Kiely Financial Services, Inc.

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BEHIND THE SCENES

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Opening Thoughts

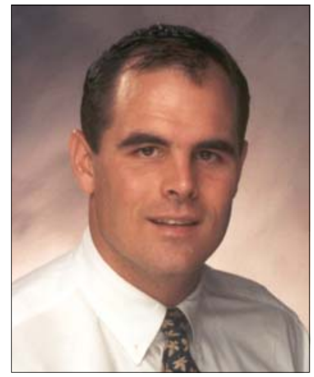
We hope this October 2008 newsletter finds you enjoying the fall weather and brisk cool evenings. If there is ever a time to get outside and hike, it's now. Not only is exercise good for your physical wellbeing, it can be great for your mental wellbeing as well. Being inside the house on the computer or watching the financial news makes you far more likely to get caught up in the media feeding frenzy surrounding the problems on Wall Street. This can make you lose sight of the big picture and become far more emotional about what is going on than is healthy for either you or your portfolio. The news media has become adept at capturing viewer's attention with hyperbolic headlines, dire forecasts, and hysterics that often border on theatric. This strategy keeps people glued to the tv screen and increases their advertising revenue, but the damage it does in terms of creating stress and encouraging inappropriate, emotionally-driven investing behavior is immeasurable. For example, comparing the current economy to the "Great Depression" is beyond ridiculous, not to mention that it flat out scares the daylights out of people. That's wrong and highly irresponsible. Thus, one of our main goals in this quarterly newsletter is to inject some reason and perspective into recent events and let you know this too shall pass…assuming we don't react irrationally or do anything foolish.

Newsletter Specifics

A few weeks ago (on September 30th), we wrote an update discussing the root causes of the current credit crisis and the government's plan to fix things. We don't want to repeat the same message here, but if you'd like a copy of that update we encourage you to contact our main office in Greenville. What we intend to do here is provide some context for what is happening in the stock market as a result of the credit crisis and to discuss how these events have impacted you and your portfolio. If you are now desperately trying to figure out what's going on in the markets by watching TV or reading mainstream media, STOP. All you will likely get is bits and pieces of the story mixed in with significant amounts of misinformation and hysteria. It's difficult for even professional investors to effectively filter good information from bad information at times like these. If you want to understand what's happening, a good place to start is by taking the time to read our recent quarterly newsletters and monthly updates thoroughly. As educators, we know how important it is for our clients to understand what's going on in volatile times like these. We also know how difficult it can be to find credible sources of information and straightforward, non-technical explanations that make sense. This newsletter is our attempt to provide just that type of information for our clients. Thus, we will examine the current crisis through an educated lens; look back at past newsletters to reinforce our consistent message; examine market returns (over the short and long run); and provide additional insights through Ten Questions with Joe.

Our Consistent Message: Previous Updates

Over the past year, you should have received at least sixteen separate written communications from us (four quarterly newsletters and twelve monthly e-mails) – in addition to personal phone calls, e-mails, client dinners, and physical meetings. Our goal is



Dr. Joseph Kiely

Inside this issue:

Special Enclosure:

Please see the inserted document for information regarding our attempt to obtain your current email address.

We want to be sure you are on our email update list.

Please read the enclosed one page document and return it as soon as possible!

simple: We want to provide a consistent, commonsense message about how we build portfolios and manage money…even when things seem dire. Our approach to investing has always been consistent. We build stock portfolios with a long term perspective, recognizing there will always be a chance of short term volatility. For those of you who already read our communications thoroughly, you know that for the past few years we've been discussing the eventual return of volatility to the markets and how we have pro-actively rebalanced portfolios to help lessen these effects. We were certain there was going to be an increase in volatility at some point. But it was impossible to know when the volatility would return, how long it would last once it did, and how nasty it would get before things bounced back. As you will see shortly, the volatility our portfolios experienced through the **end of September** was not all that unusual when placed in a historical context. In fact, it was quite normal. Unfortunately, the same cannot be said for October…although there are two fairly recent points of reference that give us some context as well.

As you know, we usually focus our quarterly newsletter on what happened in the three months leading up to the end of the quarter. However, the events that have occurred since the beginning of October have been so dramatic that they deserve our attention as well. We're assuming you want to hear our opinions on what has recently transpired, so we'll also take a look at the October sell-off and the resulting government stimulus package.

October's Sell-off

Many people are clearly wondering "how the heck did the market sell off so quickly?" We know the main culprits…panic, hysteria, and fear…which played a fairly large role in the massive sell-off we observed over the first eight trading days of October (through October 10th). However, many people are unaware of the "forced selling" on the part of institutional portfolios and hedge funds that were using a number of investment strategies involving huge amounts of leverage (i.e. margin accounts). As global markets tumbled last week, leveraged portfolios received margin calls that forced wholesale liquidation of assets, sending blocks of thousands — and in some cases millions — of shares into the market for immediate sale. With investors already cautious/scared due to the credit crunch and the mortgage crisis, there were very few willing buyers in the market each day. Thus, stock prices tumbled at a rate not seen since similar situations occurred in 1987 and 1998. The impact of "forced selling" and the ensuing "panic selling" on stock portfolios worldwide over the past few weeks was obviously gut wrenching. However, things are rarely as bad as they seem.

Past Experience Points to Opportunities

Over the last twenty years we have had two other "panic" sell-off's that were similar in terms of the widespread fear and strong emotional responses they elicited. These two time periods also give us some guidance and perspective on how things can be expected to play out over the next few years. You may be surprised how quickly the markets bounced back in those previous instances, which is why it is critical that people refrain from making ill-advised, emotionally charged decisions to sell at what is likely the worst possible time. As we have said a number of times over the years, human nature and stock markets are unpredictable in the short run. Right now, it is clear that there has been a ton of panic selling to go along with the forced selling from the institutional accounts. Combined, these actions have driven the prices of some stocks to ridiculously low levels that have no bearing on the actual values of the underlying companies. When situations like this occur, it has NEVER been a good time to sell and, in fact, has always been a good time to buy or (at worst) hold. Valuations always return to rational levels and those who sell into the face of this pandemonium will miss out on the recovery. In addition, the Federal Reserve and the U.S. Treasury have taken some unusual, but much warranted steps to stem the tide. This will help to reduce the impact of the credit and mortgage crises on the economy going forward and will make the recovery occur far quicker than it would have without intervention. Given the unprecedented stimulus levels being applied to markets and economies worldwide, we know there are some incredible opportunities for those investors who keep their heads. Furthermore, when hundreds of publicly traded companies (as of 10-10-08) sell for less than their per-share cash on hand...you know there are more than a handful of opportunities. For example, when companies such as Charles Schwab have $27 Billion in cash and have a market value of $21 Billion, the sell-off has reached levels that are too low on the down side.

So please find a comfy chair, get out your favorite writing utensil and prepare to take some serious notes. If you're currently feeling nervous and scared about things, that's to be expected and we totally understand. However, after you read our newsletter, we think you'll feel much better. If not, call us. That's what we're here for. We will always be a source of rational, unbiased information and provide advice that you can always depend on. One more point. Some of you will notice that we repeat ourselves a few times in this newsletter…we know…it's what good educators do to make sure you remember our key points.

(Continued on Page 3)

The Take-Away

At this point, we are concerned about the financial markets (which include the stock, bond and credit markets) and their volatility. However, let's make sure we're ALL on the same page. As we write this, financial markets ARE NOT trading based on the underlying fundamentals of the overall economy or the individual securities being traded. The magnitude of the downturn has been historic, and no one likes to experience these sorts of gut-wrenching events. Why? Because the fear and panic created by dramatic market declines elicits strong emotional responses on the part of many otherwise rational investors. At KFS, looking out for our clients best interests is the overriding objective of everything we do. At times like this our job pretty much consists of staying out of the way of the stampede, lest we get trampled. And while we will certainly investigate ways to capitalize on all the indiscriminate selling and irrational market behavior, our primary task is to continue building and rebalancing portfolios as we always have, using the same fundamental, research-driven approach that has served us all so well over time. We will also continue to make financial decisions based on each client's investing goals and time horizons. If these have not changed over the past few weeks, neither should your portfolio. Over the coming days and weeks we will be rebalancing into the stock market (not away from it) and we will be taking additional tax losses where possible. Our biggest worry at this point isn't the stock market…but that some investors will let their fears control their investment decisions, causing them to do things they will dearly regret.

OUR PERSPECTIVE ON THE MARKETS

2007 Newsletters: Looking Back

Volatility in the stock market is nothing new. In fact, it's a topic we have been writing about for years. Last year, for example, we discussed market volatility in three straight quarterly newsletters beginning in April 2007. We warned of an abnormal "lack of volatility" in the post 9-11 recovery and how investors were becoming conditioned to believe that the uncharacteristically docile market behavior was, in fact, the norm. Next, we discussed how we were diversifying portfolios to protect against a "certain increase" in volatility going forward. In response, we continued tweaking and adjusting our client portfolios in order to maintain optimal levels of diversification. Let's take a moment to revisit our April 2007 newsletter. In the opening paragraph, after our observations on the spring weather, we wrote…

> *"As they say in gardening circles, running groups and investment shops 'You reap what your sow'. We think this is particularly true in today's stock market. As we have been saying for some time now, the relatively "smooth" run-up in stock prices is an aberration. In fact, over the last five years we've seen some of the lowest price volatility in stocks ever. And while it's certainly been enjoyable, we like to prepare for volatile times. Therefore, we've become extra diligent in regards to our diversification strategies. While the last five years have been unusually calm, the five years before that were some of the most volatile years in history. Not to mention that the events driving that volatility reshaped all of our portfolios significantly. Common sense tells us it's only a matter of time before similar events could happen again."*

Our Point: No one knows what's going to happen from one year to the next, but we felt a return to normal volatility levels was overdue. Going back to the 1970's, we knew stocks (as measured by the S&P 500 index) averaged a peak-to-trough dip of 13% annually…so we knew the volatility we'd been experiencing for roughly five years was abnormally low. When the inevitable dip occurred, we wanted people to recognize that dips are a normal part of stock market investing and to behave rationally. Remember, we don't like dips any better than the next guy, but the key to dips is not to react irrationally to them. History is a great teacher and it shows over and over that those who focus on short run moves often do so at the expense of the long term well being.

In the April 2007 newsletter we went on to write...

> *"Consistent with our expectation of a return to more normal levels of volatility going forward, the predominant theme of this newsletter is one of managing your risk exposure. Research shows that market volatility causes many investors to make irrational investment decisions. As a result, we want to make sure our clients understand how we proactively manage portfolios so as to reduce both your overall risk exposure and the volatility of your overall portfolio. What many investors fail to realize is that a simple reduction in volatility, all else equal, is guaranteed to provide you with increased portfolio returns. Dr. Scott Below will provide a nice illustration that explains why this is true. At this time of year, most people are worried about the tax man and returning their "net" return on investment. What they may not realize is "volatility" can be a much bigger problem. And while "you don't know what*

(Continued on Page 4)

you don't know", after reading Scott's piece on managing risk I'm confident you'll understand why we're so adamant about adhering to sound diversification strategies."

Our point: We basically dedicated an entire newsletter to the topic of protecting your portfolio during volatile times. In part, this was designed to help you understand why we believe so strongly in our diversification strategies. But we were also trying to manage expectations in an attempt to make sure our clients were prepared for the next dip or financial crisis.

(**Note:** If you would like a copy of the KFS April 2007 newsletter, or any of our past newsletters or monthly updates, please feel free to contact Kristen in the Greenville office. She will be happy to send you a copy. Furthermore, if you do not receive an e-mail update by the fourth day after the end of any month, you know your e-mail update from us has either been blocked, diverted to your spam folder, or that you changed your e-mail address without letting us know. In this case, call our main office and we'll get it to you ASAP.)

Our Consistent Message - Focus On the Long Term

We honestly had no idea when volatility would return or when the next market crisis might occur. In fact, no one does. All we knew for certain was that future volatility was inevitable. Further, we knew that when volatility did return, many people would become emotional, lose focus on the long term, and make irrational, shortsighted investment decisions with their long term money. Not good. As a result, we felt it was important to review how we build portfolios and show how this actually helps mitigate the impact of market volatility. We also wanted to remind everyone that we proactively manage risk even <u>during the good times</u>. In a subsequent newsletter we even went on to suggest it may be a good time to take some cash out of your long term portfolio if you had some short term needs. Otherwise, we continued to stress stock investing as a long term proposition (with a time horizon of <u>at least</u> five years).

<u>A Reminder:</u> By the end of 2007, all of our stock portfolios were positive for the fifth year in a row. Even more important, we were as prepared as possible for any potential increase in volatility. That said, our assumption (since we repeat it in every newsletter) is that everyone who has money in the stock market has <u>at least</u> a five year time horizon. Why is this important? Because we know dips happen and we never want anyone to be forced to liquidate some of their stock holdings in the midst of a dip in order to meet immediate cash needs. Meeting immediate cash needs is what fixed-income holdings are for.

2008: The First Two Quarters

The first six months of 2008 saw increased volatility in the stock market, which came as no surprise. It began with a "panic-driven" sell-off in the first three weeks of January that saw every style box in the Morningstar grid lose more that 10%. Things settled down a bit after that and the market slowly recovered most of its losses through mid-June. During our January client appreciation dinners, we discussed why we felt the "panic" sell-off would provide great opportunities for investors who remained patient. By mid-June our client stock portfolios were in positive territory once again. This is important to note because the major indices, including the S&P 500 (large stocks) and the Russell 2000 (small stocks), were NOT in positive territory at that point…yet our actively managed stock portfolios were. In other words, our managers were outperforming their benchmark indexes, some by extremely large margins.

Our Point: You want to own active managers who can beat their benchmarks in both up and <u>down markets</u>. We spend a great deal of time examining the long-term track record of the managers we use. Their track record has been, and continues to be, impressive in both up and down markets. If we felt otherwise we would not use them. Frankly, our portfolio performance over the first two quarters (on a relative basis) was one of the best six-month periods for our firm ever.

2008: The Third Quarter

From mid-June on, the financial markets have experienced an unprecedented series of interconnected financial events that began with the sub-prime mortgage implosion and moved through the global credit markets like a string of toppling dominos. First, we saw the bailout of Bear Stearns and then witnessed in quick succession; the takeover of Fannie Mae and Freddie Mac, the Lehman Brothers collapse (which unhinged the credit markets), the Bank of America takeover of Merrill Lynch, the government rescue of AIG, the failure of Washington Mutual, the sale of Wachovia, and the Federal Government's rescue plan to purchase mortgages from financial institutions. These events were the result of a toxic brew of factors, including negative real interest rates, lax lending standards, poor regulatory control, gimmicky mortgages, foolish borrowers, poor oversight, exotic mortgage securities few understood, unreliable credit reporting, fraud, greed, hubris, and a list of additional abuses that would fill the rest of this newsletter. What's remarkable is that by themselves, any of these occurrences would have been big news. Together, they

(Continued on Page 5)

formed a perfect storm in the financial markets. The fact that everything took place within a matter of a few months is remarkable and, quite frankly, difficult to comprehend. The financial landscape we once knew has been forever altered…which in many ways is good. What's unfortunate is that much of the damage could have been averted with better disclosure and more openness among the financial institutions with respect to what they actually held in their portfolios. The bulk of the damage has been caused by a lack of transparency and a lack of trust among the major global financial institutions. In turn, this has resulted in a near complete freeze up in the global credit markets. Had there been a quicker resolution to capital infusion it is possible the credit markets may not have seized as severely as they did, but the real culprit here is the astonishing lack of transparency. And lost in all this…was the fact that our portfolios were still holding up very well even through most of September.

The Lesson: While everyone was watching the stock market yo-yo-ing up and down, many clients failed to recognize their portfolios were doing quite well. In fact, during the first week of significant volatility (Sept 15th – Sept 19th) our clients actually made money in stocks.

The September /October Sell-off

So what caused the dramatic sell-off we've seen since mid-September? A number of things have played a role. First, media coverage of the credit crisis bordering on the hysterical certainly hasn't helped. In turn, this has fueled and amplified investor fears and led to significant levels of panic selling, particularly in October. Finally, as stock values dropped, "sophisticated" investors who used leverage (i.e. borrowed money) to buy stocks began facing margin calls that forced them to immediately liquidate entire portfolios. Millions of shares began flooding the market at a time when many potential buyers preferred to take a wait and see approach, helping stock indexes behave like a roller coaster, with sharp swings downward often occurring in just a matter of minutes.

The media, notorious for wanting the first news scoop – even if it's wrong – also didn't disappoint. They reported many aspects of the credit crisis incorrectly and insisted on making the most spectacular and outrageous claims possible. In the short run, markets can often be driven to extremes by emotion. In fact, this is one of the most dramatic emotional sell-offs we've ever seen. In relatively short order the market reached all out panic mode, with lots of sellers and few buyers – a surefire recipe for prices to tumble. Psychological studies indicate that human reaction is twice as strong to bad news as it is to equivalent good news. So in essence, for every piece of bad news, we need two pieces of good news to balance it out. This may help explain why markets can sometimes react so severely on the downside. Once things get rolling, selling drives prices down sharply, which creates panic, which begets more selling…and more panic…and more selling…and so on. This is clearly what we've experienced since mid-September, and the worst thing we could do as financial advisors is to participate (or encourage our clients to participate) in the contagion by selling stocks into it. Stock prices at this point are as far below their fundamental value as we have ever seen and, in our opinion, the market has become irrational on an epic scale. Fortunately, such extremes don't usually last very long, as rational investors soon begin taking advantage of the fire-sale prices.

Our Take: Rationality will return to the market and when it does, the value lost in stocks in the panic will be recovered. For those that stay in the market over the next five years, this period will be remembered as a fascinating study in investor psychology and the madness of crowds. Academics will be studying and writing about this period for decades to come. The key is to not become the subject of one these studies, because most of the studies will be focused on how not to behave during market meltdowns and contagions. In case you haven't noticed, there are already plenty of rats in that maze.

Third Quarter, 2008: More Details

Let's go back and look at the end of the second quarter, which was a positive for stocks and ended with stocks barely down on the year. What happened next? Stocks slid a bit more during July, but bounced back in August, which was a positive month for all but one of our stock managers. Relatively speaking, our KFS portfolios were doing extremely well at that point. They were still mostly down for the year, but the losses were manageable. And when compared to the broader indexes like the S&P 500 or their specific benchmarks they were in terrific shape. Then September arrived. Almost all of the negative results generated in the third quarter were the result of a highly volatile September. We saw intraday swings of 2% to 3% almost daily (21 trading days to be exact). In fact, although there was a great deal of intraday volatility during September, most of the September losses were confined to the five day period between September 23rd and September 29th, which saw both the S&P 500 and Russell 2000 fall more than 8%. During those five days the year-to-date losses in our portfolios nearly doubled.

The Lesson: To those of us in the industry, the volatility experienced in September was typical stock market behavior. Stock losses (and gains) are often confined to very

(Continued on Page 6)

short time periods, making attempts to "time the market" very dangerous. In addition to trying to predict the unpredictable, being wrong for even a short period can be devastating to a portfolio. How so? There are academic studies that show almost 100% of the market's gains are confined to just 10 of the roughly 250 trading days each year. In addition, we know large dips are generally followed in close proximity by large rebounds, which is why it is so important to stay in the market during downturns. Hundreds of academic studies have looked at market timing and concluded the same thing – no one knows when a downturn will occur, how long it will last, or when the eventual bounce-back will begin. (There are always those who claim they knew, of course, but for some reason they never seem to announce this until well after the fact and they usually have something to sell you…)

Mental Accounting

Behavioral research shows investors tend to use "**mental accounting**" methods that can make stock market returns seem far worse than they actually are. For example, people will be quick to point to their portfolio values as of last October, when they were at a high point, and use this value to assess their losses. This type of behavior is called "mental accounting" and leads to frustration because it makes losses look greater than they really are. If you invested all of your money last October, then this "mental accounting" approach has validity. However, if you have been invested in the stock market for a number of years this approach as no validity at all. By comparing your highest portfolio value to your current portfolio values all you are doing is maximizing your "mental" losses, which encourages you to lose focus on the long term performance of your investments. Nobody likes feeling depressed, but by choosing your highest portfolio value as a yardstick with which to gauge your losses, that's about all you're accomplishing. If you have been investing with our firm for a while and go back two years from the end of September (9-30-08), you'll likely find your portfolio values are not significantly changed over that period. And if you go back three, four or five years, your annualized returns will only increase. Mental accounting only adds to the stress felt in down markets by making investors feel like they lost more than they really did. It also tends to increase the odds that investors become panicked and sell at or near market bottoms.

The Lesson: We understand why people are worried. Volatile markets get everyone's stress levels up…and the media doesn't help by trying to over-hype and sensationalize every single down day. Then we beat ourselves up further by using "mental accounting" techniques to make things appear far worse than they really are. If you want to evaluate your stock portfolio's performance, go back several years and calculate your average annual rate of return over that period. This is far more revealing and a lot more accurate than using peak-to-trough mental math.

The Big Picture
A Recap of Normal Volatility

Prior to this year our portfolios have had positive annual returns each year for five straight years. And our portfolios and managers have regularly outperformed both their individual benchmarks and the S&P 500. During this time there were a number of rather large stock market dips, particularly in small cap stocks, which were our best performers. In fact, small caps have had double-digit intrayear dips no fewer than **seven times** over the previous five years. Yet the Russell 2000 has still increased 145% over the five years ending September 30, 2007. Furthermore, over that time we have faced a number of concerns about the economy, including stagflation, a weak dollar, federal deficits, inflation, deflation and inverted yield curves. Each of these factors has at one point or another been blown out of proportion in the media in order to grab your attention. Perhaps not surprisingly, every year we also field all sorts of questions about issues that have little or no impact on long term investors. These issues become worrisome to the average person because they have been made larger than life by a media reliant on hype to sell advertising. It's no wonder people get caught up in the hysteria, particularly since in this age of instant communications it's in their face 24/7. However, let's step back and think about things for a minute. Since stock markets were born, diversified portfolios that encompass the entire stock market have done extremely well. Sure, stocks have gone through tough times before — just as they will go through tough times again. However, investors who buy well diversified portfolios of stocks and hang on through good times and bad have always done well. Why? Because stocks will always eventually recover and good quality buy-and-hold portfolios will continue to grow and prosper.

The Lesson: The media, mental accounting, a short-term focus and outright fear are your worst enemies right now. Bear markets are a normal occurrence and surviving in bear markets is a function of not letting your emotions make you do something you will deeply regret a year or two down the road.

(Continued on Page 7)

The Conclusion: Let's summarize what we have discussed thus far.

1. Prior to 2008, the stock market increased every year for five consecutive years.
2. In 2007, we pointed out that the run-up was unusually smooth, with significantly low volatility.
3. In 2007, we began warning of an eventual and significant (i.e. normal) dip in large caps.
4. That dip finally occurs in January 2008 and prices recover by mid-June.
5. In July, prices drift slightly lower given market uncertainty…but nothing out of the ordinary.
6. In August, prices drift back up - once again, nothing out of the ordinary.
7. In September, a confluence of events takes place - markets get rattled and stocks begin to slide.
8. Most of the third quarter price decrease was confined to five trading days in September.
9. In mid-September, the media begins comparing current events to the "Great Depression".
10. This incites significant amounts of anxiousness and fear on the part of investors.
11. Investors begin to panic and sell, driving prices lower and setting off a stampede for the exits.
12. The first eight trading days in October sees a panic sell-off of historic proportions.
13. Much of the sell-off was driven by margin calls and highly leveraged hedge funds liquidating their positions.
14. On Monday, October 13th buyers flooded back into markets. Stock indexes rise roughly 12%.
15. Over the next two days they gave back most of this gain.

So how has all of this affected your portfolio? Well, if you are using your "mental calculator" you would say you are down quite a bit since last October. But what happens when we put on our "big picture" glasses and look back a little longer? Going back from the end of September (09-30-08), the results are basically unchanged going back two years. If one looks back three, four, five, or ten years from 09-30-08, the long term results of a diversified portfolio are fine. However, if you include the first week and a half of October, the results going back look a lot less rosy for everyone (Warren Buffet included). However, we believe the effects of this sell-off will be temporary and the markets will recover what they've lost and then some. To date, our managers have still held up well versus their benchmarks. Furthermore, we think they are well positioned to take advantage of the epidemic of irrationality and wholesale selling that has been occurring since late-September. As such, we also believe the long term numbers will be drastically different and tell a much different story (in a positive way) after the market rebounds. To illustrate why we feel this way, let's look back at the last two panic sell-off's, occurring in 1987 and 1998 respectively.

Some Recent History

Two Previous Panics

Over the last twenty years, we have had two instances of large fear-induced market declines. First, in **September and October 1987**, large caps lost 34% of their value and small caps lost more than 40% of their value over a six week period. However, what a lot of people fail to recognize is that the overall market still managed to generate a positive return in 1987! Furthermore, in less than two years the market had fully recovered and both large cap and small cap indexes were once again setting all-time highs. In just two years…

During a six-week period spanning **July and August 1998**, large cap stocks lost 20% of their value and small cap stocks lost over 30%. Within months (not years) both indexes had fully recovered from these declines. The events that led to the panic sell-off in 1998 are particularly interesting since there are some parallels to what is happening today. At that time, Russia had defaulted on its national debt, Long Term Capital Management (the world's largest hedge fund at the time) went belly up due to excessive leverage and risks they didn't fully understand, and we were in the midst of a Presidential impeachment. The response from our government should sound familiar...significant rate cuts and a bailout package, both of which worked as planned. Again, markets recovered within months…

So although the recent sell-off of 2008 is gut wrenching... if history is any guide it may also be short lived. Furthermore, if you go back and look at how a diversified portfolio using our managers has done since 1998 (which includes the tech-stocks collapse and three-year bear market from 2000 to 2002), we think you will be pleasantly surprised. It's one of the many reasons we use the managers we do - and - its why we diversify our portfolios across the entire market to include significant amounts of small and mid cap stocks.

(Continued on Page 8)

MORNINGSTAR NUMBERS

Morningstar Numbers: 2008

We recently began presenting the nine equity style boxes each quarter to show our clients how the entire stock market performed over various time periods. To us, the stock market over the first nine months of this year is best described as three separate periods. During the first three weeks of January we saw a panic-driven sell-off where stocks were sold across the board, without regard for the underlying fundamentals of the companies. The following chart tells the story.

Russell Style Index Performance
01/01/08 through 01/22/08

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

Every style box was down more than 10% on the year, but the wholesale nature of the sell-off provided a great opportunity for our managers to take advantage of stocks that had been driven down. Over the next five months our portfolios slowly increased and eventually moved into positive territory by mid-June, with virtually every manager in our stable outperforming their benchmarks. As the summer progressed and volatility increased, our managers continued to hold their own, with most of our small cap managers even moving into positive territory for the year (even though the small cap indexes remained in negative territory for the year).

Russell Style Index Performance
01/23/08 through 08/31/08

	Value	Blend	Growth
Large	-2.20%	-0.13%	1.68%
Mid	4.76%	4.77%	4.32%
Small	12.08%	11.04%	9.86%

During September, the stock market trended downward with most of the damage for the quarter occurring in the final five trading days of the month. As you can see in the chart below, the month of September was much like the month of January, where there was a broad sell-off across all market sectors without regard for individual company fundamentals, indicating the sell-off was being driven largely by fear and panic. Of course, this pattern continued on into October through the first 11 trading days…

Russell Style Index Performance
September, 2008

	Value	Blend	Growth
Large	-7.35%	-9.53%	-11.58%
Mid	-9.05%	-12.26%	-15.28%
Small	-4.69%	-7.97%	-11.30%

Hopefully, you're noticing a trend about how small and mid caps (particularly on the value side) perform in up and down markets. Over the short run, any market sector can lead the charge. However, over time the trends are undeniable.

So Where Do We Go from Here?

We don't go anywhere. We continue to do exactly the same things that have resulted in excellent long run returns in the past because we know these strategies will continue to provide superior long run results in the future. We believe this current sell-off, just like the last one, will provide terrific opportunities for our managers to find great bargains. Sanity will eventually return to the markets, but in the meantime our managers will have an opportunity to capitalize on the staggering levels of fear and panic displayed by market participants though early October. Last January, we encouraged everyone to be patient through the panic sell-off and your patience was rewarded by mid-June. We even argued that it was a time to be buying stocks…not selling them, which was the right call. Through early October the markets are clearly experiencing another panic -induced selling spree and we once again advocate patience and recommend buying rather than selling.

(Continued on Page 9)

Who's Buying? You All Are…

Many of our clients are fully invested in stocks and bonds, and tell us they don't have any cash to invest. But while you may not, our managers and other investors do… and this indirectly benefits you. Right now, our managers are all busy putting their idle cash to work and they are retooling their portfolios daily to take maximum advantage of the current chaos. Furthermore, we (at KFS) will be rebalancing portfolios out of bonds and into stocks as the panic subsides and the dust begins to settle. For those of you who are contributing to your portfolios monthly, we recommend increasing your contributions to the largest extent possible. There is no question that investments made in this environment (whether they be direct investments of new cash - or - indirect investments made via the managers you already own) will be extremely rewarding long term…and they will probably result in positive returns much sooner than you think.

Our Managers

At the end of the third quarter, all but four of our domestic stock managers were outperforming their benchmarks year-to-date. When we examine our top ten managers (by total dollars invested) only a few funds were not beating their YTD benchmark as of the end of September. Given the volatility of the markets in the past month or so, we feel this is a positive sign as we go forward. When we talk to our managers, they are almost giddy over the abundant opportunities to buy stocks at the "fire-sale" prices. None of them are happy about the current panic, but they've been through times like this before and they recognize a great opportunity when they see one. The general thoughts and feelings of our managers, and of us at KFS, were recently summed up by Chuck Royce (President/CIO of the Royce funds):

> *"While we remain concerned about the current financial crisis and the potential for an extended economic recession, we believe the resulting overreaction to recent market turmoil has laid the groundwork for what should be a solid period for equities, led by small-caps, over the next three to five years."*

To which we say, "Amen!"

The Lesson: As long term investors, we must maintain a long run perspective even in volatile times like these. Rather than panic, we must remember that turbulent times present our seasoned, highly-skilled team of managers with tremendous opportunities, which they are diligently taking advantage of each and every day. Therefore, the long-term prospects for our clients are extremely bright…even though the immediate situation may be unsettling. History shows that the investors who get hurt in panic sell-off's like the one we're experiencing are those who are either forced to liquidate their portfolios in order to raise cash or those who liquidate their stock holdings out of panic and fear. Our role is to keep our clients out of these situations by making sure any funds that might be needed in the next five years are invested in fixed income securities rather than the stock market — and by maintaining our focus on the long term. And since we stay fully invested, we know we will ultimately benefit from the current pandemonium rather than become victims of it. In a nutshell, the secret to successful investing is to simply keep your head while everyone else around you is losing theirs.

Morningstar Numbers: Perspective Looking Back

Look, we understand why people are nervous about the stock market. These are difficult times and it's natural to be scared. But it's never as bad as it seems. Looking back over the past two years as of the quarter-end, the style indexes are all negative but have not actually lost much in value. And, when you look at our portfolios, they are not significantly different from two years ago thanks to our managers and their stock picking strategies.

2-Year Russell Style Index Performance ending 09/31/2008

Value	Blend	Growth	
-6.26%	-4.46%	-2.78%	Large
-4.79%	-4.24%	-4.33%	Mid
-3.46%	-1.96%	-0.69%	Small

(Continued on Page 10)

If we go back five years from quarter-end, we see all market sectors are positive with some styles even averaging double-digit annual returns over the period. It is also clear that value stocks outperformed their growth counterparts and small cap stocks outperformed large caps over the last five years. We have written extensively about this trend in earlier newsletters and even documented its existence going back over 38 years…including an update on these numbers in last quarter's newsletter (see KFS July, 2008).

5-Year Russell Style Index Performance ending 09/31/2008

Value	Blend	Growth	
8.20%	6.13%	4.03%	Large
12.17%	10.24%	7.44%	Mid
11.41%	9.59%	7.58%	Small

We can also look back over the past ten years to obtain even further evidence of the trend's persistence, so we've included a chart covering that period as well. We know most U.S. investors tend to hold predominately large cap stocks in their portfolios, and that these large cap portfolios also generally have a growth tilt. We also know this is a poorly conceived strategy that has resulted in lackluster returns (see the chart) and led the media (who are probably also invested primarily in large growth) to draw some extremely misleading conclusions about the long-run performance of the stock market. Yes, large growth stocks returned less than 1% annually over the ten years ended September 30, 2008. However, four of the nine style boxes actually generated double-digit annual returns over the same period. In other words, if you held a well-diversified portfolio, the previous decade treated you well. If not, you probably weren't as fortunate. We believe this should be a lesson to all investors going forward…but we're not holding our breath. Let's also not lose sight of the fact that these are the returns our markets experienced after the last panic sell-off in 1998 and they include the decline of 2000-2002. If these tables don't convince you to diversify, and focus on the long run, nothing will.

Annualized 10-Yr. Russell Style Index Performance ending 09/31/2008

Value	Blend	Growth	
7.16%	4.09%	0.61%	Large
14.09%	12.28%	7.09%	Mid
16.27%	11.20%	5.79%	Small

Looking Forward: A Final Thought

We are extremely confident that Congress, the Federal Reserve and the U.S. Treasury will act diligently and responsibly to restore confidence in our financial markets and keep the economy moving. And say what you will about politicians, in times of crisis they typically do tend to come together, put partisanship aside, and do the right thing (even if it takes longer than it should and involves way too much posturing and self-aggrandizement). Eventually, the credit and housing problems underlying the market's downturn will be worked through and their impact on the economy and the financial markets will diminish. Eventually the assets companies own will once again be recognized for what they are actually worth, which means stock prices will return to reasonable, rationale levels from the fire-sale prices we've seen recently. While a recession seems virtually certain at this point, we believe recessionary expectations have already been priced into the market. In fact, we believe this has likely already been overdone. Time will tell, of course, but once the credit markets are restored and banks begin lending again, business (outside of Wall Street) will gradually return to normal. Financial services companies are likely in for a longer ride, and while the final form of that industry is far from certain, we know it will be far removed from the industry we knew just a few months ago.

On the positive side, the outlook for corporate earnings remains remarkably strong (outside the financial sector), unemployment is still relatively low, the U.S. dollar is strengthening versus foreign currencies, and the price of oil is falling. And while we won't know the final cost to taxpayers of the "rescue plan" for several years, we believe it will be quite low and that we may even wind up generating a small profit on it.

(Continued on Page 11)

Our best guess on the economy is that we will begin to see some improvement between the 1st and 2nd quarter of next year. The stock market hates uncertainty, so after we begin to sort through the rescue plan, add the needed liquidity to the credit markets, and elect a president, uncertainty should decrease and the volatility we've been experiencing should fall dramatically. For all of us, this can't happen soon enough!!

10 QUESTIONS WITH DR. JOE

1. Dear Joe: Thank you (and your firm) for your timely email updates and insights into the current financial mess. I have been with your firm for a number of years now, and although I feel anxious about the markets (who doesn't?), I feel even better knowing I'm in your capable hands, which gives me confidence that we'll be fine over the long run. J.M.

Dear J.M. Thank you for your kind words. A few years ago, we asked all of our clients what we could do in terms of increasing our communication efforts. A number of people recommended monthly email updates. We now send a monthly email update two or three days after the end of each month that covers recent events or topics we think will be of interest to our clients. We will also write additional email updates when circumstances dictate, as we have done recently regarding the mortgage crisis and the market meltdown. We have received some very positive feedback from a number of clients regarding these email updates – along with our four newsletters. We will be writing semi-monthly email updates as long as the markets remain volatile. In addition to our written communications, we are also working on a new technology that will allow you to simply click on a web link to watch and listen to our updates and seminars on your PC. This will take some time to perfect, but we have started testing the software already and the initial results look promising. Finally, we have a KFS retreat next week where we hope to put together a seminar schedule for this spring.

2. Dear Dr. Kiely, Are you planning on doing any client dinners over the next few months? K.D.

Dear K.D. We will be holding four client dinners in January, 2009. We had given some thought to doing a few educational seminars sooner than that, but logistical issues proved too great. The earliest date that we could all get together would be between Thanksgiving and Christmas and most clients are too busy during that time to commit to attending a seminar. And since our annual client appreciation dinners are held in January, we don't think there is much need for a seminar in December. Our primary role at this point, in addition to managing your portfolios, is to keep our clients up to date and informed on what is happening in the economy and the financial markets. These are times like no other and people are concerned, since you only fear the unknown. Information is the key at times like this, which is why we've increase our e-mail update frequency to twice per month. FYI, our January dinner schedule is as follows…

KFS CLIENT APPRECIATION DINNERS 2009
Asheville, NC Thursday, January 22nd, 2009
Charlotte, NC Friday, January 23rd, 2009
Sunset Beach, NC Monday, January 26th, 2009
Greenville, NC Tuesday, January 27th, 2009

3. Dear Dr. Kiely, What is your typical day like? B.H

Dear B.H. Since I love my job and view it as my passion, everyday (weekdays & weekends alike) is virtually spent in the same manner. I am a creature of habit and every day begins around 6:30 or 7:00AM. I start by firing up my computer, turning on CNBC/Bloomberg and making some fresh brewed "strong" coffee. I usually spend the first two hours of almost every day reading emails from clients, fund managers, the media, our employees, industry magazines and a number of our peers. It is amazing how many different emails I get from our industry each day…most of which are really good…and most of which are germane to our clients and what we are trying to do with their long term portfolios. Some sources (like Investment News) send out updates four times daily. I could literally read all day… but have pared down my resources to only those that affect our clients and their portfolio's

At 9:00AM I start returning any calls to clients, managers, the media and our firm. On most mornings I have meetings/calls with clients, prospective clients and/or our managers. At 11AM every day, I have a conference call with Katie (On weekends this time varies, but we usually end up talking a number of times over each weekend also). Katie updates me about each office, every client call, various client trades, trade-clearing issues, client questions, and anything else going on at the moment. This is usually the first of many calls to Katie each day. After this call, I usually return client calls and emails. Monday – Wednesday I usually work right through 2PM. On Thursday and Friday

(Continued on Page 12)

things slow down a bit, so I spend early afternoons writing our updates, developing seminars and/or writing newsletters.

Somewhere between 2PM to 3PM each day I go work out (on the stair machine, elliptical trainer or swimming) and grab a bite to eat. I try to read the USA Today and the local paper while I work out. This helps me clear my mind for the evening ahead. On Mondays, I hold office hours and teach Finance at UNCA. I'm home by 9PM and try to return any emails that have come in after 4PM that day. Usually, on one or two nights a week I speak at a local dental chapter, an investment club or a small dinner. Most nights I meet or call clients after their work day. Almost every night, it seems like I'm educating a different part of the economic spectrum. In fact, on Thursdays, Kellie and I like to have a beer at one of our favorite bars and I end up educating people there. Every night before I go to bed, I check emails and scan the news. Some people would call what I have an addiction. I just love what I do.

If you talked to Brownie, Scott or Katie, you would see different daily schedules but equally as busy and committed to what they do. Each of them love what they do and are dedicated to doing the right thing for our clients. For me, it's great to be surrounded by such a fine management team and staff. It allows me to spend my days doing what I love and I like to believe we make a difference. I do take some time to travel, kite-surf and garden…in addition to enjoying a beer here and there…but I still try to maintain the same work schedule even on the road.

4. Dear Dr. Kiely: With so many differing opinions out there, who do you recommend we listen to (outside your firm) when gathering information about finance and the markets? RM.

Dear R.M. As we stated in the newsletter, we think the best way to stay current is to read our twelve monthly email updates and four quarterly newsletters. This provides an excellent base of knowledge for <u>long term investors</u>. I make a point of saying long term investors, because much of the media is focused on the short term. This short term focus creates a sense of urgency, forces you to take your eye off the ball, and this is where investors get into trouble. Outside of our money managers and some of my peers, there are four people you can follow regularly whose advice is unbiased, consistent, and similar to our own: Warren Buffet (who just invested $10 billion in the market) and is the consummate long term investor; Ben Bernanke (our Fed chair) who has written a book on the Great Depression and built a think-tank at Princeton in the early 1990's that focused on market bubbles; Henry Paulson (secretary of the Treasury) and former CEO of Goldman Sachs, when they were the "gold standard" on Wall Street; and Bill Gross of PIMCO (one of our bond managers). Bill Gross tends to be more pessimistic than most (which is actually a characteristic common to most good bond managers) but if you read his comments with the negative bias in mind you will pick up some very valuable information. Remember, most of the mainstream media have no idea what they are talking about when it comes to finance and economics and they have little or no formal training in either. When you listen to people with no training in the field...you do so at your own peril.

5. Dear Joe, What are some basic things we can do in tough markets…so we feel like we're doing something? H.G.

Dear H.G. Good question. The three most important things for investors to do in tough markets like this are: 1) make sure your money is invested in good, solid long-term investments (which we already do for you); 2) make sure you are not forced to liquidate your investments at unfavorable prices to meet cash needs; and 3) remain calm and cope as best you can with the feelings of anxiousness and fear that can come with investing in the capital markets.

Successful investing is a discipline, the value of which is recognized slowly, over a long period of time. Good investing does not depend on luck or clairvoyance. It depends on hard work and the consistent application of a few basic principles: avoid making big bets in any direction; implement changes slowly; stay diversified; and understand what you own. Most of all, you have to maintain the courage to take uncomfortable steps, which sometimes means "buying" while the stock market is down.

6. Dear Dr. Joe, In December of 2007, you wrote an opinion piece about why oil should not be trading over $100. I have to admit as oil increased to $145, I did not believe your message and I encouraged you to buy an oil-based mutual fund for my portfolio when the price was close to $140. Thanks for providing some broad perspective and teaching me to focus on longer term trends. S.N.

Dear S.N. There was no question oil was trading at a price that was speculatively driven and too high to be sustainable. When you have the following four conditions it's almost always possible to detect speculative bubbles.

(Continued on Page 13)

They are: 1) much higher than normal trading volume; 2) very few sellers; 3) rapid price appreciation outside of normal bounds; and 4) speculators dominate the trading volume (up to 85% of the daily trades being executed in oil this past summer were by those with no connection to the oil industry). When these things occur together, it's an almost certain bet that prices are speculatively high. Bubbles can last for a long time, however, so even though we knew oil was overpriced, we didn't know how long the overpricing would last. I am always amazed at how people ignore the obvious. Right now, the stock market is on sale and long-term investors should be diving in and buying stocks. Yet, they would rather buy something overpriced like gold. Ugh! Read on.

7. Dear Dr. Kiely, What do you think about increasing the percentage of our investments in bonds? T.R.

Dear T.R. Sounds like a "reactive" strategy versus a "proactive" strategy. Unless your investment goals have changed and you now need income, I believe selling stock when the market is down and buying bonds (when you don't need income) is counter-productive. Prior to the market dip, I thought stocks looked attractively priced for long term investors. Now that the market dip has occurred, I really love buying into the stock market and all of our managers agree. I have to admit, I have heard a few brokerage firm advisors recommend moving from stocks to bonds last week on TV and over the radio. <u>Their investments licenses should be immediately revoked</u>. As a long term stock investor, you should have a time horizon of at least five years. That said, within three years, I believe a lot of investors will look back at this period and wonder why they didn't buy more. Investors actually have an easier time buying overpriced assets after they have increased to unsustainable levels than buying assets at fire-sale prices… go figure. Our goal as investment advisors is to keep your focus on the long run and avoid listening to the hyperbolic news media. In essence, we want to pare you away from the reactive herd. In the oil question (#6) above, I gave four reasons why we felt we had a speculative bubble in oil. Today, in the stock market we have 1) much higher than normal trading volume; 2) very few buyers; 3) fast price depreciation outside of normal bounds; and 4) up to 85% of the daily trades being executed by those with short term time horizons. It looks like a bubble in reverse to us.

8. Dear Dr. Kiely, Do you still feel confident about the long term prospects for stocks? J.P.

Dear J.P We do…particularly if you include small and mid caps in your portfolio. We know that over time, the addition of small and mid-cap stocks to our portfolios decreases risk and increases returns. When the general media (which includes CNBC and the WSJ) talks about the stock market they are usually discussing the S&P 500, which ignores more than 80% of the stocks which trade in our markets. Thus, their prognostications about the future of large caps only tell part of the story. If you look at the 5-year and 10-year tables inside this newsletter, you'll see why we're excited about the long term prospects of the stock markets. Going back almost 40 years, the trends are virtually the same. Stocks reward long-term investors, but as we've seen recently, the ride can get a bit bumpy from time to time.

9. Dear Dr. Kiely, Can you comment on how your investment advice is aligned with our interests? E.G.

Dear E.G. Where available, every employee in our firm owns the exact same managers and uses the exact same diversification strategies as our clients. We do this for a number of reasons. First, we believe in our managers. Second, we believe in our diversification strategies. Third, we believe we should practice what we preach. Also, when our clients portfolios go down, I feel it three times. I accept the risks of owning a business in this field. However, when markets decrease like they do…our personal portfolio's decrease, our income decreases and the value of our practice decreases. We believe this clearly aligns our interests with our client's interests - which means we clearly understand how you feel.

10. Dear Joe: Why did the market go down when the "rescue bill" was passed? I thought everyone wanted this? This is not the first time I have seen positive news affect the market in a negative way. Why does this occur? L.D.

Dear L.D. This is a great question. Every day the media reports on how the market indexes change. To explain the change, they look at the most obvious issue of that day and assume there is a direct cause and effect relationship. You have to remember, there are so many traders behind the scenes, like private equity funds, hedge funds, mutual funds and foreign investors who trade based on any number of issues…that have nothing to do with the current "rescue bill". Furthermore, the "rescue package" was for the credit and bond markets. So, just because a bill goes through does not mean everything is all better. If fact, one could argue

(Continued on Page 13)

the delay allowed credit markets to seize up more. Of course, there are still a number of unanswered questions like:

1. Who will the Fed buy the assets from?
2. At what price will they buy these assets?
3. How long will they hold the assets?
4. When will real estate prices stop falling?
5. At what price will these assets be sold?

I could go on and on. The "rescue bill" will definitely help the economy out over time, but things won't get better overnight.

A Final Note

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

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

~ Joe and the Gang at KFS

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