KIELY WEALTH ADVISORY GROUP, INC.

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BEHIND THE SCENES

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OPENING THOUGHTS

Just four short years ago, the financial markets were fraught with worry and many investors had serious doubts whether their portfolios would ever get back to where they once were. Fast-forward to today and those doubts and fears have eased tremendously, although some concerns still exist—as evidenced by the number of questions we received in recent months about the "fiscal cliff." The fiscal cliff was never actually a cliff, of course, and we referred to it as the "fiscal nuisance" instead. Even then, the nuisance was more psychological than fiscal. Given the rapidly approaching deadline, coupled with all the political bickering, we can see how this caused some significant concerns among investors. This is understandable, particularly given what we'd been through four years earlier. Major market downturns like the one in 2008-09 inflict psychological impacts on investors that can last for years or even decades. That's unfortunate because we know major market downturns are invariably followed by sharp recoveries, as evidenced in the table below.

4-Year Annualized Russell Style Index Performance through 12/31/2012

	Value	Blend	Growth
Large	15.77%	19.05%	22.36%
Mid	23.92%	25.88%	27.64%
Small	16.87%	19.97%	23.28%

The average annual return across the nine style indexes over the last four years was 21.64%, making this one of the most powerful market rallies on record. In fact, since WWII the market has averaged 20% or more over four consecutive calendar years only twice. These returns have been terrific news for some investors, including our clients. However, many others haven't benefitted because they sold into the 2008-09 decline and have

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2012 TAX NOTE:

TAX DOCUMENTS WILL BE MAILED FROM THE KIELY GROUP BY FEBRUARY 15TH.

TD AMERITRADE'S TAX DOCUMENTS WILL BE MAILED BY FEBRUARY 20TH.

remained mostly on the sidelines since. The end result is that literally millions of investors have missed out on one of the largest multi-year rallies they'll see in their lives. That's too bad, because they'll never get the last four years back. Even if they came off the sidelines today, it could take a decade or longer to match the returns we've seen in just the past four years.

The "Media" Disconnect

In early 2009, we began discussing the "disconnect" between investor perception and economic reality in our monthly updates and quarterly newsletters. Our initial focus was on the false perceptions being propagated in the media, which were (and still are) numerous. We believed the hysteria displayed in the media during the period was a major contributor to the worst panic selloff we had ever seen. Raw emotion can easily trump reason, making sharp downturns especially dangerous for panicked investors. Anyone who studies finance and investing should know this, making the financial media's behavior during this time even more egregious. Media companies knew that fanning the flames of investor emotions during that time period could cause tremendous harm, but they went on creating the most apocalyptic headlines and stories they possibly could, placing the quest for market share and advertising revenue above integrity. For the media it was a huge windfall, but for much of their audience it was the exact opposite…

As we've stressed numerous times over the years, today's journalists are in the advertising business, not the truth business, and their audience grows in proportion to the amount of sensationalism they can cram into every "news" story. Therefore, it's critical that the consumers of this "news" recognize it for what it is. Sensationalism has a cost to investors who unwittingly act on it, and far too many are doing just that. We saw the process play out again recently with the tremendously overhyped "fiscal cliff" stories, and information being intentionally distorted or omitted in order to create a more extreme sense of urgency. We wish this sort of thing would stop, but recognize it's an inevitable part of today's investing landscape and something investors will need to learn to recognize if they want to avoid making the same mistakes over and over. That's precisely why we spend so much time talking about it.

The "Global" Disconnect

As the recovery gained traction in the latter part of 2009 and beyond, another disconnect we focused on was global in nature. Early in the recovery we noticed investors were having trouble disentangling the health of the domestic economy from the performance of U.S. corporations (and therefore domestic stocks and corporate bonds). A strong, vibrant domestic economy is extremely important for the country, but investors needed to realize that the global economy is the engine that drives today's multinational corporations. In today's global economy, U.S. corporate earnings have remained strong (and continued to grow) in spite of rather anemic domestic economic growth. Some people may be uncomfortable with the rapid pace of globalization, but it has been extremely beneficial for our domestic corporations and, as a result, our portfolios.

Remember, capitalism is like a virus - a good virus - that is spreading rapidly across the globe to the benefit of billions of people, including investors. Since 95% of the world's consumers live beyond our borders, it would make sense that multinational firms concentrate much of their efforts overseas. In addition, the vast majority of growth in the "middle class" market is occurring overseas. Therefore, if you want to really understand why corporate America continues to thrive and report record earnings, you have to look beyond our borders.

The "Stock Market" Disconnect

For over two decades, we have always maintained that a properly built stock portfolio should have roughly equal exposure to small, mid, and large-cap stocks. Incorporating small and mid-cap stocks in significant amounts in our portfolios improves diversification, reduces risk, increase returns, and gives all investors a much-needed mechanism to proactively rebalance. Surprisingly, very few firms have embraced this notion, even though there is overwhelming empirical evidence, which includes a publicly available study we published in a peer-reviewed academic journal several years ago. When one looks at the evidence over longer periods of time, the benefits of being well diversified across the ENTIRE stock market should be apparent to anyone… advisors included. Incredibly, when we examine other advisors portfolios, to our amazement they are almost always "large cap" dominated. This implies that most "conservative" investors own a much more aggressive portfolio than they believe, and they are paying for it in the form of lower long run returns. Ouch!

The "Bond Market" Disconnect

Perhaps an even more important disconnect exists in the bond market, where investors largely view bonds as a homogenous asset class and expect all bonds to behave similarly. Unfortunately, this view couldn't be further from the truth. Understanding the differences between the wide array of bonds and bond funds is crucial, especially when confronted with the interest rate environment we face today. In fact, the differences in the characteristics of

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various types of bonds have driven a few fairly significant shifts in our fixed income strategies over the last few years. We think it's important for our clients to understand 1) the rationale behind these shifts, 2) how their portfolios have been affected by these shifts in strategies, and 3) what they might expect to see going forward. As a result, we'll devote a portion of this newsletter to discussing the bond market disconnect, since it is one of our biggest concerns going forward.

A REVIEW OF THE PAST FOUR YEARS

In our year-end newsletters we typically review the performance of the financial markets over the previous year, and then discuss our thoughts regarding the future. This time, given the significant downturn that occurred in late 2008 through early 2009 - and the significant rebound that followed - we thought it would be more informative to broaden our historical perspective a bit. This broader perspective will allow us to drive home the importance of 1) ignoring the media; 2) paying attention to global growth (versus domestic growth); and 3) building well diversified stock and bond portfolios which embrace the new global economy we live in.

Most investors know financial markets can be fickle and notoriously unpredictable. Yet, the periods following extreme market events are a rare exception to this rule. While no one has the ability to accurately and reliably predict the timing of extreme events, we are able to predict how investors will react once these events have occurred. And we can predict these reactions with a high degree of precision. For example, we know extreme market downturns are often characterized by high levels of fear and panic. This fear and panic triggers the human flight response, which fosters the indiscriminate selling of stocks, and in some cases, bonds. Remarkably, this process gets repeated again and again for a number of years after the initial event. In essence, investor's emotions linger for some time. While that's bad for the financial markets overall, for savvy investors it creates an opportunity, as asset prices get driven down below fair and reasonable levels. Unfortunately, studies show that most individual investors are unable to capitalize on these opportunities because they remain paralyzed by fear until long after these opportunities have vanished.

For decades, Warren Buffet has told people to, "*Be fearful when others are greedy and greedy when others are fearful.*" He has repeated this message a number of times over the last four years. Since he is the most successful investor in history and was the wealthiest man in the world before he began giving his fortune away to charity, you would think people would value and heed his advice. But no…

2009 Newsletters & Dinners

Many of you might recall our newsletters, e-mail updates, and dinner presentations from four years ago. We certainly do. Everyone was extremely concerned—and with good reason. The stock market and economy had taken a serious hit; the financial markets were dominated by fear and extreme volatility; and journalists were trying to convince anyone who would listen that we were entering the next Great Depression. We knew our most important job at that point was to keep clients from panicking and selling out - and given the magnitude of the downturn we knew it would be a significant challenge. As academics who have always believed that knowledge truly is power, we broke out the biggest weapon in our arsenal - education. We hoped that by sharing the findings of the academic research on investor behavior during financial market panics, we could help our clients overcome the innate fears that doom so many investors during such times.

January 2009: Look at the Price!

In the January 2009 newsletter we focused on two primary themes. First, we stressed that the credit crisis had been contained by the actions of the Federal Reserve and U.S. Treasury, and although it would be some time before things returned to normal, we had averted a credit market collapse. We also believed the worst was over and that things would improve, albeit slowly, and in fits and starts. Second, we focused on the most important aspect of panic-driven selloffs - asset prices. We wrote, "*…there has been nothing but pessimistic news over the last three months. And while media headlines are full of doom and gloom, they seldom address the most important factor in investing: **PRICE**. Any investment is a good deal if the price you pay is low enough. And while we don't pretend to know when a market recovery will begin, markets generally move six or more months ahead of the economic recovery.*"

We then went on to provide ten reasons for investors to be optimistic going forward. In a nutshell, we felt pretty confident about stocks and bonds being bargains at that point, but given the extreme level of fear and panic, we had no idea how long it would take before their prices began to recover. What we did know, was that things would likely move quickly once the rebound began, so it was critical to keep our clients fully invested (in order to capture the

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benefits of the upturn when it occurred) and properly positioned (in order to help maximize the impact of the inevitable rally).

2009 – Client Communication

We followed our January 2009 newsletter with a number of meetings, calls and e-mail updates outlining why we believed the biggest challenges facing investors at that point were psychological. A major emphasis in 2009 was to get people to stop looking in the rearview mirror and focus on the task ahead. There was no way anyone could change what had already happened and obsessing over it would only increase the likelihood of making an emotionally-driven investing decision. With this in mind, we provided a series of tables that examined typical "dislocations" in pricing that exist during periods of extreme volatility. We hoped that if we could show investors how irrational prices had become, it would be easier for them to maintain a long-term perspective. We also believed that those who did would be handsomely rewarded. In retrospect the rewards wound up being realized more quickly than we expected, but we're not complaining.

Today, we believe the same is true. If we can keep people focused on the facts (like financial statements, cash flows, earnings and a growing global marketplace) and away from the sensationalistic front-page news (which highlights the fiscal cliff, political gridlock, our mounting debt), they'll be less likely to make emotionally driven investment decisions…and they may sleep a lot better too.

The Stock Market

The market recovery we've seen since 2008 has followed the general pattern we described four years ago. We pointed out that fear had driven stock prices to absurdly low levels, which could lead to a rapid recovery since large declines are always historically followed by strong rebounds. We also noted that in a typical recovery, small and mid-cap stocks tended to outpace large caps by a fairly wide margin and perceived safe-haven assets (like Treasuries and Treasury-equivalents) tended to significantly underperform. Finally, we pointed out that as economies recover from severe recessions there tended to be a marked absence of inflation, particularly financially-driven recessions. These predictions weren't the result of clairvoyance or superior intellect (rest assured, we possess neither) but came instead from studying the remarkably similar patterns of previous recessions and market downturns, both at home and abroad.

History is a powerful teacher, so with the benefit of 20/20 hindsight, let's look a little closer at what happened between 2009 and 2012.

The Numbers

As we alluded to at the outset, the stock market recovery has been quick and powerful. From the market low (reached on March 9, 2009) the S&P 500 index has more than doubled, while the Russell 2000 has risen a remarkable 140%. Four years ago, many investors were convinced that the indexes would never again reach 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 has yet to get back to its all-time high, but has hit multi-year highs in each of the last three years…and the companies that make up the S&P 500 continue to post record cash flows and profits.

In sum, we've had a significant 4-year rally, which has been led by small and mid-cap stocks…by a considerable margin. In the meantime, Treasury securities have continued to yield next to nothing while core inflation has been almost nonexistent. These numbers reinforce our observations from four years ago…and follow the trends we outlined in previous newsletters. For those of you who wonder how our markets performed over the past year (2012), the S&P 500 was up 13.4%, while the Russell 2000 grew 14.6%.

The Style Index Numbers

By the end of 2012, all nine Russell style indexes had increased by double digits for the third time in the past four years. Overall, small and mid-cap stocks once again beat their large cap counterparts, while value outperformed growth across each style category. In terms of the individual indexes, mid-cap value led the way in 2012, following the general long-term trend.

1-Year Russell Style Index Performance through 12/31/2012

Value	Blend	Growth	
17.51%	16.42%	15.26%	Large
18.51%	17.28%	15.81%	Mid
18.05%	16.35%	14.59%	Small

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If we examine style box performance over the previous three calendar years, a similar pattern emerges, with small and mid-cap stocks outperforming large caps by a fairly wide margin. Again, this is typical of economic recoveries. That said, the rebound we've seen in stocks of all sizes and styles has been nothing short of remarkable and we think it is a testament to the innovative resolve and resiliency of American corporations.

3-Year Russell Style Index
Cumulative Return through 12/31/2012

Value	Blend	Growth	
40.83%	42.00%	43.11%	Large
53.16%	51.93%	50.70%	Mid
44.13%	47.41%	50.26%	Small

If we go back and examine the post-crash recovery from the lows reached on March 9, 2009, the difference between the various style boxes becomes even more pronounced. Small and mid-cap stocks have significantly exceeded their large cap peers since the crash. When one examines any single calendar year returns (like 2012), the differences between small/mid caps and their large cap brethren exist, but they are smaller and more difficult to discern. However, when returns are compounded over longer periods, as seen below, the magnitude of wealth effect of owning small and mid-caps becomes readily apparent.

Post-Crash Recovery for Russell Style Index
03/09/2009 to 12/31/2012

Value	Blend	Growth	
136%	132%	130%	Large
181%	169%	158%	Mid
161%	161%	160%	Small

In fact, over the last decade small and midcap stocks averaged a combined 16.20% annually, while large cap stocks averaged just 10.56%. Don't get us wrong, 10.56% is a nice annual return. However, adding in the 16.20% from small and mid-cap stocks makes it a lot better.

10-Year. Annualized Russell Style
AVERAGE Return ending 12/31/2012

Value	Blend	Growth	
10.38%	10.66%	10.65%	Large
17.46%	17.51%	16.71%	Mid
14.79%	15.28%	15.47%	Small

It's hard to make a better argument for diversifying into small and mid-cap stocks than the three previous tables. Over the last 10 years, small and mid-caps have outperformed large cap stocks by an average of 5.64% annually, and it's important to note that this is NOT an anomaly. Evidence of the "size-premium" (as it's called in the academic literature) has been around for decades and data like we've presented here is readily available (via the internet) and FREE for everyone to examine! Yet most portfolios today are still being constructed with a strong (or total) overweight in large-cap stocks.

We're at a loss to explain why more investors don't hold meaningful allocations to small and mid-cap stocks. It truly baffles us. The only thing we can conclude is that investors either don't know about the well-documented size premium or they significantly underestimate its power over time.

Where Do We Stand Today?

By virtually any measure, individual firms are healthier today than they were <u>before</u> the recession began. They are more productive, more competitive, generating higher profit margins, and growing revenues at rates that continue to surprise economists and analysts on the upside. While the media continues to focus on negatives like high domestic unemployment, the "fiscal cliff" 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

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interest rates to their advantage, which is something most people seem to overlook.

Because interest rates are at all-time lows, corporations are able to raise capital at a lower cost than any time in history. Since corporate profit margins are determined by the cost of the capital they raise versus the return they make when investing that capital (investing in new plants, new equipment, expanding into new global markets, etc.), low-cost capital provides a tremendous boost to the bottom line. For example, if I can borrow money at a cost of 3% and reinvest overseas it at 10%, that's a pretty good deal. That's a pretty easy concept to grasp, right? Borrow money at a low rate and then reinvest it at a higher rate. Strangely, we NEVER hear the media talk about the ridiculously low cost of capital corporations currently enjoy and how this has helped profit margins reach all-time highs - in spite of the recession and slow recovery.

There is obviously still a lot of room for economic improvement domestically. The good news is, we're pointed in the right direction and the vast majority of economic trends look positive. Unfortunately, many people will continue to dwell on the negatives like the high unemployment rate or the gridlock in Washington. We agree that those are both significant problems. However, if they haven't managed to bring down corporate profitability over the last four years, why should we expect them to do so going forward? We've been saying all along that jobs are always the last thing to recover in recessions, particularly credit-driven recessions like this one. And when you factor in the rapid pace of technological change, we see corporate profitability continuing to increase at the expense of adding new workers. Thus, the unemployment picture is not going to change much over the next few years. As far as political gridlock goes, we just need to get used to it because it's probably not going away anytime soon. Heck, maybe we should even be encouraged by it, secure in the hope that the inaction of our politicians could mean that at least they aren't making things any worse?

The Bond Conundrum

Although we believe stocks will continue to outperform bonds for the foreseeable future, we still believe bonds should play a vital role in almost everyone's portfolio. Unfortunately, if you stay abreast of the financial news, it will come as no secret that most analysts and economists expect bond investing to be both riskier and less lucrative than usual over the next several years. We agree and have been echoing these sentiments for a few years now. In fact, over the last few years, we have altered our firm-wide fixed income strategy several times in light of the bond market environment. However, before we discuss the challenges ahead, it's important to first look back and see how we got to where we're at today.

Basic Bond Pricing 101

If you study investment returns, you know the environment for bonds over the last ten years has been one of the best in our history, with bonds generally holding their own against stocks in spite of carrying significantly less risk. However, this bond rally was built on the back of steadily declining interest rates - as virtually all bond rallies are – so we know that it's unsustainable. Interest rates have likely reached bottom and at some point in the future they will begin to go up. This doesn't bode well for bond investors who stand pat because interest rates and bond prices always move in opposite directions. However, before we delve into strategies for dealing with this "new" bond environment, we need to first finish examining the fixed income environment of the recent past.

Panic Presents Opportunities

Even though the past decade was excellent for bonds, it's important to understand that even the strongest rallies are not without challenges. For example, you may recall that in late 2008 many of the nation's largest investment banks, insurance companies, hedge funds, and commercial banks were forced to liquidate their extensive bond holdings in order to offset the billions of dollars they had lost in the sub-prime mortgage market. This created what was essentially a "fire sale" in bonds, with most of the biggest institutional investors trying to beat one another to the exits in a desperate attempt to raise the cash they needed to remain solvent. This flood of forced-selling by the large institutions touched off a tidal wave of panic selling across global fixed income markets unlike anything we'd ever seen. Every type of fixed income security - with the exception of Treasury bills - was being indiscriminately dumped by investors, which drove bond prices to absurdly low levels. Watching a market meltdown of that magnitude can be frightening, especially when no one had ever seen anything like it before. In late 2008, fear was literally feeding on itself.

However, where there is fear there is also often opportunity - if you understand the mechanism behind the selloff. In this case, we knew the world's largest financial institutions were being forced to liquidate high-quality assets at ridiculous prices to stave off insolvency. That

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meant the selling had nothing to do with the quality of the bonds themselves, but was instead an artifact of greedy institutional investors who had overextended themselves in mortgage derivatives, losing billions in the process. They were now being forced to sell virtually everything in order to avoid the fate of Lehman Brothers. Some barely did. All of the forced selling created a rare David and Goliath opportunity where astute individual investors could turn the tables on the Wall Street behemoths and profit from their greed and self-indulgence. What happened in the bond market in early 2009, will go down in the annals of investing as one of the greatest bargain hunting opportunities of all time. It was like shooting fish in a barrel, after all the water had been allowed to run out.

Opportunity Meets Action: 2009

In late 2008 (after pinching ourselves repeatedly to make sure we weren't dreaming) we began discussing strategies to capitalize on what was happening. We decided early on to focus primarily on corporate bonds, as they appeared to possess the most attractive combination of upside potential (since we could by bonds at steep discounts to face value) with limited downside risk. In early 2009 we began increasing our portfolio exposures to corporate bonds using funds like Loomis Sayles Strategic Income Fund (NEFZX) and Calamos Convertible Bond Fund (CCVIX). At the same time, we began cutting back on allocations to bond funds that held no corporate bonds, such as the Vanguard GNMA Fund (VFIIX). As we stated in our newsletters and updates at the time, we felt a reasonable expectation for this strategy would be equity-like returns on the order of approximately 9% annually over the subsequent five years, with little downside risk due to the historic discounts.

In the end, the results exceeded even our most optimistic forecasts. In 2009 alone, NEFZX returned more than 39% while CCVIX returned 34%. At the same time, the fund in which we had pared back allocations, VFIIX, gained just 5%. We should point out that no one could have predicted returns of this magnitude over such a short period of time, especially in bonds. We would have been quite happy with our original 5-year projection of 9% annually, and never anticipated nearly meeting the five-year target in less than twelve months. It's something we were happy to endure, however.

One Final Push in 2010
At least that's what we thought…

Entering 2010, the bond market had largely stabilized and bond prices had, for the most part, normalized. In other words, we felt much of the easy money in bonds had already been made. However, interest rates continued to fall through most of the year, which helped push bond prices even higher. In addition, occasional outbursts of panic in Europe and indiscriminant selling from overseas provided continuing opportunities for our fund managers to acquire bonds at attractive prices. The net result was that our bond funds continued to exceed expectations. Loomis Sayles Strategic (NEFZX) and Calamos Convertible (CCVIX) finished 2010 with returns of 13.5% and 10.8% respectively, and our more conservative bond funds were also turning in good numbers. PIMCO Total Return (PTTRX) gained 8.8% on the year and Vanguard GNMA Fund (VFIIX) was up 6.9%.

The End of Lower Rates: 2011

As we entered 2011, we felt there would be serious headwinds in the bond market – and we were correct. Interest rates bottomed out early in the year and began rising. The good news was our bonds funds finished in positive territory during 2011. The bad news was that our largest holdings, NEFZX and PTTRX, were up only 3.4% and 4.2% respectfully. The ultraconservative VFIIX provided our clients with a nice surprise, however, returning 7.7% on the year—largely due to European fears and a flight to high quality Treasuries and Treasury-equivalents.

Volatility was our Friend in 2012

Entering 2012, we felt the likelihood of generating above average returns in conventional bonds was virtually zero. At that time, the economic recovery was showing signs of accelerating its pace. As a result, we felt the likelihood of interest rates rising during the year was close to 100%, and that bonds investors would probably have a difficult road… if they didn't think outside the box and have flexible bond managers who could take advantage of short term economic flare-ups.

Three things happened to help make 2012 another stellar year in bonds. First, the economy sputtered in the first half of the year and growth slowed. As a result, the Federal Reserve intervened with another round of quantitative easing (bond purchases) that pushed interest rates even lower. Second, Europe experienced some short-term set-backs, leading to additional ECB intervention and occasional European bond sell-offs. Finally, new rules aimed at strengthening the balance sheets of large banks provided a unique opportunity for our bond managers to buy healthy mortgages at discounted prices. The net result was another excellent year for our bond funds. Loomis Sayles Strategic (NEFZX) and PIMCO Total Return (PTTRX) both finished 2012 with double-digit returns (13.1% and 10.2%,

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respectively). At the same time, one of our new bond funds, DoubleLine Total Return (DBLTX) - which focuses almost entirely on purchasing discounted mortgages – was up 9.2% for the year. Our most conservative fund, Vanguard GNMA (VFIIX) gained just 2.3% in 2012. Although, it still managed to beat the Barclays Intermediate Treasury Index, which was up just 1.7%. In other words, all four of our core bond funds bested what you could have earned in intermediate Treasuries in 2012, and three of the four absolutely crushed the index.

In Sum

We've been worried about 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. However, given the risks we see, once interests rates finally do start to rise, we believe it's wise to be cautious. We've had four tremendous years in both stocks and bonds, and think 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.

As many of you know, we continually reassess both our bond and stock strategies through regular investment committee meetings. Once interest rates start to go up, our current fixed income strategies will likely change. For now, however, we think the risks of chasing yield in the bond market far outweigh the potential rewards. To illustrate, let's look at what happened recently. Following the passage of the fiscal cliff compromise, long term interest rates ticked up in the first few trading days of 2013, driving the price of 30-year Treasury bonds down 3.5% over a three day period. A 3.5% loss may not sound like much, but the annual interest rate on these bonds is just 3.0%! In other words, a small blip in interest rates over just three days more than wiped out the interest these bonds will pay out for the entire year.

That, in a nutshell, illustrates the dangers of interest rate risk and explains why we want to remain cautious and conservative in our bond allocations.

Questions with Dr's Joe & Scott

We believe one of the most important aspects of money management is...Education. The goal of this firm has always been transparency and making sure our clients understand both what we do and why we do it. It can be a challenging goal because the field of portfolio management is broad and often complex. However, the questions we receive each quarter provide us with an opportunity to identify various educational gaps and allow us to address your concerns and expand on things you want to know more about. The questions we receive are interesting, provocative, insightful, and sometimes unpredictable. We frequently get questions about a news story a client has encountered, and given the media's penchant for exaggeration and factual inaccuracy, these questions tend to keep us on our toes.

Let's be frank…the global economy is complex, making it difficult for the average investor to understand the bigger picture. Financial markets are complex as well, and understanding the interactions between the global economy and the performance of the wide variety of financial assets that trade on these markets requires a background in a variety of fields, including macro and microeconomics, finance, accounting, and psychology. The media (and some less-than-scrupulous money managers) use this complexity and lack of understanding to their advantage, knowing the vast majority of their audience doesn't know when they're being factually misled. In the case of the media, the goal is often to create a sense of fear and urgency that will keep you watching or reading. In the case of less-than-scrupulous advisors, the goal is often to keep you in the dark while selling you something that provides them with a high payout. With either group, the less you know the better they like it.

Our view, however, is just the opposite. We've devoted our lives to studying finance and economics and want to share the knowledge we've gained with our clients. Knowledge truly is power, and we seek to empower our clients as opposed to keeping them in the dark. We have a fiduciary duty to place our clients' interests ahead of our own, and because we take that responsibility seriously, education and transparency are things we fully embrace. In addition, we believe that the more clients know, the easier it is for them to see that we

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are indeed acting in their best interests. So we encourage your continued questions and we look forward to your ongoing feedback.

The Questions

Q1. What are your thoughts on the "Fiscal Cliff"? Despite the passage of a bare bones bill (as you alluded to in your year-end update) the Washington soap opera is far from over. There is still uncertainty surrounding the debt ceiling and the upcoming sequestration of budget cuts. Won't his lead to a rocky road during the first quarter? J.B.

Joe: You're right, the budget debates are far from over. In late February, our country will run out of borrowing capacity, which means Congress will have to raise the debt ceiling again. (Technically, the debt ceiling has already been passed on December 31st, but Congress has engaged in a few technical accounting maneuvers, which have given them five to six extra weeks.) In addition, on March 1st, spending cuts estimated at $108 Billion will go into place, unless Congress acts to change them. And on March 27th, Congress will have to act on various pieces of legislation to fund various Government agencies for the coming year. So, there will be no shortage of drama for the media to seize upon - and - there will be no shortage of fear-mongering across party lines. It should be an entertaining few months! And it should have absolutely no effect on our portfolios over time.

Scott: Political gridlock doesn't really impact our investing strategy because everyone already knows the issues we face as a country. We know we have a dysfunctional Congress that accomplishes very little—except for spending too much. We also know the only way they anything done is by having their feet held to the fire, as we saw again recently with the fiscal cliff deadline. The financial markets know this as well, which is why we didn't see a major spike in volatility or a major decline in stock prices as the year-end deadline approached. Everyone expected an agreement would be drug out until the last possible moment and this expectation was pretty much already impounded into asset prices. The things that move markets are the things the market doesn't anticipate, so I think we can safely scratch political gridlock from our biggest concerns list. We view it as a non-event, and if by some chance there is some volatility, we use that period to rebalance our portfolios.

Q2: Why is the Federal Reserve continuing to print money and keep interest rates low? Won't this strategy lead to hyperinflation, a weakening dollar, and the end of our run as the leading economy in the world? G.M.

Joe: The Federal Reserve is buying Treasury securities in an effort to keep interest rates low. Lower interest rates help our economy in a number of ways. First, it allows more people to buy homes, cars, computers, TV's and other items at a very low cost, which help stimulate the economy. Second, it encourages companies to expand their businesses. Third, it keeps our American companies competitive in a global environment (through a weaker dollar). All of those things lead to more jobs, which is one of the Fed's mandates. The Fed is clearly trying to create an environment where banks can loan money - and - consumers can afford to take out loans. Why? Every time a bank makes a loan, it increases the money supply though a process called the "multiplier" effect. The media and a few others have recently termed this common practice "printing money". No money is really printed. And this strategy does not lead directly to inflation. I believe anyone who says it is simply uninformed…or fear mongering.

Scott: What the Federal Reserve is doing now is called "quantitative easing" (QE) which few understand but most seem to disagree with anyway. Essentially, the Fed is buying large amounts of government bonds, which drives their prices up and yields (i.e. interest rates) down. Quantitative easing also increases the money supply because the Fed buys the bonds from banks, where the cash winds up on their balance sheets. Since cash doesn't earn anything, banks don't want a lot of it sitting around and are therefore encouraged to be more aggressive in lending to businesses and consumers, which helps further stimulate the economy.

There are risks to everything, of course, and monetary policy is no different. However, I don't see much threat of QE being inflationary at this point. When the economy gets stronger the Fed will begin pulling back on the reins and allow interest rates to rise. In turn, higher rates will keep the economy from growing too fast, which is where inflation comes from. The Fed has already been discussing winding down their bond purchases because of recent signs of strength in the economy. That's good news because it indicates the recovery may be picking up steam, but since we're still a long way away from "normal" economic growth rates, I just don't see inflation as much of a concern.

Joe: We should also point out to our readers that all of the above monetary policies are easily reversed if things don't go as planned, by doing the exact opposite. Over the last 30 years, the Fed has increased (and decreased) the money supply to accelerate (or decelerate) the economy and job creation. Over the last 30 years we have had virtually no inflation. This should help comfort those who are worried

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about the Fed strategies and unintended consequences.

Q3: I hear so many things about our budget deficit? Some say it will eventually bankrupt our country, while others say it's not that big of a deal. Where do you stand on this issue? J.M.

Joe: Personally, I am debt – averse. That is, I prefer less debt to more. And, I believe we need to get back to having a balanced budget. That said, if debt is used correctly, it can be a very powerful tool. For example, almost every business, home and car is purchased using debt. In addition, many Americans, get an education through the use of debt. And almost every wealthy person I know leveraged some form of debt to get there. So the key is identifying the appropriate amount of debt that a country should hold. And, then the question is, how do you use that debt? I'll focus on the debt amount, and leave how we use that debt to our politicians.

When you look at anyone's debt (including a country's), you have to look at a number of items. And this is where it gets much more complicated than just looking at one number and waving it around for public scrutiny - which is what most people like to do. When you look at a countries debt, you have to assess the following: Are you solvent? What is your ability to repay that debt? Are we looking at gross debt or net debt? What type of currency risk exists? What percentage of debt is being held by outsiders? What specific countries hold your debt? Why do they hold that debt? How long do they hold it? What does your balance sheet look like? What is the liquidity of your currency? What is the term structure of interest rates? How much of your debt is short term? How much is long term? What are the market perceptions about your debt? What is your ability to tax? Is your debt general obligation or revenue based? Can you print money? What is your current deficit? What are the assets backing up that debt? Are their additional contingent liabilities? I could go on and on, but I think you get the point. It's a little more complex than looking at one number, holding it up for scrutiny, and then blaming one party (or another) for bankrupting your grandchildren.

Over the past few years, the surge in debt has been a result of lower tax revenues and higher federal spending related to the severe recession, health care, our defense budget and the financial crisis. Today, gross public debt is near 100% of GDP and net debt (a better measure) is around 85% of GDP. These numbers are important, but there is a more important one…which is called the "cost of carrying" that debt. The good news is, the low interest rate environment has held down interest costs to approximately 2% of GDP, which is still lower than the carry cost of all of the 1980's, the 1990's and most of the 2000's. So, in my opinion, we do have a debt problem. However, lower interest rates have given us a window to deal with the deficit before it gets worse.

Scott: I agree. I think the budget situation is manageable as it stands right now, but as we continue into the economic recovery we will need to get more serious about reining in deficits. In general, the American people are going to have to get used to the idea of getting less help from the government and doing more on their own. We know we eventually have to address cuts to both Social Security and Medicare, because both will become insolvent if we don't. This will obviously put more pressure on people's retirement nest eggs and makes getting good financial advice even more important than it already is. It also presents a significant challenge for financial advisors and is something we already factor into our portfolios, especially for our younger clients. It seems unlikely anyone at or near retirement age will see much in the way of cuts from these programs. However, those in their mid-50s or under, will almost surely be affected at some point with lower Government funded benefits.

Q4: If the consumer represents 70% of the economy, isn't it important to look at consumer spending each month? B.G.

Scott: Consumer spending is an important indicator, but I think personal income and unemployment are even more important, since consumers can't spend more than they earn—at least not over the long term. More people finding work means greater levels of disposable income and, in turn, leads to increased levels of consumer spending. We're seeing the unemployment rate come down, albeit slowly, and that's a good sign. We'd like to see it come down faster, of course, although there are some encouraging signs that this may be happening. It looks like the situation in Europe is improving, growth in China looks to be on the rise, and emerging markets like Brazil and Mexico are showing signs of coming out of a recent slump. All these things bode well for employment in the U.S., so they are things we will follow closely as the year progresses.

Joe: That's true. I should also point out that this is one of the "disconnects" we've discussed in the past. Even though the unemployment rate is just under 9% and our economy is growing at a lower rate than we would like, it does not mean companies (and thus the stock market) can't continue to grow. Remember, the global economy is what drives our stock market today and it does not look like

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the global economy is going to slow down for the foreseeable future.

Q5: Given your firms thesis that it's the global economy that is driving our stock market, shouldn't we have more invested in foreign securities? W.D.

Joe: Good question. Right now, most of our stock portfolio's have between 10-15% of direct international stock exposure. However, this perspective only gives you half of the bigger picture. We estimate that over 50% of the revenues generated by our large cap companies come from overseas. That adds another 16% to our overall global exposure. In today's global environment, we believe the revenues generated by mid and small cap companies are not far behind. So, we probably have closer to 50% foreign exposure when you look at both foreign stocks and/or foreign revenues. We're comfortable with that.

Another reason we're comfortable with indirect "revenue" exposure is because we limit the amount of direct exposure to foreign stock exchanges, which are more risky, less regulated and more expensive than our own. In addition we also avoid the issue of currency risk.

Scott: Because of globalization, the benefits of owning foreign stocks aren't as great as they once were. The correlation between foreign and domestic stocks has been rising steadily for a couple of decades, especially among developed nations, and higher correlations make foreign shares less attractive from a diversification standpoint. Emerging markets tend to have lower correlations and are expected to generate higher returns, both positives, but they're also extremely volatile and not appropriate for everyone. Emerging market stocks had a rough year in 2011 but started to recover in 2012. We already have some emerging markets exposure in our core portfolios and it's something we'll probably be adding to gradually as the global economic picture continues to improve. Given what happened in 2008, we have found high volatility funds are the last thing most of our clients want. So, we think emerging markets will provide higher than average returns over the next five and ten years. However the ride will NOT be smooth.

Q7: I have to admit I probably watch way too much news and then get scared. Then I read your newsletter and I usually feel better. It's almost like my quarterly jolt of optimism. I just wanted to let you know I appreciate the efforts you put into your newsletter and your message… its refreshing. A.R.

Joe: Thank you for the compliment. I am definitely an optimist, but I also believe that optimism is rooted in the strong belief that our country and our citizens can overcome anything. We have a pretty darn good track record overcoming much greater obstacles than the ones we face today. I just think the media makes things seem much worse than they really are. For example, home prices have clearly bottomed and are now rising; consumer debt is falling every month; the unemployment picture is improving; and we are now looking at being energy independent within a decade. That's amazing. I recognize that we have some serious headwinds…but those headwinds have abated significantly over the last four years…and our markets have thrived as a result.

Scott: We put a lot of time and effort into our newsletters and email updates, so I'm glad they're helping you. This has been a very trying four years for everyone, with no shortage of things to worry about. But we're really proud of our clients and the way they've handled themselves. There was plenty of fear to go around, especially early on, but our clients trusted us to handle their investments for them and didn't let fear dictate their long-term decision making. As a result, our portfolios have recovered nicely and I think we can look forward to even better times ahead. More and more signs are pointing toward a strengthening recovery, both here and in Europe. We're still not out of the woods, but every day that passes puts us one day closer to a full recovery. We won't get there overnight, but we're headed in the right direction and I really like the signs we're seeing right now.

Q8: Dear Dr's Kiely & Below, What do you believe is the biggest threat to the domestic economy?

Joe: As long as there is appropriate regulation along with the free flow of capital, labor, commodity resources and technology, I believe we'll be fine. When one of those core elements breaks down, it will disrupt our economy in a significant way. For example, if we fail to get our debt situation under control over the next decade, I could see our capital markets breaking down. Alternatively, if we get into a trade war, I could see that affecting our economy. Fortunately, most people recognize the need to get our finances in order and they recognize the need to keep free trade agreements in place, so I don't really see a major threat on the horizon outside of a 9/11-type event.

Scott: For the long-run health of <u>domestic</u> economy I think the biggest threat is probably in Washington. I don't know whether our politicians have the resolve or political savvy to fix our budgetary problems in a bipartisan fashion.

Hopefully, a strengthening economy will help tone down the partisan rhetoric and they will be able to work together

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to arrive at some meaningful solutions, even if it means having to hold their noses while doing it.

Beyond our politicians, I think the biggest threat to the economy is probably some sort of nuclear attack, either by terrorists or a rogue nation. I'm encouraged by signs that the new regime in North Korea is beginning to reach out to the West, but unfortunately don't see many encouraging signs from inside Iran. Continued economic pressure is having a significant impact, but that's a long, slow process and I'm not sure we have enough time for it to work as intended. On the bright side, what we've gone through in Iraq and Afghanistan will be valuable if we're forced to take action against Iran, and I have every confidence our military can achieve whatever objectives they set out to achieve.

Q9. Dr. Kiely, Last year at the annual client appreciation dinners, you had a list of prognostications/predictions. I was curious to see how many of them were right. B.M.

Joe: Here is a list of the prognostications that our firm put out at annual client appreciation dinners in January 2012, and in our monthly update following those dinners. I follow the prognostications with a "**Yes**" if it occurred or a "**No**" if it did not occur. As you will see, we had a decent year…

1. Double-digit Returns in the Equity Markets. **Yes**
2. Small/Mid caps hit all time highs. **Yes**
3. Above average volatility. **No**
4. A 10% to 20% market dip during the year. **Yes**
5. All-time highs in S&P 500 profits and cash flows. **Yes**
6. 2% to 2.5% growth in the U.S. GDP. **Yes**
7. 4% to 4.5% growth in global GDP. **Yes**
8. Interest rates will remain lower than normal. **Yes**
9. Interest rates will increase slightly. **No**
10. Inflation will remain muted for all of 2012. **Yes**
11. Europe will NOT collapse. **Yes**
12. Europe will improve because of the ECB. **Yes**
13. Real Estate will bottom in many more markets. **Yes**
14. We will experience a few global surprises. **Yes**
15. Transparency in the markets will increase. **Yes**
16. More fraud cases against 2008 profiteer's. **Yes**
17. We'll be surprised at the resiliency of mankind. **Yes**

Scott: Last year, was another good year for our financial markets. Outside of the 15 predictions we shared at the dinners, we also predicted the bond market would have a challenging year and gold would fall. Specific areas of the bond market - like Treasuries and Municipals – did have a challenging year. However, our bond managers wound up having a superb year and far exceeded expectations. Regarding Gold…it was up 6%, so it underperformed relative to the stock market and a number of our bond managers. The area we missed the worst was increased market volatility. The markets were relatively calm compared to the previous three years. That was another nice surprise and hopefully indicates we're beginning to put the emotions of the 2008 - 2009 credit crisis behind us.

Q10. A few weeks ago, I called Dr. Kiely with some concerns regarding the "fiscal cliff", and you said something in our conversation that should NOT have surprised me…but it did. I am so used to reacting to the market news and daily swings in prices, and I assumed advisors behaved in the same way. However, you had a plan that factored in future market volatility - before it happened - which made me feel much better after thinking about it later. Those comments need to be shared in your upcoming newsletter. Of course, looking back at your old newsletters…you did cover this topic. A few times. H.B.

Joe: When we build our clients portfolios, we do so under the assumption that the next ten years may be as volatile as the past ten years. In essence, we EXPECT significant volatility to occur at some point as we look out into the future.

Scott: Right - we build our stock and bond portfolios assuming there will be surprises and knowing full well we can't possibly anticipate every possibility. Diversification, asset allocation, and rebalancing are of critical importance when designing portfolios that will provide some downside protection without being overly restrictive in up markets. We know there will be surprises in both directions over time, which is why if stocks have a big year relative to bonds, we proactively take profits by paring back on stocks. Likewise, if a certain sector of the stock market outperforms in a given year we will rebalance back to our standard equal-weight core portfolio, which forces us to take profits on whatever has been on a protracted hot streak and invest the proceeds in whatever hasn't. Buy low, sell high. It sounds simple. Our approach mandates it, but we know most investors wind up doing just the opposite.

Joe: Unfortunately, many investors get focused on many of the items they can't control…which can lead to emotional (versus rational) responses. We know the markets are going to get volatile from time to time. It's a given. So we focus on the items we have 100% control

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over. Clearly, we can control how we build portfolios from the start. We can control our asset allocation. We can control who our managers are. We can control how we rebalance. In addition, we have done the necessary background research, so we know we have a well thought out strategy if significant volatility does occur. This allows us to keep our emotions in check and rebalance pro-actively. Many people DO NOT have a pro-active pre ordained rebalancing strategy in place, so they end up "reacting" to the issue of the day.

Scott: That's true. We don't have to know what the issues are going to be. However, we do know we will have periods of irrational short-term volatility, so we want to be prepared to use those periods to our advantage. It's one reason we sleep well at night. There are lots of things we can't predict and can't control, so we focus on the things we know we can. We have found focusing efforts on things we have no control over is a waste of time and energy…and doesn't improve our portfolios.

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 New Year!

~ Joe and The Gang at KWAG

2013 KIELY GROUP CLIENT APPRECIATION DINNER SCHEDULE

Ocean Isle, NC Monday, January 28rd Sea Trails Convention Center 6:00-8:00PM

Greenville, NC Tuesday, January 29th Brook Valley Country Club 6:00-8:00PM

Asheville, NC Thursday, January 31st Asheville Country Club 6:00-8:00PM

To reserve your seat, please call our headquarters office at 877-366-5623 or your specific advisor. If you would like to register via email, please email Kristen Below at kbelow@thekielygroup.com

We encourage you to bring a friend and/or someone who would like to hear our educational message.

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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