

# KIELY WEALTH ADVISORY GROUP, INC.



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## BEHIND THE SCENES

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### OPENING THOUGHTS

We hope this newsletter finds you doing well and staying cool as the summer temperatures have begun to heat up again. In addition to the increasing temperatures, the usual political rhetoric regarding our economy, current debt levels, government spending, and a host of other controversial issues has heated up again. The good news is, we've seen all of the above issues debated before. In fact, these are the exact same issues that were being beaten to death last spring (2010) when the S&P 500 and the Russell 2000 indexes experienced their normal annual 10%+ dip. As the New York Yankee great Yogi Berra once so eloquently put it... **"It's déjà vu all over again!!"**

Last spring, after experiencing a typical short term dip in market, we spent the first part of the July 2010 newsletter examining why those who focus too much on "the now" do so at their own peril. We stressed that a short-term focus often obscures the broader, longer-term picture that is so critical to investing success. Furthermore, we encouraged investors to look beyond the shorter-term, transitory problems and focus instead on the longer-term trends, like cheap labor prices; access to inexpensive capital; improving technology; increased access to global markets; and an expanding global middle class. These macro-economic issues are the very things that define the prospects

for the global economy and thus, our investors portfolios going forward. In essence, we warned against becoming mesmerized by all the negative headlines because, beyond all the pessimism, there was (and still is) good news regarding the global economy - particularly on a company by company basis. In fact, from the standpoint of balance sheets, cash flows, revenues, and profits, publicly traded corporations have seldom been in better shape.

This would explain why the S&P500 (large companies) has rallied 28% and the Russell 2000 (small companies) has rallied 35% over the last year ending 6-30-11. So, while we believe it's important for Americans to debate the merits of one domestic policy versus another, we want our clients to understand that the health of individual companies (and thus our portfolio's) are driven primarily by broader "global" issues over the long run. When you understand these broader macro-economic issues, it allows you to look beyond the negative current headlines.

#### Our Point

If you are going to be a successful long term investor in today's global economy, you need to behave like one, meaning you need to understand exactly what drives

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#### BE PREPARED!

PLEASE SEE OUR COMPLIANCE NOTES SECTION AT THE END OF THIS QUARTER'S NEWSLETTER FOR MORE INFORMATION ON ESTATE PLANNING

KEEPING YOUR WILL'S AND IRA BENEFICIARY FORMS UP-TO-DATE IS AN IMPORTANT STEP IN THE ESTATE PLANNING PROCESS!



publicly traded companies cash flows and profits. Furthermore, you have to develop a strategic plan that embraces today's natural market swings (or volatility), versus reacting to the "in vogue" crisis of the moment. Why? Because there will ALWAYS be a crisis of the moment. Those investors who focus too much on them tend to become intractably pessimistic and psychologically incapable of maintaining the longer-term view investors need to have. Any worthwhile endeavor - be it gardening, life relationships, or investing - will always have its ups and downs. The key to long term success is to not let setbacks and negative events define you. Instead, view them as a normal part of the process and learn from them. Our country has an extraordinary track record of overcoming some extremely daunting obstacles, including the credit crisis of 2008. So, as we continue to recover from the most recent recession, we recognize there will be some tough days ahead. However, at the same time, we're more confident than ever that our best days still lay ahead of us. We can't tell you what's going to happen over the next few weeks or months. That said, if one looks at the broader macro-economic trends, and uses that as our guide, we can tell you that you'll probably underestimate the outcome. If you need concrete evidence of this new trend, look no further than the growth of your portfolio over the last two years.

### **Our Perspective**

After numerous discussions (and meetings) with our clients over the first half of the year, we believe the vast majority of our clients understand that short-term volatility has virtually no impact on long-term investing success. Given that crucial understanding, the vast majority of our clients don't let market dips impact their long term investing strategy. Our clients also largely understand that short term volatility is an inevitable part of investing. Since volatility is guaranteed to flare from time to time, it only makes sense to view it as an opportunity. As you might imagine, we are fully aware of the economic and political issues that our country faces today. In fact, given the definition of our job, we probably are more acutely aware of the issues than most. However, it's critical to remember that we're NOT investing in any of the domestic issues we outlined above. Instead, we ARE investing in well run, extremely efficient, global companies, who will make money over the long run in almost any market environment. If you can separate the difference between those two distinct issues, it's relatively easy to be a successful long term investor. However, if you can't separate those two issues, you are likely doomed to follow the same path as many short term traders, market-timers, and speculators before you.

Even though we believe almost all of our clients can appreciate the fact that the fortunes of well-run global corporations are NOT highly correlated with the issues that confront our current political system. We still recognize that some of these economic issues may result in some doubts, a little anxiety, or a sleepless night here and there. That's why we want to spend the first part of this newsletter examining the current topics that have been dominating the day-to-day headlines of late. Hopefully, a review of the facts and a dose of common sense will help offset some of your natural concerns.

## **CONFRONTING SHORT TERM CONCERNS**

Over the past few months, there has been a great deal of focus on the state of the economy, which is understandable given the severity of the recession we continue to recover from. Just keep in mind that to the news media, economic uncertainty, political stale-mates and market declines mean larger audiences and increased advertising revenue. Since economic growth never moves in an uninterrupted straight line upward, we will invariably hit a soft patch (which happens in every recovery) where the media can use fear and uncertainty, in conjunction with partial facts, to spice up their story-lines, and thus sweeten their advertising revenues. Many of the headlines recently have revolved around whether or not we're heading into a major slowdown, double-dip recession or bankruptcy. Given the fact that we have had a recent market dip (which was much milder than last year), we thought it would be a good idea to review the major media assertions regarding the markets and the economy, by filling in the missing pieces from their headlines and hopefully providing some much needed perspective. We appreciate the fact that most of you understand these issues play very little role in your current portfolio over time. We also appreciate the fact that many of you realize that we (at KWAG) have been expecting these issues to rear their ugly heads when we develop and build our portfolio's. In other words, your portfolio is built under the assumption that we are going to have debt issues, political wrangling and economic flare ups from time to time. However, because long term investment success is largely dictated by **psychological factors**, we believe each of these shorter term issues are still well worth examining.



**Assertion #1:** “Job growth is ‘dismal,’ and the U.S. economy can’t grow without job growth.”

This is actually false on both counts. First, new jobs, particularly in the private sector, are rising in number, both month-over-month and year-over-year. In fact, over two million jobs have been created over the last few years. However, when job creation is measured, it also includes government jobs, which have now been significantly reduced to balance local, state and federal budgets. The good news is the vast majority of “sustainable” long term economic growth and productivity come largely from private sector jobs (versus government jobs) which are being created at a very reasonable pace. That’s why the economy (even with higher than normal unemployment) is still growing. In addition, if you take the total number of hours worked in the domestic economy (which is higher than a year ago) and multiply it by the average hourly wage (also higher than a year ago) you get a number that is the equivalent to hundreds of thousands of new jobs. This is precisely why we see the economy continuing to grow at a slow steady pace and consumer spending continuing to rise over time.

**Assertion #2:** “The U.S. consumer is too strapped to spend. A recession will soon follow.”

The data tells a very different story. In fact, consumer spending has increased almost every month since the low it reached in April, 2009, and it hit an all-time high in March, 2011. In addition, spending by consumers at mid to high-end retail department stores is rising at a nice clip, while spending on all services (which represents 47% of the gross domestic product) is also rising. Other important indicators like airline ticket sales, airline revenue per seat, hotel occupancy rates, and restaurant visits are also seeing steady increases. In addition, American consumers have less debt than they did a year ago; they are saving more; and also spending more of their disposable income - all at the same time. These are all positive trends. In fact, when you examine year-over-year consumer trends, there are increases in consumer spending across every age group and every income level.

**Assertion #3:** “Emerging market economies are slowing, meaning U.S. exports will be hurt.”

The first part is true, emerging market economies have slowed from the torrid pace they experienced post-recovery to a more moderate rate of growth. They are also shifting to more consumption within their borders. These are actually good trends. In fact, containerized

shipping out of the Port of Long Beach, California - to Asia - keeps rising. Furthermore, last month showed U.S. exports rising at an annualized pace of 20%! No, that’s not a typo, we said 20%! Even at the low point in the expansion (in early 2010) U.S. exports were rising at an annualized rate of 6%. So even though growth in emerging markets economies is slowing to more sustainable levels, those economies are still growing, and so are U.S. exports, corporate cash flows and profit margins. We believe that the QE2 program instituted by the Federal Reserve has purposely kept interest rates and the dollar low. A weaker dollar has clearly helped our competitive edge overseas, which shows up in record exports.

**Assertion #4:** “U.S. government debt ceiling problems and ballooning deficits will crash the economy.”

It is true, excess government debt, when compared to GDP, can be an impediment to growth over long periods of time. However, it is not likely to cause a recession by itself. Everyone who really understands debt markets recognizes that the U.S. debt ceiling will be increased, in spite of all the political posturing on both sides of the aisle in Washington. The good news is that while the national debt as a percentage of GDP is relatively high, it is NOT yet at debilitating levels. In addition, thanks to record low interest rates, interest payments on the debt as a percentage of GDP are at their lowest point in a decade. At this point, lower interest rates have created a window of opportunity to get our fiscal house in order and develop a strategy that will eventually allow the federal government to balance the budget. We believe it is likely that we’ll see some sort of deal along these lines within the calendar year. In our opinion, a good starting point would be the plan already laid out by the bipartisan deficit commission. There is absolutely no credible evidence that current debt levels will crash the economy. However, high debt levels do act as an impediment to domestic growth, just as it has always done. Because the debt service remains relatively low, however, we don’t believe the large increase that we’ve seen in the national debt over the past few years is having (or will have) a significant impact on the publicly traded companies we specifically invest in.

**Assertion #5:** “The end of QE2 (quantitative easing) by the U.S. Federal Reserve will cause runaway interest rate increases, collapse bond prices, and kill the business cycle.”

Anything is possible. However, interest rates (over all maturities) have trended down, while Treasury bond prices have trended up recently. Here’s what we know for certain when it comes to QE2. Long rates have remained at or near



all-time record lows in spite of the economic recovery, so it appears QE2 did precisely what it was designed to do. The question now is what will happen as QE2 is unwound? While no one knows the answer to this question, the debt markets themselves indicate that the major institutional investors are largely unconcerned. Debt markets typically move way ahead of the usual news cycle, with bond prices reacting to what investors think will happen months and years into the future. Because the Fed has been extremely open with their actions and intentions regarding QE2, the major market participants all know exactly what is going to happen going forward and they've already factored this into current bond prices. If this event were going to trigger a "bond catastrophe" as some have claimed, then we would already be seeing signs of it. Smart hedge fund managers and foreign central banks would be dumping Treasuries and prices would currently be in free fall. However, this isn't happening. Instead, U.S. Treasury auctions continue to proceed very well with prices remaining quite stable and bond yields remaining close to their all-time lows. So, we see no signs of any tremors, much less a collapse. If this (QE2) really was a big issue, we'd be observing a massive selloff of treasury bonds today...which is just NOT happening.

**Assertion #6:** "The U.S. housing market is in a double dip and a new crisis is forming."

Yes, the Standard & Poor's/Case-Shiller Home Price Index shows continuing home price erosion, and new housing starts remain at rock bottom levels. However, what most forget is that in 2006 and 2007, when housing was king, and housing starts hit 2.7 million units on an annualized basis, the building of primary residences for American families represented fully 6% of the economy (GDP). Today, the entire enterprise of making, selling, and financing new homes is down to 2% of the overall economy - and the economy is bigger today than it was in either 2006 or 2007. This indicates we have found a way to grow the economy without building, selling and financing new homes that nobody wants. This is a very good sign.

The data also indicates that housing may have already reached rock bottom. We currently build just 400,000 new primary residences per year - which is barely at replacement levels. If you're wondering why the unemployment rate is stubbornly high, you need look no further than the real estate industry. Nearly every recovery/expansion cycle in history has been aided significantly by new construction and the real estate industry. This time, however, real estate will not drive the recovery, which means the economy will take longer to

rebound, and the rebound will be more gradual as a result. This should NOT be a surprise to our readers, as we've discussed this issue (at length) in our previous writings over the last few years.

The bottom line is that housing isn't experiencing a double dip, but a continuation of the original dip. Fortunately, there are signs of a bottom beginning to form. However, working through the excess capacity of homes built during the boom will take time. There are no magic bullet solutions, but the economy is recovering anyway, and that's a very encouraging thing to see.

**Assertion #7:** "Oil prices and inflation are killing the US consumer."

Yes, oil prices and inflation can be killers of the business cycle, but there is absolutely no sign of this yet. In fact, as we pointed out in our last newsletter, we felt the surge in oil prices was transitory. Today a barrel of oil sells for \$95 and gas prices are down significantly from their highs. There has been some inflation in clothing, food and at the gas pump, but these items amount to only about 18% of the consumer price index and they are now beginning to stabilize and even decline. The other 82% of inflation is made up of housing and wages, which right now is not moving higher. The Federal Reserve doesn't think inflation will be a major concern anytime in the foreseeable future, and long term interest rates, which serve as a market-based barometer of inflationary expectations, also show no signs of concern over inflation. The spike in oil and food prices earlier this year clearly acted to slow the economy, and it created a normal soft patch. However, the consumer continues to spend (see Assertion #2) and the recent price declines should help consumer spending going forward.

**Assertion #8:** "The Global Debt Crisis will result in lower returns over time."

Yes, government debt is a problem both in Europe and at home. However, country after country has acknowledged the problem and are now taking concrete steps to fix them. In addition, don't lose sight of the rest of the world economy, which will play a much larger role in global growth going forward. Brazil, China and India are growing at rates which are sustainable for quite some time and they have huge surpluses - which implies there is a regional debt crisis - not a global one. In addition, since the "surplus" countries represent a major portion of future global economic growth, and given they are 20 times larger than the U.S. in terms of population, we



believe the regional debt crisis is imminently fixable for countries that have competitive, productive economies.

**Assertion #9:** “The drop we’ve seen recently in the stock market is different this time.”

Yes, the markets turned south over a six week period near the end of the 2<sup>nd</sup> quarter of 2011. However, the decline was not particularly dramatic and fits the normal post-recovery pattern of rise, retreat, readjust, and advance. If anything is different, it’s probably our collective understanding of how markets behave over the short run. (We should all be expecting normal dips at this point!! Right?) When one examines publically traded corporate cash flows and profits, they are either at - or above - the levels they were when the nervousness began, which indicates continuing strength in our recovery and global growth. Market participants seem to agree as mid-cap companies traded at an all-time high on July 7th, and small companies got within 1% of their all-time high on the same day. When we examine Price-Earnings ratios, we could actually make a good case for stocks being cheap!

**Assertion #10:** “Gold provides safety for investors.”

We continue to be amazed at the obsession we’re seeing with gold, a non-earning asset that does little more than sit there. Since the market lows reached in March 2009, the S&P 500 index, Russell 2000 index, all of our stock fund managers, and most of our bond funds have actually outperformed gold. Yet, gold continues to garner all of the attention. The obsession and irrational behavior we’re seeing among those buying gold leads us to believe gold is a “bubble” waiting to burst. So when you hear those ads on radio and television touting gold as the ultimate inflation hedge, it’s important to know that historically, gold has “underperformed” inflation by a substantial margin since 1980. So, at this point, we see absolutely no reason to get excited about the prospects of gold, since there are so many better options.

## OUR ECONOMIC CONCLUSIONS

We believe it’s very unlikely that the current business cycle expansion will reverse itself just two years after it began. Historically, recessions last under two years on average, and post-recession expansions last four years or longer. Further, expansions have been getting longer and longer as our ability to control business cycles through monetary policy has improved. The current expansion,

however, follows a credit collapse of historic proportion and it will take time to fully recover from a crisis of that severity. Remember, the major investment and commercial banks, that we count on every day to conduct our business, and live our lives through, were on the brink of collapse.

Since March 2009, however, we have seen two solid years of growth, productivity and corporate profits. In addition, the capital base of our major lending institutions is much stronger than it was two to three years ago, and they too are returning to consistent profitability. Of course, as we all know, the Federal Reserve has used monetary policy (QE2) to reduce the cost of borrowing to all-time lows. In the past, low borrowing costs have historically stimulated economic growth, and this is what we see happening this time as well, albeit at a slower than normal rate. The slower than normal pace is explained by the lack of residential and commercial real estate, which are typically the biggest drivers of expansion during recoveries. Clearly, real estate won’t drive our expansion this time. So, as we have been saying all along, the rate of recovery will be slower than normal, and it will take time to get used to the “new normal.” The good news is, we live in a global economy which is growing at a nice sustainable pace.

### What Does This Mean for America’s Publicly Traded Companies?

The situation with publicly traded companies is, frankly, impressive. As we have pointed out on previous occasions, a number of macro-economic factors are all lined up in such a way that we believe will favor publicly traded companies for some time. At the risk of repeating ourselves, factors like low and stable labor costs; cheap capital; limited trade barriers; improving technology; and billions of new global consumers point to strong positive global growth over the next five and ten years. If there are no major long-term disruptions to any of these factors, we believe even the most optimistic investors will be surprised at the result. Of course, disruptions do occur, so the ride will never be a smooth one. However, America’s publicly traded companies are sitting on record levels of cash, and they continue to break earnings records in spite of the fact they are tending toward more conservative balance sheets. In addition, profit margins are approaching historic highs, revenues are rising, and those large cash hoards are slowly being released into the system in the way of orders for new trucks, containers, manufacturing equipment, computer servers, software, etc. So, as the global economy continues to expand, so will



corporate America's balance sheets and their stock prices. In addition, as we're seeing now, this global expansion will eventually trickle down through the entire world economy and the U.S. over time.

## INVESTING IN STOCKS: WHAT WE OWN AND WHAT WE DON'T OWN

It's important that our clients understand there are two types of companies in America today, and each is being impacted by the current economy and our politicians in two very different and distinct ways. First, there are **publicly traded companies** (i.e. those that trade on the major stock exchanges) like Google, GE, 3M, and Microsoft. These are the kinds of companies we hold in our client portfolios. These companies have access to 1) a cheaper labor pool, 2) cheaper sources of capital, and 3) global marketplaces. In addition, they experience economies-of-scale (and thus greater productivity) than other privately held companies. Publicly traded companies are somewhat impacted by our domestic economy. However, because of their global nature, they are much more insulated from most of our domestic issues, which means the impact of our politicians and their domestic economic strategies is much less than most people truly understand. We'll be the first to admit that our political process is far from perfect and often counter-productive. However, record profits and record cash flows would indicate publicly traded companies are insulated and not driven by our economy.

On the other hand, **private companies** (like your local bakery, bank or retail store) and many of the local and regional businesses you see in and around your town, do not have access to 1) cheaper labor, 2) cheap start up capital and 3) global capital markets. This makes it more difficult for them to compete and grow, given the moderate growth our economy is experiencing. Private companies also do not operate with the same economies-of-scale (or productivity) as publically traded companies, which restricts their profit margins. Private companies therefore tend to be much more directly impacted by our domestic economy and our government. For this very reason, we DO NOT invest in privately held companies at KWAG. This is important to note, particularly when you watch the news and hear about the struggles of privately held (i.e. mom and pop) companies and the families they support – versus publicly traded companies which are experiencing record cash flows.

If you can grasp and understand the key distinctions between public and private companies, we think you'll also understand why we're so optimistic about our global stock portfolios going forward. As long as 1) global labor remains cheap, 2) capital costs remain low and 3) the global economy continues to grow, our portfolios will grow as well. Since the global economy is growing (and should continue to grow rapidly for some time) it's just a matter of finding the best companies to invest in, which is precisely why we hire the most experienced, best-performing money managers on the planet. So, we believe the following...

- There are significant macro-economic factors that will drive our markets for some time.
- The best way to capture these market returns is through owning publicly traded companies.
- These companies are more insulated from our domestic economy and our politicians.
- They are also more able to access cheaper labor, lower capital costs and global markets.
- The best way to find these complex global firms, is through experienced money managers.
- We monitor these money managers on a daily basis and rebalance across them as necessary.
- We are long term conservative investors, who build well diversified portfolios.
- We recognize/embrace the inevitable short term volatility, which we use to our advantage.
- We are cognizant of fees, taxes and transaction costs and thus try to minimize them.
- We are driven by a logical, long term investment process that works over time.
- We are dedicated to our clients and their unique and individual needs.
- We love what we do and feel blessed to have so many families who believe in us.

## THE NUMBERS

As we alluded to in previous updates, the stock market recovery from the lows in March 2009 has been quick and powerful. During the first quarter of 2011, this recovery continued, with the S&P 500 index (large-cap stocks) increasing more than 5%, and the Russell 2000 index (small-cap stocks) increasing more than 7%. Over the second

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quarter of 2011, the S&P 500 gave back most of the first quarter gains but then recovered quickly to finish the quarter down just -0.39%. The Russell 2000 followed a similar second quarter pattern, finishing the quarter down -1.91%. Over the previous year, the S&P 500 index has gained more than 28%, while the Russell 2000 has gained more than 35%. Over the past two years, the S&P 500 is up 43% while the Russell 2000 is up over more than 62%. From the low on March 9<sup>th</sup>, 2009, the S&P500 has risen more than 100%, while the Russell 2000 has risen over 140%. Clearly the fortunes of America’s publicly traded companies have thrived over the past few years.

**The Style Index Numbers**

Looking at the twelve months preceding the end of the second quarter, all nine style boxes were in positive territory once again. Overall, small and mid cap stocks performed better than their large cap counterparts, while the difference between value and growth stocks was slanted in favor of growth. In terms of the individual indexes, small and midcap growth led the way once again with both finishing the 12-month period up more than 43%, while large cap value lagged at a rate of return just below 29%.

<b>1 Year Russell Style Index Performance through 6/30/2011</b>			
Value	Blend	Growth	
28.94%	31.93%	35.01%	Large
34.28%	38.47%	43.25%	Mid
31.35%	37.41%	43.50%	Small

Since the lows reached on March 9, 2009, the pattern of performance remains typical of an economic recovery, with small and midcap stocks outperforming large caps by a fairly substantial margin. In fact, when one takes the average return of mid and small caps and compares them with the average return of large caps - since the low on March 9<sup>th</sup>, 2009, we observe the former (small and mid caps) has outperformed the latter (large caps) by some 43%! If there was any question as to where the “blue chip” companies have resided over the last 30 years, we hope this data puts that to bed.

**Post-Crash Recovery of the Russell Style Indexes 03/09/2009—06/30/2011**

Value	Blend	Growth	
112%	109%	100%	Large
156%	152%	148%	Mid
143%	149%	154%	Small

When we examine style box performance over the last five years a similar pattern emerges, with small and mid-cap stocks outperforming large caps by a wide margin. This time period includes the credit crisis, the slow period before the credit crisis and the current rebound. As we keep reminding everyone, this pattern of performance is not new and is very typical of recoveries. While the pattern may have been typical, the magnitude has been anything but. In fact, the rebound in stock prices has been nothing short of remarkable and is a strong testament to the resiliency and innovativeness of Americas publicly traded companies.

<b>5 Year Annualized Russell Style Index Performance ending 06/30/2011</b>			
Value	Blend	Growth	
1.18%	3.53%	5.93%	Large
4.35%	5.89%	7.12%	Mid
2.34%	4.43%	6.50%	Small

Finally, if you go back ten years, the differences between size and style become even more pronounced. Small and mid-cap stocks beat their large cap brethren by a large margin, while value, easily outpaced both blend and growth within each size category. This clearly illustrates the value of holding small and mid-cap stocks over the long run, as they tend to provide superior long run returns while also diversifying your risk exposure. In fact, a small and mid cap portfolio, spread equally across each style box, outperformed an all large-cap portfolio by more than 5.5% annually. When you factor in active



management and proper rebalancing, it's obvious that for investors who were properly diversified, the last decade was quite good, even though the large cap indexes struggled.

10 Year Annualized Russell Style Index Performance ending 06/30/2011			
Value	Blend	Growth	
4.78%	3.72%	2.48%	Large
12.45%	10.77%	7.11%	Mid
10.66%	8.37%	5.73%	Small

The amazing thing about the last ten years is the period includes both the tech-wreck of 2001/2002 and the credit crisis of 2008. Yet, the 10-year average return for small and mid-cap value and blend are above the historical long-term average for the overall market (which is just under 10%). That's amazing! These returns only show the market averages. When you examine our managers (on page 12) and factor in some basic rebalancing, the returns get even better. It's why we continually preach a long-term focus and a consistent commitment to a basic set of investing principles. It works...but only if you remain patiently focused on the long-run and keep your emotions in check during the inevitable pullbacks and dips.

## OUR MONEY MANAGERS

When you examine the long term track record of our money managers, we remain pleased. Many of our money managers have begun increasing the quality of the stocks they hold. This has actually had a negative impact on their most recent performance as lower quality stocks have continued to rally. Last quarter, when we commented on our money managers, we stated that, "they have performed well over the quarter." One of our clients questioned this statement by making the observation that our own data showed that some of our core equity funds performed below their quarterly and yearly benchmarks. He pointed out that the longer term five year performance was much better, but felt a three year performance number should be included in our data, which he ranked in high importance.

His comments finished with the following observation "It just seems you should recognize poor short term performance instead of sugar coating it."

**Our Answer:** Ouch! To be honest, we think this is an interesting point worth exploring. First, we don't place a great deal of emphasis on the short-term performance of our managers. The truth is, all top performing managers go through periods of under-performance from time to time. Obviously, we are pleased when their short-term performance is strong, but we also recognize that no manager is going to beat their benchmarks each and every quarter, which means they will undoubtedly underperform over some calendar years. This is precisely why we're much more interested in a manager's long term track record over five years and more importantly over ten years, which is what we have consistently stressed in our newsletters, updates and meetings. In addition, there is a great deal of academic data that indicates investors may be making a crucial mistake by fleeing from recent underperformers and flocking to recent winners, especially if they act on relatively short term results. We couldn't agree more. Since all top performing managers will go through periods when they underperform, it would be a mistake to place a lot of importance on short term results which can be driven by one or two off quarters. Furthermore, our research, (which has since been fortified by other academic papers) indicates top managers can (and do) make up for lost ground by producing excess returns later.

A good example of this is David Williams (of Excelsior Value and Restructuring Fund) who told us in the late 1990's that he would NOT expose his portfolio to a large amount of tech related stocks. Value stocks (like those he owned) languished during this period as investors were all clamoring for tech related returns. However, Williams was convinced tech stocks were overvalued and he stuck to his guns while tech stocks roared off into the stratosphere. As a result, his portfolio suffered for two years (1998 & 1999)...relatively speaking. Over 2000 – 2007 tech stocks returned to earth with a thud, while Williams fund posted year after year of stellar returns. The key was that he was patient, he stuck to what he did best, and he maintained his conviction that tech stocks were overvalued in spite of all the hype. His numbers over that time period speak for themselves.

In 2008, Williams again underperformed for a couple of quarters during the market collapse. A few of our clients questioned why we would continue to use his



services after such a tough year. If you looked at his three-year track record at that point, those two off quarters were dragging it down, in spite of the fact that he had beaten the benchmark in two of the three previous calendar years. When we spoke with him, he felt confident in his portfolio and believed he had identified a number of companies that were significantly undervalued, to the point of reminding him of 2000, which was music to our ears. In 2009 and 2010, he once again hit it out of the park.

So, if you look at his last ten years, they have been great for David Williams and for our clients. However, there are always going to be periods where managers will underperform and as investors we need to remain patient. In fact, you can say this about any money manager...including Warren Buffett and the iconic Peter Lynch, who had one of the greatest investment runs ever over a twenty year period. Yet, there are estimates that 50% of those who invested in Fidelity Magellan during that time lost money, which means their individual buy and sell decisions were driven primarily by short term results.

One of the things our firm has really improved upon is reducing exposure to a manager after he/she has a great run (selling high) and buying into them after they have had a few bad quarters (buying low). Most investors, who tend to chase short term performance, will do the exact opposite, which is why they also tend to underperform basic benchmarks over time. Buying what was hot last year basically guarantees you will always own funds whose stocks will soon rotate out of favor, which pretty much guarantees subpar performance over the long haul.

In the first quarter of 2011, when we looked at our managers' returns, we honestly felt they performed well. There were no red flags, since most of the returns were within what we consider the normal range from their benchmarks. And we were also aware that many of our managers had recently altered their portfolios toward higher quality stocks, which underperformed during the early stages of the recovery and continued to underperform in the first few quarters this year. High quality stocks will again lead the way at some point, however, and we don't want to fault our managers for being ahead of the curve by a quarter or two. In fact, being ahead of the curve is exactly what we expect from them, so we're very comfortable with where all our managers are positioned at this point. **If we were worried about any of our managers, we would have acted long ago since it also affects our own personal portfolios which are made up of the exact same managers.**

## CLEANING UP SOME LOOSE ENDS

Over the past six months, the vast majority of our client questions have revolved around the economy and its effect (or lack thereof) on our portfolio's. Since the vast majority of client questions we receive are driven by short term recent news items, we felt it was appropriate to comment on and reiterate our position regarding the economy and our investment strategies. However, there were two other questions that have come up more than once. It seems our comments on the media struck a nerve...while our comments regarding rebalancing during the market lows are probably misunderstood. So, we'd like to set the record straight on these two issues.

### The Media: Friends or Foes?

**Question #1:** Dr. Kiely, I really enjoyed your last newsletter as it provided some very interesting information, but I have a comment that I would like you to consider. First, your continued criticism of the media is "over the top." I know you are all very educated, but you need to consider opinions of other well informed folks. As a regular listener of CNBC, I think they present a balanced view of the financial world. I know guys like Larry Kudlow are rampant right-wingers but it seems to me, most programs always try to have a "talking head" on each side of the issue. I also find Kiplinger's Financial and Money magazine to be very helpful-they are part of the media. You should understand that many of us value diverse opinions. We certainly valued your advice not to panic and stay invested in 2008.

**Our Response:** Okay. We get your point regarding the "media" and recognize that our disdain for much of the media often comes through loud and clear in what we write. There are many good media outlets, but almost all of them are in the print media rather than broadcast media. Please do not view our disdain for much of the media to mean that we do not pay attention to well-informed folks. We do. But the popular broadcast media (which most people listen to) for the most part is NOT well informed when it comes to finance and economics. For example, only one member of the CNBC news team is a trained economist. The rest are very good TV personalities, but their educational background is NOT in the areas they cover, and some are clearly biased in their views. Remember, the broadcast media's job is NOT to educate, but to entertain (thereby generating advertising revenue), and that's an important distinction the audience needs to always keep in mind.



The truth is, we spend most of our time reading and listening to the opinions of those with “skin in the game” (i.e. money managers, economists, and market analysts who work in the investments industry). Those people are well-trained, thoughtful, and have years of experience doing what they do. In short, they’re investors, not entertainers. In addition, we regularly read a number of publications where the writers, for the most part, have educational backgrounds in finance and economics. These include publications like The Wall Street Journal, The Economist, Business Week, and Barron’s. Of course, we also watch some of the financial news reported on television, but mostly because we want to know what many of our clients are being exposed to.

An example may help. Let's start with the most watched financial news channel, CNBC. One of the problems with television news is there is not time for anything more than small snippets of information, and CNBC is no exception. For example, Bill Gross, who manages PIMCO Total Return, shows up for a 2-3 minute interview almost every week. But in order to really understand what Bill Gross is thinking, you need to listen in on PIMCO's conference calls, and read their very detailed bond market updates and economic reports. This is just the tip of the iceberg, but the point is that this type of information (detailed written bond market reports) is much more valuable than anything you will see in a two-minute segment on CNBC, Bloomberg, FOX or any other financial news channel.

We're not saying financial news channels provide no value, because at times they do. However, viewers need to filter the information they receive through a fine sieve, recognizing 1) the political biases, 2) the frequent lack of expertise on the subject matter, 3) the often sensationalized headlines, and 4) the lack of content depth due to the time constraints inherent in television news. Based on the vast majority of our questions - which we are happy to answer (in depth) at any time – it's clear that the broadcast media has gotten very good at developing a highly biased storyline that elicits frequent viewers, encourages emotional short term responses and an occasional sleepless night.

This is why we have a lot of disdain and very little faith in the broadcast media. That said, we appreciate this type of question, and we always encourage constructive criticism, since it helps us all.

### **Market Dips**

**Question #2:** Dr. Kiely, In your updates, you keep talking about how your advice helped us buy in at a low

part of market two years ago. Many of us aren't investing any new dollars - but as retired folks we did stay in the market instead of selling. The fact that some of your managers had cash holdings that they used to buy in low is great, but it certainly didn't help that much. This discussion of buying low is not appropriate for many of us.

**Our Answer:** We respectfully disagree. First, we rebalanced all of our portfolios during February and March, 2009. So, you didn't stay invested in a static portfolio. You were rebalanced into areas we felt were significantly on sale relative to the rest of the market. Specifically, 1) we rebalanced into more small and mid-caps, since they had become underweighted in most client's portfolios, 2) we locked in tax losses wherever we could, and 3) we rebalanced out of more conservative bond funds like the Vanguard GNMA Fund and into more aggressive bond funds (like Loomis Sayles Strategic Fund and Calamos Convertible Bond Fund) that could take advantage of the tremendous opportunities available in the bond market at that point. So, not only were we able to manage the market collapse, but we also stayed as fully invested as possible. Rebalancing helped every one of our portfolios, whether you added new money during that time period or not.

Second, as assets are added to any one of our given managers, you benefit from those purchases as a shareholder, so you don't need to invest to directly benefit. One of the items we examine when we look at a potential manager is their flow of funds (in and out). We prefer managers that have manageable positive cash inflows. This helps you directly. Many other money managers did not perform as well over the last few years, because they had to hold cash to deal with significant outflows. Almost all of our managers, particularly on the bond side, had huge cash inflows. This definitely helped all of our portfolios out.

Finally, many investors hold static individual stock portfolios, which they either never sold or they sold and held cash. Our managers, on the other hand, altered their portfolios in significant ways to take advantage of the large number of companies selling at huge discounts to their intrinsic value. Individual stockholders and people who hold ETF's or index funds did not get this benefit. Yes, some of them held on too, but they held on to the exact same thing they had before rather than seeking out the best bargains as our managers did.

So, our clients benefited from our management in five discernable ways without adding anything to their portfolio's. First, we would not let anyone panic or sell out. I believe we provided solid common sense evidence as to



why this was not prudent. Second, our managers rebalanced into a number of new companies that they believed were severely depressed. Third, we pro-actively harvested tax-losses (almost at the exact bottom). Fourth, we rebalanced our portfolio's pro-actively into small and mid-caps. We rebalanced into Loomis Sayles Strategic Income and Calamos Convertible, which purchases discounted and convertible bonds respectively. Finally, we pro-actively sought out managers who we believed would benefit from the rebound through additional deposits. We did all of this - and - reduced our clients risk exposure at the same time.

In all honestly, we do believe people underestimate just how often our managers and we (at KWAG) rebalance their portfolio's, and we believe they underestimate how important that is on both a risk- adjusted and return side.

## A FINAL NOTE

### Thank You

As usual, we want to thank each of you for your continued confidence in our abilities and services. Our overall philosophy, which combines using the best managers (and mutual funds) within a set of research-driven asset allocation strategies, has provided excellent returns to all of us.

As we go forward, we remain committed to continuing to refine and improve our proactive strategies. As always, our goal is to provide each of our clients with the best possible mix of assets given their particular situation. If 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.

Again, we thank you for your kind comments, your kind referrals and your feedback regarding this newsletter. If you have any questions regarding the markets, the economy, our managers or your personal portfolio do not hesitate to call or e-mail us.

Enjoy your summer!

**~ Joe and The Gang at KWAG**

## COMPLIANCE NOTES - BE PREPARED!

### A Note From KWAG's Chief Compliance Officer

We would like to take this opportunity to remind each of you how important Estate Planning is. Two important parts to this planning is having an Updated Will and IRA Beneficiary Forms. If you have not updated these recently, please take the time to do so now!

Your IRA Beneficiary forms can be requested through Katie Burr at the email address below. They are simple and easy to fill out. Please let Katie know if she can provide one for you.

Regarding your Will, we have many resources that we can provide for you if you do not have one or just need to update yours. Contact Katie or your advisor to get you pointed in the right direction.

These items play such an important role in what happens to your accounts in the event of your death. Before it's too late - don't leave your loved ones unprepared!

Best Regards,  
Katie Burr, Chief Compliance Officer  
Email: [katie@thekielygroup.com](mailto:katie@thekielygroup.com)

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## THE GANG AT KIELY WEALTH ADVISORY GROUP



Left to Right: Brownie Cordell; Katie Burr; Joe Kiely; Kellie Kiely; and Scott Below

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**\*IMPORTANT DISCLOSURE INFORMATION**

**Performance results** represent results reported by each reflected mutual fund during the corresponding time period. Kiely Wealth Advisory Group, Inc. ("KWAG") currently utilizes these mutual funds in managing actual client portfolios. However, the individual mutual fund performance results **do not** reflect the results of any specific KWAG client portfolio or any KWAG composite.

**Past performance** may not be indicative of future results. Therefore, no current or prospective client should assume that future performance will be profitable, or equal either the performance results reflected or any corresponding historical index. The historical index performance results are provided exclusively for comparison purposes only, so as to provide general comparative information to assist an individual client or prospective client in determining whether the performance of a specific investment meets, or continues to meet, investment objective(s). It **should not** be assumed that any account holdings will correspond directly to any comparative index. The performance results do not reflect the impact of taxes.

**Please Note:** the individual depicted mutual fund results **do not** reflect the results of any specific KWAG client portfolio or any KWAG composite. **For reasons including** variances in portfolio account holdings, market fluctuation, and any account contributions or withdrawals, the performance of a specific client's account may have varied substantially from the indicated reported mutual fund results. In addition, the above results only reflect the results as reported by each respective mutual fund company. Portfolios managed by KWAG would also incur a KWAG advisory fee, the deduction of which would result in decreasing the reported performance results. **For example:** a KWAG advisory fee of 1% compounded over a 10 year period would reduce a 10% return to an 8.9% annual return).

**Please Remember:** In the event that there has been a change in a client's investment objectives or financial situation, he/she/it is encouraged to advise KWAG immediately. Different types of investments and/or investment strategies involve varying levels of risk, and there can be no assurance that any specific investment or investment strategy (including the investments purchased and/or investment strategies devised or undertaken by KWAG) will be either suitable or profitable for a client's or prospective client's portfolio. **In addition,** the mutual funds depicted are funds that KWAG may utilize and/or recommend as of specific date, and are subject to change without notice. **Accordingly,** no client or prospective client should assume that the above reflected mutual funds serve as the receipt of, or a substitute for, personalized advice from KWAG, or from any other investment professional. **Information** pertaining to each depicted mutual fund is set forth in each respective fund's prospectus, a copy of which is available directly from each mutual fund company or from KWAG upon request.

**All performance results** reflect the performance results reported by each respective mutual fund to Morningstar, and have not been independently verified by KWAG. KWAG also maintains all information supporting the reflected mutual fund performance results.

**Information pertaining** to KWAG' advisory operations, services, and fees is set forth in KWAG' current disclosure statement, a copy of which is available from KWAG upon request.

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