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KIELY FINANCIAL SERVICES, INC.

BEHIND THE SCENES

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OPENING THOUGHTS

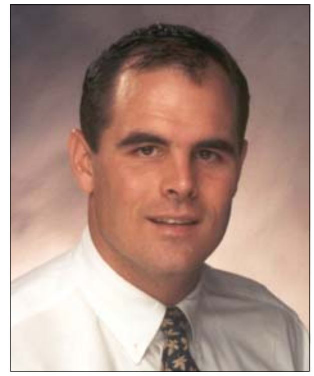
We hope this July 2008 newsletter finds you enjoying the warmer months of summer. We love summers for all of the obvious reasons…longer days, warmer weather and getting to see the fruits of our labors in the yard and garden. In our April newsletter, we took the liberty of using a number of gardening analogies to drive home some critical concepts related to investing…and to life. Another of our favorite gardening/life analogies is: "You reap what you sow." For years now, we have strongly advocated broad style-box diversification and using only the best money managers with the longest track records. Why? Because we're convinced this will allow our portfolios to not just excel in up markets, but to offer significant protection in down markets. Put simply, we believe investors reap what they sow. If you plan for "rainy" days, you will be prepared for their inevitable occurrence. If you don't, well…

Rainy Days

Everyone is aware of what's been happening to the prices of oil / food and many are worried about what impact this will have on our economy. After all, the prices of oil and food affect our pocket books on a daily basis. Thus, many investors are probably wondering what kind of impact these short term changes in the prices of oil and food will have on the long-run performance of their portfolio's. The answer should be "none", assuming your portfolio is properly diversified and you avoid the temptation to cut and run, which almost always ends badly. When we build portfolios we know there will be rainy days and we assume the "unexpected" can (and will) happen. It's inevitable. This is why we've spent so much time scrutinizing our money managers' practices and analyzing our portfolio diversification strategies. We prefer to be proactive with our trading strategies rather than reactive to the poorly reported economic news. In essence, we like to plan for every potential economic scenario and leave little to chance. Interestingly, many of the best corporate CEO's and professional mutual fund money managers engage in this practice as well. They too, like to plan for "inevitable" rainy days. In fact, today if you take the time to examine the balance sheets of U.S. corporations and the amount of cash they have on hand, you will find many companies are in the best financial shape they have been in for a long time. Outside of the financial services and housing sectors, we don't see a great deal of risk in the valuations of other businesses. In fact, if you eliminate financial companies from the S&P500, earnings are expected to grow 8.2% over the next quarter. This is indeed good news.

What Gorilla?

Every quarter seems to have an 800-pound gorilla that grab's Wall Street's (and the public's) attention. In the first quarter of 2008 it was the collapse of the mortgage market, and while this is still making news, the second quarter's 800-pound gorilla was unquestionably the skyrocketing price of oil. As a result, we thought it would be valuable to share our views on what's happening with oil, explore why there seems to be so much disagreement over what's causing the spike in oil prices, and look at what can



Dr. Joseph Kiely

INSIDE THIS ISSUE:

TO BETTER ENHANCE OUR MUTUAL FUND QUARTERLY REPORTING, WE HAVE MADE SOME MINOR CHANGES TO OUR FUNDS AND BENCHMARKS CHART.

WE HAVE NOT CHANGED THE INFORMATION WE REPORT, JUST THE SECTORS IN WHICH THE NUMBERS ARE REPORTED.

PLEASE SEE PAGES 11 & 12 FOR YOUR 2ND QUARTER REPORTS

(and can't) be done about it. First, we'll examine economic bubbles in general and provide what is probably a little "different" slant on them than you've seen before. Next, we'll take a closer look at Federal Reserve Chairman Ben Bernanke and provide some insights into why he may well be the perfect person to lead us through this economic cycle. Finally, we'll examine the role of speculators on oil prices. In other words, the overriding theme of this quarter's newsletter is clearly oil.

Other Newsletter Specifics

Of course, we will also cover the conventional topics, taking a look at the broader economy, our mutual fund managers, and how each has performed over the past quarter. As you will see, the 2nd quarter was another exceptionally good one for our managers. As usual, we'll end our current newsletter with "Six Questions with Joe." (We know we usually provide 10 questions and 10 answers. However, since many of our questions revolved around oil speculation, we added a bunch of questions and answers in the oil speculation section.) As always, Brownie, Scott, Katie, Joe and the rest of our staff look forward to your comments and feedback. Like good gardeners, we want people to enjoy the fruits of our labor, but we need and rely on your feedback to keep improving.

Returns & Diversification

In our last newsletter, we explained that it is precisely periods like this - with market dips and unusually high volatility - where the groundwork for future success is laid. It is also times like this when successful investors separate themselves from the not-so-successful. As you know, we feel periods of turmoil and uncertainty are the times we can make the largest difference in our clients' long run financial well-being. So get in a comfortable chair, warm up your favorite beverage and prepare yourself for some positive and encouraging (yup, positive and encouraging) financial news.

Second Quarter Returns, 2008

Let's start with the most recent stock market numbers… which at first glance might seem a little grim. Over the last month of the quarter the news regarding the stock market was pretty dismal. For example, the Dow Jones Industrial Average saw its biggest June decline since the Great Depression…down over 10%. Over the entire second quarter, the Dow was down 6.4%, the S&P 500 decreased 3.23%, while the Russell 2000 actually eked out a small gain. It was a tough environment in which to succeed, unless you were well-diversified across all market sectors and used a wide array of excellent money managers. If you've taken a moment to examine your enclosed quarterly statement, we think you'll be pleased. On the whole, our portfolios and many of our managers had positive quarterly returns. Don't forget, many firms are healthy, financially sound and growing…even in this seemingly volatile economic environment.

Year-to-Date Returns, 2008

Remember, prudent investors need to have meaningful exposure to the entire stock market—not just large cap stocks. Every day we are bombarded with reports of how the "markets" are doing but the media's message can often be misleading. Media outlets generally only provide information on the Dow Jones Industrial Average (DJIA), the NASDAQ index, and the S&P 500 index (all three being large-cap indexes) and simply ignore the rest of the stock market. At the end of the 2nd quarter, the DJIA was down 14.5% year-to-date, the NASDAQ was down 13.5% and the S&P500 was down 12.8%. Those are some pretty disheartening numbers. However, if you are well-diversified across the entire stock market, the numbers above should bear little resemblance to your portfolio performance over the same period. Take a minute to look closely at your own personal year-to-date portfolio return enclosed with this newsletter. We think you'll be pleasantly surprised when you compare your year-to-date return with the numbers reported above. (On page 5, we take a closer look at how each of our managers performed versus their specific benchmarks. Again, we believe you'll be pleasantly surprised.)

Goals, Diversification & Insurance

When it comes to building portfolios, our investment goals have always been two-fold. In up markets, we want our portfolios to outperform the indexes. In down markets, our goal is to provide downside protection. In essence, proper diversification acts as an insurance policy by reducing risk (or volatility). Diversification is similar to using fertilizer and pesticides on your roses. If used correctly, they can help keep your roses looking good all summer. If used incorrectly, the net result is much like using too many large cap stocks to build your stock portfolio…you end up with a poor result that you didn't plan on. As a reminder, we'd like to take a closer look at why we remain so committed to the "other" stocks you don't hear about in the media (i.e. mid-sized, small-sized, and value stocks) as critical diversifiers of your portfolio. We know other investment advisors preach "safety" in large caps and feign "concern" over small caps and their potential risks, but they might want to do a little more homework…

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A Narrow Examination of the Stock Market

Last quarter, we introduced the stock market style-box grid to show you how we make long and short run decisions with our portfolios. Specifically, we wanted you to see why we are so adamant about diversifying across all sectors of the market. There is a great deal of confusion over what exactly constitutes proper diversification, even among investment professionals. Most people are under the impression that "broad-market" indexes like the S&P 500 constitute proper diversification, but we know nothing could be farther from the truth. To illustrate, we have provided a percentage break-down for how the 500 firms that make up the S&P 500 index are divided across investment styles. (Note: Numbers do not sum to 100% due to rounding.)

Table #1

Vanguard S&P 500 Index Fund Breakdown by Percentage

Value	Blend	Growth	
30%	31%	27%	Large
5%	5%	3%	Mid
0%	0%	0%	Small

You'll note that 88% of the S&P 500 index is invested in large cap stocks, with just 13% invested in mid cap stocks and **nothing** in small caps. Sadly, the media, most brokerage firms, and the vast majority of investment advisors still believe this sort of portfolio represents broad diversification across the overall stock market. Sadder still, this is how the vast majority of investment portfolios are constructed. Portfolios like this may well represent diversification among large cap stocks, but it doesn't take a rocket scientist to see that large areas of the overall market are either underweighted or entirely ignored.

Our Practice and the Use of Table #1

In our practice, we use some variation of Table #1 almost daily as a diversification tool. When a new client comes to us, the first thing we do is take a snapshot of their entire portfolio, yielding a style box grid similar to the one above. We refer to it as an asset allocation "diagnostic test" which provides a detailed picture of how a client's holdings are diversified. The results are almost never pretty and overwhelmingly large cap based. We also use the above style -box grid above to examine how our current client portfolios are balanced across all nine style boxes on a continuing basis. Why? Because using the style-box grid allows to closely examine when portfolios need to be rebalanced which helps us manage (and mitigate) downside risk exposure. Why is this important? Let's re-examine the long term numbers.

The Long Term Numbers

We have found that regularly reviewing the long-term numbers below with our clients is always a valuable (and often eye-opening) exercise. Tables 2 and 3 below basically tell the same story in terms of the rate of return for each style box over long periods of time. Table #2 lists style box returns going back 38+ years. As you can see the numbers overwhelmingly support investing in small caps, mid caps and value stocks.

Table #2

Russell Style Index Performance
01/01/1970 through 06/30/2008

Value	Blend	Growth	
11.22%	10.51%	7.89%	Large
12.95%	n/a	10.69%	Mid
14.09%	n/a	9.11%	Small

Table #3 which examines style box returns over the last ten years, is perhaps even more compelling, with small and mid-cap styles dominating their large-cap counterparts by even larger margins. The large cap numbers, particularly on the growth side leave you scratching your head and wondering why so many supposed financial "experts" recommend stock portfolios that are dominated by large cap stocks.

Table #3

Annualized 10-Yr. Russell Style Index Performance ending 06/30/2008

Value	Blend	Growth	
6.16%	3.94%	1.00%	Large
12.50%	11.79%	7.31%	Mid
10.55%	7.12%	3.18%	Small

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Now, imagine if you had owned a predominantly large cap portfolio (i.e. An S&P 500 index fund or a similar broad market index fund) over the past 10 years. It's enough to make you ill. We know from our previous analysis that only about 13% of the S&P 500 index is comprised of assets other than large-cap, with no exposure to small caps at all! This means the vast majority of S&P 500 index funds (and the many funds that track other broad market indexes) are invested in areas that have consistently been the worst performers. No wonder Vanguard and most investment advisors believe the past decade was lost! For them it clearly was. However, had they been properly diversified, their opinions would be radically different. We've known about this for years, but have yet to see a single investment advisor, brokerage firm, or media outlet sing the praises of "total" diversification. This is puzzling, to be sure…

A Closer Look at 2008 in Stocks

The first six months of the calendar year can be summed up as a tale of "three markets" (decline, recovery and decline). As we discussed in our 1st quarter newsletter, the first three weeks of January witnessed an across the board, panic-driven sell-off, without regard to underlying intrinsic firm values. In Table #4 below, you can see all market sectors decreased by more than 10% in that brief span. We took great care to communicate the role of fear and greed in our markets and explained in our April newsletter why we felt "fear" was driving the stock market during that three week period…and why we felt this provided a nice opportunity for our managers.

Table #4

Russell Style Index Performance 1-1-08 thru 1-22-08

	Value	Blend	Growth
Large	-10.45%	-10.90%	-11.31%
Mid	-11.27%	-12.43%	-13.28%
Small	-11.41%	-12.30%	-13.07%

Over the next four and a half months the market rallied, not only recouping the previous losses but moving into positive territory with our portfolios. Table #5 shows how each area of the stock market rallied over this time period. Notice that once again, small and mid caps fared better during this rally than their large-cap counterparts. Are you starting to see a trend?

Table #5

Russell Style Index Performance 01/23/08 through 06/5/08

	Value	Blend	Growth
Large	6.68%	9.12%	11.52%
Mid	13.82%	15.76%	17.22%
Small	14.89%	14.21%	13.60%

In mid-June, oil speculation ramped up considerably and the price of a barrel of crude jumped more than 13% over a two day period. This sharp increase in oil prices rattled the stock market and it has remained rattled ever since, with the price of oil continuing to increase beyond $145 per barrel. As one would expect, the last three weeks of June saw the stock market reverse course to finish negative for the year. Table #6 illustrates the dip that occurred over the last three weeks of the second quarter.

Table #6

Russell Style Index Performance 06/05/08 through 06/30/08

	Value	Blend	Growth
Large	-9.53%	-8.73%	-8.05%
Mid	-9.48%	-8.82%	-8.33%
Small	-11.42%	-9.53%	-7.78%

So, let's review the first half of the year. The market experienced a nasty three week "panic" sell-off. We urged patience and noted the opportunity this presented to our managers. Over the next four and a half months we regained all of the losses and our portfolio's remained positive through much of June. Over the last few weeks we have experienced another sell-off driven by oil speculation. We hope you're noticing the same trend we observe as patient long term investors. We view the most recent sell-off as being quite similar to the January sell-off, driven largely by fear and greed. We also view it as an excellent opportunity for long term investors (and money managers) to buy stocks while they're on sale. We also want to point out that while the broader market indexes finished the quarter down in double-digit territory, your "diversified" portfolios did not follow suit. A closer look at our managers reveals why.

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Our Managers

Quality Over Quantity

Just because a coffee cup or t-shirt says someone is the world's greatest Mom or Dad does not make it an established fact. The same can be said for many money managers (and investment advisors for that matter). Just because someone has a plaque on the wall saying they're educated in the field of investments does not mean they know how to pick stocks or allocate assets correctly. The proof…as they say…is in the pudding. During the first three weeks of the year, our managers made significant changes to their portfolios during the panic sell-off. Why? Because they were presented with a great short-term buying opportunity in stocks that does not come along very often. The net result of the "panic" sell-off and the opportunity it presented can be seen in the performance of our top three "value" managers. All three (UMBIX, ARTQX, and KSCVX) finished the 2nd quarter in positive territory (yes, positive!) for the year, which is a strong testament to their stock picking skills. By keeping their emotions in check, they were able to use the short term volatility to find excellent opportunities. When we look beyond our top three value managers we find every one of our top eight managers (by total dollars invested) is beating their specific benchmarks—and they are doing so by an average of 8%! If that's not protecting portfolios on the downside, we don't know what is!

Other Managers

On the bond side of the investment equation, five of our six managers finished the mid-point of the year in positive territory and all five outperformed their benchmark. For our retired clients, the performance of our value managers in combination with our fixed income managers should come as particularly good news. In fact, the performance of our portfolio's and managers should come as good news to everyone.

(**Editor's Note:** At this point, we usually discuss our thoughts on the economy. This quarter our economic thoughts are included in our "Six questions with Joe". In the meantime, here are our thoughts on bubbles, Bernanke and oil speculation.)

Bubbles, Bernanke and Oil Speculation

Before we get started with our analysis on oil, a small disclaimer is in order. As much as we wish we could tell you exactly what will happen to oil prices going forward, that is simply not humanly possible. Anyone who claims otherwise is either completely deluded, trying to sell you something, or perhaps both. What we will do is give you our honest assessment of what is going on in the oil markets today and lay out the factors we think are most likely to impact oil prices going forward. We're not in the business of predicting the future and never will be, as those who live by the crystal ball usually wind up eating a lot of broken glass.

Bubbles: Some People Only Love them in Baths

Looking back over time, we all realize booms and busts have been part of the U.S. economy since the beginning of free markets. In fact, the sensationalism associated with booms and busts have fascinated people for centuries in sports, music, celebrities…and now finance. Given our appetite for sensationalism, it should come as no surprise that asset bubbles are one of the most fascinating issues in finance (and to the average person) today. The history of asset bubbles began in Holland with tulip bulbs – which fetched as much as a canal house at its peak – and continued with bubbles in railroads, telegraphs, gold, Japanese stocks, telecommunications, dot-com's, real estate, India, China and now oil. When one looks back at the economic carnage that follows an asset bubble, there is always a question over how so many smart people could have been so dumb with their money. The answer is quite simple…people (even some of the smart ones) tend to think in "herds."

Speculators Are Our Friends?!?

Bubble bashers always dwell on the bad news and ignore the positive role speculation plays in a global marketplace. Speculative fevers often emerge during times of major paradigm shifts, whether they emanate from technological change, innovation, or major demographic and/or political shifts. The end result of these paradigm shifts is, however, always unpredictable. **This is important to understand, because markets faced with the increased unpredictability of a major paradigm shift are going to respond with increased volatility.** We have seen this story play out again and again over the past decades and the results are always the

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same. For example, think about the dot-com era and how quickly the internet economy was established. Conventional wisdom would argue that the dot-com bubble was a period of irrational exuberance where no value was created and people lost millions. We would respectfully disagree. Bubble bashers greatly underestimate the vital role speculators and speculative markets have in allocating resources toward an economy's fast growing sectors and away from stagnant industries. Most people forget that the infrastructure that gets built during speculative fevers remains long after the fever has subsided. Railroads, telegraph wires, and fiber-optic networks are just a few examples of things left over following speculative bubbles. Looking back, we can clearly see how new entrepreneurs (and speculators) enter the "post-bubble" markets with lower cost structures, better business plans and better capital structures to tap into the leftover infrastructures and join in with the survivors who made it through the tough times. During the dot-com era, cheap capital from speculators enabled risk-takers to try out all sorts of ideas simultaneously on a very large scale. One of the end results was an information highway that now links the world in ways that were unimaginable just 10 or 15 years ago. (See "The World is Flat" by Thomas Friedman.)

Speculation on a Global Scale

Think about it, while you sleep every night, much of the rest of the world is still humming along, thinking about ways to take (or improve) your job. The internet changed borders and boundaries as we once knew them. This same ritual is currently playing itself out in the energy field. You can be certain that as you are sitting reading this newsletter, there are large numbers of entrepreneurs across the globe trying to solve the world's energy problems. The high price of oil is encouraging enormous investment in alternative energy sources (see Pickensplan.com as an example). The world's economic resources are increasingly being focused on alternatives to crude oil, such as natural gas, hydro, wind, solar and nuclear power. In the long run, we will all be huge beneficiaries and whether we like it or not, we will have the risk takers and speculators to thank. In a globally competitive marketplace, speculation in the short run can actually end up being your best friend over the long run. It may not be the message you want to hear when you're filling your SUV with $4.00 gas, but it's true. Speculators in essence, are essential to a vibrant, growing economy. Even so, if you don't feel up to writing Congress to encourage speculation…we'll understand.

Big Ben Bernanke

Many people are aware that Ben Bernanke had an academic life before the Federal Reserve, but most aren't aware of one of his most important academic achievements. Dr. Bernanke was asked to chair the Economics department at Princeton in 1996, and his first action as chair was to raise $10 million to lure the top academics to the University to research – you guessed it – economic bubbles and manias. Basically, he was interested in expanding on the theoretical work of Hyman Minsky and Charles Kindleberger. He wanted his research group to develop models to help explain why and how bubbles occur in markets that are, in theory, driven by rational, risk averse investors. A good deal of their work centered on the role of the "herd" mentality in financial markets, and their findings are germane to what's happening today in the Indian stock market (off 40% so far this year), the Chinese stock market (off 50% so far this year) and oil (which is clearly reached the speculative bubble stage). The following is a brief summarization of the findings of Princeton's researchers:

1. **Dogmatic beliefs.** Humans can be very single-minded about a subject, which can lead to tunnel vision and a disregard for the "rational" facts. During bubbles, as one set of speculators becomes less optimistic about a price run-up other speculators will readily step in to fill their place.
2. **Optimists overwhelm the Pessimists.** As prices increase, optimism/irrationality/greed overwhelms pessimism/rationality/fear which drives the pessimists out of the markets. Essentially, prices increase so rapidly that even though the pessimists are convinced they're correct, the costs associated with going short (or against the market) are too great. T. Boone Pickens learned this lesson by shorting oil at $100 per barrel and losing a bundle. He was driven out and is no longer shorting oil, even though he's convinced the price is far above where it should be.
3. **Volume increases well beyond normal levels.** In other words, trading in the speculative asset takes off. Daily volume today in oil futures is currently running roughly 50% higher than a year ago…and new numbers suggest the increase may actually be much greater.
4. **Leverage.** As investors become convinced it's virtually impossible to lose money, they borrow more money, sell their other assets and increasingly leverage their position in the speculative asset.
5. **Greed.** The fear of being left behind takes over. Today, most of the new investors in oil futures are entities that don't even use oil, like pension funds,

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university endowments, and hedge funds. These entities, of course, and are simply speculating on oil's rising price. This is reminiscent of a few years ago, when even real estate neophytes were flipping condos in Miami. Care to guess who took the biggest hit?

The Bottom Line: Based on the work of Bernanke's group at Princeton, oil currently shows all the typical characteristics of a bubble. In other words, we have a Federal Reserve Chairman who understands (and is way ahead of the curve on) asset bubbles, which we feel is very good news. His main job at this juncture will be to minimize the damage when the oil bubble eventually bursts…and preparing and educate Congress (and the American people) to deal with future bubbles. In a growing global economic environment where resources (like water) are increasingly scarce, we have probably only seen the beginning of bubble mania.

Oil Speculation

Now that we have set the table on bubbles, speculators and Big Ben, we thought you might appreciate our specific views on the current oil situation. If you follow the financial news, you probably know there has been a lot of disagreement on precisely which factors are driving the price spike in oil. The two major contenders are 1) increased world demand for oil and 2) rampant speculation. At this juncture, we lean strongly toward the latter. Why? Because a logical examination of those who buy oil future contracts, points clearly to speculation. So let's get to your questions.

1. **Who are the buyers of oil futures contracts?** Buyers of oil future contracts can be broken down into two distinct groups: 1) those who actually intend to use the commodity, (like refiners, airlines, trucking companies, oil distributors, and utilities) and 2) those who have no intention of ever touching a drop of the oil (like institutional trades) who are buying oil futures with the intent of capitalizing on oil's rising price. The institutions we're talking about include university endowments, government and corporate pension funds, commodity index funds, hedge funds and even some ordinary mutual funds. What makes this "bubble" so interesting is we've never seen anything like this in the oil market before, primarily because we've never seen so much "demand" for oil coming from speculators (i.e. synthetic demand) as opposed to the fundamental users of the commodity (i.e. fundamental demand). The increased imbalance between "synthetic" and "fundamental" demand is what's driving much of the price run-up. Since none of these institutional traders are equipped to do anything with the oil itself, they obviously never intend to take possession of it. And regardless what other people think, we academics believe betting on the price of a commodity you never intend to own or use…**<u>is speculation</u>**…in the truest sense of the word.

2. **What, exactly, is a futures contract anyway?** Each futures contract must have a buyer and seller on each side of the equation. Simply stated, a futures contract obligates <u>the buyer</u> to take delivery of a fixed amount of a commodity (oil in this case) at the going contract price, on a certain date in the ***future*** (which is where it gets its name). In contrast, the seller of the contract is obligated to deliver a fixed amount of the commodity at the specified contract price on the future date specified by the contract. Futures contracts are standardized and used to increase market liquidity and decrease market risk. On the NYMEX exchange, which handles oil futures in the U.S., each contract represents 1000 barrels of oil and physical delivery of this amount of oil is required as settlement for the contract. As in any market, as demand for a product increases, the price rises. Futures markets are no different. So when speculators drive demand for oil futures up, the price of the underlying commodity (oil in this case) goes up as well.

3. **Does a speculator have to take delivery of oil?** No. In fact, most futures contracts are closed out before the date on which delivery of the oil would be required (this date is called the maturity date). For example, assume you bought an August futures contract for oil at a price of $140/barrel. Since each contract is for 1000 barrels, the contract's value would be $140,000. In effect, the contract obligates the holder to take physical delivery of 1000 barrels in late August from the seller of the contract, at a price of $140/barrel. But this obligation only applies if you still hold the contract on the maturity date in August. Let's say that by the end of July, August oil futures are trading at $150/barrel. You could sell your contract for $150,000, pocket the $10,000 difference between what you paid for it and what you received for selling it, and have no further obligation. There is a lot more to futures trading than this simple example suggests, but that's by design. Futures are complex financial instruments and the goal here was to provide you with a very basic introduction into how futures trading works, without loading you down with lots of unnecessary information.

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4. **Why do we use futures?** The reason futures markets were created in the first place was to allow producers and consumers of commodities (agricultural commodities like corn and wheat were the first to have futures traded on them) to hedge (or reduce risk) against seasonally fluctuating prices. In the spring, for example, a farmer might sell corn futures contracts that would obligate him to deliver 20,000 bushels of corn the following October at whatever the current contract price of October corn is. The buyer of the contracts, who in contrast would be obligated to take delivery of the corn in October, might be a feedlot operator who needs the corn to fatten his cattle. In October, when a glut of corn from a bumper crop at harvest time can drive prices lower, the farmer would be protected because he had contracted for a better price back in April. From the farmer's perspective, the futures contract acts as insurance against a steep decline in the price of corn come harvest time. Conversely, the feedlot operator, who bought the contract, would be protected against adverse events that might drive the price of corn higher, such as adverse weather conditions of or widespread disease or pest problems. Both parties to the futures contract are happy to enter into the contract in April because it reduces their uncertainty and risk exposure come October. This makes futures an extremely valuable tool for reducing risks associated with either producing or consuming large amounts of any commodity, and there are futures contracts traded on pretty much any commodity you can think of.

5. **What are Speculators?** We define speculators as market participants with no ties to the commodities they're trading in. Anyone can buy and sell futures contracts, so the number of potential speculators is basically unlimited, regardless of the underlying commodity. In turn, this means the potential synthetic demand for a commodity is also essentially unlimited. No one knows exactly how much speculative demand has contributed to oil's recent price run-up, but a recent Congressional report based on data obtained from federal regulators indicates that about 70% of the demand for oil futures on the NYMEX now comes from speculators. And while the current speculation in oil bears remarkable resemblance to the speculation we've seen in real estate (think condos in Miami) or tech-stocks (think dot-com's), the biggest difference is that those who didn't participate in those markets were largely unaffected by the price run-up. With oil, however, virtually everyone is feeling the effects.

6. **Are there other differences?** Another difference between oil and other bubbles we've seen historically is that the oil bubble is being driven by both fear AND greed. Emotions are powerful things, as we've discussed many times in the past, and bubbles are driven by the greed of speculators. When the bubble pops, fear and panic set in as the speculators simultaneously begin heading for the exits. With oil, on the other hand, the fear of oil disruptions resulting from things like war and weather also play a significant role. From the perspective of those who study financial markets and still own SUVs (like Joe, Scott and Brownie, to name a few) this is as intriguing as it is painful.

7. **What can the government do to rectify the situation?** We believe it's been well established that oil prices are being driven, at least in part, by speculation. The "solutions" being bandied about the halls of Congress run the gamut from investigating futures traders for evidence of collusion or other criminal activity to reducing or eliminating the ability of speculators to speculate in oil. It seems unlikely that anything substantial will come from the criminal investigations, simply because speculation is legal and the oil market is huge. While it is theoretically possible that collusion among traders (which is illegal) could have occurred in an attempt to drive oil prices higher, the sheer size of the global market for oil would make this incredibly difficult to achieve, at least without the assistance of a major world government or two.

8. **So how about banning or limiting speculation in oil?** There are a couple of problems here. First, the U.S. is not the only country where oil futures are traded. Banning speculators here would simply drive them to other markets. A large amount of oil is also traded outside the major futures exchanges, meaning even a collaborative effort on the part of the world's exchanges to restrict speculation would be easy to circumvent, and of limited value. Increased transparency of who is trading in what amounts would be a good thing, in our view, and that's a regulatory move that seems likely to occur. Ending oil speculation, however, is not possible and would be unwise even if it were. Futures markets rely on speculators to provide liquidity, and without them many legitimate market participants looking to hedge their risk would be unable to find a sufficient number of willing counterparties with whom to trade.

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9. **What's the bottom line?** The bottom line is that we're currently witness to a feeding frenzy in oil futures, the likes of which we've never seen before. The aggressors include large financial entities from across the globe and the situation is not dissimilar to feeding frenzies we've seen in the past (i.e. in real estate, tech stocks, bio tech firms, and Japanese stocks, etc.). As prices climb, greed draws more speculators to the table looking to make a quick buck, in turn driving prices still higher and encouraging even more speculation.

10. **So when will it stop?** Speculation will stop when the market price of oil becomes so divergent from the fundamental price of oil (i.e. that which is based solely on fundamental demand) that logic and rationality overwhelm greed. Unfortunately, greed is very powerful and it may take a long time before this point is reached. The good news is…much of the original speculation was being driven by the growth in India and China…who are in the midst of some very real problems, and this should help dampen demand. India's economy is cooling down, the government has some serious liquidity problems, and their stock market is off 40+% this year. In China, the economy is slowing, there is a very real backlash against their products worldwide, and their stock market is off 50+% this year. Many believe the Chinese economy will slow to a crawl after the Olympics. Thus, the main drivers of the original frenzy in oil are clearly less relevant today. If you throw in the fact that U.S. (and European) oil demand has decreased; our economy is slowing; and other world economies are fighting potential inflation fears with increases in interest rates, the oil bubble has plenty of reasons to "pop". That said, we believe that the current oil bubble will go on for a long while… which will ultimately lend itself to the building (and use) of alternative energy infrastructures. In the long run, this is good news for all of us. (You really didn't believe Congress was going to help…did you?)

6 Questions With Dr. Joe

Since we answered "ten questions" on oil speculation, we decided to reduce the number of our broad economic and mutual fund questions to six that concentrate on the upcoming election, tax harvesting, the economy and our managers. Enjoy…

1. Dear Dr. Joe: ***How do you think our economy (and the markets) will change if Obama or McCain is elected? R.K.***

Dear R.K. Hmmm…this seems like a loaded question! Actually, this issue is on a lot of people's minds today given the current volatility. I think Presidents get too much blame and too much credit for the economy and the stock market. Our markets are mostly driven by competitive forces and interest rates. I believe the Federal Reserve and Ben Bernanke play a much larger role in our markets since the Fed is autonomous - and - it controls interest rates and the money supply. That said, I believe any President that reduces tariffs, increases trade, and balances the budget is a good president…economically. It remains to be seen which of the candidates can increase trade and balance the budget. I wouldn't worry too much about who our next President is when it comes to our markets. Other factors play a much larger role in your portfolio…and so far, on an "economic front" I don't see much of a material difference between the two.

2. Dear Joe (and Katie), ***Thank you for your timely follow through on my gains and loss report through the first six months of this year. Your team has been doing a good job of harvesting the losses in a strategic manner. I am much relieved to know that I took a tax loss in the second quarter, while my portfolio increased!! Thanks for harvesting tax losses. I love the idea that I may have a positive return and a tax rebate at the end of the year! J.M.***

Dear J. M, Over the first six months of the year, we (at KFS) have been pro-actively taking (or harvesting) tax-losses for our clients in taxable accounts. Basically, we sell a mutual fund on one day and buy a similarly managed fund on the next. This way you stay fully invested in similar stocks, but can take a "tax loss" that you can use at the end of the year to reduce your tax liability. It's a great strategy to use in down markets. This is why we like to have a number of managers for each equity style…it gives us the flexibility to work for our clients in down markets by reducing your tax bill.

3. Dear Dr. Kiely: ***Are we in a recession? A.E.***

Dear A.E. Officially no…based on the definition of a "recession" being two quarters of negative growth. At this point, we have yet to receive an official reading of even one quarter of negative growth. So, we are not in a recession. However, whether or not the economy meets the official definition of a recession matters little, because as a result of all the negative news and higher oil/food prices, we feel like

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we are. I recently heard a term I think describes how many people feel. It's termed a "mental recession."

4. Dear Joe: *I can see why you are using First Eagle Global as one of our international managers, yet I found an article that said the current manager will only be there for a year. Can you comment on the article and the fact that he will be there only one year? J.L.*

Dear J.L. I'm glad you did a little research on Eveillard. We have been using him a while over the past few years...until he retired. Then we held what we owned and stopped buying the fund. As you might imagine, we stay in close contact with our funds and their managers. Now that Eveillard is back, we think it's worth investing with him again. Mainly, because his (and the funds) holding periods in the stocks they hold have been for so long. Thus, we think our investors will benefit from his investments for a number of years. We took some losses in other global funds and thus decided holding some SGENX made sense for all our clients. Don't lose sight of the fact that all of his money is invested there...and his assistant is just like him. Based on our conversations, we believe he will be there a bit longer than one year and we believe his presence will be felt for a while. Again, remember, all of his money is invested in SGENX. He is a very interesting guy and was much more engaged during his brief retirement than you would think. We know that he was much more involved in the fund during his retirement than the fund company lets on...and he did teach finance that year. On a personal note (and in some comparison), I think about finance 24/7 and can't help myself. I just love numbers! For example, I am insanely addicted to Suduko's. Of course, I also teach part time at UNC-Asheville and do a number of educational seminars because I love talking about numbers. (See Eveillard's stint at Columbia). That said, if you believe he just stopped thinking about markets while he was gone...think again. It's just not possible for us numbers guys...and he has said as much many times. We believe his presence (and his stock picking skills) will be felt for a long time.

5. Dear Dr. Kiely: *Are you concerned about the problems in the real estate market? A.E*

Dear A.E. The real estate market is hurting, particularly when you look at the decline of prices since the "bubble" burst sometime in 2006. However, there are signs we may be nearing the bottom, at least regarding prices. Homes still make a good investment and if you view the value of real estate over the last five or more years, instead of the last two. The problems in real estate will take time to work themselves out, but we do not expect home prices in most regions of the country to either appreciate or depreciate significantly over the next few years.

6. Dear Dr. Kiely: *Inflation seems to be a major problem for the economy today, what are your thoughts? S.W.*

Dear S.W. Inflation is rising. Even the government says so – so it must be true. Clearly, the huge increase in the price of energy has had a major impact and is trickling down to all parts of the economy. Prices of virtually all goods and services are going up and we think this is inevitable as long as the price of oil keeps rising. That said, we believe we have the best person keeping a watchful eye out over our economy and we feel he (Ben Bernanke) will manage interest rates, the money supply and inflation with the deftness of a brilliant symphony conductor over the long run. Thus, as a long term investor I believe we are in good hands to meet an unknown future.

A Final Note

As usual, we want to thank each of you for your continued confidence in our services. Our overall philosophy, which combines the best managers with research-driven asset allocation strategies, has provided excellent results to our clients over the long term. As we go forward, we remain committed to continuing to refine and improve these proactive strategies. As always, our goal is to provide each of our clients with the best possible mix of assets given their particular financial situation.

If you need anything or your goals or time horizons have changed, please do not hesitate to contact us. We are here to serve your financial needs, whatever they may be. Thank you for your kind comments, your considerate referrals and your feedback regarding this newsletter.

Enjoy this beautiful summer!

- Joe and the Gang at KFS.