

KWAG October Update

Good Afternoon. We wish there were a good way to sugarcoat the news. The third quarter of 2011 was basically brutal. There is no other way to put it. The quarter began innocently enough, with a mild rally in July which brought us close to yearly highs. However, as the month wore on, the coverage of a potential U.S. default and the political dysfunction in Washington dominated the air waves, resulting in rising stock market volatility and a relatively modest decline in prices. Frankly, we were surprised how well the stock market behaved given the tone of the news. Overall, the S&P 500 declined 2.15% in July, while the Russell 2000 fell 3.67%. As we noted at the time, dips of that magnitude are common and nothing out of the ordinary and there were no signs of overt concern or panic on Wall Street. In fact, corporate earnings continued to come in above expectations and analysts were upbeat about prospects for the remainder of the year. Unfortunately, the news got progressively worse as the quarter wore on.

Month #2: August

August was a challenging month on a number of fronts. The month began with an ugly political battle over the debt ceiling, which ultimately led to the controversial S&P downgrade of U.S. debt. The troubling triumvirate of a dysfunctional Washington, the S&P downgrade, and renewed debt fears in the Euro zone, precipitated a significant selloff in equities across the globe and a marked spike in market volatility. However, the second half of August saw a nice rally in both large and small cap stocks, partially offsetting earlier losses. Overall, the S&P 500 (large company stocks) was down 5.6% for the month of August, while the Russell 2000 (small company stocks) finished down 8.8%. For the year (through August), the S&P 500 was down 3%, while the Russell 2000 was off a little over 6%. Given the continued positive news about corporate

balance sheets and the fact that the debt ceiling was raised we thought perhaps the worst was behind us.

Month #3: September

The financial news in September was focused primarily on four items: 1) the dysfunction occurring within European politics, 2) Europe's anemic recovery and economic slowdown, 3) the complete lack of European exports to growing economies, and 4) the potential for default by Greece and the group of countries known by the acronym PIIIGs (i.e. Portugal, Italy, Ireland and Greece). This news was compounded by weaker than expected economic data out of the U.S., although corporate cash flows continued to grow. Through the middle of the month the markets were essentially unchanged when an interesting thing happened. The news out of Europe improved. (Yes, improved!)

First, European leaders acknowledged the potentially dire consequences of a default by Greece and the ensuing contagion that would likely spread through the European financial system. It was reassuring to finally know they grasped the gravity of the problems they faced. Second, Greece passed an important measure to shore up their balance sheets. The austerity measures were severe and, not surprisingly, hugely unpopular with the Greek people. However, passing the measure was the right thing to do. Finally, last Thursday, Germany (the main driver of the European economy) passed some very tough legislation that allows Europe to move forward with a massive and much needed bailout plan. Taken together, these were genuinely positive developments. However, there still remains a significant amount of uncertainty over the measures that must be implemented over the next six months in order for the bailout plan to work. Unfortunately, the tone and pessimism permeating European politics over these potential stumbling blocks is being matched by the tone and pessimism in financial markets. In fact, the financial markets are clearly betting

that a rescue plan in Europe will not be large enough or come soon enough to head off Greek default. In addition, the domestic markets have now largely “priced in” a second U.S. recession.

The Quarter

Overall, for the month of September, the S&P 500 was off 7.18% and the Russell 2000 was down 11.37%. For the quarter, the S&P declined 14.23%, while the Russell 2000 fell 22.15%. And year-to-date through Friday, the S&P 500 is off 10.04% and the Russell 2000 is off 17.02%. The third quarter was obviously tough on our stock portfolios, which implies our quarterly statements will not be pretty. At this point, we believe the worst case is largely already priced into the market. In fact, many analysts believe the market is significantly oversold and it’s difficult to disagree. If you examine corporate balance sheets and income statements it’s clear that valuations – especially price-earnings ratios - are near levels not seen since March 2009, when the market bottomed and then rallied over the next 30 months.

So while we hate to see our clients (and their portfolios) go through periods like this, we recognize that markets are emotionally driven in the short-run and rapid selloffs like we’ve seen in the last few weeks are inevitable. We also think valuations are very favorable for stock investors and that long-term prospects remain excellent. This does not mean we won’t see further volatility going forward, we almost certainly will. As we’ve seen before, once fear and panic enter the market they tend to stay a while. This means further short-term selloffs are possible but they will be driven mostly by fear, and should therefore be temporary in nature.

Good News?

Of course there is good news. There is always good news. Even though this has been a very difficult short term period for our portfolio's and our clients, this does not mean we are going to revisit the lows of March, 2009 again. Nor does it mean we are abandoning our prudent, well-thought-out investing strategies. In fact, with some perspective, 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. But even with the inevitable setbacks, the general direction continues to be up. In today's global electronically-driven financial markets, significant moves (in both directions) will occur much more rapidly than they once did - and - 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 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 panic selling creates.

Patience

Many people are unaware of this simple fact - today over 70% of all trading is the result of computer models. Most of this trading is NOT based on company fundamentals, but on short term trends instead. These trades happen very rapidly and involve huge amounts of capital. Thus, in the short run, prices can deviate substantially from the true intrinsic value of the underlying assets...particularly when fear and pessimism are high and confidence is low. This creates an opportunity for those of us with longer term time horizons.

In 2008, the financial markets experienced a near meltdown. There was good reason for concern, as we stood on the edge of a precipice staring into an abyss that represented the total collapse of the global financial system. Yet, within just a few years, small and mid cap indexes rallied to all-time highs! At that time, once we knew that the economy was no longer teetering on the edge, we used the irrational valuations created by all the fear and panic to our advantage. Today, we are dealing with serious issues in Europe, to be sure. However, unlike late 2008, the problems Europe faces, and their magnitudes, are known. In essence, we are not staring into another abyss.

We would like to reiterate that we are not pleased with the current market decline. However, this is not the time to run for cover. Need evidence? Think about those poor souls who panicked in 2008, only to sit by idly as the stock market more than doubled over the next two years.

Our Plan

Our plan and perspective have not varied. The portion of our portfolios invested in stocks are long-term investments, with long-term being defined as a minimum of five years. This has always been the case. We are long term investors, NOT market timers. We assess opportunities rationally, and avoid making irrational, emotionally driven decisions. Everyone who owns stock in their portfolio needs to ask themselves this simple question, “Can I remain patient and focused on a five-year time horizon beginning today?” If the answer is yes, then short term reversals like the one we’re in now are largely irrelevant. That said, they can provide nice opportunities to take advantage of the opportunities created by those who are unable to remain patient and focused.

If the answer is no, please contact your advisor immediately and we will adjust your portfolio accordingly.

Dips & Rally's

Almost all of our “working” clients are investing regularly into a retirement account every month. By doing so, they are automatically taking advantage of the inevitable market dips through the process of dollar-cost-averaging. Those who have continued to invest in stocks - particularly over the last few years - have been well rewarded for sticking to their convictions. They have purchased more shares during the dips, when stocks are “on sale” and fewer shares near peaks. In fact, if you are working and contributing to a retirement account, market dips should be viewed as your friend!! In essence, short term dips are an advantage for those making periodic contributions and should be embraced.

For those of you who are retired and taking distributions from your accounts, we (at KWAG) use a fairly simple approach to provide income every month. When the stock market is rallying, we pull income from your stock holdings. By selling stocks during rallies, we ensure we are paring back on stock investments during periods of strength, when prices are high. Alternatively, when the stock market dips, we pull income from the bond portion of your portfolio, meaning we avoid selling assets when their prices are down. This is precisely why we build diversified portfolios...it allows our clients and their portfolios to weather the inevitable storms that are going to occur from time to time.

Emotions

Emotions are a difficult thing to control when the markets are falling and you're watching the financial news each and every day. We understand this, which is why we continue to preach a long term philosophy that is UN-

emotional. Interestingly, when you are worried about the stock market and your emotions are at their peak, this is probably the absolute best time to invest in stocks. Unfortunately, investors tend to extrapolate the current ongoing “bad” events out into the future, making it virtually impossible for them to capitalize on the cyclical lows. By having a strategy in place ahead of time, and by assuming that volatile periods like this will happen, we make sure to take advantage of these unfortunate periods as opposed to the other way around.

We will stick to those same plans this time as well.

Opportunities

Over the last few months a number of opportunities have arisen to invest in high-quality assets at extremely attractive prices. One such opportunity is the ability to purchase stocks with dividend yields that significantly exceed the yield on long-term Treasuries. This is a rare occurrence indeed and a rare opportunity. In essence, we can invest in quality companies with stable, growing dividends and wait patiently for the market to bounce back. In the meantime, the dividend income we’re receiving exceeds the interest income we could get off even the longest maturity Treasury bonds. And unlike with bonds, the dividend income grows over time! When the market does bounce back, we’ll still have the dividends...and we’ll get to enjoy the capital gains as well. This is a unique opportunity, and every time dividend yields have exceeded long-term Treasury yields in the past a significant rally has ensued.

So, if you’re nervous about the stock market, just remember that there are reasons why buying by corporate insiders is off the charts and why Warren Buffett has started repurchasing shares of his own stock on the open market. These people, who should know better than anyone else what their companies

are worth, are convinced that the prices they see today are way below intrinsic value. It's usually a good idea to follow the "smart" money and right now the smart money says many stocks are really cheap.

Upcoming Newsletter

This quarter, our newsletters and your accompanying statements will go out on or around Thursday, October 20th. In the upcoming newsletter, we'll focus on understanding the global economy and the impacts of new short term computer trading. Look, we understand why people are concerned. You'd have to be inhuman not to be. However, to this point, our clients have remained amazingly patient. We hope some of that has to do with our educational efforts. However, we always feel like we can provide more on the educational side. Why?

Because today's global economy is different!

Today, we live in a new global economy where it's often difficult to connect all of the dots. In addition, we have a very pervasive media that fuels "fear" by focusing on the negative and sensationalizing virtually every dire prediction for the sake of ratings. Finally, the increase in volatility through computer-driven flash trading, which now represents 70% of all trades placed each day, only serves to ratchet up the volatility. Now, every bit of negative or positive news is met with wild swings in stock prices each day. So, we understand why people are concerned. However, we want to reiterate, this is why we are long term investors. In this new world, it is more important than ever to have a well thought-out investment plan that incorporates the increased volatility. You must be as patient as Job. You must have nerves of steel. And, then you have to have the willingness to execute that plan by keeping your emotions in check.

Think about it...If you really want to earn decent returns in the stock market, you need to examine how the most successful investors in history have achieved success. Investors like Warren Buffet have invested in the face of adversity, many times over the last half century. Yet, when things look gloomy and pessimistic, it is still very difficult for the average person to pull the trigger and invest or rebalance into stocks. Our DNA subconsciously encourages us to flee from fear...

We'll make sure this does not happen with our portfolios.

Our Dinners

One last item. We have reserved rooms and set up our annual client appreciation dinners for late January. Let's hope we have a warmer winter this year and there are NO weather delays! Please mark your calendar and make your reservations as soon as possible by calling our main office in Greenville, NC (877-366-5623):

SUNSET BEACH, NC MONDAY, JANUARY 23RD SEA TRAILS CONVENTION CENTER

6-8:30PM

GREENVILLE, NC TUESDAY, JANUARY 24TH BROOK VALLEY COUNTRY CLUB

6-8:30PM

ASHEVILLE, NC WEDNESDAY, JANUARY 25TH ASHEVILLE COUNTRY CLUB

6-8:30PM

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. 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.

- Joe and The Gang at KWAG

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