

KFS 1st Quarter, 2009 Update

Over the last year, we have written numerous times about the “excess behavior” that led to the financial market meltdown in September and October of last year. We have also covered the gluttonous, deceitful behavior of Lehman Brothers, AIG and other Wall Street firms with respect to creating and marketing the deeply flawed mortgage-backed products that got us into this mess, culminating in a three-week period in September and October when the economy suffered what amounted to a financial “heart attack.” The seriousness of that attack nearly led to the total collapse of the global financial system and was obviously cause for great concern. When you block the major arteries of any system, be it financial or cardiovascular, that’s about as serious as it gets. Fortunately, we have some of the world’s best surgeons working on our financial system and they were able to deftly step in and save the patient.

Looking Back

Looking back, it’s obvious the response of Ben Bernanke and Hank Paulson to the crisis over that initial three weeks was extraordinary. Like well trained surgeons, they quickly identified the blockages starving the financial system of capital and opened them, thereby stabilizing the economy. They did so via a series of innovative moves that included propping up the commercial paper market, insuring all bank deposits, and providing a much-needed capital infusion to troubled banks. In essence, they removed the blockage and put in the financial equivalent of stents to make sure the arteries stayed open. Heart attacks—whether human or financial—are scary. The consequences are potentially severe and the outcomes unknown. September and October of 2008 was a difficult, scary time for all of us. But Bernanke and Paulson got us through that critical period, got the financial system back on its feet, and put us on the road to recovery.

The Past Five Months

Since October, both the government and the Federal Reserve have some provided powerful medication designed to help heal the economy. This has come in the form of new regulations, fiscal and monetary stimulus, and plans to remove the toxic assets from the financial system. We’ve been impressed with the innovative approaches

being taken to help resolve the crisis and the collaborative public/private programs being put in place. Unfortunately, the problems we're facing are very complex and it is difficult for those without backgrounds in finance or economics to know whether an approach is good, bad, or indifferent. And, as is often the case, the financial media has probably done more harm than good—getting things totally wrong on many occasions and always managing to focus on the sensational worst-case scenario, no matter how implausible. This is where things can get really scary for the average investor. Without extensive knowledge of finance and economics, how would you know what to believe? No wonder people are scared and confused...

Confusion Leads to Volatility

The financial market volatility we have experienced recently is unlike anything any of us have experienced before—resulting in sleepless nights, countless questions, frustration, fear, and even anger. We understand. We're human too and we've been angry over some of the shenanigans. Our biggest fear as humans is fear of the unknown, so if you understand the root cause of that which you fear (which in this case is short run volatility) the fear tends to subside. Unfortunately, the stock market can act as a negative feedback loop in the short run. Uncertainty leads to confusion. Confusion leads to fear. Fear leads to panic. And panic leads to emotional “sells.” If enough investors sell, the market decreases for a few days. This provides additional fuel for the media, who like to give conflicting implausible reports as to why it decreased. During our dinners in January and in subsequent updates, we have provided some compelling evidence on the disastrous impact of emotional investing. In February, as if proving our point, virtually all of the selling was being driven by fear and panic.

The Numbers Looking Back

On October 10, 2008 the Dow Jones Industrial Average (Dow) hit a low of **7773**, while the S&P 500 hit the **840** mark and the Russell 2000 fell to the level of **468**. At that point, after three weeks of intense selling, it became clear we had averted an economic and financial disaster. We knew we weren't out of the woods, but the patient (our financial system) was at least stabilized. Over the next few months, various forms of treatment were prescribed and we began to see signs of improvement in a number of

areas, particularly in the credit markets and bank balance sheets. Unfortunately, fear was still pervasive among investors, and many remained chained to a counterproductive short-run mentality.

Our Dinners

During the last few weeks of January we held a series of client appreciation dinners, at which we explained how market prices were virtually unchanged from the levels we'd seen in October. The day of the first dinner, on January 23, the Dow closed at **8077**, the S&P 500 at **830** and the Russell 2000 at **444**. At each successive dinner throughout the next week these numbers increased, as we explained that the economy was going to get worse before it got better, that market volatility would continue to be high for the foreseeable future, and that the economic stimulus would take time to be felt. We also noted that long term investors had nothing to worry about, even though stock prices could go lower in the short run. We encouraged people to turn off their TV's and focus on our common sense, long-term approach.

And Then February Came

In mid-February, three interesting things happened. First, two of the largest banks to receive Federal bailout funds reported that they were profitable for the quarter to date and would remain in the black through quarter-end. Second, the Obama administration passed a massive stimulus bill to help shore up the economy. And finally, Warren Buffet urged patience and spent three hours one morning going over why he felt the stimulus bill would work and why the banks and our economy would be just fine. Collectively, these three pieces of information would have had a positive effect on a rational stock market. But fear was still pervasive and rationality in short supply. The positive news from the banking sector and Warren Buffett's wisdom, were all but ignored and the media focused on what they disliked about the stimulus bill. We conducted our own assessment of the bill and determined that while it was far from perfect, it would provide a great deal of badly needed economic stimulus—particularly in the area of job creation. But the overblown negative reports by the financial media served to heighten the level of uncertainty on the part of investors and the selling began anew. And as the decline began, fear and panic fanned the flames and individual

investors once again led the charge to the exits, responding to fear and panic with—more fear and panic.

Today: The Recovery Phase

In late March, the S&P 500 experienced its biggest two-week gain in over 70 years and the markets are now once again basically unchanged since mid-day October 10th, 2008. It has been an incredibly bumpy ride, of course, but we're basically right back where we were nearly six months ago. In other words, it has been "a tale full of sound and fury; signifying nothing." At the end of trade today (April 3rd, 2009), the Dow closed at **8017**, the S&P 500 closed at **842** and the Russell 2000 closed at **456**. Look, it's obvious we've been through a very scary period, but today the patient appears to be in good shape and is recovering nicely. As with any recovery from serious illness there will be good days and bad days. Things may not always progress as rapidly as we'd like. However, the patient is on course for a full recovery and with proper treatment can look forward to a long, healthy future. That's basically where the economy stands right now.

The Forest

Obviously, even with the excellent care provided to the economy, we're not out of the woods yet. Over the long run, we believe the economy and financial markets will be just fine and we believe that the future is bright for long-term investors. That said, unemployment will continue to rise, not all new economic data will be positive, and there will be additional bumps in the road. In addition, volatility will not abate until uncertainty does, and uncertainty looks to be with us for at least the foreseeable future. No one knows what the short run will bring, but with the unprecedented amount of economic stimulus being poured into the global economy, it's only a matter of time until things turn around.

The Newsletter

Our goal is to get the quarterly newsletter in the mail on Monday, April 20th. Given tax season ends just a few days earlier, however, it may wind up going out a few days late. In the newsletter we will take a detailed look at the economy, the markets, and discuss our views on when the economy will begin growing again. We will also look

at the various stimulus plans initiated by the Fed, the Treasury and the new Administration. As usual, we'll finish up with 10 questions, which will include responses to client questions on inflation, toxic assets, and Treasury Secretary Geithner. We look forward to your additional questions, which can be sent directly to Joe at jkiely@kielyfinancial.com.

Thank You

This has been a very difficult time and we know many of you are still nervous. Who wouldn't be? But if history is a good guide (and we think it is), our investment approach and strategic asset allocation will serve everyone very well. The nay-sayers, who say diversification is dead and that we should abandon sound asset allocation strategies going forward, have failed to do their homework and they don't understand the sole driver of future returns is "price." Today there are hundreds of great companies trading at unbelievably attractive prices. And when the fiscal and monetary stimulus fully kicks in, look out.

As usual, if you have any questions or concerns about your portfolio, the stock market, the economy or these updates, you can contact us directly via phone or email (see the numbers and email addresses provided below). Thank you for your continued confidence in our firm. We remain wholly committed to your financial well being!

Have a great weekend.

-Joe and The Gang at KFS