



BEHIND THE SCENES

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OPENING THOUGHTS

As we write this year-end newsletter, we are acutely aware of the impact the difficult markets and economy have had on nearly every investor's portfolio. For investors, 2008 was a year for the record books -just not the kind of records we were looking for. It was a year in which only one segment of the financial markets – treasuries – made money, and many believe they are now so overpriced as to constitute a bubble of their own. In addition to unprecedented losses in the stock market, we saw some money market funds which were previously viewed as inviolable safe havens for even the most risk-averse investors - fail. We also saw municipal bonds become worthless, corporate bonds lose as much in value as stocks, and many segments of the global credits markets simply stop functioning for a period of time. Following suit, commodity prices tumbled - led by oil falling more than 70% from its high of just a few months earlier! And finally, we discovered investors with Bernie Madoff had lost untold billions in what looks to be the largest Ponzi scheme in history. 2008 was a difficult year indeed, and we're more than happy to bid it adieu.

Moving Forward

As painful as 2008 was in the economy and financial markets, we can still learn from the experience. First, we must not forget that after recessions, economies invariably recover. Likewise, after steep declines markets bounce back, often dramatically so. But it's also important to remember that these recoveries and bounce backs can take time and that the short run is vexingly unpredictable. However, there are penalties for holding cash and abandoning well

thought out plans in markets like this - and those penalties are potentially huge. Every dark cloud has a silver lining, and the silver lining of this financial mess is that extreme pessimism and panic creates excellent opportunities for rational, patient investors.

If you go back and look at how the history of stock and bond markets behave following severe declines the evidence is compelling, irrefutable, and even comforting. Based on the historical record, the next five to ten years have the potential to be some of the most rewarding in history. But capitalizing on them will require patience and an adherence to sound investing fundamentals. There will be challenges ahead, just as there always are, but the potential rewards could be unlike anything we have seen in decades. Warren Buffet probably summed our views up better than anyone, saying, *"Look at market fluctuations as your friend rather than your enemy; profit from folly rather than participate in it."*

OUR ECONOMIC OUTLOOK

Prior to 2008, we had been forecasting increased volatility in the financial markets for some time. In fact, in 2007 we devoted an entire newsletter to the subject. Then, after the volatile start to the markets in 2008, we felt it would be prudent to provide a handout at our client appreciation dinners in January that reviewed the behavior of returns on stocks, bonds and cash going back to 1926. The table highlighted stock market dips greater than 10% in red and the



Dr. Joseph Kiely

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KFS CLIENT APPRECIATION DINNERS DATES 2009

- ASHEVILLE DINNER**
ASHEVILLE COUNTRY CLUB
Thursday, January 22nd
6:00-8:30 PM
- SUNSET BEACH DINNER**
SEA TRAILS
CONVENTION CENTER
Monday, January 26th
6:00-8:30 PM
- GREENVILLE DINNER**
BROOK VALLEY
COUNTRY CLUB
Tuesday, January 27th
6:30-8:30 PM



subsequent bounce-backs in green. Our goals were simple; 1) provide our clients with a perspective on how markets behave over both the long and short run and; 2) show how dips (some of which can be significant) are part of the investment process, and; 3) reinforce that large market drops are invariably followed by large bounce backs. Looking back, we probably should have done even more in the form of education to prepare our clients for the market contraction that occurred between September 19th and October 10th. Why? Because there is clearly a difference between seeing red numbers on a piece of paper...and actually experiencing them. Classroom education only takes us so far, after which life experience takes over. If nothing else, 2008 provided all of us with an extensive and very educational life experience.

The Credit Crisis Contraction

Looking back at the first part of 2008, it was clear that stock market volatility had returned. However, through August the increased volatility was nothing out of the ordinary. Then, when Lehman Brothers failed in mid-September the floodgates opened. The Lehman collapse produced an abrupt contraction in the worldwide credit markets and kicked off a rapid series of bank failures, bond failures, and a stock market freefall.

At that point two things became clear. First, because of deregulation almost no one, including those at the Treasury and Federal Reserve, understood the magnitude of the role investment banks played in the secondary credit markets. If they had, Lehman Brothers would not have been allowed to fail. Second, it was abundantly clear regulators had failed to keep pace with financial innovation - and - as a result we had no idea how deep and destructive the market for collateralized debt obligations would become.

Fortunately, a series of aggressive, albeit inconsistent, actions by the Treasury Department and the Federal Reserve brought the financial system back from the brink of total collapse. Economists will long argue whether a different approach may have been more effective, but the immediacy of the situation required the Fed and Treasury to act without the benefit of time to thoroughly study each of the options. To their credit, they acted quickly and aggressively, and in turn avoided the worst case scenario of a total collapse of the global financial system. Even so, it is clear many problems and dislocations in the stock, bond and credit markets still exist today.

Where Do We Stand?

The U.S. economy is presently mired in a severe recession that will likely last through most of 2009 and could well linger into 2010. Economic expansion in 2009 seems

unlikely, as consumers continue to tighten their belts and the problems in the housing sector continue to unwind. Unemployment will certainly rise from present levels and credit will remain tight. Lest we sound too negative, however, we believe these dismaying expectations are already priced into the stock market and that in many cases the price reductions have been significantly overdone. In other words, 2009 could well turn out to be a better year for investors than many expect, even if the economy continues to languish. But no matter what stocks do, 2009 will be a year of economic stabilization, consolidation, and little or no overall economic growth. There are signs some stabilization is already occurring, but the challenge for corporations will be to grow in a less leveraged environment. And since corporations are dependent on consumers (or aggregate demand), this task will be difficult, since 60% of all CEO's say they see more layoffs before things start to get better later this year.

The Federal Government

If you watch the news you know that all eyes at this point are focused on the Federal Government. Up to this point, the government's model for stemming the crisis has been to: 1) recapitalize banks; 2) increase capital availability to qualified borrowers; 3) expand assistance to unemployed, underemployed, and lower income Americans; and 4) create jobs. The first two are largely the responsibility of the Federal Reserve, while the final two items will fall largely on the shoulders of the President and Congress.

Federal Reserve Actions

We believe the first \$350 billion spent on TARP prevented a banking collapse and oversight issues aside; it looks to be money well spent - at least in the short run. Over the long run, however, the success of TARP will be measured by the pace of future bank write-downs. If existing nonperforming loans can be renegotiated and if new loans can be made available to qualified borrowers, we could be largely out of the woods on item one. Regarding item two, the Fed's direct participation in the interbank and commercial paper market has been relatively successful thus far, as evidenced by interest rates returning to their pre Lehman collapse levels. Companies are once again able to fund their short term needs, which is absolutely essential to a functioning economy.

In addition, when the Fed recently pledged to buy mortgage-backed debt, long-term mortgage rates came down to 5% and there was an immediate surge in home refinancing. If mortgage rates drop even further, as many



expect, it will go a long way towards stabilizing both the mortgage and housing markets. In fact, existing home sales are already rising in many communities. But the trade-off to low interest rates, as we all know, is the threat of future inflation. At this point, however, inflation is not a big concern. In fact, the Fed is actually far more worried about deflation versus inflation.

The President and Congress

Most people are probably already aware of the new President’s fiscal stimulus plan, the goal of which is to create more jobs and reenergize the economy. The plan proposes to accomplish this by expanding certain benefits and investing in infrastructure. Benefit expansion will come primarily in the form of unemployment benefits and tax cuts. This is one way to increase the “velocity” of money, which is a critical component of a healthy economy. Infrastructure build-outs will have less immediate impact on the economy, but they will help protect endangered jobs in manufacturing and construction. Modernizing roads and bridges, improving medical care, increasing energy efficiency and enhancing education are all admirable goals, but such fiscal stimulus will only be effective if pork barrel spending and special interest politics can be avoided. To that end, strong bipartisan support will be “key” to the Obama plan.

Make no mistake; the massive amounts of monetary and fiscal stimulus being pumped into the economy will eventually have an impact. The decline in economic activity will slow, then it will level off, and we’ll ultimately see signs of a modest recovery. At some point growth will return to “normal.” It’s always been this way. Economies are cyclical by nature and these cycles are often exacerbated by fear and greed, so eventually our old friend “greed” will even begin rearing its ugly head again. There are many who argue that this time is different. They’re right. But no matter how different this cycle is from those preceding it, it is still just a cycle that will grow and contract. Going back hundreds of years the one constant across every business cycle has been the impetus provided by human emotion - namely fear and greed.

In other words, we may not need robust economic growth (or any growth at all) in order to generate positive stock returns in 2009. Given the fear gripping the financial markets late last year and the panic selling it evoked, it may take only a modestly improved economic outlook to move the financial markets up dramatically. Markets overreact in both directions, which is why overreaction on the downside is invariably followed by a significant bounce back on the upside.

INVESTMENT THEMES

The S&P 500 (large company stocks) lost 38.5% in 2008, while the Russell 2000 (small company stocks) lost 34.7%. Notably, most of these losses were contained within a three-week period between the open on 09/20/08 and mid-day 10/10/08. Over just those 15 trading days, the S&P 500 lost 28.2% of its value and the Russell 2000 lost by 37.3%. Since the mid-day low reached on October 10th (just three months ago) the S&P 500 and the Russell 2000 have both continued experiencing high volatility but both have trended upward. To many this may come as a surprise, particularly in the face of the continuing poor economic news, so let’s take a broader look...

Style Box Data

Examining the equity style box data allows us to see how each sector behaves independent of the others. As you know, we prefer to invest in the entire stock market rather than just the large cap stocks followed by most brokers and advisors. As you can see in the following table, from the first of the year through September 19, losses were mostly confined to large cap stocks, particularly those with a growth tilt. Investors often ask how they can become more defensive when investing stocks, and this shows that simply diversifying into small and mid cap value stocks is a good place to start.

Russell Style Index Performance 01/01/2008-09/19/2008			
Value	Blend	Growth	
-12.10%	-13.01%	-14.05%	Large
-5.87%	-10.48%	-14.87%	Mid
4.97%	-0.67%	-6.20%	Small



Following the Lehman Brothers failure in mid-September, the entire stock market went into freefall mode, finally culminating on October 10th. During that pivotal day, the broad market indexes hit lows roughly ten percentage points below where their closing prices ended, thanks to a furious late-day rally.

**Russell Style Index Performance
09/19/2008-10/09/2008**

Value	Blend	Growth	
-29.50%	-28.11%	-26.74%	Large
-33.18%	-32.52%	-31.85%	Mid
-33.91%	-33.70%	-33.47%	Small

From mid-day October 10th through the end of the year, the overall stock market trended upward. In the table below (based on closing prices), you'll see the only indexes that finished the final two and a half months of the year in positive territory were comprised of small and/or value stocks. Overall, our clients' stock portfolios basically mimicked the broader market averages. Over the first eight and a half months of the year, our stock portfolios were off 6% to 10%, depending on specific fund allocations. Over the three week "correction", our stock portfolios were off roughly 30% and then during the final two and of the half months of the year we saw little change in portfolio values overall.

**Russell Style Index Performance
10/09/2008-12/31/2008**

Value	Blend	Growth	
1.91%	-0.21%	-2.23%	Large
-2.13%	-3.09%	-4.04%	Mid
2.45%	0.54%	-1.51%	Small

For the entire calendar year, the style box numbers are obviously not very pretty, falling in line with the declines experienced by the broader S&P 500 and Russell 2000 indexes. Examining the previous three tables, however, illustrates how the vast majority of the damage in stocks occurred over a period of just fifteen trading days - from mid-September through early October.

**1-Year Russell Style Index Performance
ending 12/31/2008**

Value	Blend	Growth	
-36.85%	-37.60%	-38.44%	Large
-38.44%	-41.46%	-44.32%	Mid
-28.92%	-33.79%	-38.54%	Small

The Lost Decade?

The end of 2008 marked the first time the S&P 500 had lost money over a decade since 1941, prompting some to call it the "lost decade" and question the wisdom of investing in stocks at all. Before joining the stampede for the exits, however, it's important to consider a couple of facts. First, in the decade following 1941 the overall stock market averaged a whopping 17.28% gain annually. There is no guarantee we'll see similar results this time, but it does demonstrate the kind of returns that are possible following an extended downturn.

Second, most investors (and even many academics) are unaware that the broad market indexes are constructed using market-cap weighting, where the largest companies carry the greatest weights in the index. As a result, indexes like the S&P 500, Russell 3000 and Wilshire 5000 indexes (the three primary broad-market indexes) are all dominated by the same 100 or so extremely large companies. Any smaller companies in the index carry weights so small as to be inconsequential to index performance. In other words, of the more than 7000 stocks that currently trade on the three major U.S. exchanges, as many as 6900 are not meaningfully represented in any of the broad market indexes. We contend any index that ignores more than 98% of publicly traded stocks can't possibly be a reliable proxy for the overall market, and the following chart illustrates our point.



**Annualized 10-Yr. Russell Style Index Performance
ending 12/31/2008**

Value	Blend	Growth	
1.54%	-0.96%	-3.48%	Large
5.87%	4.08%	0.12%	Mid
8.69%	3.93%	-0.41%	Small

So even though the past decade may not have been stellar, it was hardly “lost” to investors who held well-diversified portfolios. Large company stocks and the broad market indexes did not fare well and lost money over the decade, but most sectors did not. Take a moment to look at our managers 5 and 10 year track records on page 13. You’ll note, the decade was not “lost” if you owned a well diversified portfolios of good money managers. However, because everyone pays too much attention, and owns broad-market indexes like the S&P 500, few actually knew...or experienced it.

Beyond Our Borders

Investors typically look beyond the domestic stock market to enhance returns and reduce risk, but this approach proved ineffective in 2008, particularly over the second half of the year. As investors around the globe sold risky assets and moved to the safety of U.S. Treasury bills, the U.S. dollar strengthened and foreign investments got pummeled. Emerging market stocks declined 51% last year and developed markets weren’t much better, with the Europe Asia and Far East (EAFE) index falling 43%. Of the developed nations only Japan fared better, but they were still off roughly 20% on the year.

Other Financial Markets?

So what about other assets classes like corporate bonds, municipal bonds, commodities and cash? Unfortunately, the damage was not limited to stocks. In 2008 we saw the oldest money market mutual fund in existence fail, while municipal bonds got hammered and some high quality corporate bonds lost as much as stocks did. Commodities also lost money - led by oil’s 70% drop from the highs it had reached just a few months earlier (wiping out many speculators, momentum traders and market timers in the process). Hedge funds were also hit hard, with many losing so much that they were forced out

of business. Finally, investors who trusted their money to Bernie Madoff discovered he was a fraud and lost untold billions in the process.

Lifestyle Funds?

2008 was a brutal year for investors pretty much across the board, even with supposedly “low risk” lifestyle funds racking up big losses. Vanguard, Fidelity and T. Rowe Price currently dominate the market for “Target Date” or “Lifestyle” funds. Basically, these funds allocate money across stocks and bonds based on the year in which you expect to retire. They are designed to protect investors during tough times when the stock market dips, but given that both the stock and bond markets had poor showings in 2008, most lifestyle funds also suffered. Two of the three firms’ most conservative funds (with a target date of 2010) lost more than 25% in 2008. And funds with target dates of 2020 and beyond lost from 27% to 38% of their value, in spite of having significant exposure to bonds in each case.

Market Timers?

A question we often get after the stock market falls is, “Why don’t you pull our money out before the dip and then reinvest it at a later date before the market goes back up?” First, we hope you recognize that we would if we thought we could “time the market”...we would. Second, if we knew of a money manager who could consistently move to cash at or near market peaks and become fully invested at or near market bottoms, every single one of our clients would hold 100% that manager’s fund in their respective portfolios. The history of market timers, however, is not very encouraging. In fact, we’ve never found one with a long-term track record that beats the market averages. The major problem faced by market timers is that, on average, just 10 of the 250 trading days in a given year are responsible for virtually all of the year’s returns. This means a market timer who is in cash during just one or two of those days would likely under-perform the overall market for the entire year. Good luck.

Taxable accounts are another problem for timers because the frequent buying and selling creates a huge amount of paperwork. In addition, if there are gains in a timer’s portfolio during a given year, you can rest assured that they will be realized and hence taxed in that year. Of course, there is also an overwhelming amount of academic evidence that market timers significantly under-perform the overall market, due primarily to the expenses incurred from frequent trading and by being out of the market at the wrong time.



Even though most of the evidence is stacked against “market timers”, some may still be wondering whether there are any market timers that made money last year. That’s a good question and several have been brought to our attention, so let’s take a look.

And the Winners Are?

In a down market you would ordinarily expect market timers to do better than buy-and-hold investors and there are actually a few who did make money in 2008. For example, the Crawford Perspectives newsletter was ranked the top performing market timing letter of the year by MarketWatch, ending 2008 return of 42%. The newsletter’s recommendations are based on technical analysis and astrology (we’re not making this up) and since it appeared to work so well in 2008 we were naturally curious about long-term performance. Well, over the previous ten years MarketWatch reported that Crawford Perspectives lost an annualized 4.7% per year. Ouch....

Another well known market timer who has been on TV a lot lately is Doug Fabian. He earned 15% last year using market timing techniques. Unfortunately, Hulbert Financial Digest places his 10-year record at an abysmal -11% annually. Yes, that’s annually! We’ve also had a few clients ask us about Comstock Partners, a company founded by Charlie Minter and Marty Weiner. These two men run a mutual fund based on their “market predictions.” Last year their fund was up an impressive 54%. However, over the past 10 years the fund has returned just 0.02% per year, including the stellar 54% return last year. Since its inception in 1985 (23 years ago) the fund has returned just 0.92% per year (again, we’re not kidding). Over the same 23 year period the S&P 500 averaged 9.49% annually. Hmmm...

The Lesson?

The lesson is that it is virtually impossible to reliably predict what the market is going to do in the short-term. There will always be those who claim they can, of course, and every now and then they will guess right and have a big year. But even a broken clock is right twice a day. If you go back and check the long term numbers you’ll invariably find that market timing is a losing proposition, just as we have.

Investor Behavior

While we will never claim to be clairvoyant regarding the market in the short-run, investor behavior is another story. As a group, investors exhibit an unflinching preference for overpriced assets compared to underpriced ones. And this preference is so strong that they will absolutely shun underpriced stocks. To illustrate, in the late 1990’s we were criticized for not having more of our portfolios tied up in

technology stocks...until the tech bubble burst. Then in 2003 and 2004 we were criticized for not having more money invested in real estate investment trusts (even though we had published a number of academic papers on REITs and felt they were significantly overvalued)...then REITs fell by more than 60% over the next few years. Last year, as oil prices shot through the roof, guess what? Yep, some clients wanted us to buy oil futures and load up on oil company stocks. We’re not criticizing these clients because it is basic human nature and they were just following the herd. However, we hope you’re starting to see the pattern we’ve been trained to avoid.

Avoid the Hot Hand and Focus on Price

To reiterate, we don’t pretend to be clairvoyant but we have studied enough boom/bust cycles in our lives to know that investors invariably become enamored with what’s hot and loathe buying what’s not. This isn’t to say that when you buy what’s hot it won’t keep going up; or that when you buy what’s not it won’t keep going down. The sheer popularity (or lack thereof) of an asset class can drive the price up (or down) for a significant period of time. Just look at oil last year! Eventually reality will set in - and when it does, the price of the asset in question returns to a level justified by the economic fundamentals. Then those who bought what was hot will discover they paid too much and those who bought what was not will find they got a good bargain. But it can take some time before the final outcomes are revealed and there is always plenty of opportunity for second-guessing along the way. The key is to remember that “**PRICE**” is the single most important determinant of your investment outcomes. When hundreds of companies are trading at prices below their break-up value or the value of the cash they have on hand, you know fear is driving prices and fundamental values are being ignored. Investors who buy at these points may very well find that prices go even lower in the short-run, but eventually rationality will return and stock prices will once again begin to reflect the fair value of the underlying assets.

Our Point

We spend a great deal of our time thinking about how to position our clients’ portfolios over both the short and long run. And we have plenty of incentive to get it right, as our compensation is tied directly to the value of the assets we manage. In our opinion, the best way to diversify a portfolio over time is to allocate your assets across stocks, bonds and cash, with the allocation decision based on one’s time horizon and desired cash



flow needs. We have retired clients who have up to 50% of their portfolios invested in bonds and cash because they have significant short term cash flow needs. During the inevitable dips these clients should have more than enough money in bonds and cash to get them through bumpy periods. And once the stock market recovers we can replenish their bond and cash holdings. Of course, we also have a large number of non-retired clients who have most of their assets in stocks. Why? Because over longer periods of time stocks provide the highest return relative to all other asset classes. This fact is undeniable, and going forward we don't believe it will be much different.

OPPORTUNITIES GOING FORWARD

Since the fixed income markets have been at the epicenter of the financial crisis, let's take a careful look at bonds. Over the past few months we've seen an unprecedented flight to safety, as investors dumped anything risky in favor of Treasuries. This was driven by a loss of faith in credit rating agencies and the financial system as a whole. This behavior has driven T-bill rates to record low yields.

Bond Opportunities

The wholesale flight to safety has driven the prices of some bonds to historic lows and has created what some believe is a once in a lifetime opportunity. Going into 2009, we believe there are three separate opportunities in bonds: 1) Treasury Inflation Protected Securities (or TIPS) look attractive for two reasons. First, our bond markets are pricing in significant deflation given the anemic amount of economic activity, causing a dislocation in TIPS pricing. Second, given the huge amount of fiscal and monetary stimulus, it is likely inflation will return at some point down the road. Given that interest payments on TIPS are adjusted for inflation, it makes these bonds particularly attractive. 2) Investment-grade corporate bonds. Investors are avoiding any type of default risk and this has driven corporate bond prices to historically low levels. In fact, a recent study by Loomis Sayles showed that even if the default rate on corporate bonds were equivalent to that of the Great Depression, they would still experience "stock like" returns over the next five to seven years. Please note that we're talking about high quality companies like Disney, Verizon and IBM, with sound balance sheets, cash on hand, and the ability to wait out a recession. Defaults among such issues are highly unlikely. 3) Global bonds. Although we believe the U.S. will lead the rest of world out of the

economic slump, there are still thriving economies in places like Brazil, with strong economies, lots of natural resources, and thriving democracies. With the global flight to quality U.S. Treasury-bills, we have seen prices of many foreign bonds drop to unprecedented levels.

To take advantage of the dislocations in the credit markets you need a strong stable of bond fund managers, and we believe we have just that. Going forward we intend to increase allocations to areas of the fixed income markets where we feel there are the greatest opportunities.

Stock Opportunities

As we begin the New Year, our outlook for the stock market going forward centers on the following five key points.

1. Recession in the global economy.
2. Corporate earnings will continue to contract with the economy.
3. Volatility will fall, but remain higher than normal.
4. In spite of 1-3, stock valuations are cheap by almost any financial measure.
5. Markets anticipate recoveries long before they actually occur.

The last two points may seem out of place after examining the first three, but strong market upturns almost always emerge out of bad news. In fact, there has been nothing but pessimistic news over the last three months but the stock market is still above its October lows. And while media headlines are full of doom and gloom, they seldom address the most important factor when 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 economy.

Ten Reasons for Optimism

There are actually a plethora of reasons to be optimistic about stock market: First, trillions of dollars are being pumped into economies around the globe, acting as a powerful economic stimulus. Second, interest rates are low and likely to go lower. Third, endowments, pensions, sovereign wealth funds and other asset allocators have to rebalance their portfolios into stocks because they have become underweighted as a result of the sell-off. Fourth, there is a ton of cash sitting on the sidelines in T-bills earning basically nothing. Eventually this money will have to move back into the markets. Fifth, when a company's

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stock value is below the value of the cash the company has on hand, it's hard to go wrong. We may never see prices this low again. Sixth, investors tend to be contrary indicators. Since they have retrenched and pulled back by selling, we think it's a good time to get in. No less an authority than Warren Buffett has advised against the temptation to sell. We agree. Seventh, reaching a five-year low in the stock market (as measured by the broad CRSP stock market index) is a fairly rare event. In fact it has only happened five times since 1926. And each time the subsequent five year annual return (as measured by CRSP) averages out to 20%. The market behavior in 2008 has followed the general pattern observed the previous five times. Thus, a bounce-back seems inevitable. Eighth, history has taught us that the biggest gains for small caps come when you're pulling out of a recession. That's good news because we feel like we have some terrific small cap managers. Ninth, history also shows that the biggest gains in the market come when pessimism reaches its highest levels. If we're not there yet we have to be close. And tenth, as a long term investor with at least a five year time horizon the odds are overwhelmingly in your favor.

Our Take

We have no doubt that there will be significant challenges going forward. However, there are also some once in a lifetime opportunities in a number of areas for those who remain patient. The key is in finding good stock pickers who can uncover the best bargains. We spend a great deal of time pouring over the track records of mutual fund managers and only the most consistent performers wind up in your portfolio. One of the most important traits we look for is a manager's performance following market dips. During bounce-backs our managers' numbers are all very impressive. In fact, all one has to do is go back to the first half of this year to see what we mean. Following the January dip our managers bounced back so well over the following five months, that our mid-year numbers versus the benchmarks were as good as they've ever been. We believe this bodes well for our clients going forward.

10 QUESTIONS WITH DR. JOE

1. Dear Dr. Kiely: In the past you have provided a list of investment professionals whose opinions you respected. Outside of the more popular Wall Street names, who else do you like? J.H.

Dear J.H. I try to read as many opinions as I can - including dissenting ones. Here are three guys I read religiously. In the bond arena, I look for anything written by Dan Fuss. He is the vice chairman of Loomis Sayles & Co. and his analysis is usually spot-on. Fuss, like a number of bond professionals believes bonds are as attractive now as he has seen in at least 50 years (he's been managing money a long time). To quote him "I've never seen an opportunity - relative or absolute - as good as this, in the investment-grade bond market". In the stock market, I really like Robert Turner of Turner Investment Partners. I like his writing style as he uses great analogies, which is paramount if you want to be a good educator. Today, he believes the stock market is severely oversold and he is always bemoaning the fact that most investors are really "speculators with short-term time horizons". I couldn't agree more. Finally, I like the analysis of Dr. Jeremy Webman. He is the chief economist for the Oppenheimer funds. We refuse to use Oppenheimer funds because of high loads and fees, but I don't hold it against him. His economic analysis is always thorough and full of commonsense. Of course, any time I get a chance to see Bernanke speak...I listen. We are fortunate to have such a fine Fed Chair.

2. Dear Dr. Kiely: What are your thoughts on Fed Chair Ben Bernanke and Treasury Secretary Henry Paulson? Most of my friends are unimpressed and the media has been particularly tough on them...what are your thoughts? L.S.

Dear L.S. Over the past few months, the media has second-guessed every decision made by the Federal Reserve and the Treasury Secretary, as they have been busting their humps to increase capital flows, regulate markets, and stimulate the economy. I believe the media has clearly influenced the average person's view of our two leading regulators...in a negative light. Some believe they have done a poor job, but the fact that the market is positive over the last three months would say otherwise. We believe the Fed and the Treasury have both done a better than average job (an "A-" for the Fed, "B" for Treasury) in an extremely tough environment. They have

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made mistakes, to be sure, but overall they've helped avoid a situation that could have been far worse. One of their biggest problems is that they've done a poor job explaining their strategies to the "Average Joe", which includes Congress and the media. The average market "expert" has given the Fed a "B" and the Treasury a "C".

3. Dear Dr. Kiely, What do you think about gold as an investment? D.F.

Dear D.F. Not much. Gold is a highly speculative investment that has increased from \$271 an ounce in 2001 to \$1,023 an ounce in March of last year. To me, it's screaming "bubble". Prior to 2001 it dropped for 21 straight years from an approximate inflation-adjusted level of \$1,500 an ounce in 1980 to \$271 an ounce. Gold is not vital to human existence and has relatively few practical uses. If you would like to read a great article on gold, please purchase the most recent (January) National Geographic. The article is at the very least...eye-opening. We believe investments should generate cash flows and gold is obviously a non-earning asset. In fact, since it costs you money to store it, it actually generates a negative cash flow.

4. Dear Dr. Joe, Do you really think most investors in the stock market are long term investors? If not, do you think that hurts us investors who see the light and are in it for the long haul? P.B.

Dear P.B. I briefly answered the question above, but let me elaborate a bit more. Academics have always known investors fall into three basic categories when it comes to investing and their time horizons. This year basically crystallized these previous notions. Many investors – most of them – focus on the very short term of the stock market, which is a matter of months. This means they focus their efforts on things they can't control and often look for data which validates their pre-conceived notions. Studies overwhelmingly show these investors tend to get the lowest returns over time. The second set of investors, take a slightly longer perspective, where a few years or a market cycle may define their view. They are not as impulsive as the first group, but their returns tend to be lower than those who develop a long term plan and stick to it. Finally, the very smallest of group of investors look at the stock market from the vantage point of five years and beyond. These observations are validated by cash flows into and out of the stock market over time. This year, we saw the greatest sale of stock mutual funds in October and November...right after the stock market hit its first bottom. Rational, long term investors should have done the opposite. Over the short run, the impatience of short-

sighted investors drives prices lower, which is fine with us because we like an occasional sale. So, yes, I believe most people are short-term focused and have very little patience. In the long run I don't think it has hurt us. In fact, it probably helps us. Finally, I feel like most of our clients fall in the latter group. I hope our educational efforts play a role in that.

5. Dear Dr. Kiely, What are your thoughts on Madoff? K.D

Dear K.D. Obviously, I don't think much of him and his story certainly doesn't do much to help our industry. Most people in our industry are good individuals trying to help people manage their financial futures. Madoff was obviously an immoral, selfish individual who was only thinking about himself. The thing that is so fascinating to people is not necessarily what he did, but who he duped. The bulk of Madoff's clients were rich, successful people. In our office we think about due diligence and transparency continuously. Last month we wrote an update about why this type of thing will never happen to our clients. However, 90% of all people pick an advisor based on trust - and those same people usually do not do enough due diligence in selecting an advisor. In any relationship, you shouldn't be afraid to trust...but you also have to verify!

6. Dear Dr. Kiely, I saw you speak at a local event and you mentioned how volatile the markets have been. Can you provide some perspective for just how volatile the markets have been? H.W.

Dear H.W. As much as I would like people to relax and focus on the long term, I also understand why they are on edge. Although most of the market drop this year was contained within a three week period, the volatility that accompanied it was unprecedented. Going back to 1950 we have had only 11 trading days where we experienced a 5% single-day drop in the market...until 2008. In the last three months of 2008 we had a remarkable 10 days where the market fell by more than 5%. This kind of volatility clearly shakes the confidence of investors. Thus, even though our markets have generally trended sideways to upward since the big sell-off, the magnitude and frequency of the drops increased the anxiety of already nervous investors. Of course, you can be sure the media did their best to play up the fear and panic. Jeez...



7. Dear Dr. Kiely, This is a group message. You manage a decent number of accounts in our retirement community. Over the past year, we have appreciated the additional updates, the pro-active correspondence and the professionalism your entire staff has shown. We feel confident your commonsense strategies can guide us through this period. Thanks from all of us. J.T.

Dear J.T. Thank you from all of us at KFS. Again...we are acutely aware of the impact the difficult markets and economy have had on nearly every investor's portfolio (and psyche) in 2008. We think about it every day. It's definitely a team effort and I couldn't be happier with their efforts over the past few months. When you work with a team of people you generally find out more about them during bad times versus good. At KFS, nobody panicked and everyone went above and beyond the call of duty to service our clients' needs. We are by no means perfect at what we do, but we love what we do and each and every employee of the firm values our clients above all else. Going forward, I strongly believe the lessons learned in this market and economy will make all of us better people and better investors.

8. Dear Dr. Joe, I am amazed at the number of people in my office who are petrified of the stock market. Most of them will never have enough to retire. They feel like the deck is stacked against them. What can I do to help them? B.C.

Dear B.C. Knowledge is power. I believe anyone can invest correctly if they are exposed to the appropriate education and information. My father, who believed an education was the most important thing you could earn, used to always say "there is information...and there is useful information." Then he would point out that 96% of all people put peanut butter on first when making a peanut butter and jelly sandwich. And then he would smile. The problem with many people is they are not exposed to enough education and thus they are not exposed the right information. We are doing a number of educational seminars in Ocean Isle (January 25th and 26th), Asheville (Mid-February and March) and Greenville (TBA) this quarter. We will outline these seminars at our dinners. Attending one of these would be a good start for your peers.

9. Dear Dr. Kiely, When you look back into the past, who do you think is to blame for the credit crisis and the following market meltdown? M.P.

Dear M.P. Looking back, I don't believe any one person and/or group is to blame. Honestly, there's plenty of

blame to go around, but I don't think it's appropriate to point fingers. I do think it's important to understand what happened, so we can prevent this type of event from happening again. First, there were a number of people and/or groups who helped create the perfect conditions for this to happen. Then there were a group of people/companies who used those conditions to push questionable products. Finally, there were a number of groups who were supposed to act as watchdogs to prevent bad behavior and/or provide fair market conditions. In each case there were breakdowns. Here is a list of the various groups and people who played a role... some unintentionally...and in no particular order. Investment Bankers, Alan Greenspan, the Federal Reserve, Rating Agencies, Predatory Lenders, Clueless Borrowers, Congress, George W. Bush, Bill Clinton and a bunch of Regulatory Agencies. It was a perfect storm...of sorts.

10. Dear Dr. Kiely, I recently read that Required Minimum Distributions (RMD's) from IRA's have been canceled for 2009. Is this true? S.R.

Dear S.R. It is true. This calendar year, RMD's are not required to be taken on your retirement accounts. We also believe other tax related measures will be passed and we'll provide updates on these as they occur via our website, e-mail updates and future newsletters.



UPDATE ON KFS

Recent Happenings at KFS

Over the past few months, a lot has been going on. On the educational front, we are currently in the process of revamping our entire website and building a virtual university that will be focused on the fundamental concepts of investing. During the upcoming client dinners in January we will unveil this work-in-progress for you to review and comment on. Since this website is being designed for your benefit we want this to be a collaborative effort. We need and value your feedback on the project! Our hope is to have it up and running by February 1st.

In addition, we will start writing a regular blog-like column dealing with a variety of topics related to finance, investing, and the economy. A number of clients can't get enough of our regular e-mail updates, while others think we write too much. As a result, we believe a regularly updated blog will provide a good solution for both groups. We will send fewer e-mail updates but will frequently post thoughts, comments, and answers to client questions on the web. We have even more website-related news, but we'll save that for the newsletter and client dinners.

On yet another note, we will once again begin doing regular five and six-week educational seminars. During trying times like this we believe it is particularly important to provide investors with access to sound, evidence-based financial advice. We plan to hold seminars in Asheville, Sunset Beach, Greenville and Hendersonville. If you have a conference or group that you'd like us to speak at, please let us know.

Finally, Scott and I are in the early stages of writing a book on investing. This has been in the planning stages for some time, but this year it will finally become a reality. We'll share bits and pieces of the book as we go along and as always, we look forward to your feedback and value your input.

On a personal note, Brownie and his wife Donna welcomed in a beautiful new granddaughter on January 8th! Katie turned the ripe old age of 30 on January 13th! Kellie has been featured in two future articles regarding the KFS "Pay-it Forward" community service program. Last but not least, Scott and Joe are excited about another new semester of teaching at ECU and UNCA. Congrats to all!

A FINAL NOTE

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

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

Enjoy 2009 - let's hope it will be a better year than 2008.

~ Joe and The Gang at KFS



The KFS Gang (Left to Right): Brownie Cordell, Katie Burr, Joe Kiely, Kellie Kiely and Scott Below

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

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