

A Special Note: Before we even begin this update, we want to take a minute to thank the vast majority of our clients and friends for being so calm and levelheaded during the market turmoil of the past month. A number of you sent in checks to invest in the stock market, increased your 401k contribution limits, rotated out of bonds into stocks and/or reduced your monthly withdrawals. These are the exact things you're supposed to do (and can control) when the market drops!! (Please note that we didn't ask any of our clients to reduce withdrawals as that is a personal decision and is not an option for everyone...but a number of you focused on what you could control - and acted). We also appreciated the feedback regarding our updates during this period. A number of you called to thank us and/or ask follow up questions on certain topics. While much of the financial world was in the state of panic, we were (and remain) quite proud of the overall calm reaction of our clients. You are a great group to work with and its times like this that make our team want to work that much harder for you. Now, on to the regularly scheduled update!

KFS October Update

Hopefully everyone enjoyed their Halloween weekend and the last few days of daylight savings. We're certain all of us are glad to put the month of October behind us. Overall, it was obviously a tough month for all financial markets...and their participants. The good news is (over the last week), the tide has finally begun to look as if it is turning. Credit markets are beginning to thaw, bond prices are edging up and the stock market made a very strong showing last week. It is clear to those of us who follow the financial markets closely that the "worst case" scenario - and then some - is already priced into the financial markets. This means stocks are still undervalued and there remains a great deal of upside potential going forward.

Our Management Team

Last weekend our entire management team met in Asheville to go over our stock and bond fund managers, as well as our client portfolios. The focus of our meeting was straight forward. Since fear & greed are a regular part of our markets, we wanted to use this downward price imbalance to improve our portfolio positions going forward. In essence, we wanted to analyze the known opportunities...and look for additional ones we could capitalize on. Whenever the stock market becomes significantly oversold, we will always focus first on the items we can control. These include "tax" harvesting and rebalancing portfolios to maintain the proper asset allocations. Remember, back in

January we used the three week sell-off as an opportunity to take tax losses and rebalance, which resulted in positive returns by June. Today, a severe price disconnect exists again...but this time the imbalance is far more severe....which implies the opportunities are even greater for long term investors who remain patient. So what are we doing? We are in the process of carefully reviewing every single client portfolio and rebalancing and/or adjusting those that have needs in any of the four following areas:

1. The portfolio has become less well-diversified across the 9 equity style boxes.
2. The portfolio had diverged from the target balance between stocks and bonds.
3. A need to minimize or eliminate substantial year-end distributions in taxable accounts.
4. Tax loss selling (again, just in taxable accounts) to offset future gains.

Basically, we try to use market declines to our advantage by harvesting tax losses to the extent possible. In addition, we want to make sure no one is underexposed to any area of the market because going forward we don't know which area will bounce back first or by the largest amount (no one does). For clients who own bonds funds, we have one manager who holds investment grade corporate bonds that are currently at fire-sale prices and we'll be cautiously rebalancing bond portfolios in that direction to make sure our fixed-income clients are able to profit from the bounce-back in this area.

Our Mutual Fund Manager's Holdings

As we have mentioned before, our managers continue to be astonished at the prices of both stocks and "investment grade" bonds today. There are no shortages of managers who believe the stock market will double over the next three to five years. Managers from Vanguard, Royce, PIMCO, Oakmark, Keeley, and Goldman Sachs have all told us how oversold the market currently is and how they love stocks at these seriously discounted prices. All of these folks understand the role of "Fear & Greed" in the financial marketplace over the short term. And while no one denies we are headed for a

slowdown or a recession, prices are currently so distorted (on the downside) from reality that everyone agrees stocks are an incredible bargain at these prices. And as the economy starts to heal (which it always does), the pricing distortions will begin to go away and stock prices will rise dramatically. All of our managers also understand the remarkable amount of stimulus that has been poured into the global economy by central banks and governments across the globe. This stimulus will have a major impact on the global economy; although it will probably take some time before the effects become noticeable. Usually, we assume a 6 month lag between economic stimulus and a noticeable response on the upside. At this point the future looks very bright, although we would expect things to remain quite volatile for the next several months.

The Numbers: Long Run Returns

Prior to this recent stock market dip, we wrote numerous times about the likely increase in market volatility. Many of you wanted us to comment further on this topic, specifically wondering if anyone could predict when these dips will occur, how long they will last and how big they will be. The answer to all three questions is an emphatic NO. It is virtually impossible to predict the timing of dips with any degree of certainty, just as it is impossible to predict their length or their magnitude. That's why it's so important that investors remain focused on the long run. We know the stock market still provides the best long term returns versus all other alternatives and we know patience and diligent adherence to sound investing strategies will be rewarded in the long run. In our last newsletter, we provided the returns over the last 5 and 10 years for each of the nine equity style box indexes. The average return over 5 and 10 years across the nine style indexes was 8.5% and 8.9%, respectively. This is significantly greater than bonds or cash.

That said these returns did not come without risk.

Historical Guides: Dips are part of reality

If historical results are any guide, stock investors should expect to see declines between 5% and 10% occur virtually every year and more severe downturns occur every few years. In our newsletters, we have covered the frequency and magnitudes of historical stock market dips a number of times. We have also discussed how to minimize them by using well thought-out diversification strategies and strong managers.

However, it's always helpful to revisit these topics, particularly at times like this. We think the following table will help you understand why we were convinced volatility would return after virtually five years without it. This table examines the size, frequency and the length of declines in the Dow Jones Industrial Average ("the Dow") going back to 1900. The results are pretty illuminating. Our recommendation? Cut out this table and tape it to your TV remote. 😊

<u>Declines in the Dow (1900-2007)</u>	<u>Number of Declines</u>	<u>Average Length (Days)</u>	<u>Frequency</u>
Routine Dips (5%+ Loss)	360	39	3.3 times/year
Moderate Declines (10%+ Loss)	117	106	1.1 times/year
Severe Corrections (15%+ Loss)	58	211	1 every 2 years
Bear Markets (20%+ Loss)	31	367	1 every 3 years

Since 1900, there have been 360 declines of at least 5% and nearly 60 declines of 15% or more. In essence, "routine dips" of 5% or more should be expected to occur about three times a year. "Moderate declines" should be expected to occur almost every year, on average, and "severe corrections" should be expected to happen almost every other year! Finally, bear markets, which are defined here as dips of 20% or more, happen can be expected to occur once every three years. Remember, in our most recent newsletter, we pointed out that the Russell 2000 (small cap stocks) had double digit dips no fewer than seven times over the past five years (between October 2002 and October 2007) yet still managed to increase 145% over the period! Clearly, market declines are part investing in stocks and are something long-term investors should expect to occur many times. This is simply the nature of the stock market – and it always has been.

Psychology

The most interesting observation we have about this recent six week dip (Yes, six weeks ago, the Russell 2000 was down only 1% year-to-date) is the following: Investor psychology is clearly shaken. We are genuinely surprised at how many people have panicked, sold stocks and continued to think we're in for a major "depression-like" recession. Furthermore, we are surprised at how often people look at the value of their portfolio's...as if that's going to help them make unemotional decisions regarding their financial future. To us, nothing has really changed. The economy goes through normal

economic cycles; fear and greed dominate short term time frames; and stock market dips (some severe) occur with regularity. Our hope is that those who had trouble sleeping or were on the verge of doing something “reactive” will understand that the next “big” event is always right around the corner and that the only ones who are impacted adversely by these events are the ones who lose sight of the long-term and react to what is happening in the “now.” If this describes you, you either need to gain control of your emotions or you need less stock exposure going forward.

Common Sense – Follow the Titans

As we move into the winter, we’d like you to keep in mind sage advice we keep hearing from such titans as Warren Buffett, Jack Welch, David Williams and John Keeley. In a nutshell, they invest and buy companies for the long run. They don’t try to pick bottoms. They don’t worry about short-term price movements. And they understand the global economy is going to be fine over the long run. Based on the feedback we’re getting from the majority of our clients, you feel the same way and that’s terrific. You have a long term focus and have maintained it through a difficult period. Common sense tells us if we build portfolios for the long run we should therefore be focused on the long run, but emotions can sometimes cause common sense to go flying out the window. If you spend all of your time and effort worrying about short term movements listening to the hyperbolic talking heads on TV, you’re going to ruin your day and may potentially do something that will ruin your portfolio. Let us do the worrying for you.

Overall:

Overall, we are pleased with our managers and feel very comfortable with them and with our portfolios. We assume we will see more volatility in the markets going forward and are certain we will experience additional short-term challenges. As always, we will continue to use these challenges as long term opportunities to strengthen our core strategies. Remember, our markets have overcome much greater challenges than those we face today. So take some time to enjoy the pleasant fall weather we’re having and let us focus on your portfolio for you. In other words, relax and enjoy yourself. You deserve it!

As usual, if you have any questions about your portfolio, the stock market, the economy or our updates, you can contact us directly at phone numbers and e-mail addresses below. Thank you for your continued confidence in our firm and our strategies. Please know that we are always focused on your financial well-being.

Joe & The Gang at KFS