KIELY WEALTH ADVISORY GROUP, INC.

From Left To Right: Joe Kiely, Scott Below, Katie Burr, Brownie Cordell, and Kellie Kiely

BEHIND THE SCENES

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OPENING THOUGHTS

Academics tend to be inquisitive by nature and are fascinated by what motivates people to behave the way they do. In many cases, it's why we become scholars and educators in the first place. We're curious, what inspires people like Duke's Coach K to continue coaching when he has already achieved every major goal and won more basketball games than anyone else? We also wonder what motivates people like Warren Buffet and Bill Gross to continue working when they have more money than they could possibly ever spend. Perhaps the most puzzling question of all, at least to Scott, Brownie and I, is what motivates so many investors to actively trade and attempt to time the market, especially when an overwhelming amount of research so clearly demonstrates that holding an investment over the long term is a far superior approach.

The Long-term Numbers

Every so often, we come across yet another research paper that examines the returns of a passive buy-and-hold approach versus the performance of the "average investor." Another such paper was recently published and it came as no surprise that it served to reinforce the previous literature, showing that the "average investor" does not do well compared to any sort of passive indexing approach and, in fact, even failed to break even with inflation! Just how poorly does the "average investor" perform? Very poorly, at least according to Dalbar, the authors of the study who analyzed the most recent investment data they gathered from the Investment Company Institute, Standard & Poor's, and Barclays.

As the chart on the following page shows, the average investor performed dismally over the last two decades, earning an average of just 2.1% annually and even losing out to inflation (CPI). In contrast, domestic stocks, oil, and gold all grew by around 8% annually. Looking at this, it's only natural to wonder how the "individual investors" - who act on their own without an advisor - could perform so poorly. It turns out the answer lies in their emotions.

INSIDE THIS ISSUE:

2013 ANNUAL COMPLIANCE OFFER

ENCLOSED IN THIS QUARTER'S NEWSLETTER ARE A FEW IMPORTANT COMPLIANCE ITEMS:

KWAG 2013 PRIVACY POLICY & ANNUAL ADV OFFER

PLEASE TAKE TIME TO READ THE **COMPLIANCE NOTES** SECTION ON PAGE 12.

FIND OUR NEW ADV BY VISITING:

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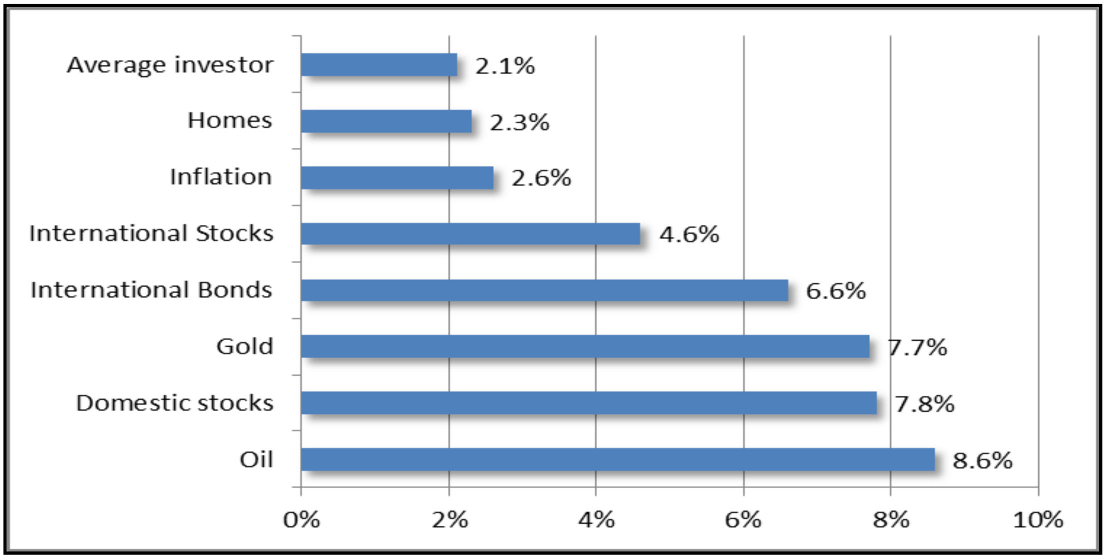
Annualized Asset Class and Individual Investor Returns 1992– 2011



Emotions

The meager returns documented above were driven by an emotional roller coaster that, for so many individual investors, motivates their buying and selling decisions. Individual investors tend to be driven by the most recent news cycle to a large extent. If the economic news is particularly bad, many stock investors will flee stocks for the safety of cash or T-bills. Conversely, when the economic news is good, they flock back to the stock market. Unfortunately, in both cases, they often wind up doing the wrong thing at the exact wrong time. Think about it, there is hardly an investor alive who hasn't thought about adding more money to their stock holdings recently, especially after hearing on the news that virtually all the domestic indexes have been hitting all-time record highs. When things are going well everyone wants to jump on the bandwagon. Emotions of this sort are just human nature, but the goal of savvy investors is to not allow their emotions to dictate their investing decisions.

Our Point

As we have frequently reinforced in previous writings, investors are best served by building well-diversified stock portfolios designed for the long-run. We define the long-run as at least five years, but prefer ten years or even longer. In addition, we recommend that people maintain an allocation between their stock and bond holdings based on their investment needs and level of risk tolerance. Any short-term market dips – which are a common occurrence and to be expected – should be used to *rebalance* between stocks and bonds in order to get back to their original target asset allocation. For example, let's assume an investor starts out with a 60% stock, 40% bond portfolio, with the bond allocation earmarked to provide for their monthly cash flow needs. If stocks increased significantly in value, this investor should either rebalance away from stocks (and back into bonds) or sell some stocks in order to meet their monthly income needs. Conversely, if stocks were to drop in value, they should sell bonds and use the proceeds to add to their stock holdings, returning to their original 60/40 target allocation. By sticking to a predetermined target asset allocation and rebalancing as market conditions change, investors are forced to buy stocks when they're on sale and sell them after a major run-up, which is just the opposite of what the average investor (driven by their emotions) does.

The investing mistakes made by the average investor are driven by several factors. First, individual investors rarely establish a target asset allocation based on their personal investment goals, time horizon, and expected cash flow needs. Second, even if an investor establishes a reasonable target asset allocation, they rarely stick to it allowing their emotions to dictate their decisions instead. To make matters even worse, many individuals tend to extrapolate the current news cycle out into the future, expecting that during bad times things will only get worse—and during good times things will only get better. In reality, when things are at extremes they tend to revert back to the mean, so anyone extrapolating recent trends into the future is setting themselves up to miss the mark by a wide margin. That's obviously not the kind of behavior you want to see, but it's precisely how individual investors manage to perform so poorly over time.

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FORECASTING

Inquisitive academics have also investigated how people make forecasting decisions regarding a wide variety of issues. They have long felt that for most people emotions were driving their forecasts and/or predictions of future events, but until recently had no concrete empirical evidence to back these views up. In 2006, political scientist Philip E. Tetlock published a landmark book titled, "Expert Political Judgment". In it, Tetlock demonstrates quite convincingly that most political "experts" and "pundits" are actually pretty awful at making predictions and forecasting future outcomes. As you might suspect, his methods have also gained popularity with those studying forecasting behavior in areas outside of political science, perhaps most notably in economics and finance. As it turns out, economic and financial forecasts are just as inaccurate as the political predictions Tetlock documented. The findings suggest that economic experts are terrible at making predictions and forecasting future market moves. Yet, as bad as that is, they also find the predictions of "individual investors" are even worse.

The good news is that forecasting can be improved upon if you follow the correct approach and have the appropriate tools at your disposal. Here are some of the highlights of Tetlock's forecasting tools and a few examples of how our firm has long embraced them when making decisions for our clients.

Probabilistic Thinking

Forecasting can be done in a number of ways. It can be done in teams or individually, and it can also be performed using probabilities/statistics or narrative thinking. There are other forecasting nuances that Tetlock describes in his book, but what's clear from his research is this: Those who; 1) work in teams and 2) use probabilistic thinking do much better than those who don't.

If you are a long-time reader of our newsletters, you'll note that we rarely make definitive statements regarding market returns going forward. Instead, we use probabilities and likelihoods and adjust their magnitudes as new data presents itself. For example, we know stocks have historically provided better returns than bonds and we know that over long periods of time this relationship is virtually certain to continue. But that relationship only exists over the long term, and in the short run anything can happen. In other words, we have no idea what will happen in a given year. More importantly, we don't pretend to know what will happen in any given year. However, we give our stock and bond portfolios the best chance of success by adhering to a strategy we know will outperform over the long run, where there is a much higher degree of certainty. In essence, most of our investment strategies are driven by probabilities and long-term trends.

For example, in our most recent monthly update (April) we examined the significant run the stock market has enjoyed over the last few quarters and how this has increased the likelihood of seeing a dip in the near future. As a result, we have encouraged investors NOT to add significantly to their current stock positions unless the factors underlying their original target allocation have changed significantly for some reason. The goal of this advice is, as always, to put the odds in our favor. We know it's virtually impossible to predict short-term stock price movements, but we also know that over time everything tends to revert to the mean. In other words, we know that periods of significant outperformance (or underperformance) in the financial markets tend to be followed by sharp and often significant reversals. We don't know exactly when these reversals will occur, but we do know that by employing a probabilistic strategy designed to exploit corrections, we will be significantly better off than if we did nothing—and infinitely better off than the aforementioned legions of investors whose decisions are dictated by extrapolating recent trends out into the future. Our overriding investment philosophy is to design and implement strategies that increase our clients' odds of success over time. Examples of other such strategies include diversifying into small and mid-caps; using only the best money managers with stellar long-term track records; and rebalancing our portfolios back to their target allocations when they become unbalanced.

Maximizing the odds of success over time

The "average investor" tends to view the stock market incorrectly, seeing certainty where there is none, and black & white where there are only shades of gray. When we speak to people about investing they often tell us they're convinced the market will either go up (or down) over the next few months and that it will do so because (insert random reason here). The reasons we hear run the gamut but are typically driven by something that has recently been beaten to death in the media, and has thus been exaggerated considerably in an attempt to draw an audience and generate advertising revenue.

Unfortunately, what many individual investors don't understand is that financial markets are highly competitive and, as a result, assets are very efficiently priced most of the

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time. This means that with the exception of a few very rare occurrences, all pertinent publicly available information is already impounded in asset prices. So, if you believe any of the news you heard last night on the television will have any meaningful effect on your portfolio…think again. That news has already been factored into the stock price long ago. It's why we rarely watch the news…it has virtually no effect on the long term portfolio's we manage.

The bottom line is that individuals generally make poor economic forecasts and equally poor investment decisions because they rely on their own uninformed judgment of how markets work and of what drives stock prices. To make matters worse, they also tend to see things in black and white, which causes their investment decisions to fall into the all or nothing category.

However, the world's best investors recognize they can never know everything there is to know and tend to make team-based decisions rather than relying solely on their own beliefs. In addition, they recognize there are no absolutes in investing and that things are never black and white. That's why at KWAG we work in teams and use probabilistic thinking when constructing our portfolios and developing our strategies.

Multiple Views

Tetlock's research also found that it was tremendously important to look at forecasts from many different vantage points, adjusting your forecast probabilities as you go. In essence, he found that those who DID NOT get Information from a number different outlets and WERE NOT exposed to a range of different opinions tended to be much worse forecasters.

If you have been to any of our January client appreciation dinners, you know we typically discuss research from a variety of sources that we continuously stay abreast of. We often point out how we like to get opinions from multiple sources and how divergent these opinions can be, even though those rendering them are all very intelligent and equally well-informed. We embrace these differing opinions because we know it's important to examine all sides and perspectives of each issue. Each viewpoint contributes something to our overall view of the world and, as a result, helps determine our investment strategies. Years of experience has taught us that we are much better at managing assets and forecasting the economy and financial markets when we remain open-minded to all viewpoints, especially those that may not fully mesh with ours. No one has a corner on good information or original thought, and no one knows everything there is to know.

In contrast, studies have found that the "average individual investor" tends to go into the decision-making process using a set of preconceived notions (e.g. that the deficit is bad for stocks) and then looks at data that verifies and reinforces what they already believe to be true. Good, unbiased research is obviously NOT conducted this way and one needs to keep an open mind when evaluating economic data, especially with your own money at stake. One way to do this is by exposing yourself to alternative ideas. On the other hand, alternative ideas are of no value if you can't keep hubris at bay, so it's also important to remember that no matter how smart you think you are, no one knows everything they need to know (as you may have read somewhere before.)

Different Analysis

When it came to problem-solving, Tetlock found it was important to use different types of analysis. For example, if three forecasters arrive at the same judgment using different approaches and sets of information, Tetlock found the collective judgment was much stronger. It is important to know this isn't the same as three people saying the same thing about the same set of information on three separate occasions. Parrots can do that, and we wouldn't want to take investment advice from a parrot.

Most individual investors aren't researchers and know very little about the scientific method or how research is supposed to be conducted. As a result they don't understand the financial danger of going into a decision with preconceived notions. Effective, well-trained researchers take pride in following a strict protocol so that their conclusions can be replicated by anyone. In fact, for some research to get published it has to first be replicated independently by other researchers. At the end of the day, the strength and reliability of any forecast or conclusion comes from a consensus view, and from different people examining the same question or problem from a variety of differing viewpoints, using different sets of tools.

We read as many different research reports as time allows each day, and we try to make sure these reports are from respected people on all sides of a particular issue. We purposely attempt to remain agnostic with respect to economics and politics, skeptical of everything, since it allows us to gather data and sort through this information in as unbiased a fashion as possible. But even when we reach a consensus on an issue and have moved forward with our strategy, we continue to reevaluate the factors that led us to that decision in the first place, because no decision made under uncertainty can ever be viewed as

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flawless or perfect. In investing, as in life, there is no such thing as perfection.

If you want to read a truly fascinating and enlightening book, please pick up a copy of Philip E. Tetlock's book. We think you will find it well worth the time and money.

In Sum

Over the last four years, our message on the economic recovery has remained unchanged, but that doesn't mean our investment strategies have followed suit. Early on in the financial crisis we pointed out that the Federal Reserve had completed critical repairs to the most vexing problems facing our country. As a result, we predicted U.S. companies and the domestic stock market would bounce back powerfully, but that the overall economy would take a lot longer to recover.

We based our predictions on an in-depth analysis of the economy and a number of economic studies from respected researchers, many of which looked at the impact of financially driven recessions. These studies found that financially driven recessions, unlike their more common demand-driven counterparts, tended to last much longer, with full recovery generally requiring from 7 to 10 years. Another common theme was that the stock market recoveries in those countries, like the economic recoveries, were also characterized by long, anemic recoveries. Had we stopped our analysis there we could have easily made the same error committed by so many other investors and investment advisors during that period, who made a headlong dash to cash by liquidating all the risky assets in their portfolios.

Fortunately, we didn't stop there. Instead, we continued to analyze a wide variety of factors, focusing in particular on those we felt might be different this time around. Much of our analysis centered on four basic economic themes that, for the most part, didn't exist during the previous recessions detailed in the research. These were; 1) low interest rates, 2) cheap labor, 3) technological innovation and advantage, and 4) unprecedented global economic development. The intent of this analysis, as is the case with all quality research, was to leave no stone unturned. Ultimately, we adopted strategies during that tumultuous period that were atypical of what most investment advisors were recommending, based on our belief that there were a set of critical disconnects that even many of the most seasoned investors were failing to recognize. In fact, if you go back to our earlier newsletters you will find much of our strategy over the past four years was based on the following five "disconnects":

1. **The "Media" Disconnect**, where we highlighted the false perceptions propagated by the media on a number of fronts, particularly with respect to the economy and the stock market. In various newsletters we listed upwards of twenty-five economic issues that the media and many financial and economic prognosticators claimed would lead us to financial catastrophe. So far, financial and economic prognosticators are 0 for 25.

2. **The "Globalization" Disconnect,** where we pointed out how investors were having trouble disentangling the health of the domestic economy from the performance of multinational corporations. A few decades ago all you had to do to get an idea of how the US stock market was doing was to take a look at the US economy. Following World War II, the US economy essentially <u>was</u> the global economy and we continued to dominate the global economy for many years. But recently we've seen a paradigm shift, where countries with some of the largest populations on earth have, for the first time in history, begun to embrace capitalism and develop economically. This is a radical shift and is still in its early stages, but the umbilical cord that once ran between US companies and the US economy has been cut, with the end result that US companies no longer need a strong, vibrant domestic economy to grow at record rates and post record earnings. Today, domestic stock investors have to look beyond our borders and assess the global economic environment in order to get an accurate view of how corporate America is doing.

3. **The "Stock Market" Disconnect**, where we maintained that stock prices across the board in 2009 had significantly diverged from the intrinsic values of the underlying companies. We argued that this mispricing was being driven by rampant panic selling, with irrational investors acting on raw emotion and rushing headlong for the exits, with little or no regard for the actual values of the underlying assets. In fact, our analysis during this period uncovered a large number of companies trading at negative enterprise values, meaning a company's outstanding stock was selling for a price below the value of the net cash the company had on hand (i.e. after paying off all the company's debt). In a rational market this sort of thing should never happen because it allows an investor to take control of an entire company with a zero or negative net investment. In addition, the firm's other assets, like land, buildings, and equipment would've all

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been acquired for free. Seeing this, it was clear that the financial markets had become wholly irrational and that risky assets were significantly underpriced, even in a worst-case scenario. We didn't know how long the market would take to come to its senses, but we knew it eventually would and when it did those who had resisted the temptation to sell would be handsomely rewarded. As we wrote at the time, it was the biggest fire sale in stocks we'd ever seen.

4. The "Bond Market" Disconnect, where investors largely viewed bonds as a homogenous asset class and expected all bonds to behave similarly. One of the unique situations encountered by financial services firms at the beginning of the great recession was a significant lack of liquidity, which forced them to sell assets regardless of the price, in order to raise the cash they needed to stay afloat. This was similar to the panic driven selloff we were seeing in stocks in that the bond mispricing had also reached epic levels. Once again, we didn't know when the bond market would come to its senses, but we knew a large number of very low risk assets were trading for extremely low prices, creating one of the best buying opportunities for fixed income investors in history.

5. The "Known vs. Unknown" Disconnect, where investors incorrectly believe that the economic news they hear in the media will affect their portfolio going forward. The truth is if you read (or listen) to a story about a specific economic topic (say the budget deficit), those issues are already KNOWN to the public and will therefore have little effect on the value of your portfolio. Markets react the instant news is released, making it virtually impossible for individual investors to profitably capitalize on anything they hear on TV or read in the newspaper, because that information has already been impounded in the stock price. In general, UNKNOWABLE events (i.e. those that have yet to occur) are what drive financial asset prices, making forecasting short-term market moves almost impossible to predict.

It is disconnects like these that contribute to the poor performance of the average investor over time. Most investors don't employ probabilistic thinking and don't have the time to seek out the opinions of multiple experts on the factors that myriad factors that might affect their portfolios. Most people are simply too busy managing other aspects of their life. Thus, much of their analysis comes from one type of media, and from pundits who are often media celebrities, with good hair perhaps, but with little formal education in the field they cover. Basing opinions that will impact the value of your life savings on the views of one or two non-experts can be extremely dangerous, yet millions do it every day.

How Dangerous?

A few weeks ago, the Pew Research Center released it tenth annual report on the health and status of American journalism. They found, among other things, that local and cable news stations had cut coverage of actual news events by 30% and increased interview and opinion pieces by 31% over the past five years. In fact, they found that "opinion pieces" accounted for 55% and 85% of the time on the two most watched cable news stations in America. The conclusion they drew was that most people no longer get unbiased information, and are therefore making decisions with only a small subset of data available. That's tragic because it's costing millions of people a secure retirement. On the plus side, however, cable news advertising revenues are up.

The Stock Market

Just four years ago our financial markets were gripped by worry and many investors had serious doubts whether their portfolios would ever get back to where they once were. Today, most of those worries no longer exist. For example, the markets seem to have shrugged off the recent budget crisis in Washington, having learned from numerous crises in recent past that these man-made predicaments are more political theater than imminent fiscal concern. As a result, on March 9, 2013 the current stock market rally celebrated its fourth birthday with a bang. As shown in the nine equity style boxes on the following page, through the end of the first quarter, each of the nine sectors generated annual returns exceeding 20% over the last four years.

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4-Year Annualized Russell Style Index Performance through 3/31/2013

	Value	Blend	Growth
Large	21.80%	21.56%	21.29%
Mid	27.21%	26.07%	24.85%
Small	23.50%	24.17%	24.75%

If you take a closer look, you'll see that the returns across the nine boxes was actually averaged closer to 24%, making this one of the most powerful market rallies on record. The past four years have clearly been terrific for some investors, including our clients, but not so terrific for others. Many investors have failed to benefit from this epic rally because they sold into the 2008-09 decline and have remained mostly on the sidelines in cash ever since. That's too bad because they won't get the last four years back, and most of us will likely never see another rally of this magnitude in our lifetimes.

Other Data Points

As we alluded to at the outset, the stock market recovery has been strong and resilient. From the market lows reached on March 9, 2009, the S&P 500 has increased 140% and the Russell 2000 has risen an even more remarkable 160%. Four years ago, many were convinced the major market indexes would never again reach their pre-crisis levels. Yet the Russell 2000 hit new all-time highs in 2011, 2012 and now again in early 2013. The S&P 500 finally surpassed its previous all-time high on the last day of the first quarter this year. In sum, we've had a terrific four-year rally in stocks, while Treasury securities and other ultra-safe investments continue yielding next to nothing. This just continues to reinforce and validate the investment decisions we made four years ago.

The Style Index Numbers

We have frequently written about the "size" and "value" premiums that have historically existed in stocks over the long term. Unfortunately, most investors have failed to capitalize on these well-known anomalies, even though they're extremely well documented. In the case of individual investors it may be because they (or their advisors) aren't familiar with the academic literature.

By the end of the first three months of 2013, eight of the nine Russell style indexes had already seen double digit gains, with the size and value premiums both clearly evident. Consistent with the well-documented size premium, small and mid-cap stocks once again beat their large cap counterparts. Similarly, the value indexes outperformed their growth counterparts across each size category, which is consistent with the value premium. In terms of the individual indexes, mid-cap value led the way in the first quarter, following a general longer-term trend.

Russell Style Index Performance 1st Quarter, 2013

	Value	Blend	Growth
Large	12.31%	10.96%	9.54%
Mid	14.21%	12.96%	11.51%
Small	11.63%	12.39%	13.21%

Examining the style box performance over the previous one and three-year periods, a similar pattern emerges, with small and mid-cap stocks outperforming large caps by a fairly sizable margin. On the other hand, the rebound we've seen in stocks of all sizes and styles has been nothing short of remarkable and is a testament to the innovative nature and resiliency of American corporations.

1-Year Russell Style Index Performance ending 03/31/2013

	Value	Blend	Growth
Large	18.77%	14.43%	10.09%
Mid	21.49%	17.30%	12.76%
Small	18.09%	16.30%	14.52%

3-Year Annualized Russell Style Index Performance ending 03/31/2013

	Value	Blend	Growth
Large	12.74%	12.93%	13.06%
Mid	14.96%	14.62%	14.23%
Small	12.12%	13.45%	14.75%

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If we go back even further in time and examine the past decade, small and midcap stocks averaged a combined 11.80% annually, while large cap stocks averaged just 8.92%. Don't get us wrong, 8.92% is a nice annual return for any asset class, but the additional 2.88% return earned annually from small and mid-cap stocks provides a welcomed boost. To illustrate, if we compounded an original $100,000 investment at 8.92% annually (the 10-year average return on large caps) over 10 years, it would have resulted in a final portfolio value of $235,077. Not bad. In contrast, however, a $100,000 initial investment compounded at 11.80% (the 10-year average return on small and mid-caps) over 10 years would result in a final portfolio value of $305,038. That's a roughly $70,000 advantage to small and mid-caps on an initial $100,000 investment over just 10 years!

10-Year. Annualized Russell Style Index Performance ending 03/31/2013

Value	Blend	Growth	
9.18%	8.97%	8.62%	Large
12.57%	12.27%	11.53%	Mid
11.29%	11.52%	11.61%	Small

It's hard to make a better argument for diversifying into small and mid-cap stocks than the results provided in the previous table. Over the last 10 years, small and mid-caps have outperformed large caps by a sizable amount and it's important to note this is NOT a random event. In fact, evidence of the "size-premium" has been around for decades and the data is freely and readily available via the internet for everyone to examine! Yet most investor portfolios today are still being constructed with a strong overweight in large-cap stocks, with many containing no small or mid-cap stocks at all. We're at a loss to explain. The only thing we can conclude is that investors either have never heard of the size premium or don't realize the value it can bring to their portfolios over time.

Corporate America Today

Over the past few months, we have continued to receive a number of questions about the profitability of corporate America, the high unemployment rate, our country's debt problems, and the gridlock in Washington. Given the 24/7 media we're confronted with today, we can't say we're surprised, and we are more than happy to cover these topics yet again.

Corporate America: In general, individual firms today are healthier than they were at any time before the recession began. They are more productive, more competitive, generating record profits, and growing revenues at rates that continue to surprise economists and analysts alike. While the media continues to focus on negatives like the high domestic unemployment rate, the deficit, and weak GDP growth rates, corporations are sticking to their strategic game plans and taking advantage of all the opportunities the global economy affords. They're also using record-low interest rates, lower than normal wages rates, and a burgeoning developing nation middle-class to their advantage, which most people seem to overlook.

Corporate Profits: Because interest rates are at all-time lows, corporations today are able to raise capital at a lower cost than any time in history. A major component of corporate profit margins is the cost of capital, as it allows firms to inexpensively build new plants, buy new equipment, and in general operate more inexpensively. In turn, cheap capital provides a tremendous boost to the bottom line. For example, if a corporation can borrow money today at a cost of 3% and then uses that money to acquire manufacturing plants, equipment, or invest in projects that will return a net 10%, that equates to a profit margin of 7%, which is a pretty good deal. In other words, if firms can borrow money at a low rate and then reinvest it at a higher rate their profit margins will be strong, which is exactly what we've seen over the last four years. Strangely, however, we NEVER hear anyone in the media talk about the ridiculously low cost of capital corporations are enjoying or how this has helped goose profit margins to all-time highs (in spite of the worst recession in history and a slow, drawn out economic recovery).

The Economy: We're the first to admit that there is still a lot of room for the domestic economy to improve. The good news is, we're pointed in the right direction and the

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vast majority of economic trends look positive. The bad news is, many people continue to dwell on the high unemployment rate, subpar GDP growth rate, massive government debt, and the pervasive gridlock in Washington. Clearly, those are all significant issues.

Of course, if those issues haven't managed to bring down corporate profitability over the last four years, why would we expect them to do so now? We've said all along that jobs are the last thing to recover in recessions, and particularly in severe credit-driven recessions like this one. The bottom line is, that we don't expect the unemployment picture to improve rapidly anytime in the near future. While we expect unemployment rates will continue to fall, all indications are that the rate of decline will continue to be slower than normal.

As far as political gridlock goes, we probably just need to get used to it because it doesn't look like it's going away anytime soon. Instead of stressing over it, perhaps we should even be encouraged by it, hoping that inaction on the part of our politicians is an indicator that at least they're not making things any worse.

Government Debt: We seem to get questions about the government debt at least once a week. Most people are under the impression that we have run-away debt, and assume we need to do something drastic today in order to save ourselves from oblivion tomorrow. In fact, that's just not the case. Unbeknownst to the majority of Americans, the U.S. Government posted a $3 Billion budget surplus in the month of January. Yes, you read that correctly: a $3 billion budgetary surplus! As a result, for the first time since 2008, the government actually collected more than it spent. Although a $3 billion surplus is a tiny drop in the bucket, compared to the $290 billion in debt accumulated since October 2012, the fact that there was a surplus at all suggests fears of a run-away deficit are overblown. Indeed, the Congressional Budget Office (CBO) estimates the budget deficit will shrink to $845 billion this year, an amount equal to just 5.3% of Gross Domestic Product (GDP), making the 2013 budget deficit the smallest since 2008. Also largely unnoticed has been the fact that this decline continues a three-year trend where the budget deficit as a percentage of GDP has been roughly cut in half. The truth is, we are moving in the right direction budgetarily and appear to be doing so at a pace that is not overly threatening to the still fragile economic recovery.

Interestingly, as we look 2-3 years out, the debt picture gets even better - even given the tepid CBO growth and unemployment forecasts. Specifically, the CBO believes the budget deficit could be cut in half from today's levels by the end of 2015, giving us plenty of time to wrestle with comprehensive budget reform. Beyond the next three years, however, the picture becomes a little more clouded, as the aging population, rising health care costs, and growing interest payments on the federal debt will all put additional pressures on the budget. As a result, the CBO anticipates that the deficit as a percentage of the GDP could start rising again as early as 2016.

Our Point: When we examine the national debt, we see no immediate cause for concern, so long as the deficit continues to shrink relative to GDP. We would prefer a balanced budget, who wouldn't? But given the hand the economy was dealt four years ago, we believe we are on the right path, and any hysterics regarding the impending bankruptcy of the country or the demise of our grandchildren's future are just that…hysterics.

We think all the factors are currently in place to allow the stock market to continue grinding higher throughout the remainder of 2013 and into 2014, but also believe volatility will probably increase, perhaps significantly, thereby raising the potential risks for investors. (Remember, you should always expect a 10-15% market dip every year.) In the long run, we still think the prospects for stocks are terrific, but we need to be prepared for possible turbulence in the near-term. If your goals and time horizon have NOT changed, we don't think it makes sense to change your portfolio's target allocation at this time. However, if your goals or time horizon have changed, we obviously need to sit down and talk about it, and perhaps develop a new course of action that better addresses those changes.

THE BOND CONUNDRUM

If you stay abreast of the financial news, it should come as no surprise that most analysts expect bond investing to be more risky and less lucrative over the next several years. We agree and have been echoing these sentiments for several years now. In fact, over the last few years, we have altered our firm-wide fixed income strategy several times in light of changes in the interest rate environment. And even though we believe stocks will outperform bonds by substantial amount over the next decade, we still think bonds need to play a vital role in virtually everyone's portfolio.

Bond Pricing 101

If you study investment returns, you know the environment for bonds over the last three decades has

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been the best in history, with bond returns generally holding their own against stocks in spite of carrying significantly less risk. It's important to note that this historic bond rally was built on the back of steadily declining interest rates—from the record highs of the early 1980s through the record lows of today. With interest rates now near zero, everyone knows the decades-long party is near an end, and at some point interest rates will invariably start to rise again. This doesn't bode well for bond investors, especially those who hold long term bonds that are more sensitive to interest rate changes, because as interest rates go up, those bond prices will go down.

Some Perspective

Because it is difficult for many investors to understand how small increases in interest rates can result in sizable declines in bond prices, illustrations can be valuable tools. As we've covered in previous newsletters, the bonds that are the most sensitive to interest rates are those with the longest maturities and the lowest coupon interest rates. And don't look now because the coupon interest rates on long-term Treasury bonds are as low as they've ever been. To make matters even worse, most investors are oblivious because they have never seen a protracted period of rising interest rates and have nothing of substance on which to base their expectations. What happened to long term Treasuries in the first quarter does provide a small glimpse of what is in store, but we will see more turbulent bond markets going forward and those who are unprepared stand to lose a lot of money.

To get a better understanding of the extent to which rising rates can impact bond prices, let's look at what happens to the price of a $1,000 face value, 30-year Treasury bond as interest rates rise. We'll assume the stated (coupon) rate of interest is 3.0%, which is the approximate rate on 30-year bonds currently. The table below displays the somewhat gory details:

Price volatility on a 30-year, $1000 face value Treasury bond with a 3.0% coupon interest rate

Increase in Interest Rate	New Bond Price	% Change in Bond Price
1%	$826.20	-17.38%
2%	$690.91	-30.91%

In other words, if the interest rate on long-term Treasuries were to suddenly rise by 1% from current levels (of 3% to 4%) the prices of 30-year Treasuries would fall more than 17%. Similarly, if interest rates rose 2%, 30-year Treasury bonds would lose more than 30% of their value! Sadly, rate increases of this magnitude are very possible over the next few years. In fact, if the last three quarters of 2013 mirrored what we saw in the first quarter, the interest rate on 30-year Treasury bonds would rise by 1.33% over the course of the year, resulting in a price drop of 22.2% in the value of 30-year Treasury bonds. Ouch!

All Bonds are NOT Created Equal

Those numbers are a little frightening, but it's important to point out that none of our clients are exposed to bonds with risks anywhere close to that magnitude. Unlike stocks, there is a great deal of certainty in the cash flows generated by bonds, allowing investors to precisely gauge risk by measuring how much a specific bond stands to gain or lose if interest rates fluctuate by X%. In turn, this allows bond managers to insulate their portfolios from a rising interest rate environment by choosing bonds that are less sensitive to changes in interest rates. Fortunately, all bonds are not created equal…and that's a good thing for investors.

Diversification Matters!

Our approach to protecting fixed-income investments against both political and interest rate risk is pretty straightforward, but also evolves with the changing risks facing fixed income investments over time. The foundation of our fixed income portfolios is anchored by a group of diversified bond funds managed by what we believe are the best and brightest group of bond managers on the planet. We frequently stress the importance of diversification in stock investing, but in periods of high interest rate uncertainty like we face today, diversification is every bit as important to bond investors. Here are some of the ways we are diversifying our bond portfolios given the risk of rising interest rates:

1. **Focus on undervalued bonds, high yield corporate bonds and foreign bonds:** Amazingly, there are still some really nice bargains in the corporate bond market, particularly for those portfolio managers who focus on "discounted bonds" and riskier high yield corporate bonds. In addition, there are plenty of opportunities in foreign corporate and government bonds denominated in currencies that are expected to increase relative to the dollar. Bond funds like PIMCO Total Return (PTTRX) and Loomis Sayles Strategic (NEFZX) both focus in these areas to varying degrees, and their decades of experience gives them a major advantage in times like this.

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2. **Cushion against rising rates:** Although we don't believe we're likely to see dramatically higher rates in 2013, even a modest increase could have a significant negative impact on longer-term bonds, particularly Treasuries. None of our bond funds hold long-term bonds currently, preferring instead to limit the average maturity, and therefore the interest rate risk, of their portfolios. In addition to the enhanced safety of shorter maturity bonds, however, we have also added a floating -rate fixed income fund to our arsenal. There aren't many floating-rate funds in existence because with rates falling over the last 30 years they simply weren't very attractive. Today, however with interest rates poised to rise, there is a renewed interest in floating-rate funds, which are not familiar to most investors. Floating -rate funds invest mostly in commercial bank loans (which have variable interest rates) rather than traditional bonds (which carry fixed rates). Therefore, as interest rates go up so do the interest payments received by investors in a floating-rate fund. The floating-rate nature of the fund also helps keep the value of the loans held by the fund stable as interest rates rise, thereby isolating them from the kind of interest rate risk that afflicts longer-term fixed-rate bonds. With rates poised to rise for the foreseeable future, we believe adding a floating-rate fund to our core fixed income strategy was wise, and we will be rolling it out in client portfolios over the next few quarters.

3. **Convertible Bonds:** In 2009 and 2010 we used convertible bonds with great success, in part because illiquidity in the convertible bond market caused their values to fall to unprecedented levels during the 2009 selloff. Since that time, however, convertibles have generally underperformed traditional bonds, largely due to the continued free-fall in interest rates. Today, with interest rates bottoming and beginning to rise, convertible bonds are once again beginning to look attractive. This is because the bonds are convertible into shares of stock once the company's stock price reaches a certain level. Since rising interest rates are usually associated with rising stock prices, this makes convertible bonds largely immune to the interest rate risk that afflicts traditional bonds. At the same time, convertible bonds make regular interest payments just like traditional bonds, making them suitable for investors seeking current income. On the other hand, since convertibles are influenced by stock prices they are also more volatile than traditional bonds, and so are not suitable for all clients. However we believe they can be attractive alternatives for clients with higher risk tolerances and longer time horizons.

4. **Seek income from alternative sources:** We haven't limited our search for yield to just traditional bonds, and for a number of clients we have been using the JPMorgan Alerian MLP Index ETN (AMJ) over the last several years. The JP Morgan Alerian MLP Index Fund invests in an index oil and gas pipeline MLPs. Individually, MLPs are difficult to invest in because their complex structure can make a tax-filing nightmare. The ETN (exchange traded note) structure of this fund eliminates these problems, although it's important to point out that the income received from it is taxable at the investor's regular marginal tax rate, just as it is with corporate bonds.

The assets held in the Alerian fund are publicly-traded master limited partnerships (MLPs) involved in the transport of petroleum liquids, such as gasoline, crude oil, and natural gas. The revenue stream comes from the transportation of the product through the pipeline, so the ETN is not subject to the wild commodity price swings that can plague the revenues of other natural resources companies, like drillers and refiners. In fact, most pipelines are natural monopolies, similar to electric utilities in that they operate under regulatory constraints meant to protect the public interest. Unlike traditional utility regulation, however, pipeline regulation is relatively noninvasive and pipeline operators are allowed to adjust the rates they charge for inflation. This also makes pipeline MLPs a surprisingly good inflation hedge, providing yields that are expected to be significantly higher than those found on Treasury Inflation-Protected Securities (the current yield for AMJ is approximately 4.5%, in contrast to the negative yield currently available on TIPS).

As with convertible bonds, AMJ is expected to be more volatile than our traditional core bond funds, so it's not an appropriate investment for everyone. Still, for many people looking to increase investment income from their portfolios we think it is an alternative well worth considering.

Year-to Date Fixed Income Returns

When you examine fixed income returns over the first quarter, it becomes clear we are entering a new era in bond investing. Morningstar, Inc. reported that high-yield corporate bond funds turned in the strongest fixed-income performance in the first quarter, up 2.8%; while adjustable-rate bank-loan funds gained 2.2% and multi-sector corporate bond funds increased an average of 1.4%. In contrast, long-term government bond funds lost 2.4% for

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the quarter, while inflation-protected Treasury (TIPS) funds lost 0.3% over the period.

No matter what the outlook, bonds will continue to play an important role in our portfolios. They offer the potential to generate income, lower portfolio risk, and provide diversification. At the same time, however, the challenges facing bond investors today are greater than any we have seen in our lifetime. This means it will be important to continue to think outside the box when it comes to fixed income investing, both for bond fund managers and for advisors building bond portfolios. We believe we offer unique set of solutions that will not only be able to meet these challenges, but excel in spite of them.

In Sum

We've been anticipating interest rates rising for several years running now, and have used alternative bond strategies to offset the potential rise in interest rates. Specifically, we've looked to purchase "discounted" bonds. However, we know interest rates can't go much lower from here, which is why we prefer using unique bond managers who can take advantage of mispriced bonds. Since the chances of generating above-average returns in conventional bonds over the next several years are very low, we feel it's important to remain conservative on the fixed income side, while also adding some flexibility to our menu of fund options. We have a nice mix of stellar bond managers who over the last four years have demonstrated the ability to not only beat their benchmarks, but crush them. Yet, given the risks we see once rates finally do start to rise, we believe it's wise to remain cautious. We've had four tremendous years in both stocks and bonds, and believe the best strategy going forward is to focus on wealth preservation on the bond side while continuing to seek wealth accumulation in our stock funds.

A Final Note

As usual, if you have any questions about this update, our newsletter, your accounts or our managers, please feel free to call or e-mail us at anytime. The recent referrals are much appreciated and we thank you for your continued confidence in our firm and our services. As we go forward, we remain committed to continuing to refine and improve our proactive strategies and portfolios. As always, our goal is to provide each of our 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 wish you and your family a happy and healthy Spring!

~ Joe and The Gang at KWAG

Compliance Notes

A Note From KWAG's Chief Compliance Officer

It is time again to offer our annual Disclosure Document. We want to take the time to offer this document to you and encourage you to take the time to read it. ***Our KWAG FIRM BROCHURE can be found on our website at www.thekielygroup.com, under KIELY FORMS.*** If there is anyone who would like to receive a paper copy of this document, please email me at the address below or call our headquarters office at #877-366-5623. We will be happy to send one to you.

In addition to the newsletter and statements, we have also included in this mailing our most current Privacy Policy for you to read. As always, we want you to know how important your confidential information is to us and the policies we follow to ensure your privacy.

Thank you for your continued confidence in our firm. As always, we are committed to better understanding your investment objectives, goals and knowing how we can better serve you.

- Katie Burr
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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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.*

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<u>Please Remember</u>: *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 Morningnstar****,*** *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.*