KIELY FINANCIAL SERVICES, INC.

Volume 11
Number 3
Date: October 2007

# BEHIND THE SCENES

1290 E. Arlington Blvd., Suite 102 Jefferson Place, Greenville, NC 27858 | **Phone** 252 439-1888 | **Fax** 252 439-1348 | **Web Site** www.kielyfinancial.com

## OPENING THOUGHTS

I hope this newsletter finds you happy, healthy and looking forward to the cooler months ahead. After the hottest, driest summer on record I know we're all looking forward to some cooler days and (hopefully) a little rain. It's not often you'll hear me wishing for rain…maybe all those academics are right about this global warming thing! And as long as we're wishing for positive things, a fourth-quarter rally would be a great way to end the calendar year. If the beginning of October is any indication, we're well on our way!

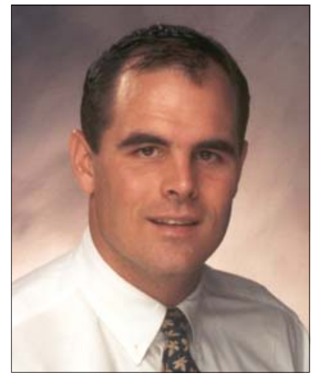
**Newsletter Specifics**

Speaking of academics, Dr. Scott and I will spend a portion of this newsletter discussing the recent stock market volatility and its underlying causes. Everyone has heard about the sub-prime mortgage mess, but few understand how the sub-prime market actually operates or why it got into so much trouble in the first place. Dr. Scott will provide some compelling insight into these and a few related issues, while I cover the economy, recent stock market performance, and our managers. Frankly, the tone of much of the current "financial news" belies the fundamental health of the domestic and global economies - particularly looking long term. But we all know bad news sells. The key in accurately assessing the economy is to, as always, maintain a big picture (i.e. macro) focus and avoid getting myopically caught up in the day-to-day minutia (i.e. micro) reported in the financial news. Taking a macro view, the positives of the current global and domestic economies far outweigh the negatives, but more on that later.

Of course, this newsletter also contains the latest edition of "10 Questions With Joe" and a short update on the comings and goings at Kiely Financial Services. We look forward to your feedback on this newsletter and are always open to input regarding how we can improve our topics for the benefit of our readers.

## THE YEAR-TO-DATE IN REVIEW

After an up and down first quarter where the stock market finished moderately positive, things heated up in the second quarter and the market took off, reaching a peak in mid-July. Between mid-July and mid-August, however, we witnessed a sizable, yet not atypical dip, only to rebound through the end of August and into September. At the end of the third quarter, the S&P 500 (large-caps) finished up almost 2%, while the Russell 2000 (small-cap) finished down approximately 3%.



Dr. Joseph Kiely

**INSIDE THIS ISSUE:**



### CLIENT APPRECIATION DINNER DATES 2008

**ASHEVILLE DINNER**
**ASHEVILLE COUNTRY CLUB**
WEDNESDAY, JANUARY 23RD
6:00 - 8:00 PM

**SUNSET BEACH DINNER**
**SEA TRAILS CONVENTION CENTER**
MONDAY, JANUARY 28TH
6:00 - 8:00 PM

**GREENVILLE DINNER**
**BROOK VALLEY COUNTRY CLUB**
TUESDAY, JANUARY 29TH
6:30 - 8:30 PM

### The Big Picture

Looking back over the previous twelve months, large stocks are up 14% and small stocks are up 11%. This sustains an excellent five year run that has seen large companies increase in value by over 85% while small companies have increased more than 135%. This growth has been driven by a worldwide economic expansion that doesn't show signs of abating anytime soon. In fact, this expansion has now entered its sixth year and is the fourth longest expansion on record. We believe this results from, at least in large part, the steady hand and timely moves of the Federal Reserve. If you closely examine the quarterly notes of the Federal Reserve board, you will find Fed Chairman Ben Bernanke also believes the current expansion will continue into the foreseeable future. And if you listen to the speeches given by Treasury Secretary Henry Paulson, he too expects this period of worldwide economic growth to continue for some time. Both are concerned about the current housing slump, but neither believe it will result in a recession. The housing slump will take some time to play out. However, as for now, the majority of long-term economic data remains positive.

### The Specifics

Analyzing the performance of the various stock market style sectors, we see the market has finally experienced a flip-flop in leadership. Over long periods, we know that value has historically beaten growth and that small stocks have outperformed their larger counterparts. During the third quarter, however, we've witnessed a significant rotation into larger and more growth-oriented stocks, which is a distinct departure from both the recent and long-term historical trends. Within the Morningstar Style Indexes, large growth led the way in the third quarter, gaining 5.30%. Mid-cap growth came in second with a gain of 4.87%, and large blend was third, up 3.35%. In contrast, small-cap value lost 6.81% during the quarter, with mid-cap value down 6.25% and small blend down 5.95%. It is rare to see such a strong dichotomy between styles in a single quarter, so what gives?

First, it's important to remember that when investing, the unexpected is often the rule rather than the exception, at least in the short-run. And since no one knows for sure what the short-run will bring, it's critical to <u>always</u> adhere to sound investment practices—like NOT trying to time the market; maintaining a long-run focus; avoiding emotion-driven investment decisions; and staying well diversified.

Second, last quarter's market patterns were heavily influenced by some unusual trading in hedge funds, as Dr. Scott will explain in detail. As you may have already guessed, this was a short-run phenomenon and is nothing for long-run investors to worry about. In fact, the anomalous situation we saw in the third quarter is already beginning to reverse itself early in the fourth quarter.

### Remember…Dips Are Your Friends

For years now, we have preached that investors need to maintain a long-term investment philosophy, using short-term dips and market fluctuations as opportunities for buying and/or rebalancing, as opposed to panic selling. When you get the type of divergence across the style grid that we saw in the third quarter, it's safe to assume that some investment opportunities probably exist. Over the next few weeks we will be analyzing our portfolios and rebalancing on an as-needed basis. We are waiting to get accurate end of the quarter data before we make any changes. Obviously, we like to see how our managers have specifically altered their portfolios. This way we make sure we don't replicate the same changes twice. Once we receive the current holding data on each of our funds, then we rebalancing our portfolios. We expect many portfolios will need at least a little tweaking. However not every portfolio will need rebalancing. Why? Because even though market sectors have changed leadership, this does not necessarily mean our managers have followed suit. As usual we think you'll be happy to see that our managers have performed quite well overall throughout the third quarter of 2007.

## New Funds and New Managers

We are always looking to add new stars to our stable of managers and I'm pleased to report that we have recently added three new mutual funds to our list of approved funds. We ordinarily like to incorporate new funds into our client portfolios gradually, but there are exceptions to any rule and this is one of those times. Occasionally, the actions of a mutual fund company or fund manger dictate that, in the best interest of our clients, we exit. We don't take these decisions lightly and we don't make them hastily. But after much thought, deliberation, and due diligence, we're in unanimous agreement that a change is required.

(Continued on Page 3)

## Good Gone Bad

For several years we have been singing the praises of FBR Small Cap fund and its manager Chuck Akre, and most of our clients have experienced some excellent returns in this fund as a result. We know the folks at FBR quite well and we worked closely with them to maintain access to FBR Small Cap fund after it closed its doors to new investors several years back. Because of the amount of client assets we had tied up in the fund, we were one of the few firms in our industry that was allowed to continue adding new clients.

In the past year, however, FBR has re-opened Small Cap Value fund to the public and the resulting rush of new money into the fund has been amazing. Unfortunately, much of that cash has remained largely uninvested. According to Dow Jones news reports, Chuck Akre has previously resisted numerous requests from FBR to reopen the fund, only to finally relent to pressure from the board this time. The fact that the fund manager originally opposed reopening the fund troubles us, as does the fund's current cash position, which represents 29.8% of the fund's assets under management. And, perhaps even more concerning, FBR has no plans to close the fund anytime soon. To us, this seems unconscionable as it means the cash position of the fund will likely only grow.

And as if that weren't enough, the fund's largest stock holding, Penn National Gaming (PENN), agreed to be acquired by the private equity firm Fortress Investment Group for $67 per share. The deal is expected to close in June 2008, and with PENN representing roughly 15% of the fund's assets, this will constitute another huge cash windfall for the fund…which we fear will also sit un-invested for an extended period of time.

Finally, the fund's parent company recently filed with the SEC to remove its investment policy restriction that 80% of its assets be invested in the stocks of companies valued under $3 billion. In effect, this change moves the fund's focus from virtually all small-cap stocks to one of anything goes. Such a major shift in investment policy makes us uncomfortable because, as you know, we require all our managers to maintain successful long-term track records with little style drift. Small-cap stocks are a totally different animal from large-caps, and Chuck Akre will be forced to invest a large part of the fund's ever growing cash holdings in areas where he has little experience. Within the universe of successful mutual funds, a shift in investment policy of this magnitude virtually never occurs. In fact, none of us can recall ever seeing anything like this before. Normally, when you have a manager that's as successful at what he does as Chuck Akre has been, why change the playing field on him? This is akin to Michael Jordan leaving the Chicago Bulls to pursue a baseball career—and we all know how that turned out…

Mr. Akre may well end up making this transition successfully and he may continue performing well, but we have no way to know and we're not going to allow our clients to become FBR's guinea pigs. With no track record of managing large-caps, we believe the prudent course of action is to reduce our exposure to the fund as much as we can. As a result, we recently began swapping out of FBR Small-cap for investors who hold it in their retirement accounts. For taxable accounts with large positions in the fund, we will gradually diversify away over time in order to avoid realizing sizable taxable gains. We will continue monitoring the situation at FBR and we will watch Chuck Akre's post-transition performance closely. We still believe Mr. Akre is one of the best small-cap managers on the planet and, if things go well, we don't rule out moving back into the fund at some point in the future. But our fiduciary duty is to act in the best interest of our clients. To that end, we believe reducing our exposure to the fund is the best course of action.

## The Three Amigos

We have recently added three new mutual funds to our list of approved investments. The first of the three is the Champlain Small Company Fund (CIPSX). Its holdings are quite similar to the FBR Small Cap, which is why we will be swapping Champlain for FBR in all IRA accounts. While we may be able to negotiate with Champlain to remain open for new KFS clients, we have no guarantee at the time of this writing. (A short note: Champlain will keep its doors open for KFS clients only - nice!) The manager of Champlain, Scott Brayman, has an excellent track record. He ran Sentinel Small Company fund from 1996-2004 and then left, along with most of his research team, to start Champlain Small Company Fund. The fund posted double-digit returns in 2005 and 2006 and was up 14.68% YTD through the end of the third quarter. Overall, Brayman's ten year track record has been extremely consistent and he has expressed a desire to keep the asset base small, which is something we applaud.

The second fund we've added is 1st Source Monogram Income Equity fund (FMIEX). This is a large-cap blend fund that will be used to balance our large-cap holdings. With no danger of the fund closing anytime soon, it will be added to our portfolios gradually as the need arises. Ralph Shive, the fund manager, has run the fund since its

(Continued on Page 4)

inception eleven years ago and has put together a consistent record of investment returns. The fund also has an impressive track record versus the S&P 500 and has experienced only one down year since 1997. We think this fund will be a good fit for our clients.

The final fund, Vanguard Small Cap Value (VBR), is actually an exchange-traded fund (ETF) that tracks a small-cap value index. As our "actively managed" fund holdings have moved upward and to the right on the style index grid, it has become increasingly difficult to get appropriate levels of exposure to small value stocks. And because there are currently no other alternatives among actively-managed small value funds that meet our stringent selection criteria, we believe it is appropriate to add a small-cap value index to assist us in rounding out the lower left corner of our client portfolios. We rarely recommend index funds or use them in our portfolios, but in this case we believe it is the best alternative to help us achieve proper diversification within client portfolios that are underweighted in the small value area.

## The Global Economy

As we have mentioned in recent e-mail updates and newsletters, we believe we are in the midst of a Goldilocks economy, both domestically and internationally. We're not sure who originally coined this term, but it is an apt description of an economy that is neither too hot nor too cold. Let's be honest, if we could find reasons to get up in arms about the recent stock market volatility we would—but we just can't. Inflation is tame, unemployment is down, consumers continue to spend, companies continue to grow earnings, trade barriers continue to fall, and we have a pro-active Federal Reserve that has plenty of weapons at its disposal and knows how (and when) to use them. The long term prospects for the global economy have never looked better, meaning this isn't just happening in the US or Western Europe, but across the entire globe. There will always be risks (like the current housing crisis) and there will always be unexpected short-term challenges that crop up. But at present we can't find a better long-term investment opportunity than the one that exists within the US Economy, which is what we basically own when we buy domestic stocks. By adding a select group of international companies to our equity portfolios, we believe we increase the likelihood of success and decrease our risk exposure. But don't take my word for it…read on and gather some wisdom from Dr. Scott who looks at the recent surge in volatility…and thus risk.

## Dr. Scott On The Return Of Volatility

If you looked at your monthly portfolio statements this year, I don't think telling you volatility has returned to the stock market will come as much of surprise. From July 19 to August 15 of this year we saw the largest peak-to-trough decline in the S&P 500 index since 2003. The S&P 500 fell from 1553.08 (an all-time record high at the time) to 1406.70 over that period, marking the first time in four years that we had seen a drop of more than 9%. This dip was remarkable for its speed (occurring in less than a month) and for its marked departure from the unusually tame markets we've experienced since the end of 2002. If there's a silver lining, it's that the recent turmoil may serve as a cautionary reminder to investors regarding how volatile stock prices can be. We all tend to have short memories, and it's a safe bet many of us have all but forgotten the 1997-2003 period, when peak-to-trough declines in the S&P 500 index averaged a whopping 19.5 % annually. While we thankfully haven't revisited volatility of that magnitude this time around, there is a common thread underlying the market we saw this past quarter and the one we saw back then. In a word, that thread is "bubbles".

In the 1990's we watched the birth of the tech stock bubble, and by mid-2000 we were witnessing its death. The speed and severity of the collapse caught many investors off guard and had a negative impact on portfolios with excess exposure to technology stocks, ultimately dragging the economy into a recession in 2001. Now, in 2007, we're experiencing something similar, only this time the asset underlying the bubble is not dot-com stocks but real estate. Even though the underlying assets are different, the pattern of the bubbles has been similar. This is because all bubbles occur when speculators, in a quest for quick profits, fail to adequately assess the risk of the investments in questions and bid the price of these assets up well above their true (intrinsic) value. To put it another way, zeal and greed replace commonsense in the midst of bubbles, and this time was no different. The result, of course, is the current sub-prime mortgage mess.

(Continued on Page 5)

**Sub-prime Loans & Mortgages**

In recent years, interest rates have hovered at or near historical lows, so it is not surprising that fixed-income investors have been clamoring for higher yields. This quest for yield, however, led many to abandon safe, stodgy alternatives like Treasury bonds for new kinds of higher-yielding mortgage-backed bonds. And, of course, large banks and brokerages were only too happy to provide a seemingly endless supply of them. Probably the best description of what led to our current mortgage-backed mess comes from Warren Buffett, who wrote; *"Many in Wall Street - a community in which quality control is not prized - will sell investors anything they will buy."* The only problem is that Mr. Buffett wrote this in his 2000 letter to shareholders, long before the current bubble began. Yet he was still referring to a bubble, only it was the dot-com bubble. Wall Street is obviously big on re-runs…

Getting back to the bubble at hand, mortgage-backed securities are created by pooling together hundreds or thousands of individual mortgages, which are then split into bundles from which bonds are created and sold. The bonds pass a borrower's interest and principal payments through to the bondholder, which is why they are also referred to as "pass-through" securities. But while mortgage-backed bonds have been around for decades (i.e. GNMA and FNMA bonds), the mortgage backed bonds responsible for today's problems are far riskier than those we've become accustomed to.

When mortgages are pooled, bundles are typically created with varying levels of risk, with the riskiest bonds tied to mortgages from least creditworthy borrowers. It is the riskiest (sub-prime) pools that paid the highest rates of interest and these pools were therefore in the greatest demand from those chasing yield. And as long as real estate prices were increasing, as they did through 2005, all was well. In a hot real estate market, any borrowers who run into financial trouble can sell their homes for more than the original loan value, making defaults and foreclosures rare in even the riskiest classes of bonds. As a result (and similar to what happened in the 1990s with tech stocks) market participants got lulled into a false sense of security and began increasingly ignoring the risks inherent in the housing market. In other words, they violated Dr. Scott's first law of investing. They forgot risk can be risky!

Of course, housing prices eventually peaked and began to retreat in many markets, leading to a rash of defaults, foreclosures and general panic in the mortgage-backed market. What originally appeared to be a minor problem in a relatively small sector of the overall economy grew to the point where the Federal Reserve felt it necessary to lower interest rates by 50 basis points (0.5%) in order to avert a possible economic downturn.

Because the stock market hates uncertainty, this made for a bit of a bumpy ride through the third quarter, although things certainly could have been worse. For the most part, it was largely institutional investors who got burned in the subprime mortgage market and (for once) individual investors were largely unaffected. On the borrowing side of the equation, however, scores of individual homeowners have lost their homes and seen their financial security destroyed. This is truly sad to see. In response, we're already seeing a return to fundamental lending with easy money and rampant speculation, at least for now, things of the past. And risk is once again being recognized, evaluated, and priced accordingly—at least until the next bubble rolls around…

**Hedge Funds**

Another recent symptom of speculative excess can be found in a class of hedge funds commonly called "quant" funds. Quant funds use computer models to build their portfolios, and some are automated to the point where little human intervention is required…or even allowed. Like many hedge funds, quant funds tend to use high amounts of leverage (debt) which magnifies profits when things are going well but increases losses if the model turns out to be wrong.

In the third quarter, a number of leading quant funds ran into trouble because their models failed to adequately account for the rapid increase in volatility caused by the fallout from the subprime mortgage market. To make matters worse, many of these funds tend to follow similar strategies, often investing in stocks of small-cap firms while shorting those of large-cap companies. Shorting, or short-selling, refers to the practice of selling borrowed shares of stock, usually in hopes that the price of the stock will fall so that the borrowed shares can be repurchased at a lower price and returned, thus generating a profit for the short-seller. In this case, however, hedge funds were shorting large-cap stocks and using the proceeds and additional borrowed funds to buy small-cap stocks. If small-caps rise more than large-caps, this strategy can be very successful, and that's obviously what the hedge funds were counting on.

Since some hedge funds use margin accounts to borrow lots of money, things can go downhill quickly if the

(Continued on Page 6)

market moves unexpectedly, which is precisely what happened as a result of the sub-prime debacle. When the prices of small stocks started to drop, many quant funds received margin calls from their brokers, forcing them to sell the stocks to meet their margin requirements. And since many of the funds were pursuing similar strategies, they all wound up trying to sell the same thing (small-caps) at the same time, which drove the price of small-cap stocks down quickly and severely. In large part, we believe selling pressure from these hedge funds was responsible for the poor third quarter performance of small-cap stocks. But since hedge funds aren't forced to regularly report their holdings, it may be months or years until we know for sure.

### In Sum

In sum, the recent volatility was driven by a mortgage market "bubble" and concentrated speculative trading. We don't believe either of these issues will affect the long term viability of the global economic expansion. And we believe both issues will be played out in an orderly fashion. Of course, these issues (or others) could rear their ugly heads in the months or years ahead. The good news is…our portfolios are built with the expectation these short-term problems will occur. And our managers, who have been around the block more than once, use these opportunities to buy certain subsets of stocks (like small caps) while they are on sale.

## 10 Questions With Dr. Joe

Each quarter I like to answer ten questions that I believe are germane to a large cross-section of our clientele. For whatever reason, I have recently received a large number of questions about our federal budget deficit, our trade deficit, the value of the U.S. dollar, and opinions from various financial newsletters. Even though I have pointed out on numerous occasions the fundamental flaws in using one or two economic variables to validate some preconceived notion…people still can't seem to resist doing so.

Scott and I have written about each of these items in the past, and I can only assume that some people just don't read our newsletters each quarter or our updates each month. We have always had a trade deficit and will continue to so long as we are the wealthiest nation on this planet. So should you be concerned about the trade deficit being too large? Not in our opinion. However, if the trade deficit ever goes away, you can (and probably should) start to worry.

We're also not big fans of large Federal deficits, but let's keep things in perspective. Our current deficit only represents approximately 2% of our gross national product. That's small by virtually any measure you use and far smaller than the deficit of most other developed nations and US households. Would we like to see it brought down? Yes, but at this point it's not something we're losing any sleep over.

As for the value of the U.S. dollar, it only seems to be a problem if you're traveling to Europe right now. If you're a U.S. based multinational company in today's global economy, the weak dollar is your best friend because it makes your products less expensive (and therefore more competitive) overseas. What people tend to forget is that there are tradeoffs everywhere. Japan runs a trade surplus…and their stock market has been terrible for almost 20 years! So while these items make for good fodder during election years, taken alone and out of context, as they almost always are, they mean very little.

So please, stop assigning inordinate predictive power to single economic variables. You are only going to get yourself worked up over a something that is usually wholly inaccurate. And worse, you are likely to use that "economic point" to make a bad economic or investment decision. Now, let's get on to the 10 questions…

**Q1: Dear Joe…Recently one of the financial newsletters I follow noted that "speculators had pushed the put-call ratio to levels last seen in 2001." Don't you think it's about time we start to recognize the U.S. is entering a recession? JW**

**A:** Dear JW: Puts and calls are basically the same thing as going long (buying stocks) and going short (selling stocks short), except you are using options to make long and short bets. Since so many "speculators" are betting the market is going to go down, you (and your newsletter) seem to feel that's a bad sign, right? There are a ton of fallacies in this argument, so where do I begin?

1. First, don't take one market variable and extrapolate it to the overall market. That's dangerous.
2. Second, puts and calls do not measure the overall

(Continued on Page 7)

health of the economy or the stock market. All they measure is the level of speculation on the market.

3. Third, much of the activity in the options market is driven by hedge funds, who have been getting killed in their heavily leveraged stock positions and have been buying puts to save themselves from going under.
4. Fourth, options markets are for speculators (traders who bet on short-term market movements). We are long term investors who use these movements to our advantage, by rebalancing and buying on sale.
5. Fifth, these people have been burned twice by the Fed. Earlier this year, the Fed stepped in and cut rates unexpectedly. Those who were betting the market would go down (puts) were burned badly. Then about a month ago the Fed cut rates by 50 basis points and surprised the market again. Again, those who were betting the market would get whacked got whacked instead. (burn me once…shame on you…burn me twice…)
6. Sixth, many hedge funds are entering the fourth quarter with negative returns YTD while the market indexes are up significantly. If you follow the market closely, you will note that the shorts are leaving the market and buying stock (or going long).
7. Seventh, don't forget that companies we invest in have incentive to make money…not lose it.
8. And finally, your question says it all, "*Speculators had pushed…*" We are not speculators. We are long term investors who build sound, well-diversified portfolios. Speculators take highly leveraged positions and make bets on which way the market is going. That's a zero sum game and one we won't play. I would recommend you stop reading the "daily newsletter" and look at the bigger picture. You may be surprised to find we have a thriving economy and are in the middle of the biggest global expansion in history.

**Q2: Dear Dr. Kiely…Is it possible for you to add the previous year's return to your tables in the back? CW**

**A:** Dear CW, Funny you should ask. This past quarter we went through our normal five-year SEC audit, where they come in and spend an entire week evaluating every facet of our company. Then they follow up with additional questions over a period of several months, just to make sure the review is thorough. I am proud to say that the audit went extremely well. In fact, our legal counsel said it was one of the shortest deficiency letters they had ever seen. However, one of the items the SEC would like us to include in our newsletter is a column showing the one-year return for each of our funds. Thus, beginning with this newsletter we will be providing fund returns for each quarter of the current year, along with the year to date return, the return over the previous 12 months (1 year), and the return over the previous 5 years.

**Q3: Dear Dr. Kiely…Can you provide any updates on the "improper download" that occurred on the TD Ameritrade website this quarter? MP**

**A:** Dear MP… In today's electronic age, there will always be curious teenagers and unscrupulous hackers that will try to enter secured databases online. This is just a fact of life. TDA uses the best data protection and encryption methodologies available, and this makes it very difficult for hackers to get your information. All large, multinational, fortune five hundred firms (including Microsoft) experience similar problems from time to time. Fortunately, no vital information was gathered and their have been no intrusions since. However, if you are ever contacted by anyone outside of Kiely Financial Services about your account or holdings, please hang up and call us immediately. One of the most common ways unscrupulous operators get sensitive data is by calling people directly and posing as someone they are not.

**Q4: Dear Dr. Kiely…I seem to be getting both an email update and a hard copy update with the same information. Could you please stop sending me a hard copy update? AR**

**A:** Dear AR…For a few years now we have been providing regular monthly updates regarding current investing-related events and the economy. Originally, we only provided these updates via email but over the last six months we have asked all of our clients to contact us regarding which method they would like to get these updates. The response has been less than spectacular. Thus, starting in January we will continue to send email updates monthly and we will only send hard copy updates to those who request it. Those who do not specifically request hard copy updates will not receive them in the future.

**Q5: Dear Joe…My old advisor managed taxable and non-taxable accounts (IRAs) differently. Why does your firm seem to make no distinction? CH**

**A:** Dear CH…One of the most important criteria when choosing a money manager (beyond long term track

(Continued on Page 8)

record performance) is his or her tax efficiency. We don't ordinarily invest the equity component of our taxable and non-taxable accounts differently because we tend to use tax efficient managers. This means our clients generally see little in the way of gains passed through from the funds they own. We could use investments that are theoretically more tax-efficient, like ETFs and/or open-end index funds in our taxable accounts, but our managers have been so successful at beating their benchmarks over the long-run that we feel our clients are significantly better off in our core actively managed funds, regardless of the tax status of their accounts. In addition, long-term gains are currently taxed at a maximum rate of 15%, so even if gains are declared the tax impact is not very large. Finally, remember that we also proactively harvest tax losses in down markets, and these losses can be carried forward for up to 13 years to offset realized gains. So when you combine tax efficient managers (who have long records of significantly beating their respective indexes) with low capital gains tax rates and proactive tax loss selling, we think managing taxable portfolios to avoid taxes would be doing a significant disservice to our clients and would likely leave them <u>less well-off on an after-tax basis</u>.

**Q6: Dear Joe…Does the new United Auto Workers (UAW) contract with Ford have an effect on the stock market? JM**

**A:** Dear JM…It does. The UAW union has a profound effect on how other unions behave. A number of our older industries like steel, auto, and airlines are operating at a severe disadvantage because of their long term benefits packages. Today, long term healthcare costs and pension benefits (two items not associated with the cost of building a car) make the cost of a car uncompetitive in the global workplace. The new contract addressed these issues in a fair way for both management and workers. This new "tone" in negotiations indicates both parties understand what's at risk if they don't work together. The deal (when read closely) indicates both parties are working together… a great sign for future deals.

**Q7: Dear Joe…I am extremely pleased with the equity (or stock) component of my portfolio. However, I am nearing retirement and would like to know your thoughts on bond funds. DC**

**A:** Dear DC…On page eleven we report all of our bond fund managers and their returns. In most cases, for retirees who are withdrawing funds monthly we will add a bond component to their portfolio. The general rule of thumb is as follows: for every 1% of your portfolio that you take out annually we like to add 10% to your bond portfolio. Thus, if someone was taking out 4% of their portfolio annually we would typically invest 40% of your portfolio in bonds funds.

**Q8: Dear Dr. Joe…Everyday I like to log on to the TDA website and see how my portfolio has done. Lately, the TDA website has posted a few inaccurate numbers and their financial tool box has been less than adequate. Can you help? MA**

**A:** Dear MA…First, I do not believe it is necessary to look at your portfolio every single day, just like doctors don't generally recommend weighing yourself everyday. Even though I spend 10-12 hours daily crunching numbers and thinking about the market, I never examine my personal account balances more frequently than monthly, when I receive my monthly statement. In general, those who look at it each day tend to be more emotional in their financial decision making. (I'm not saying don't look at your portfolio…I'm just saying you should temper it… unless you revalue your house each day…then it's okay) Second, TDA provides this website you can view your accounts whenever you like. In my opinion, that is all this website should be used for. There are plenty of excellent financial planning websites out there. The web-site is not set up for anything beyond checking values. Third, we have no control over the TDA website. It's a nice tool if you want to look and see what your portfolio looks like, but beyond that I don't recommend its use. Fourth, feel free to call any of our advisors at any time about anything regarding your account. We're here to help you…and like the calls. Finally, if you can't fix the issue yourself and want to log on daily and use their website, here is their toll-free number: 1-888-354-8361, please select option 3 for technology services.

**Q9: Dear Joe…The other day the market finished significantly positive and so did my 401k portfolio with one exception. One fund decreased 10% in one day! I was startled by the large decline. Do you have an explanation? DG**

**A:** Dear DG…Typically in the fourth quarter (with a few exceptions) mutual funds distribute their gains and dividends. During the year a mutual fund may realize capital gains and receive dividend income from the stocks they hold. The law requires mutual funds to distribute these to the fund shareholders annually. In all the time I have been investing money, we have never had a fund decrease 10% when the market went up. Thus large dips

(Continued on Page 9)

(particularly in the third and fourth quarter) and usually due to normal distributions. Of course, you can always shoot me an e-mail and I'll check for you.

**Q10: Dear Dr. Joe…How is your ankle doing? I know you have written about it in previous updates, but I'm always curious to find out how my favorite financial advisor is doing. BC.**

**A:** Dear BC…Scott says he is doing just fine, and thanks for asking (Scott's joke!). As for my ankle, I am totally healthy but I am still rehabbing. It will probably take about a year for my ankle to be fully healed. I am hopeful that I will able to run like I once did in the past. Even if I can't, I have already started kite-surfing and look forward to snowboarding soon. Although I appreciate all the questions about my ankle, there are those who are much worse off than myself, so this will be the last time I mention it. I do thank you (and everyone else) for your concerns, however. Its nice to know people care.

## Special IRA Contribution Note

As the end of the year draws near, IRA contributions become the majority of our clients main focus and contribution amounts become a common question. This year, because of the TD Waterhouse/ Ameritrade merger, your contribution amounts will not be as clearly noted as they have in the past.

Between January and April 2007, you received one set of statements from TD Waterhouse (TDW). Since May you have received statements from TD Ameritrade (TDA). If you made 2007 contribution before May, it **WILL NOT** be listed on your current TD Ameritrade statement. If you made 2007 contributions after May 1st, they **WILL BE** listed in your current statement. An example may help.

For those of you who made IRA contributions in March, it will show up on your old TDW statements. If you made an IRA contribution in July, it will show up in your current TDA statement. Given the change over, we can see how this can cause some confusion. At the end of the year, the pre-May contributions will be added to your post-May contributions and reported in total to the IRS

If you have any questions or concerns in this regard, please let Katie Burr know by calling our toll free number (877-366-5623) or emailing her at katie@kielyfinancial.com. Katie can let you know of your total contribution amounts for all of your accounts. If you are set-up on the TD Ameritrade website (www.advisorclient.com), you can also view or print out your monthly statements (past to present) showing your total contribution amounts.

## A Final Note

This past quarter there were no new babies, no new injuries or anything else new or out of the ordinary at KFS. We had an excellent corporate retreat in Asheville, an excellent review by the SEC and an otherwise mostly quiet 3rd quarter…which we'll take as a good sign. Later this month, Katie will be moving her office to a new (and improved) location, so her address and phone number will change on October 20th. Please see our back page for those changes.

As usual, I want to thank each of you for your continued confidence in our services. Our overall philosophy, which combines the best managers (and mutual funds) with 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 these proactive strategies. As always, our goal is to provide each of clients with the best possible mix of assets given their particular situation.

If you need anything or your goals or time horizons have changed, please do not hesitate to call or drop an e-mail to set up an appointment. We are here to serve your financial needs, whatever they may be. We thank you for your kind comments, your kind referrals and your feedback regarding this newsletter.

~Joe and The Gang at KFS

# Kiely Financial Services, Inc.
## Office Locations

**Our New Branch Location:**
4405 Stafford Glenn Court
Oak Ridge, NC 27310
Phone: 252-258-3063
Fax: 252-439-1348

| Headquarters Location | Asheville Location | Sunset Beach Location |
|---|---|---|
| 1290 East Arlington Blvd, Suite 102 | 4 Highland Place | 8839 Carenden Court |
| Greenville, NC 27858 | Asheville, NC 28804 | Sunset Beach, NC 28468 |
| Phone: 252-439-1888 | Phone: 828-350-8681 | Phone: 910-579-8075 |
| Fax: 252-439-1348 | Fax: 828-251-1806 | Fax: 910-579-8945 |

***IMPORTANT DISCLOSURE INFORMATION**

***Performance results** represent results reported by each reflected mutual fund during the corresponding time period. Kiely Financial Services, Inc. ("KFS") 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 KFS client portfolio or any KFS 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 KFS client portfolio or any KFS 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 KFS would also incur a KFS advisory fee, the deduction of which would result in decreasing the reported performance results. **For example:** a KFS 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 KFS 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 KFS) will be either suitable or profitable for a client's or prospective client's portfolio. **In addition**, the mutual funds depicted are funds that KFS 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 KFS, 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 KFS upon request.*

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

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