

KIELY WEALTH ADVISORY GROUP, INC.



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

BEHIND THE SCENES

Volume 19 | Number 3 | Date October 2010

OPENING THOUGHTS

We hope this newsletter finds you enjoying this beautiful fall weather. After such a hot summer, the change in seasons is certainly welcome. Unfortunately, this fall also ushers in a new election season and the unrelenting din of politically motivated misinformation. Lately, as you might imagine, we've been fielding a lot of questions regarding a variety of hot topics in the upcoming election. The questions have run the gamut, from concerns about potential inflation, potential deflation, double-dip recessions, Obama, Congress, taxes, the budget deficit, last year's stimulus, TARP, the price of Gold, the Tea-Party, and more. In each case, we have tried to provide specific answers that are based on academic research, rooted in common sense, and are 100% apolitical. While we're not saying the above issues are not important, the truth is most of the issues are either being overblown by the media, exaggerated in campaign ads, or will have very little effect on your portfolio over time. What we are saying is: Blaming the Government is NOT an Investment Strategy. So it's probably best not to mix political passions and investment decisions.

Some Perspective

Our philosophy has always been to remain politically detached - with good reason. Beyond the fact that you hired us to manage your money rather than pen political commentary, we believe investment decisions tainted by emotion are generally poor ones. Our job is to act in your best interest with respect to whatever public policy decisions come down from Washington. This requires that the investment decisions we make be unclouded by personal, political, or emotional biases - and is why we so strongly believe in maintaining an apolitical stance. We know we can't control the things that happen in Washington, but we can control how we react to them and that is our focus.

Perhaps surprisingly, we find most of what happens in Washington has little impact on our portfolios over time. Instead, as long as capital, labor and technological innovations are allowed to flow freely across a level playing field, the global economy will thrive and so will our portfolios. Conversely, if one or more of these variables is disrupted or constrained, the global economy will suffer, as will our portfolios. For example, in 2008, the global economy experienced a major capital-flow disruption, nearly collapsing the global financial system and leaving most of the world's developed economies on the verge of a major global depression. Since that time, capital flows have been restored, new regulations have been put in place, and the domestic economy is back on track. More importantly, publically traded companies are beginning to thrive again. Does this mean the economy is perfect? Clearly not, but the

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economy is headed in the right direction and is growing at a reasonable rate given the severity of the recession we've been through. And at this point, we think that's great news.

Previous Monthly Updates

Over the past few months we have written about the apparent "disconnect" between investor perceptions and the performance of publically traded companies. In August, we wrote about investors' penchant for taking the macro view, assessing the economy from the top down and fixating on a few macroeconomic indicators like GDP, the unemployment rate, or the national debt. We noted that one problem with a macro-centric view is that the firms we invest in aren't necessarily impacted by the macro data - or - they may be impacted by the data in ways many haven't considered. Remember, corporations are concerned about being productive, being competitive, increasing market share, improving profitability, growing their business and increasing their free cash flows. What has caught so many macro-centric market observers off guard is that domestic companies are excelling at all of the above...in spite of the seemingly problematic "domestic" economic data.

The Big Picture

Today, as prudent investors, we have to be cognizant of the bigger global picture. In a global economy, it is important not to confuse our domestic economy with the state of the global and domestic financial markets. Everyone knows that the US economy is growing slowly, and likely will going forward over the next few years. However, that doesn't mean corporate profitability and their free cash flows have to grow slowly as well. Why? Because as long as capital, labor and technological innovations are allowed to flow freely across a level playing field, the global economy will thrive and so will our portfolios. And, that's exactly what's happening. Our portfolio's are growing as the world economy grows - and that's going to continue for some time - regardless of what you're being told by politicians and the financial media.

Cash Flow Analysis 101

At the end of the day, stockholders are the owners of the company. As owners of the company, we are concerned with the "bottom line" or "free cash flows." In essence, investors ultimately value stocks based on their current and future "cash flows". In case you haven't noticed, corporate cash flows are way up. In fact, stocks in the S&P 500 index posted second-quarter profits of \$189 billion, which was up 38% from a year earlier and represented the sixth-highest quarterly total ever! In addition, domestic second-quarter after-tax profits rose to an annual rate of \$1.208 trillion (the

highest annual rate on record), up 3.9% from the first quarter and 26.5% from a year earlier. Finally, second quarter after-tax profit as a percentage of national income was the third-highest since 1947. Pretty impressive numbers - and when the third quarter numbers are released over the next few months we expect to see more of the same.

The Untold Story: Companies are healthy

By virtually any metric you choose, firms are healthier today than they have been in quite some time. To many people this doesn't make sense because of the economic problems we're still facing at home. However, it's important to remember that firms aren't defined by things like high domestic unemployment, slow growth in GDP or large federal deficits. In fact, they are often able to use these factors to their advantage. Remember, U.S. companies compete in a global economy, so while the financial media and political pundits argue over the growth rate in GDP, companies are focused on finding and filling the needs of existing and future customers across the globe. They recognize that in a world economy they can grow their business anywhere and everywhere—and that's precisely what they're doing.

Additional Observations Worth Repeating

In last month's update (September), we reiterated our message regarding the macro/micro "disconnect" and stressed that while the economy is growing at a slower than normal pace, publically traded companies are NOT confined to that pace. Investors have to bridge the "disconnect" and come to terms with the fact that the domestic economy no longer defines our financial markets - the world economy does. Fifty years ago it was okay to make financial decisions based solely on what was happening domestically, because post-WWII the U.S. was basically the only developed economy in the world that was still functioning. Today, however, that sort of thinking is seriously flawed. So, although we are being redundant with our message, we think it's worth repeating again... and again. Think Globally.

Normal Market Behavior

At the beginning of September, we also noted that our markets had been experiencing a correction and pause that was typical given the magnitude of the market run-up over the prior eighteen months. Events like May's correction and August's dip are normal occurrences that, at this point, should be expected. In fact, we pointed out that these pull-backs are healthy for the financial markets over the long-term, because they help prevent dangerous

(Continued on Page 3)



bubbles from forming. Throughout the correction and the normal pause in the market that followed, we recommended being patient and behaving like long term investors. That patience has clearly paid off and will continue to do so as we go forward. Why? Because the “cash flows” that are being generated by America’s publically traded companies aren’t going to stop anytime soon.

Why “Cash Flow” Analysis is so Important

In the midst of the correction we also pointed out that the market had again reached a point where some companies were trading at prices below the value of the cash they have on hand. This is a condition referred to as “negative enterprise value” and, in theory, means you should be able to take out a loan to buy the company outright...use the firm’s cash holdings to pay off the loan...and there would still be some cash leftover. So not only would the deal not cost you anything, you would be getting all the other assets the company owns (things like inventory, plant and equipment, real estate, accounts receivable, and the leftover cash) for free! That’s obviously irrational, and whenever you see numbers of firms trading at “negative enterprise value” it’s a pretty good indicator that stocks are significantly underpriced. The news gets better...

Additional Clues from CEO’s

In September’s update we also noted that the strong increase in merger and acquisition activity (M&A). This M&A activity indicated that corporate CEO’s felt stock values were low and they were thus going on a buying spree. This was reinforced by a number of stock repurchase programs and an increase in the size of dividends. CEO’s and their management teams were basically signaling to the marketplace “cash flows are huge and valuations are low”. As it turns out, institutional investors and money managers agreed and the result was the best September for the stock market in over 70 years! This activity has continued through the first few weeks of October. Unfortunately, the individual investor was more focused on the negative news being bandied about by the financial media and our politicians. As a whole, small investors pulled money out of stocks...again.

OUR TAKE

By virtually any measure you choose, individual firms are far healthier today than they were even before the recession began. They are more productive, more competitive, posting higher profit margins, and growing revenues at rates that continue to surprise on the upside. While the media has focused on high domestic unemployment and weak GDP growth, firms are sticking to their strategic game plans and expanding their businesses into lucrative, high-growth markets. They’re also using record-low interest rates to raise capital more cheaply than at any time in history, adding additional fuel to the recovery. The stock market is beginning to reflect this, with small and mid cap stocks increasing double-digits through mid-October as we write this update. Unfortunately, most individual investors appear unfazed by strong corporate profitability and the market’s resurgence and have now pulled money out of stocks for twenty consecutive months, leaving the lion’s share of the gains to the “smart money” (i.e. institutional investors).

Obviously, there is still a lot of room for economic improvement. However, we’re pointed in the right direction and the vast majority of economic trends are positive. Many will dwell on things like the high unemployment rate and use it to characterize our country’s prospects. However, we’ve been saying all along that jobs are the last thing to recover in a recession and that credit-driven recessions are accompanied by high, persistent unemployment that can take years to return to normal levels. So while we hate to see a fraction of the population out of work, we don’t believe it will be a significant impediment to the profitability of the firms we invest in going forward.

STOCK MARKET RETURNS

As we alluded to earlier, the stock market posted its best September in over seventy years and salvaged what had, until then, been a fairly lackluster third-quarter. For the quarter, the S&P 500 index (large-cap stocks) rose 10.7%, while the Russell 2000 (small-cap stocks) was up 10.9%. Year-to-date (through September 30) the S&P 500 is up 2.3% and the Russell 2000 is up 8.1%. (As we write this newsletter, the indexes are up significantly more at 6% and 12% respectively.) Going forward we know there is still a great deal of uncertainty which means volatility will probably remain high, making it even more important for stock



patient and focused on the long run. Based on global demographics, the availability of low-cost capital, and healthy corporate balance sheets, we think the next five years could surprise even the most optimistic investors. America's companies held up well through a very difficult recession and they continue to show their resiliency by growing earnings - and cash flows - at higher than expected rates.

The Style Index Numbers

By the end of the third quarter all nine style boxes were up for the calendar year. Overall, small and midcap stocks performed better than their large cap counterparts, while the difference between value and growth stocks was mixed. In terms of the individual indexes, midcap value fared best in the first nine months of the year (up 11.15%) while large cap growth performed the worst (up 4.36%). At quarter-end, the "pattern of performance" remains typical of an economic recovery, with small and midcap stocks outperforming large caps by a substantial margin.

YTD Russell Style Index Performance through 09/30/2010			
Value	Blend	Growth	
4.49%	4.41%	4.36%	Large
11.15%	10.97%	10.85%	Mid
7.92%	9.12%	10.23%	Small

If we examine style box performance over the last decade, the differences styles becomes even more pronounced. Small and mid cap "value" stocks averaged double-digit positive returns over the decade, while large cap growth stocks lost nearly 3% annually. We understand why most investors are frustrated with stocks. If you had invested your hard earned money in large cap stocks, as most investors do, you'd be disappointed too. However, if you had invested in the entire stock market, using the best active managers available and rebalancing as needed, you would have walked away from one of the worst decades in history having made a respectable amount of money. In addition, you would have had lower risk exposure to boot!!

10-Yr. Annualized Russell Style Index Performance ending 09/30/2010			
Value	Blend	Growth	
2.91%	-0.21%	-2.95%	Large
11.18%	6.07%	-0.85%	Mid
11.03%	4.80%	-0.13%	Small

Our Stock Fund Managers vs. The Media

Sometimes we feel like the individual investor is at a severe informational disadvantage when it comes to obtaining accurate, market-related data. We gather much of our information from money managers, academicians, fee-based data providers (like Morningstar and Lipper), and an array of professional economists and analysts who provide hard data without all hype that is interjected by the media. Individual investors typically get their economic information from the mainstream media, who generally do a poor job reporting the complete story - and - focus only on the aspects that create the best headlines. Remember, the media's job is to grab your attention so they can sell ad time - they are not there to educate you. What passes as financial journalism is often misleading and, in our view, irresponsible. Stories are frequently slanted and data is cherry-picked to make things seem more disturbing than they really are. This is no secret to money managers, investment analysts, or anyone who works on Wall Street.

The following quote from one of our money managers, Chuck Royce, appeared in his recent third-quarter report and is typical of the analysis we see every day but that individual investors rarely have access to. When asked about the economy, Mr. Royce said...

"We've been getting primarily mixed statistics - the headlines are taken up with ominous stories about housing and unemployment, while on a company-by-company basis, we here at Royce are seeing ongoing improvement that's primarily reflected in things such as balance sheet strength, expanded market share or increased participation in the global economic recovery..."

We've seen this exact same message reiterated day



BOND MARKET RETURNS

Nearly all of our clients hold some bond funds in their portfolios and we would like to revisit our strategies regarding bonds over the last two years. Since the onset of the credit crisis in 2008, bonds have become an increasingly important piece of our overall investment strategy. This is because the panic sell-off, in response to the credit crisis, afforded us an opportunity to purchase fixed income assets at unheard of prices. This sort of thing had happened before (following the 1998 Russian default on sovereign debt), although not to the degree we saw in 2008 following the Lehman Brothers collapse. The ensuing panic and flight to safety peaked in early March of 2009 and we saw massive selloffs across virtually every asset class except Treasuries, which were seeing record buying. This indiscriminate selloff created a situation where even high-quality, low-risk investments like high-grade corporate bonds saw their prices beaten down to ridiculous levels. Opportunities like this are extremely rare and we decided to capitalize by increasing our exposure to several bond funds that we believed were particularly well-positioned to benefit from unprecedented chaos. The managers of these funds didn't disappoint. In fact, they exceeded our expectations through both 2009 and year-to-date.

The Numbers in 2010

Our two most widely held bond funds - Loomis Sayles Strategic Income (NEFZX) and PIMCO Total Return (PTTRX) - are up 11.0% and 9.8% year-to-date (through September). These are surprisingly strong returns given the difficult, low interest rate environment facing bonds these days. It's unlikely that we'll see bond returns like these in the foreseeable future. However, every time the market over-reacts to a new economic challenge, this creates a new opportunity in fixed income assets. So, when the next market scare comes along, don't panic or worry. Instead, take the time to recognize that you own excellent bond managers who understand how to take advantage of the next crisis by purchasing fixed income assets on sale. That said, we have started to transition our bond strategies towards one of preservation rather than growth. We think this move is prudent as more investors recognize the recovery is here to stay.

Buyer Beware

Lately, we've observed many investors taking significant risks by chasing higher yielding long-term bonds in this low rate environment. Unfortunately, long-term bonds are very interest rate sensitive and their prices will fall rapidly when

interest rates begin to rise again. Thus, we don't believe the minuscule yields now available in long-term bonds are worth the risk. As a result, we believe the prudent bond strategy at this point is to remain conservative, with the primary focus on capital preservation. Our bond managers (including the two highlighted above) share the same assessment of the bonds market and are holding portfolios with relatively short average maturities in order to minimize price risk when interest rates eventually begin to rise. Everyone knows that as the economy strengthens, interest rates will go back up and bond prices will move downward. At that point, the money that has been flowing into bonds over the last 20 months will begin flowing back out and into stocks. This will tend to drive interest rates and stock prices up, and bond prices down. As a result, we believe the best strategy for bond investors at present is to remain cautious, conservative, and focused on preservation rather than chasing return.

THE BIG PICTURE

At this point, it's clear that the economic recovery is underway. However, structural impediments like high consumer debt levels and high unemployment will probably keep growth muted for the foreseeable future. So far, the recovery has unfolded against a backdrop of financial restructuring and consolidation in the banking sector and this has helped facilitate the transition from recession to recovery. In fact, given that we were teetering on the edge of total economic collapse just two years ago, we would argue that the transition to this point has been nothing short of remarkable. Last quarter we alluded to the increased profit margins and the \$1 trillion in cash being held by corporations. That cash is now being put to work and the effects are evident in the current stock market rally. Merger and Acquisition (M&A) activity is up strongly and companies are also repurchasing their own shares. Both actions "signal" that corporate boards and CEOs believe stocks are undervalued and represent excellent investments at these prices.

When we take a closer look at the economic data, we observe income levels, spending, hours worked, and temporary jobs increasing every month. We would like to see more permanent jobs being created, but we recognize why firms are opting to use more temp workers at this juncture. When it comes to jobs, some will point fingers in one political direction or another but we believe the high



unemployment levels are primarily an artifact of the severe, credit-driven recession we experienced, as well as the protracted nature economic cycles following such events. On the bright side, many of those currently out of work are using educational programs at community colleges and universities to expand their skill sets and prepare them for better jobs in the future. In addition, households continue to reduce their debt loads and repair their personal balance sheets. The effects of a better-educated workforce and fewer debt-burdened consumers will take time to be felt, but both bode well for the economy in the long term. When one also factors in record low interest rates, little or no inflation, and accommodating Federal Reserve policies, we remain optimistic about the prospects for the economy going forward. To echo our message from the beginning of the recovery, patience is warranted! This was a serious credit-driven recession and the economic damage it inflicted was severe. We are recovering - and we will continue to do so - but it will take time for the economy to heal completely and there will continue to be sizable bumps and jolts along the way.

Based on the way we have structured all of our portfolios, we believe we can take advantage of these bumps and jolts by purchasing underpriced assets and rebalancing our portfolio's in a productive way.

AN INTERVIEW WITH DR. JOE & DR. SCOTT

Over the past few months, we have experienced an interesting array of though provoking questions. Investors are still clearly worried about the economy and financial markets. As a result, we've fielded a variety of questions across a wide array of topics. Last quarter, we provided our thoughts on the Europe crisis; Government spending; the Deficit; a potential double-dip; the American consumer; and the financial overhaul bill. (Please refer to our previous newsletters regarding these topics.) This quarter, we'll focus our Q&A section on additional economic topics. We'll also review some different investment options and discuss appropriate investment strategies for periods like this.

In past quarters, we have asked a client to summarize a few questions for us. This quarter, we took a number of the questions we have received over the past few months and provided them to a long time client. She asked the questions

in her own words and provided some of her own additional feedback. We hope you enjoy the interview and encourage you to follow up with additional questions.

Q1: Thanks for asking me to do this. I'll try not to let you guys down. Let's start with some of the threats being discussed by the financial media and other advisors. What is the real threat of "deflation" and what does it means for our economy going forward?

Scott: Since the beginning of the recovery we've felt fears of deflation have been mostly overblown. This is largely because the academic literature fails to find evidence of a clear link between price deflation and economic decline. In reality, recent studies of numerous economies across the globe find that economic depressions are more likely to be accompanied by inflation than deflation; and that deflation is, in fact, more often associated with economic expansions than with economic contractions. This is fascinating research and it directly challenges the conventional wisdom that deflation is bad for an economy. As a result, it is changing the way economists view the relationship between economic cycles and asset prices, but old beliefs sometimes die hard...especially in academia.

Either way, the Fed has vowed to fight deflation aggressively should it occur. To accomplish this, the primary tool at their disposal is something called "quantitative easing." When short term interest rates have been reduced to near zero, as they are now, and the Fed sees a need to stimulate the economy even further, they can buy longer maturity Treasury securities (i.e. T-notes, T-bonds, securitized mortgages, etc.) in a process referred to as "quantitative easing." Quantitative easing (QE) is basically a two-pronged approach. First, it acts to keep long term interest rates low by driving up the value of long term bonds (thereby driving down their yields). Second, QE increases the money supply because the cash the Fed uses to make the purchases is essentially created out of thin air. The Fed used QE aggressively during the mortgage crisis in late 2008 and into early 2009 and they still hold most of securities they bought back then. And QE is something the Fed is considering employing again if they feel the economy is not growing quickly enough, is at risk of slipping into another recession, or if deflation becomes a threat.

Eventually, of course, the Fed will need to reverse their QE strategy by selling off the securities they hold,



but this won't happen until the economy is healthy enough to warrant it. They're under no obligation to sell the bonds back and given the somewhat fragile state of the economy, we don't expect to see them selling anything for quite a while. As we've said over and over, credit-driven recessions are characterized by protracted recoveries and we expect the economy will be in a slow growth phase for at least the next couple of years.

Joe: NICE...I couldn't have said it better. Over the past few years we have had to shoot down all sorts of non-events created by the media and advisors trying to create panic so they can capitalize on it. In order, I believe it started with the "Second Great Depression", and was followed hyper-inflation (after the stimulus), a double-dip recession, and now deflation. I have also heard how our economy will follow Japan's over the next 20 years (impossible) and how our grandchildren will be broke (not likely, as I first heard this gem as a 6 year old in 1968). The truth is, most of the things people worry about in the press and during political campaigns are not things that will ever affect out portfolios. Not that I expect my comments will stop the incessant, unproductive debates.

I think it's worth repeating a sentence from the second paragraph of the newsletter. ***As long as capital, labor and technological innovations are allowed to flow freely across a level playing field, the global economy will thrive.*** Major disruptions in these areas are the issues that concern me. I view most of the other economic issues as noise over time. They are important issues, but they have very little effect on our portfolios long term well being.

Q2: Okay, so you feel deflation is basically a non-event. Your recent monthly e-mail update on the "global economy" changed the way I looked at the future of the financial markets. I was under the impression that our stock market was driven primarily by economic variables at home. Now, I have come to the conclusion that the global economy is more important. Are you still as optimistic about the global economy and our markets?

Joe: Thanks, we work hard on those updates and appreciate the feedback. Last quarter, I outlined why I am more optimistic than the average person, and that stance really hasn't changed. We are well aware of issues like the deficit, GDP growth rate, and the unemployment rate. However, our take is the unemployment rate is only one data point in the grand scheme of things and it is one that will not have a major effect on the stock market over time. Why? First, work hours, income levels, and temporary

employment are all rising...all good signs. Second, publically traded companies now compete in a global environment, which means they are no longer tied to one economy...which makes our current (lower than average) GDP moot. In essence, domestic U.S. consumption does not have to carry the world economy anymore. Third, although we don't like debt, we understand why we have our current deficit level and believe that the size and scope of it will eventually go down as the economy expands and the political landscape evolves. Finally, the global economy is growing at a nice rate, which makes me very optimistic. Why? American companies clearly know how to - and have become very adept at - tapping into that growth.

Scott: I agree. Corporations today are scaling up operations to meet growing demand overseas, particularly in emerging economies, most of whom weren't even on their radar screens ten or fifteen years ago. Many of our domestic companies now generate more revenue overseas than they do in the U.S., and that trend will only continue going forward. It truly is a global economy, with even the smallest businesses tapping into global markets in ways that were unheard of just a decade ago. A perfect illustration of this occurred this weekend, when my oldest daughter came home for a visit. She enjoys designing and making unique jewelry as a hobby, and until recently she gave most of her creations away as gifts to friends and family. However, a couple of weeks ago she decided to list a few of her creations for sale on the internet and, to her surprise, immediately began receiving orders from people in Germany, France, and Asia. If small hobbyists in North Carolina can tap into the global economy, so can U.S. companies...and they are doing just that.

Q3: Okay, so we all agree global growth is good. However, a number of people are worried and wary about China...myself included. Specifically, they seem worried about three main issues economically. First, they worry about the amount of our debt China holds. Second, they worry about Chinese currency manipulation. And finally, they worry about Chinese trade restrictions. What are your thoughts regarding China?

Joe: Just the way the question is asked makes me feel worried! Just kidding - I'll handle the first and last part and let Scott handle the currency manipulation issue - although they are all related. China holds our debt for two reasons. First, it is a risk-free investment. People get all worked up about our national debt, but the truth is, other countries and their central banks purchase our bonds for their safety.



The second reason China holds our debt is a bit more ominous...but it makes sense. Every time a country (like China) buys our bonds, which are denominated in U.S. dollars, it makes the dollar stronger relative to their currency. If they have a weaker currency, it makes their exports to the U.S. more competitive. So China has lots of incentive to buy our dollars and hold them. It helps their exports and it helps us finance our deficits at a very low cost. In this case, it's a win-win situation. But it gets more complicated...

Scott: That's correct. It also ties into how they manipulate the currency. Most world currencies are, in theory, allowed to fluctuate freely in the open markets. In reality, however, all countries manipulate the value of their currencies to some extent. China, on the other hand, is the global poster child for currency manipulation and has long resisted allowing their currency (the Yuan) to fluctuate freely. This has kept the value of their currency far lower than it should be relative to rest of the world's currencies and has been a tremendous boost to Chinese exporters.

Joe: That's true. Unfortunately, all countries manipulate trade laws one way or another. Some trade restrictions are overt while others subtle, but everyone imposes trade restrictions to some extent. It's sad. For example, lobbyists for U.S. industries attempt to manipulate U.S. trade laws all the time. And China not only uses trade restrictions, but they also manipulate their currency.

However, I think this issue needs some additional context here. If people believe that the exchange rate will somehow help our job situation, they are mistaken. In 1985, we browbeat Japan into letting their yen rise 50% against the dollar, with little effect on making our goods more competitive. Recently, between July 2005 and July 2008 under pressure from the US government, Beijing allowed its currency to rise 21% versus the dollar. Again, with little effect on our exports. I personally believe China should let their currency trade without restrictions, but the net result will not be more American jobs. It will just make the goods in Vietnam, India, and Bangladesh more competitive. So, Walmart will still stock their stores with cheap goods – only more of them will come from India and Bangladesh instead of China.

Either way, I don't really believe China is all that evil. They recognize that they must allow their currency to fluctuate or in the long run they risk destroying the very markets they rely on. In other words, they need us as much as we need them and they are starting to change their ways. It will just take time.

Q4: There has also been much written and much discussed in the media regarding "Black Swan's"? How do you guys view "Black Swans" and do you buy into their argument?

Joe: The Black Swan Theory or "Theory of Black Swan Events" was developed by Nassim Nicholas Taleb (a finance guy) to explain: 1) the disproportionate role of high-impact, hard to predict, and rare events that are beyond the realm of normal expectations in history, science, finance and technology, 2) the non-computability of the probability of the consequential rare events using scientific methods (owing to their very nature of small probabilities) and 3) the psychological biases that make people individually and collectively blind to uncertainty and unaware of the massive role of the rare event in historical affairs.

Basically, Taleb argues that the things that hurt us, or make us grow, are the very things that we rarely think about. For example, in 2008, it was hard to know that our economy was going to almost collapse over a week's time, because there were thousands of unknown derivative trades being made by unregulated firms. On the opposite side of the spectrum, in 1980, nobody could have predicted the role that technology and computers would play in creating wealth over the next 20 years. At that time, we had record high interest rates and inflation and people literally thought the economic world as we knew it was going to end. This is why we don't sweat the small stuff that most of the media and the public debate about. The next event that is going to drive our markets higher or lower is not the deficit, marginal tax rates, lower than normal GDP or unemployment. These issues are well known and are therefore already "priced" into the markets.

Scott: Exactly. Financial economists have never been very good modeling extreme events like black swans. The probability distributions we use to model securities returns do a pretty good job of capturing normal market behavior, but the tails of the distributions have always been inadequate when it comes to extreme events that are far from the norm. This is a serious problem because financial firms (banks, insurance companies, brokerage firms, etc.) rely on these models to predict worst-case scenarios—both for their clients and for their own portfolios. But if the models they use are inadequate, then obviously so are the model predictions, and we can wind up in situations like we recently saw with Lehman Brothers, AIG, and Wachovia when the mortgage market



collapsed, or with the infamous hedge fund Long Term Capital Management L.P. back in 1998.

So, not only are we aware of Black Swans, we're currently working on some research that examines alternative ways to model securities returns and so far it looks promising. In this case, we've teamed up with a couple of colleagues with PhDs in mathematics and statistics to help on the project. We're still just in the preliminary stages but we'll keep everyone up to date on our progress.

Q5: That's one of the things I like about you guys. I call (and e-mail) a lot and you always have a well thought answer, which implies you've already given plenty of thought to my question - even before I bring it up. I used to worry about market issues that I had no control over. Now I don't. Thanks! I like the reinforcement you provide in each newsletter regarding "control."

Scott: Thanks for the kind words. Joe and I have both been managing money for a long time and, because of our academic backgrounds, I think we approach the process a little differently than most advisors. I have always believed that one of our strengths is maintaining focus on the things we can control, like asset allocation, manager selection, rebalancing, and keeping emotions out of our investment decisions. We use an evidence-driven investing philosophy because we're finance geeks and we've crunched the numbers. We know which things increase an investor's odds of success and which things don't. We hope our clients are able to sleep a little better at night knowing that everything we do is driven by research and is very carefully thought-out. For example, the investor psychology research is unanimous in concluding that one of the biggest wealth destroyers for individual investors is allowing their emotions to dictate when they get in and when they get out of the market. Over the last decade, investors bought stocks near market highs (due to overconfidence and greed) - sold them near market lows (due to fear and panic) - and their portfolios wound up being smaller than they should have been. In other words, even if all we do as advisors is keep our clients from acting on their emotions, then I think we've earned our keep. We do much more than that, but emotional decisions can kill portfolio's in an instant.

Joe: That's correct. We know most of the things debated on TV and around water coolers everyday – things like tax rates and the deficit – don't affect an investor's portfolio that much over time. It's the emotional stuff, that investors can control that kill portfolios over time. Think

back over the last 20 months. In March 2009, more money was pulled out of the stock market by individual investors than ever before and they've kept pulling it out to this day! Never mind that they probably don't need most of that money for 20 to 30 years. Those people will never recover what they've lost from acting on their emotions. Ever.

Scott: Exactly. As volatile as today's markets are, it's more important than ever to set up a long term plan and stick to it over time!

Joe: Right. Speaking of volatility, the amount of attention individual investors pay to the daily ups and downs in the market is clearly not healthy...and it affects investors decision making. Personally, I rarely look at the value of my account. Instead I focus on things I can control like 1) Am I investing enough? 2) Am I balanced correctly? 3) Are my managers performing well? 4) Am I being tax efficient? 5) Am I using tax deferred accounts properly? These are the things I can control, and thus those are the things I can focus on.

Q6: Interesting, so you guys focus your efforts on what you can control vs. what you can't. You worry about things we can't anticipate versus those that are debated about every day in the media, right? It makes sense to me. One misconception some of my friends (including my husband) also have is how often our accounts are rebalanced. Can you go over account rebalancing?

Joe: Every one of our client accounts changes every trading day. Given the amount of volatility in our markets the changes can be pretty dramatic from month to month. When we build a portfolio, we do so with an eye to the future - knowing that each account will change daily. If the changes are dramatic, we want each portfolio set up correctly so that making trades (or rebalancing) does not result in additional taxes. We have three general types of accounts we manage: Tax-deferred accounts (IRA's or Roth's), taxable accounts, and outside 401k's (or retirement accounts). When we originally set up each account, we try to make sure the global portfolio is balanced across all nine equity (or stock) style boxes. We also put a portion of the portfolio in bonds and try to keep the percentages between stocks and bonds balanced over time.

Scott: One thing many people fail to understand is that our managers are constantly buying, selling and tweaking their portfolio holdings every day. In addition, various styles (e.g. small value, large growth, etc.) perform differently over time and this differential performance will eventually lead to an unbalanced portfolio. I also want to point out that we



don't like to rebalance a portfolio too frequently because our own research (which was published recently in [Financial Services Review](#)) shows that it's best to wait until an imbalance becomes fairly large before taking action. This is because when one area begins to outperform, the outperformance tends to persist for some time. As a result, if you take profits in a "hot" area by rebalancing too soon you'll fail to capture as much of the run-up as you could have if you'd waited a while longer. No one will ever be able to consistently pick the "best" time to rebalance, of course, but our findings suggest that waiting for the imbalance to become significant before rebalancing is the best approach.

Joe: Right. That's why there are periods when we need to rebalance quite often and other periods where we don't rebalance much at all. It all depends on what the market is doing...and what how our managers are doing relative to each other. We monitor our accounts continuously and if a portfolio gets out of balance—either within the equity style boxes or between stocks and bonds—we make changes.

Q7: That makes sense. This does not. Many investors, up until last year, have been holding way too much money in bank CDs. I admit that I had fallen into the trap of watching too much TV and regret not putting more into the bond market. Can you discuss safe alternatives to CDs that are liquid?

Joe: The alternative we use to CD's, as you well know, is bond funds. Our bond portfolios are liquid (meaning you have access to your money at a moment's notice) and very well-managed. Our top two bond funds (NEFZX and PTRRX) have returned 11.0% and 9.8% year-to-date (through the end of September). In addition, the other two bond funds we use (VFIX and LSGLX) that are up 6.5% and 8.5% year-to-date. Every one of those funds has beaten the tar out of CDs this year while still providing a great deal of safety. In fact, I can't imagine why anyone would buy CDs in this environment.

Scott: By buying bonds you are basically eliminating the middle man. A lot of people don't understand that banks take your CD deposits and either loan that money out (although not so much today...) or buy bonds themselves. When they buy bonds with your money their profit is the difference between what they pay you (i.e. the interest rate on your CD) and what they earn on the bonds. So you can build a well-diversified, intelligently-managed bond portfolio and earn a decent return...or you can buy CDs

from a bank and let them earn a decent return on your money while you make very little.

Q8: I know you guys have discussed it in the past, but what are your thoughts on Gold hitting all time high's. If we bought in now, wouldn't that be like falling into the "buy high...sell low" trap?

Scott: I think your reference to the "buy high, sell low" adage is appropriate. Gold prices have obviously skyrocketed in the past few years and I tend to get nervous about anything that climbs that far that fast. In addition to being pricey, however, gold has some other characteristics that concern me. In fact, if you examine the fundamentals and history of gold, it's difficult to come away thinking it would be a wise investment at this point.

First, I think it's important to recognize that gold has few industrial applications and little industrial demand, so most of its price is determined by demand from the jewelry industry and from speculators, who generally believe it to be a good store of wealth or a hedge against inflation. Jewelry demand is fairly constant over time so it doesn't tend to move gold prices much, but we do occasionally see periods of high speculative demand (like now) that drive gold prices way up. But most of the time speculative demand is low and gold prices follow suit, making it a relatively poor investment. For example, prior to the recent run-up gold reached a peak in 1980, at over \$800 an ounce. Adjusted for inflation, that works out to roughly \$2,000 an ounce in today's dollars - or well below the \$1300 or so it's trading at today, and effectively debunks the notion that gold is a good inflation hedge. It's not. In fact, if you had invested in gold 30 years ago, you would have seen inflation erode the buying power of your investment by 35%, or by about 1% annually. In contrast, U.S. stocks over the period have averaged 11.2% annually, beating inflation by about 8% annually!

Yet anyone who reads financial publications or listens to commercials from gold dealers on radio or television knows there is no shortage of those who tout gold as a terrific investment - claiming it not only is an excellent hedge against inflation, but provides excellent safety of principal. The only problem is that neither of these claims are supported by the evidence. To me, gold today is reminiscent of crude oil in 2008, real estate from 2003-2007, and tech stocks from 1997-2000. Each of these speculative bubbles eventually burst and investors who had jumped on their respective bandwagons lost billions in the process. That's why gold scares me at these levels. Still, it's important to note that bubbles are notoriously difficult



to forecast and that the prices of the asset can continue to climb long after anything resembling reasonable values have been surpassed. As long as there are sufficient numbers of people who believe gold is worth more than \$1,300 an ounce, its price will continue to climb. We wouldn't be surprised to see gold prices climb another 40% to 50% from current levels...but we know the speculative demand will eventually dry up and gold prices will fall. Remember, the price of gold peaked at more than \$850 an ounce in early 1980 but by the late 1990s it was trading down near \$250...roughly 70% below the peak of the bubble! Ouch...

Joe: Ouch is right. We should note that some of our managers have held gold for a while (in small amounts) and many of our managers own gold mining stocks. So, although we believe gold is currently overpriced, we have had adequate exposure to the run-up.

Q9: Every year, you put on a number of client dinners across the state of NC where you give what Dr. Kiely calls the "State of the Economy" speech. I always enjoy the dinner and I like the fact that you bring your entire Management Team to these dinners. Where do you stand on the preparation of these dinners for 2011?

Joe: The dinners are all set and we can't wait to see everyone again. We have all sorts of excellent data and we are excited to share it with our clients and friends in late January. Please see the chart below for more information on our upcoming client dinners and please feel free to bring a friend.

A FINAL NOTE

As usual, if you have any questions about this update, our newsletter, your accounts or our managers, please feel free to call or e-mail us at anytime. Enjoy the beautiful fall weather. The recent referrals are much appreciated and we thank you for your continued confidence in our firm and our services. As we go forward, we remain committed to continuing to refine and improve our proactive strategies and portfolios. As always, our goal is to provide each of our clients with the best possible mix of assets given their particular situation. 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 holidays and hope you enjoy this beautiful Fall season!

~ Joe and The Gang at KWAG

2011 KIELY GROUP CLIENT APPRECIATION DINNER SCHEDULE

Ocean Isle, NC Monday, January 24 th	Sea Trails Convention Center	6-8PM
Greenville, NC Tuesday, January 25 th	Brook Valley Country Club	6-8PM
Asheville, NC Wednesday, January 26 th	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

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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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.

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

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