

KWAG December Update

Over the past few months, as our markets gyrated downward, our communications have focused quite heavily on stock market fundamentals. Specifically, we have discussed why we think stocks are currently undervalued (see seven reasons in our most recent quarterly newsletter); why corporate America continues to grow their revenue streams, cash flows and profit margins (see November monthly update); and why we think we can buy these expanding cash flows and revenue streams at attractive prices. While many investors have remained focused on tangential factors (like unemployment rates, the deficit, volatility, and dysfunctional governments) we have tried to keep the focus on the critical core issues that drives stock prices over the long run – specifically, corporate cash flows and the price you pay for those cash flows.

The Numbers:

Over the first two-plus months of the 4th quarter, the S&P 500 index has risen more than 10%, while the Russell 2000 has increased by more than 14%. As of last Friday (12-02-2011), this rally had pushed the overall stock market (based on the Morningstar broad market index) back into positive territory for the year. Unfortunately, the road to this point has been filled with a variety of rocks, potholes, and other obstructions that have caused some investors to question whether the journey was worth

it, and still others to suspend the trip altogether - which in most cases has been a costly decision. We hope our focus on the fundamentals of investing and those critical core issues has helped provide some perspective in what is admittedly a trying time for many stock investors. Thus far in 2011, emotions have been a major factor in determining investor success, with fear inducing many to irrationally sell stocks at prices where they should instead be buying them. For those who have the ability to focus on the longer term with at least a portion of their assets, and who can keep their emotions in check, we think the future is bright, just as it was in 2009 and 2010 when we experienced similar fear-driven volatility.

Risk Management:

Unfortunately, remaining unemotional is often easier said, than done...which is precisely why we use some of the best bond/fixed income managers in the business. These managers provide income to many of our clients who have short term cash flow needs - and - they reduce the risk profile of our portfolio's over time. For example, over this past calendar year, the stock market has averaged a daily price swing of 1.8%, which is almost 1% higher than the 60 year average. This increase in volatility is quite significant and driven primarily by new computer "flash" trading, which we have discussed in previous updates. However, by including bonds and/or other fixed income securities to our portfolio's, we have reduced our portfolios volatility and added

positive income (and thus positive returns) to our portfolio's during 2011.

Fixed Income:

Since nearly half our clients take monthly or periodic withdrawals from their accounts, having access to the best possible fixed income managers is imperative. As a result, our three largest bond fund managers (Dan Fuss of Loomis Sayles, Bill Gross of PIMCO and Tom Pappas of Vanguard/Wellington) all have impeccable track records, are rated "Gold" managers by Morningstar. In addition, the latter two have generated positive annual returns each and every year over the past decade. Dan Fuss (the other manager), who was voted bond manager of the year by Morningstar in 2009, manages a somewhat more aggressive bond portfolio and did have one down year over the last ten. However, his 10-year average annual return is also 10.51%, which more than makes up for one off year. In addition to this core group of managers, we have recently added a new fund, managed by Jeffrey Gundlach (of Double-Line Total Return) whose expertise is in the area of mortgage-backed securities. His YTD return of 8.70% (through 12-02-2011) is impressive, and even though his fund barely a year old, his stellar track record managing a virtually identical fund (TCW Total Return) from 1993 through 2009 (winning Morningstar's bond fund manager of the year award in 2006) indicates he knows what he's doing.

Our Strategy:

Our fixed income strategy is straight forward. Like stocks, we try diversify across as many different kinds of bonds as possible (e.g. Treasury, corporate, high-yield, foreign, convertible, mortgage, etc.) in order to maintain a steady cash flow stream of income for our clients regardless of market cycle. In general, we like to hold enough bonds in a portfolio to meet a client's needs for withdrawals for at least ten years. This way, when the stock market experiences its invariable (and normal) dips, we can use the bond portfolio to provide safety of principal while we wait patiently for stocks to recover from dips. When the stock market increases significantly - as it did in both 2009 and 2010 - we can use our stock fund proceeds to meet our clients monthly income needs. By using both stocks (during rallies) and bonds (during stock market declines) to provide income, we're able to largely eliminate concerns over market cycles and, in essence, have created a strategy with a built-in rebalancing mechanism.

Going Forward:

We are well aware that the daily news cycle is dominated by Europe and their debt crisis. Fortunately, our domestic economy is NOT as reliant on Europe as most people think, and recent news on domestic unemployment, consumer confidence, and GDP growth clearly support this. In fact, over the last few years U.S. exports across the globe have increased by double-digits annually, while

exports to Europe have dropped from 23% to 18% of the total. In other words, Europe plays a relatively small (and declining) role in the domestic economy, with Canada, Mexico, China and India all more important as trading partners.

On the other hand, over the last few months anyone can see that our domestic stock market has moved lockstep with European markets, which we believe is an ill-conceived, emotionally based response to the debt crisis...and a significant opportunity. When Europe solves their problems and investors go back to focusing on the fundamental health of corporate America, we believe the stock market will experience a significant rally. Exactly when this will occur no one knows. However, if you can maintain a long-term perspective (with at least the equity portion of your portfolio), and if you can keep your emotions in check we think now is a really good time to hold stocks. And since we are long term, patient investors, who hold well-diversified portfolios, we'll gladly take short term income, rebalance as needed and patiently wait for the inevitable bounce-back.

Over the past three years, corporate America has proven to be extremely resilient. We don't think this time is any different. In fact, we believe stock investors will be pleasantly surprised over the next few years.

In Closing:

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. Please take some time to enjoy the wonderful holiday season with family and friends.

Wishing you and yours a Wonderful Holidays!

- Joe & The Gang at KWAG

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