

KWAG November Update

Good Afternoon. We hope most of you have had a chance to read our recent quarterly newsletter, (Volume 23, no. 3, October 2011) which went out a few weeks ago. A major portion of the newsletter focused on the key drivers of investment results over the long term, which probably wasn't news to most of you, but hopefully served to reinforce some of our previous educational efforts. Simply put, we wanted to remind readers that our main objective as stock investors is to purchase companies at an attractive price, given their current and expected future cash flows. As a result, if corporate cash flows continue to grow over the long term, so will our portfolios.

This message is worth repeating, since it is sometimes easy to lose sight of the forest through the trees, particularly given the volume of information we're inundated with each day. **Our main objective as stock investors is to purchase publicly traded companies at a reasonable price, given current and future expected cash flows. As a result, if corporate cash flows continue to grow over the long term, so will our portfolios.** During worrisome short term market swings, investors (who are part owners of the companies we own) sometimes forget that each company's worth is based almost entirely on the cash flows that they can generate. Since corporate cash flows have continued to grow over the past quarter (and year), it was pretty obvious that the market became oversold in the latter part of the third quarter. Other market participants eventually concurred, of course, with October coming in as one of the all-time best months for stocks in history.

October's Numbers

During the month of October, the S&P500 increased almost 11%, while the Russell 2000 was up more than 15%. However, what was even more important than the record-setting magnitude of the rally was what was directly behind it—corporate cash flows. During October, corporate cash flows continued to outpace analysts' expectations. As we're writing this, 349 firms of the firms making up the

S&P 500 have reported third-quarter results, with 270 (77%) reporting earnings that were higher than a year ago and only 68 (19%) reporting earnings that were lower. In addition, 69.7% of third-quarter earnings reports have exceeded analysts' expectations with just 20% trailing. In other words, corporate cash flows are strong, growing, and continue to surprise analysts on the upside! For stock investors, it doesn't get much better than that! Now you understand why corporate insiders have been on a buying binge over the last few months.

Reinforcing our Broader Message

In the last several years, we've frequently touched on the rationale for what some have called our chronically bullish stance on corporate America, and on our belief that the domestic stock market will continue to grow for some time. The recent newsletter provided an in-depth examination of seven factors that led us to the conclusion that the stock market had become significantly oversold over the third-quarter and why we believed stock prices would remain volatile, but with a positive bias, for quite some time. In essence, the market experienced a short term dip that was not consistent with longer term corporate cash flows.

Thankfully, the vast majority of our clients recognize the importance of maintaining a long-term perspective as stock investors. However, with the digital-age news cycle taking the short-term perspective to the extreme and with humans having a natural tendency to overemphasize the recent past when setting their expectations for the future, we recognize that maintaining a long-term perspective can be a challenge. In fact, even the most ardent devotees of long-term investing can sometimes become unnerved enough to temporarily lose their focus. So, every once in a while, we believe it's probably a good idea reinforce the validity of the long-term investing philosophy by looking back beyond some of the most recent market events.

(Note: Typically, we like to limit our monthly updates to one or two pages. So, we recognize this monthly update is a bit longer than normal. However, we believe the reinforcement of examining "cash flows" is worthy a few minutes of your time. In addition, there are still a few folks who can't reconcile what they see

happening domestically versus what's happening globally - so we thought our observations regarding this "disconnect" might be timely. We'll go back to our short form next month.)

Looking Back

Looking back, most people probably wouldn't be able to tell you that in seven out of the last eight calendar years, the stock market has posted positive gains, with the only down year coming three years ago in 2008. They probably also wouldn't be able to tell you that in five of those seven years the stock market gains were in double-digits. Moreover, if they're like most individual investors, they probably wouldn't be able to tell you that stock prices went up in those years...precisely because corporate cash flows were also going up!! This is because the notion that "cash flows" govern stock values in the long run is foreign to almost ALL investors. People seem to be more concerned with peripheral items like our deficit, the value of the dollar, inflation and politics. These are clearly important topics, but they don't drive stock prices over the long run - corporate cash flows do - which we might add are at record levels! To us, it's kind of alarming that the importance of cash flows remains totally lost on the majority of stock investors.

In the past, we tried to reinforce the importance of cash flows by writing about the various "disconnects" that exists between investor perception, and the reality of the assets they are actually invested in. What follows is a brief look at a few of the more prominent disconnects that we see currently, which we hope you will find educational, as well as informative.

The Economic Growth Disconnect

The World Economy: From a broader perspective, one of the most important questions a long term investor can ask is, "Will the economy continue to grow over time?"

If the answer is yes, then the problem condenses down to searching for the most attractively priced publicly traded companies that will be able to benefit from that growth. Since we now live in a global economy, we have to look beyond the

United States to get the appropriate answer. When we look beyond the U.S. and closely examine China, India, Brazil and other emerging markets, the answer is a resounding, “Yes! The world economy is growing...and that growth is going to continue for some time.”

The U.S. Economy: One of the reasons why we believe many market participants lose sight of this broader global perspective is because most of the economic news revolves around how things affect our country. The media clearly examines other global financial markets, but they always come back to “How does this affect us in the U.S.?” In a global world, this perspective is counter-productive...particularly when most of our publicly traded companies current growth and new revenues come predominantly from places overseas. For example, General Motors recently celebrated its 100th birthday this past week, making it one of the oldest U.S. corporations. However, while GM remains an iconic brand that is based in the U.S., it now sells more than 70% of its autos overseas and is the number one seller of automobiles in a number of foreign countries, including China! In other words, Americans are no longer the only ones driving a Chevy to the levee—in fact, we’re probably now in the minority.

Takeaway: The world economy is growing and will continue to grow for some time—and this growth will continue to benefit the U.S. companies we invest in for some time.

The Corporate Growth Disconnect

Publicly Traded American Companies: Since most of the new economic growth is coming from other global markets, the question one should ask is, “Can America’s publicly traded companies continue to tap into this growth over the long term?” Based on the example above, the answer is - again - a resounding, “Yes!” The truth is, they’ll be able to do so for quite some time. You see, our companies have a very distinct advantage in that they have been shifting critical resources (like labor, capital and technology) around the globe for some time. While other countries are trying to figure out how to sustain their growth at home, we have been developing global strategies for decades now. This experience will give our

American companies a huge distinctive advantage for a long time, which means American corporate cash flows are going to grow for some time.

The American Worker: Again, one of the reasons we think many market participants lose sight of this long term corporate advantage, is because they are focused on the issues that affect us here at home. We are all well aware of the higher than normal unemployment rates and the housing problems we have at home. When we see a friend get laid off - or lose a home - it hit's us like a punch in the gut!! It's hard to reconcile the loss of jobs at home with continued growth in publicly traded companies. People wonder how can we have corporate growth if our unemployment rates are up? Don't forget, most of the corporate growth now comes from overseas. The problem can be disseminated down to the American workers skill-set. Most of the new jobs today demand a specific skill-set that many American workers simply do not have. Today, there are plenty of job openings in Engineering, Technology and Health Care. Unfortunately, we don't have the skill-sets to fill them. So, not only does India and China get the more inexpensive manufacturing jobs...they also get the high tech ones as well. This trend is slowly changing, but it is going to take some time to upgrade our workers skill-sets.

Takeaway: Corporate America is benefitting from global economic growth by tapping into a global skill-set. This has resulted in record cash flows and record cash reserves. Unbeknownst to many...it has also led to a shift in the way we are educating our masses. We are making great strides...but this shift will take time.

The "Perspective" Disconnect

Long Term Investors: Simply put, rational, long term stock investors should be concerned with only two things: the expected future cash flows generated by the companies they're investing in and the price at which they can acquire those cash flows. That's it!

Yet, the stock investors we speak with regularly are concerned with a myriad of issues, such as our dysfunctional government, the federal budget deficit, the high

unemployment rate, and the recent stock market volatility. We regularly field a number of different questions on a number of different topics – unfortunately NONE of them revolve around cash flows! In contrast, when talking with our fund managers, all they want to talk about are corporate cash flows and the prices at which they're able to acquire them. In other words, most stock investors focus on the wrong things. Ask Warren Buffet what he looks at when he purchasing a company and he'll tell you that it all comes down to cash flows and a price. In fact, if you ask any college student fresh out of Finance 101, they should be able to tell you the same thing...assuming they were paying attention.

Short Term Traders: One of the reasons we think investors lose sight of this simple “cash flow” analysis is because they get too caught up in short term headline news and the short term volatility of our markets. In essence, their perspective is altered by short term issues that are highly emotional. This diverts their attention away from the more important issues of “price” and “cash flows.”

Takeaway: The truth is, when it comes to stock investing, CASH FLOWS are KING and long term investors should never forget this simple fact.

The “Expectations” Disconnect

How We See the Markets: At KWAG, we expect that the financial news will be amplified, inflated and exaggerated to the limits allowed by the network execs (and perhaps beyond). We also expect that computer trading will continue to create periods of extreme volatility, which will occasionally cause asset prices to deviate significantly from their true values. Moreover, we're okay with all of that because we're long term investors! The truth is, both hyperbolic headline news and new computer trading are great for our portfolios. Oddly, it seems like the only people on this planet who seem to hate buying assets while they're on “sale” are individual stock market investors. Here's a simple fact; short term volatility is our friend...and it has been a boon to our portfolios over the last three years.

How Emotional Traders See the Markets: Emotional traders, on the other hand, could care less about cash flows and/or markets prices because their actions are

dictated by things like fear and greed. Emotional investors don't see a global world that is growing - they see America's economy which is growing at a lower than normal rate. Emotional investors don't see a global economy, where American companies are thriving - they see high unemployment rates domestically. Emotional investors don't focus on the long run - they dwell on the current hyperbolic headline news and have trouble letting go of the past. Emotional investors don't embrace markets sales - they see increased volatility and chaos.

Takeaway: We embrace irrational, emotionally-driven markets and computer flash trading because they create nice opportunities in the short run. In truth, rational investors SHOULD embrace (and expect) volatility, since it creates opportunities that wouldn't otherwise be available to them. This is why we have consistently used volatile periods to rebalance our portfolios and pick up beaten down assets at ridiculously attractive prices. Similarly, when things look ugly and short term oriented investors begin to panic, our fund managers are instead looking at the cash flows underlying the companies they follow, and they use this analysis to take advantage of the tremendous "sales" that the short term traders have created.

In Sum

In order to make money as a long term investor, you have to maintain your focus on what's important, ignore the rest, and learn to accept the market on its own terms. For example, there are plenty of things about the global economy that we don't like. We don't like the fact that jobs are being exported...but we accept that they are, and we recognize that it actually helps corporate profitability and cash flows. We don't like the hyperbolic news and new short term volatile trading, but it exists, and it has actually made it easier to rebalance our portfolio's and thus grow them. We don't like the fact that our politicians are spinning their wheels in Washington, but in today's global world, it simply does not have the same effect on our portfolios as it once did in the past.

In the end, **cash flows are king**. For rational investors, all that matters is the price you pay for those cash flows. Those who lose sight of this will be tempted by a variety of other factors that simply don't matter—and their portfolio will likely suffer for it.

One Caveat

Anyone with a TV or access to a newspaper knows that Europe has some significant debt problems that they are addressing. The good news is, we know the size and scope of these problems, and we've known about them for some time. We also know that the euro-zone has a pretty good idea of how to handle these problems. The difficulty is...economic decisions in euro-zone require the consensus of 17 separate countries who have 17 different laws, regulations and political systems. In effect, we've got 17 different chefs in the kitchen, all with different recipes, and things are heating up. We're encouraged by the progress that's been made recently. At this point, we want you know that we are closely following the drama as it plays out, and we will adjust our portfolios as needed...particularly if we believe the events in Europe will impact long term corporate cash flows. For now, corporate cash flows remain strong and the global economy continues to grow, which more than offsets the potential issues in Europe. However, if that should change, we will let you know. In the meantime, we'll continue using irrational market selloffs to help improve the long term prospects for our client portfolios, just as we've always done.

Thank you for taking the time to read this atypically long monthly update. 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 fall colors and enjoy a HAPPY THANKSGIVING!

- **Joe & The Gang at KWAG**

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