investors will be rewarded with substantially higher returns.

### 10-Yr. Annualized Russell Style Index Performance ending 09/30/2011

Value	Blend	Growth	
4.17%	4.11%	3.79%	Large
11.03%	10.95%	9.62%	Mid
8.96%	8.46%	7.43%	Small

## BOND MARKET THOUGHTS

Although we've spent much of this newsletter writing about the importance of a long-term perspective for stock investors, there is still an obviously need for fixed income investments in a portfolio - particularly for those who want to reduce short term volatility and/or for those who need a regular income stream. For this part of our client portfolios, we use a diversified group of bond funds, with the overriding intent being to protect the principal amount of the money you'll need over the next ten years or so, while still generating a respectable return. This has obviously been a challenging period for bond investors, as already low interest rates have been exacerbated by the spillover effects from the volatile global equity markets by driving rates even lower.

### Can Long Term Rates Go Lower?

Over the third quarter, long term interest rates continued to decline as money being pulled from riskier assets was poured into downgraded Treasury securities. Most market participants, including our bond managers, had expected interest rates in the U.S. to increase this year and had positioned their portfolios accordingly, by shortening the average maturity of the bonds they hold. This was a smart move, given the expectation of rising rates. Unfortunately, the European debt crisis and unforeseen Fed action (operation twist) drove record-low interest rates even lower. This benefitted only a few bond fund managers, who were either unable to reposition their portfolios (as in the case of index fund managers) or those



who invest primarily in U.S. Treasuries or Treasury equivalents, as in the case of one of our funds, VFII (see table below). Most bond funds, however, have had a fairly unremarkable year thus far. We believe this will change for the better, as rates have to increase at some point going forward.

### Our Bond Mix

The table below presents the recent performance of our three primary bond funds plus a new fund (DBLTX) that we'll be adding to portfolios, as appropriate, over the next few months. Note that only one fund, NEFZX, finished the quarter in negative territory year-to-date (and just barely). The third quarter, however, saw losses in both NEFZX and PTTRX, which in both cases was a result of the kinds of bonds they held in their portfolios. Both funds, expecting the U.S. dollar to continue weakening over time, have taken positions in international bonds from countries with currencies that were expected to strengthen. However, the global flight to the safety of U.S. Treasuries during September's panic sell-off sharply increased demand for the U.S. dollar, driving its value up. As a result, bonds denominated in foreign currencies generally lost value during the quarter. It's important to point out that this is a temporary phenomenon that will ultimately reverse itself. In fact, as of this writing, NEFZX has reversed half of its losses in two weeks. That said, it made for a tough third quarter for bond funds with exposure to bonds denominated in foreign currencies.

<b>BOND FUND PERFORMANCE</b>			
<b>Fund Name</b>	<b>Ticker</b>	<b>3rd Qtr</b>	<b>YTD</b>
Loomis Sayles Strategic Income A	NEFZX	-6.38%	-0.03%
PIMCO Total Return Instl	PTTRX	-1.06%	1.90%
Vanguard GNMA Inv	VFII	3.05%	6.46%
DoubleLine Total Return Bond I	DBLTX	3.92%	8.84%

One fund that actually benefitted from the September sell-off in stocks was VFII, which almost exclusively invests in government guaranteed GNMA mortgage bonds. GNMA's are viewed by investors as interchangeable with U.S. Treasuries because of their direct backing by the U.S. Treasury, and they therefore benefitted from September's flight to safety in similar fashion. This led to an excellent quarter for VFII and helped push its YTD return above

6%, and is a perfect example why, even in bond portfolios, we feel diversification is critical.

### A New Bond Opportunity

The bond fund that appears at the bottom of the table, Double-Line Total Return Bond (DBLTX) is a fund we've been watching for over a year now and have just recently decided to add to our group of approved fixed income funds. The fund itself is has been in existence only since April 2010, but the fund's manager, Jeff Gundlach, and his research team are very experienced and ran the very successful TCW Total Return Bond Fund for more than 15 years, where Gundlach won Morningstar Manager of the Year honors in 2006. To us, the most attractive thing about this fund, in addition to its ability to generate stellar returns in a very difficult bond market, is the fact that it invests in assets that are dissimilar to the assets held by any of the other bond funds we use, making it an excellent fit in terms of diversification, as well as return.

Jeff Gundlach is the world's undisputed foremost expert on collateralized mortgage obligations, or CMOs, and his fund invests in mortgages almost exclusively. Rather than just passing along the cash flows from underlying mortgages like GNMA or FNMA bonds, the payments from CMOs are split among several classes of securities, each with different payment schedules and designed for various purposes, from floating-rate and inverse floating-rate bonds to defined maturity and accrual bonds. CMOs are extremely complex and few people have the skill set to analyze them, which is why the typical bond fund has virtually no exposure to them. In the post crisis mortgage market, we think this creates a distinct advantage for Double-Line, because there are lots of mortgages for sale but few willing buyers. This, in turn, creates some terrific bargains—assuming you know exactly what it is you're buying. We're impressed by the track record Gundlach has amassed, both at his new fund and at TCW before that, and we think the fund makes a great addition to our already strong bond fund arsenal.

### REQUIRED MINIMUM DISTRIBUTIONS REMINDER

IN THE NEXT FEW DAYS, CLIENTS THAT ARE REQUIRED TO TAKE MINIMUM DISTRIBUTIONS FROM THEIR IRA'S WILL RECEIVE A NOTE IN THE MAIL REMINDING THEM TO TAKE THEIR RMD BEFORE THE END OF THE YEAR. IF YOU RECEIVE ONE, PLEASE FILL IT OUT AND RETURN IT BY DECEMBER 20TH. FOR QUESTIONS, PLEASE CONTACT YOUR ADVISOR.

**A FINAL NOTE****Thank You**

As usual, if you have any questions or concerns regarding our updates, your portfolio or any of our investment strategies, please feel free to contact us immediately. We always look forward to hearing from you and thank you for your continued confidence in our firm. The recent referrals are much appreciated. As you know, we remain 100% committed towards your financial well being at all times. If you need anything or your goals or time horizons have changed, please do not hesitate to call or drop an e-mail to set up an appointment. We are here to serve your financial needs, whatever they may be.

We wish you and your family a wonderful holiday season and hope you enjoy this beautiful Fall.

**~ Joe and The Gang at KWAG**

**COMPLIANCE NOTES****Client Documents**

In an effort to serve you better and to keep our company updated on current government regulations, we will be sending out new client documents in the next few weeks. These documents will include a new management agreement, client profile and investment objectives. The purpose of these documents is to help us understand your investment objectives, time horizons, and investment profiles, so we can provide the best financial advice possible.

When you receive these documents, we ask that you fill them out to the best of your ability and return them to us as soon as possible. We hope to have the packets out in Mid-November.

As always, we thank you for the opportunity to work together and your continued confidence in our firm.

Best Regards,  
Katie Burr

**2012 KIELY GROUP CLIENT APPRECIATION DINNER SCHEDULE**

**Ocean Isle, NC** Monday, January 23<sup>th</sup> Sea Trails Convention Center 6-8PM  
**Greenville, NC** Tuesday, January 24<sup>th</sup> Brook Valley Country Club 6-8PM  
**Asheville, NC** Wednesday, January 25<sup>th</sup> Asheville Country Club 6-8PM

To reserve your seat, please call our headquarters office at 877-366-5623 or your specific advisor. If you would like to register via email, please email Kristen Below at [kbelow@thekielygroup.com](mailto:kbelow@thekielygroup.com)

*We encourage you to bring a friend and/or someone who would like to hear our educational message.*



## THE GANG AT KIELY WEALTH ADVISORY GROUP



Left to Right: Brownie Cordell; Katie Burr; Joe Kiely; Kellie Kiely; and Scott Below

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**\*IMPORTANT DISCLOSURE INFORMATION**

**Performance results** represent results reported by each reflected mutual fund during the corresponding time period. Kiely Wealth Advisory Group, Inc. ("KWAG") currently utilizes these mutual funds in managing actual client portfolios. However, the individual mutual fund performance results **do not** reflect the results of any specific KWAG client portfolio or any KWAG composite.

**Past performance** may not be indicative of future results. Therefore, no current or prospective client should assume that future performance will be profitable, or equal either the performance results reflected or any corresponding historical index. The historical index performance results are provided exclusively for comparison purposes only, so as to provide general comparative information to assist an individual client or prospective client in determining whether the performance of a specific investment meets, or continues to meet, investment objective(s). It **should not** be assumed that any account holdings will correspond directly to any comparative index. The performance results do not reflect the impact of taxes.

**Please Note:** the individual depicted mutual fund results **do not** reflect the results of any specific KWAG client portfolio or any KWAG composite. **For reasons including** variances in portfolio account holdings, market fluctuation, and any account contributions or withdrawals, the performance of a specific client's account may have varied substantially from the indicated reported mutual fund results. In addition, the above results only reflect the results as reported by each respective mutual fund company. Portfolios managed by KWAG would also incur a KWAG advisory fee, the deduction of which would result in decreasing the reported performance results. **For example:** a KWAG advisory fee of 1% compounded over a 10 year period would reduce a 10% return to an 8.9% annual return).

**Please Remember:** In the event that there has been a change in a client's investment objectives or financial situation, he/she/it is encouraged to advise KWAG immediately. Different types of investments and/or investment strategies involve varying levels of risk, and there can be no assurance that any specific investment or investment strategy (including the investments purchased and/or investment strategies devised or undertaken by KWAG) will be either suitable or profitable for a client's or prospective client's portfolio. **In addition,** the mutual funds depicted are funds that KWAG may utilize and/or recommend as of specific date, and are subject to change without notice. **Accordingly,** no client or prospective client should assume that the above reflected mutual funds serve as the receipt of, or a substitute for, personalized advice from KWAG, or from any other investment professional. **Information** pertaining to each depicted mutual fund is set forth in each respective fund's prospectus, a copy of which is available directly from each mutual fund company or from KWAG upon request.

**All performance results** reflect the performance results reported by each respective mutual fund to Morningstar, and have not been independently verified by KWAG. KWAG also maintains all information supporting the reflected mutual fund performance results.

**Information pertaining** to KWAG's advisory operations, services, and fees is set forth in KWAG's current disclosure statement, a copy of which is available from KWAG upon request.

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