

Kiely Group September Update

Good Afternoon. August certainly was an interesting and challenging month on a number of fronts. The month began with an ugly Congressional battle over the debt ceiling, with the fight ultimately leading to the S&P downgrade of the nation's debt. The combination of a dysfunctional Washington, the debt downgrade, and renewed debt fears in the Euro zone precipitated a brief selloff in the global equity markets and a significant spike in stock market volatility. The second half of the month, saw a significant rally in both large and small cap stocks. Overall, for the month of August, the S&P 500 (large company stocks) was down 5.6%, while the Russell 2000 (small company stocks) finished the month down 8.8%. For the year (through August), the S&P 500 was down 3%, while the Russell 2000 was off more than 6%. Although we don't like being in negative territory at any point in the year, we still maintain that a significant number of stocks are oversold and believe that the stock market has a high probability of finishing the year in positive territory.

The Good News:

Contrary to what you often hear on the airwaves, there actually is some very good news out there...which is why we believe the stock market has been oversold. First, Warren Buffett made a significant investment in Bank of America. Bank stocks as a whole appear to be significantly undervalued and have been under a great deal of selling pressure since late 2007. In fact, some analysts believe banking stocks as a whole are trading at a 50% discount to fair value, and the recent acquisition by Mr. Buffett does nothing to dissuade that notion. (Note: Mr. Buffett made a similar purchase in 2009 just before the markets rallied.)

Second, dividend growth has increased by double digits over the last two years, and as the stock market has declined in value, "dividend yields" have gone up. In

essence, one can now invest in the stock market (particularly on the large cap side), and get a dividend yield that is better than the yield on a ten year treasury bond—a rare occurrence indeed! In addition to the hefty dividend, stocks allow investors to participate in the upside as the market recovers.

Third, as the individual investors were selling out of the stock mutual funds in August, corporate insiders (i.e. upper management) went on a buying binge not seen since March 2009. This bodes well for the market because insider buying is a very good leading indicator of market rallies. In fact, since 1982 there hasn't been a single significant market move to the upside that wasn't accompanied by heavy insider buying.

Fourth, corporate profits and cash flows continue to surpass analysts' estimates, even as individual investors continue pulling money out of stock mutual funds in favor of overpriced gold and low-yielding Treasury debt. This seems counterintuitive to us, but emotions are powerful and fear often trumps reason.

Finally, a number of well known stock market analysts (including Abby Joseph Cohen and Byron Wien) have reiterated their belief that the S&P 500 is oversold and will finish the calendar year at or above 1,400. At the end of August, the S&P 500 stood at 1218, which would represent a gain of roughly 15% over the next four months.

When you combine Mr. Buffett's recent actions, coupled with strong dividend yields, heavy insider buying, strong corporate earnings, and the Fed's continuing commitment to keep interest rates down...we wouldn't be surprised to see our markets significantly higher by year-end. That said, as long term investors, we're more interested where stocks will be five or ten years from now than where they will be in four months. Since everyone agrees that we have an expanding global economy, we have no doubt the global markets will be higher over the long

run...and we wouldn't be surprised if they were significantly higher. While it's unfortunate that so many people get caught up in the short run emotion of the markets, we want to remind everyone that stocks remain a long-term investment in our portfolios. And even though we're long term investors, we still believe this year's short term result will play out similarly to 2009 and 2010.

Our Managers:

Many of you have seen some trades in your portfolios as we have been proactively rebalancing accounts (on an as needed basis) in light of the recent markets swings. In addition, our fund managers have been proactively rebalancing their portfolios as well. One of the downsides of using mutual funds is that fund holdings are NOT updated every day, so investors are unable to see the specific changes they're making in real time. However, we want to be clear, almost every mutual fund (and thus every portfolio) is being rebalanced in one way or another every single day. In essence, your portfolio is being pro-actively managed on a daily basis. The upside of using active managers is that they can (and do) take advantage of the many opportunities that volatility invariably creates. One of the biggest benefits associated with maintaining a long-term perspective as an investors, is that we can use short-term emotionally driven price swings to our advantage.

Our Portfolios:

One of the changes we are making (at KWAG) in our client portfolios is to increase the relative weights of large cap stocks and foreign bonds. It's important to note that these aren't wholesale moves away from small and midcap stocks or domestic bonds, but strategic tweaks designed to move additional assets into the areas of the global market that seem to be the most attractive. Larger companies often have a competitive advantage over smaller firms when it comes to tapping

into global markets. With much of the developed world languishing in a period of stagnated growth, companies that can tap into more rapidly growing economies will likely perform the best. In addition, large firms tend to pay higher dividends than smaller firms and with dividend yields currently so attractive, we think it only makes sense to take advantage of them. Since large firms also currently hold tons of cash, we think dividend payments are both secure and will likely continue to grow. Finally, firms with high dividend payouts tend to be less volatile in market downturns, making them attractive from a defensive standpoint.

The Bad News:

In spite of all the positives, however, there continues to be plenty of worries to go around. Most of these concerns have been with us for a while now and since they are all being aggressively addressed, we believe many of the issues will be temporary impediments. The list of concerns includes, but isn't limited to:

1. Europe: The major concern is a collapse of the European financial system as a result of sovereign debt restructuring or default by some of the weaker Euro zone nations. A meltdown in the European banking system could push the U.S. economy into a recession, which is clearly a significant concern.
2. In the United States, the concern is that the economy could slip back into a recession, driven largely by gridlock in Washington and the psychological impact that a dysfunctional government has on the nation's employers and consumers. Make no mistake, when the government is unable to function effectively, the American people are the victims.
3. In Africa and the Middle East ,the concern is the continuation of the Arab spring. The overthrow of Mubarak and Gadhafi has occurred, but they've been replaced by confusion and uncertainty over how the fledgling new

nations will govern themselves. Since the issues of poverty and unemployment can't be addressed until new governments are in place, we're concerned that a second wave of unrest could occur and further destabilize the global oil supply, thereby leading to much higher prices and pushing us closer to a recession.

4. The concerns over the Chinese banking system are well-known and there are serious indications that overbuilding has occurred in high-end real estate. China remains a formidable engine for growth within the global economy, and the primary concern is what ripple effects in China would have on the rest of the world.
5. Finally, there is always concern over another serious terrorist attack, either in the developed or developing world. The attack on the World Trade Center towers ten years ago pushed the economy back into a recession and an attack of similar magnitude elsewhere could be expected to have the same effect.

In short, there's always plenty to worry about. At this point, we don't believe we are on the brink of a second (or double-dip) recession. However, the odds of a recession have certainly increased during the first eight months of the year. Thus, we think it makes sense to continue gradually adding to our holdings of larger cap dividend paying stocks and international bonds. However, we need to be careful not to compromise the upside potential of our portfolios as the global economy recovers, meaning changes will be carried out in a very measured, deliberate fashion. We continue to believe the positives outweigh the negatives for stock investors, but if we can simultaneously increase the defensive posture of our portfolios while increasing exposure to asset classes we believe are currently the most undervalued, it only makes sense to do so.

Overall, we believe most of the above concerns are already “priced” into the stock market. In essence, we believe our markets have already factored in the “worst case” scenario into pricing. This is why we believe the market is oversold and will rebound significantly before the year is out. This belief is echoed by a number of well known market insiders...including Warren Buffett.

In Closing:

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 anytime. Enjoy the summer...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 & The Gang at KWAG*

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