

# KIELY WEALTH ADVISORY GROUP, INC.



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

## BEHIND THE SCENES

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### OPENING THOUGHTS

Given the unusually cold and snowy winter we've been enduring, we hope this newsletter finds you inside by a fire with a nice warm drink. We find ourselves anxiously counting down the days until spring and we take solace in the fact the snow will eventually give way to beautiful spring flowers. However, even though the weather has been lousy, the financial markets have been terrific - a trade-off we'll take every time. Just two short years ago, panic was rampant in the financial markets and many investors had serious doubts about whether their portfolios would ever recover. Fast forward two years and those doubts have eased significantly, although many concerns still exist (as evidenced by the large number of investors who remain sitting on the sidelines in cash). The concerns are understandable, as the psychological impacts of major market downturns can last for years or even decades. That's too bad, because this rally has been one of the most powerful on record and many investors who were scared out of the market following the downturn have remained on the sidelines throughout. Fortunately, our clients have remained fully invested and have thus benefited from what may wind up being the biggest rally we've experienced since World War II.

#### The "Media" Disconnect

At the beginning of 2009, we began discussing the "disconnect" between investor

perceptions and the economic realities. Our initial focus was on the disconnect between perception and reality as promulgated in the media. We believed the irresponsible histrionics displayed in the financial media was detrimental to the psyche of investors, inducing many to make emotional (as opposed to rational) decisions. In our writings, we made certain to stress that journalists are in the advertising business not the truth business, and that their audience grows in proportion to the amount of sensationalism they can cram into a "news" story. Unfortunately, sensationalism does have a cost, not the least of which is intelligent discourse. Information that is intentionally manipulated or distorted in order to gain market share can do tremendous harm to the investors who act on it. We wish the hyperbole and fear-mongering would simply stop, but recognize it's now a permanent part of the investment landscape. This is something investors will need to learn to recognize and deal with, if they want to prosper over time.

#### The "Global" Disconnect

As the recovery continued through 2009, another disconnect we focused on was the global disconnect. It was obvious, that many investors were having trouble disentangling the health of the domestic

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economy from the performance of U.S. corporations. We absolutely believe that a strong, vibrant domestic economy is important. However, investors need to recognize that the global economy is now the engine that drives corporate earnings. Because we have an extremely diverse global economy, U.S. corporate earnings have remained strong in spite of a somewhat anemic domestic economic recovery. We recognize that some people are uncomfortable with the rapid pace of globalization, but globalization is here to stay and it now plays a critical role in the performance of our portfolios. Capitalism is literally like a virus – a good virus – which is spreading rapidly across our globe to the benefit of corporations everywhere.

### **The “Bond” Disconnect**

In this newsletter we’re introducing yet another important disconnect that exists, this time in the bond market. Investors largely view the bond market as a homogenous entity and expect all bonds to behave similarly. However, this view couldn’t be further from the truth. Understanding the differences between the wide variety of bonds and bond funds is critical, particularly when confronted with the rising interest rate environment we’re faced with today. In fact, these differences have shaped a fairly significant shift in our fixed income strategy, which we will discuss in detail later in this newsletter.

## **A REVIEW OF THE PAST TWO YEARS**

In our year-end newsletters we typically review the performance of the financial markets over the previous year. This time, given the significant downturn that occurred in late 2008 through early 2009, we thought it would be better to look back over the previous two years instead. Extreme market events don’t happen very often - for which we can all be thankful - but when they do occur it’s important to gain as much insight from them as possible. Most investors know financial markets tend to be fickle and notoriously hard to predict. Yet the periods following extreme market events are rare exceptions to this rule. While no one has the ability to accurately and reliably predict the timing of extreme events, we can predict exactly how investors will react once these events have occurred - and with relatively high precision. This is because extreme downturns are invariably characterized by high levels of fear and panic, which trigger the human flight response and foster the indiscriminant selling of financial assets like stocks and bonds. While that’s bad for the

financial markets overall, for savvy investors it also creates opportunity. As asset prices get driven down below fair and reasonable levels, many good deals emerge. Unfortunately, studies show that most individual investors are unable to capitalize on these opportunities, largely because they remain paralyzed by fear until long after the opportunities have disappeared.

### **January 2009 Newsletters & Dinners**

Many of you probably remember our dinner presentations, newsletters, and e-mail updates from two years ago. We certainly do. Everyone was extremely concerned - and with good reason. The stock market and economy had taken a serious hit; the financial markets were gripped by fear and extreme volatility; and journalists were doing everything in their power to convince us we were entering the next Great Depression. Knowing how investors tend to behave during extreme market events, we recognized that our most important job was to keep our clients from panicking and selling out - and because emotions were running high we knew it would be a significant challenge. As a result, we broke out the biggest weapon in our arsenal - education. Knowledge truly is power, and we hoped that by sharing the findings of the large body of academic research on investor behavior during market panics, it would help our clients overcome the innate flight response that dooms so many investors to selling out near market bottoms.

### **January 2009: Look at the Price!**

In our January 2009 newsletter, we focused on two primary themes. First, we stressed that the credit crisis was contained and, although it would be some time before things returned to normal, we had averted a credit market collapse and things were beginning to improve, albeit slowly. Second, we focused on the most important aspect of panic-driven selloffs - asset prices. We wrote, “...there has been nothing but pessimistic news over the last three months. And while media headlines are full of doom and gloom, they seldom address the most important factor 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 economic recovery”.

Then we went on to provide ten reasons for investors to be optimistic going forward. These included:

1. The trillions of dollars that were being pumped into economies around the globe.
2. Interest rates that were already near historical lows and likely to go even lower.

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3. The fact that endowments, pension funds, sovereign wealth funds and other asset allocators would have to rebalance their portfolios into stocks because they had become underweighted during the sell-off;
4. The trillions of dollars sitting on the sidelines in cash, earning next to nothing, which would eventually have to be reinvested.
5. The record number of companies that were trading at stock valuations below the value of the net cash they had on hand (called trading at “negative enterprise value”), which in theory should never occur and never lasts long when it does.
6. The fact that individual investors, who tend to be very good contrary indicators, were still leaving the market in droves.
7. That hitting a five-year low in the stock market was a fairly rare event and that each time it had occurred since 1926, the subsequent five-year period saw stocks return an average 20% annually.
8. The tendency for the biggest gains in small cap stocks to occur when the economy was coming out of a recession (which was good news because we believe in significant exposure to small cap stocks and felt we had some terrific small cap managers);
9. That the biggest rallies in the stock market had historically occurred after pessimism had reached its highest levels, and if we weren’t there yet we had to be pretty darn close.
10. If you are a long-term investor with at least a five-year time horizon, the odds of success are overwhelmingly in your favor.

In a nutshell, we felt pretty confident about where the long-term prices of stocks and bonds were headed. But given the levels of fear and panic we saw, we had no idea how long it would take before asset prices began to recover. We also knew that once prices began to bounce back, things could happen very quickly. As a result, we believed it was critical to keep our clients both fully invested (in order to capture the benefits of the upturn once it did occur) and positioned properly (in order to maximize the impact of the inevitable rally).

**2009 – Client Communication**

We followed our January 2009 newsletter with a number of meetings, calls and e-mail updates where we outlined why we believed the biggest challenges facing investors going forward were going to be psychological. Our main goal in 2009 was to get people to stop investing

by looking in the rearview mirror and focus instead on the task ahead. There was no way we were going to change what had happened that previous October, so we had to get people focused on the future...again. With this in mind, we thought it was important to provide a series of tables that examined typical “dislocations” in pricing that exist during periods of extreme volatility. We felt confident, that if investors could maintain a longer-term perspective, they would be handsomely rewarded over the next three to five years. As it turned out, the rewards were realized much faster than we expected.

**THE STOCK MARKET**

This market recovery has basically followed the general theme we described two years ago. First, we noted that fear had driven stock prices to absurdly low levels, which we knew could lead to a rapid recovery since large declines are typically followed by powerful rallies. Second, in a typical recovery, we said that mid and small cap stocks tended to outpace large caps by wide margins. Third, we noted that safe-haven bonds (i.e. Treasuries and Treasury-equivalents) tended to significantly underperform stocks during recoveries. Finally, we pointed out that as economies recover from recessions (especially financially-driven recessions) there tended to be a marked absence of inflation. Remember, this was written in early 2009, before the recovery began. So now let’s examine what actually happened in 2009 and 2010.

**The Numbers**

As we alluded to earlier, this recovery has been quick and powerful. In the fourth quarter of 2010, for example, the S&P 500 index (large-cap stocks) rose 10.2%, while the Russell 2000 (small-cap stocks) was up 15.9%. Over all of 2010, the S&P 500 was up 12.8% and the Russell 2000 grew 25.3%. Over the two years ending December 31, 2010, the S&P 500 was up more the 40%, with the Russell 2000 increasing more than 60%. From the market-low reached on March 9, 2009, the S&P 500 has increased over 90%, while the Russell 2000 has increased more than 130%. Two years ago, many were convinced that the markets would never again reach pre-recession levels. At the end of 2007 (well before the mortgage market collapsed in late 2008), the S&P 500 index closed at 1,468.36 and the Russell 2000 index closed at 766.03. Today (as of this writing), those indexes stand at 1293.24 and 807.57, respectively. Enough said...

**The Style Index Numbers**

By the end of 2010, all nine Russell style indexes had increased by double digits for the second year in a row! Overall, small and midcap stocks performed better than their large cap counterparts in 2010, while the differences between value and growth stocks were mixed. In terms of the individual indexes, small cap growth led the way, but each of the individual small and midcap styles turned in excellent performances. Not surprisingly, the pattern of performance we saw in 2010 is typical of an economic recovery, with small and midcap stocks outperforming large caps by a substantial margin.

<b>1 Yr. Russell Style Index Performance through 12/31/2010</b>			
Value	Blend	Growth	
15.51%	16.10%	16.71%	<b>Large</b>
24.75%	25.48%	26.38%	<b>Mid</b>
24.50%	26.86%	29.09%	<b>Small</b>

If we examine style box performance over the previous two calendar years a similar pattern emerges, with small and mid-cap stocks continuing to outperform large caps by a significant margin. As we've often mentioned in the past, this pattern is typical of economic recoveries. That said, the rebound we've seen in stock prices has been nothing short of remarkable and is a testament to the innovative nature and resiliency of American corporations.

<b>2-Yr. Russell Style Index Cumulative Return through 12/31/2010</b>			
Value	Blend	Growth	
38.25%	49.11%	60.14%	<b>Large</b>
67.42%	76.27%	84.89%	<b>Mid</b>
50.12%	61.32%	73.58%	<b>Small</b>

If we go back and examine the last decade, the differences between styles become even more pronounced. Small and midcap value stocks averaged annual double-digit

gains over the decade, and were followed closely in performance by small and midcap blend stocks. At the same time, the average annual return on large growth stocks over the decade was essentially zero. It's difficult for us to make a better argument for diversification into mid and small cap stocks than the table below. On average, the three large-cap indexes returned 1.93% annually over the decade, while the average across the six small and mid cap indexes was 8.26%, equating to an advantage for the little guys of 6.33% per year! If you compare the performance of an equally-weighted WELL DIVERSIFIED nine-box portfolio to an equally-weighted large-cap only portfolio, the well diversified portfolio outperforms by 4.22% annually. Finally, if you include active management and proper rebalancing, the last decade was clearly NOT lost for investors who have followed the common sense investment strategies that we have pioneered.

<b>10-Yr. Annualized Russell Style AVERAGE return ending 09/30/2010</b>			
Value	Blend	Growth	
3.78%	1.99%	0.02%	<b>Large</b>
11.73%	8.84%	3.59%	<b>Mid</b>
12.44%	8.48%	4.49%	<b>Small</b>

**Our Take**

By virtually any measure, individual firms are healthier today than they were even before the recession began. They are more productive, more competitive, are posting higher profit margins, and are growing revenues at rates that continue to surprise economists and market analysts on the upside. While the media has focused on high domestic unemployment and weak GDP growth rates, firms are sticking to their strategic game plans and expanding their businesses into the lucrative, higher-growth overseas markets. They're also using the record-low interest rates to their advantage by raising investment capital more cheaply than at any time in our history, adding even more fuel to the recovery.

Unfortunately, most individual investors appear unfazed by the strong corporate profitability numbers and the resurgence of the markets - and have pulled money out of stocks for 24 consecutive months! This has left the



lion's share of the gains to the "smart money" - i.e. institutional investors and our clients.

While there is still a lot of room for economic improvement, we're pointed in the right direction and the vast majority of economic trends are positive. Of course, many will continue to dwell on things like the high unemployment rate and use it to characterize our country's prospects, but we've been saying all along that jobs are the last thing to recover in recessions, particularly credit-driven recessions like this one. So while we hate that a significant fraction of the country's population is out of work, we don't believe the domestic economy is a significant impediment to the profitability of the firms we invest in.

## THE ROAD AHEAD: THE BOND CONUNDRUM

Even though we believe the stock market will continue to outperform bonds for the foreseeable future, we think bonds should still play a role in almost everyone's portfolios. If you stay abreast of the financial news, it will come as no surprise that most analysts and economists expect bond investing to be both riskier and less lucrative than normal over the next several years. We agree, and have been echoing these same sentiments for over a year now. In fact, we recently altered our firm-wide fixed income strategy in light of the bond market environment we currently face. However, before we discuss how to deal with the challenges ahead, it's important to first look back at how we got where we are today.

### Basic Bond Pricing 101

If you're a student of asset-class returns, you know that the environment for bonds over the last ten years has been one of the best in history, with bonds generating equity-like returns and outpacing large-cap stocks by a substantial margin. However, because the bond rally was built on the back of steadily declining interest rates - as virtually all bond rallies are - we also recognize that it's unsustainable. The logic is simple and the facts are undeniable. Interest rates have reached bottom and will go up. Since interest rates and bond prices always move in opposite directions, this bodes poorly for bond investors who stand pat. But we're once again getting ahead of ourselves. Before delving into strategies for dealing with the "new normal" bond environment going forward, we first need to finish examining the bond environment of the recent past.

### Panic Presents Opportunities

Even though the last decade was excellent for bonds overall, it's important to understand that even the best bond markets are not without their challenges. For example, you may recall that in late 2008 many of the nation's largest investment banks, insurance companies, hedge funds, and commercial banks were forced to liquidate their extensive bond holdings in order to offset the billions of dollars they had lost in the sub-prime mortgage market. This created what was essentially a fire sale in bonds, with most of the bond market's biggest players attempting to beat one another to the exit. In turn, the flood of forced-selling by these large financial institutions touched off a tidal wave of panic selling across the global fixed income markets unlike anything we'd ever seen. Every type of fixed income security (with the exception of T-bills) was indiscriminately dumped by investors, driving bond prices down to absurd levels. Watching a market meltdown of this magnitude can be frightening. However, where there is fear there is also often opportunity. The world's largest financial institutions were being forced to liquidate high-quality assets at unheard of prices or face insolvency. This created a rare David and Goliath opportunity where astute investors could, for once, turn the tables on the Wall Street behemoths and profit from their greed and self-indulgent excesses. What we saw in late 2008 and early 2009 will surely go down in the annals of bond investing as one of the greatest buying opportunities of all time.

### Opportunity Meets Action

In late 2008 (after pinching ourselves repeatedly to make certain we weren't dreaming), we began developing a strategy to capitalize on what we saw happening in the bond market. We decided early on to focus primarily on corporate bonds, as they appeared to possess the most attractive combination of sizable upside potential with limited downside risk. So, in early 2009, we began increasing our exposures to corporate bonds using funds like Loomis Sayles Strategic Income Fund (NEFZX) and Calamos Convertible Bond Fund (CCVIX). At the same time, we began cutting back on allocations to bond funds that held no corporate bonds, such as the Vanguard GNMA Fund (VFII).

As we stated in our newsletters and updates of the time, we felt a reasonable expectation for our strategy would be able to generate equity-like returns on the order of approximately 9% annually over the subsequent five years. Equally important given the worrisome nature of the stock market, we felt we could generate these



returns with very little downside risk. We're pleased to report that the results have far exceeded even our most optimistic forecasts.

### **The Bond Numbers**

In 2009 alone, NEFZX returned more than 39% while CCVIX returned 34%, with both significantly outpacing stocks. At the same time, the fund in which we had pared back allocations, VFIIIX, gained just 5.29%. We need to stress that no one could have predicted returns of this magnitude over such a short period of time, especially in bonds. In all honesty, we would have been very perfectly happy to achieve our original 5-year projection of 9% annually. We never expected to nearly eclipse our five-year target in just twelve months - but it's a surprise we've happily tolerated.

### **One Final Push**

Entering 2010, the bond market had largely stabilized and bond prices had, at least for the most part, returned to normal levels. The easy money in bonds had largely been made and we said as much in our first-quarter 2010 newsletter. But good fortune continued to smile on bond investors and interest rates continued to fall through most of the year, driving bond prices even higher. The result was another excellent year in bonds, with NEFZX and CCVIX finishing the year with total returns of 13.5% and 10.8% respectively. At the same time, our more conservative bond funds also turned in some very respectable numbers, with PIMCO Total Return (PTTRX) gaining 8.83% and Vanguard GNMA Fund (VFIIIX) gaining 6.94%.

## **NEW CHALLENGES IN 2011**

Unfortunately, with interest rates where they are today, we believe the likelihood of generating above average returns in conventional bonds over the next several years is virtually zero. The undeniable fact is that, as the economy recovers, interest rates will rise...and rising interest rates will drive bond prices lower. As a result, we all need to accept that the days of stellar returns in bonds are gone, at least in the near term. More importantly, we need to comprehend - and maintain a healthy respect for - the potentially devastating risks bond investors can face in rising rate environments. That is why we believe it is critical for fixed income investors to shift their focus from the wealth accumulation mode of the past several years to one of wealth preservation; at least into the foreseeable future.

### **Flexibility is Our Friend**

We should also point out that our fund managers understand the hazards posed by rising interest rates and are managing their portfolios accordingly. Yet, the portfolio construction mandates of bond funds vary widely, affording some managers more leeway in their investment options than others. As a result, we believe it is imperative to adjust our fundamental fixed income strategies and reconfigure our core bond portfolio allocations in order to provide for more flexibility within our portfolios, and to best meet each client's unique investment objectives. In some cases, a client's investment objectives may dictate a very conservative approach, while in others it may be appropriate to accept the increased volatility of alternative bond investments in expectation of generating higher long-run returns. It is important to note that the fixed income portfolios of each KWAG client are based on their own personal investment needs, objectives, and risk tolerances - and no two clients are identical in this regard.

### **Using Experts is Key**

There are a variety of strategies bond fund managers can employ to help mitigate the risk of rising interest rates and these vary according to the makeup of the investment constraints of the funds they manage. For example, each of our bond managers has shortened the average maturities of their portfolios during the past year because it is one of the most effective ways to reduce the risks of rising interest rates. To the extent possible, our managers have also been diversifying their portfolios into areas they believe will be less sensitive to rising interest rates. In some cases this may mean diversifying internationally, while in others it might take the form of moving away from U.S. Treasuries and into high-yield or emerging markets bonds (like Loomis Sayles Strategic Income - NEFZX). But no matter the strategy, all our managers have dealt with rising rate environments numerous times. And if you examine their performance history closely, you will find each of their track records over such periods to be exceptional.

Nonetheless, each manager faces a different set of investment constraints and, because we believe a rising interest rate environment favors greater flexibility, we have adjusted our allocation strategies accordingly. This decision was not made lightly and we should point out that it is not dissimilar to the strategy adjustment we made in 2008 in order to capitalize on the massive bond selloff. This time, however, the rationale for the shift is defensive in nature rather than offensive.

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**New Funds and New Allocations**

The biggest change most clients will see in their fixed income portfolios will be associated with PIMCO Total Return (PTTRX). In response to the interest rate environment, PIMCO has developed a more flexible alternative called PIMCO Unconstrained Bond Fund (PFIUX). In contrast to PIMCO Total Return, the new fund has the freedom to go almost anywhere in order to eliminate – and potentially even profit from – the risk associated with rising interest rates. After much thought and deliberation, we have decided to largely replace PIMCO Total Return with the PIMCO Unconstrained fund in our existing client portfolios. The manager of PIMCO Unconstrained Bond fund is Chris Dialynas, and we admit that the prospect of moving money away from the legendary Bill Gross did give us pause. However, while Dialynas may not be a household name, he is one of PIMCO's great intellects and has been with the firm for more than 30 years. He works alongside Bill Gross and other PIMCO stars on the firm's investment committee and the ideas generated by that committee drive the new fund's strategies. In other words, PIMCO Unconstrained Bond fund provides an opportunity to capitalize on the best ideas from PIMCO's unmatched fixed income research staff, which we find both appealing and comforting in such a challenging environment.

**Flexible Bond Strategies**

The biggest difference clients will notice between the new PIMCO fund and the venerable Total Return lies in the flexibility afforded to the manager. The unconstrained fund can hold large amounts of cash if conditions warrant, or even bet against the bond market, and it can also hold as much as 50% of the fund's assets in high-yield and emerging-markets debt, with no limit on the fund's non-U.S. holdings (although the fund won't typically take on more than a 35% exposure to other currencies). The objective of the fund is to provide good returns with low volatility in any environment, which we think makes it particularly attractive at this juncture. In terms of risk, PIMCO believes the new fund will actually be less risky than Total Return. In their own words,

*“The Fund is designed to offer the traditional benefits of a core bond fund – capital preservation, liquidity and diversification - but with the potential to mitigate downside risk to a greater degree than what is reasonably possible from a traditional active fixed income management approach...”*

Modifications to most clients' portfolios will be limited to swapping PFIUX for PTTRX and adding back some exposure to the Vanguard GNMA Fund (VFIX), which we have begun moving back into due to the fund's very conservative, low-risk approach. We will also be adjusting the holdings of Loomis Sayles Strategic fund (NEFZX) as needed, in order to maintain well-diversified fixed income portfolios.

**An Alternative Strategy**

Another addition to the KWAG fixed income arsenal is an exchange traded note (ETN), run by JP Morgan, which tracks the Alerian Master Limited Partnership index. The JP Morgan Alerian MLP Index Fund (ticker: AMJ) invests in an index containing a wide variety of oil and gas pipeline MLPs. Individually, MLPs are difficult to invest in and their structure can make tax filing a nightmare for investors. While the ETN structure eliminates these problems, it is important to note that within taxable accounts, the income received from the note is taxable at the investor's marginal tax rate, just like the interest income on corporate bonds. The assets in AMJ provide exposure to publicly-traded MLPs involved in the transport of petroleum liquids, such as gasoline, crude oil, and natural gas. Since the revenue stream emanates from the transportation of product through a pipeline, the ETN is not subject to the wild commodity price swings that can plague the revenues of natural resources firms. In fact, most pipelines are natural monopolies, similar to electric utilities, in that they operate under regulatory constraints meant to protect the public interest. But unlike traditional utility regulation, pipeline regulation is relatively noninvasive and pipeline operators are allowed to adjust the rates they charge for inflation. This makes the MLPs a good inflation hedge that also provides yields expected to be higher than Treasury Inflation-Protected Securities (the current yield for AMJ is approximately 5%). AMJ will likely be more volatile than our core bond funds, so it is not appropriate for everyone. But for those looking to increase their investment income without increasing their exposure to stocks, we think it is an alternative worth considering.

**Old Friends**

Finally, we continue to like and use the Calamos Convertible Bond fund (CCVIX) which, like AMJ, is appropriate for clients who can handle a bit more volatility in their fixed income investments. Convertible bonds are a hybrid security that fall somewhere between ordinary bonds and stocks in terms of volatility. Over the past



decade, CCVIX has been able to capture roughly three quarters of the performance stocks (S&P 500) in up markets while only declining about half as much as stocks in down markets. So for clients for whom it's appropriate, this fund provides an opportunity to generate returns closer to those of stocks with significantly less risk.

### **Overall**

Since the chances of generating above average returns in conventional bonds over the next several years are low, we felt it was important to remain conservative on the fixed income side, while adding flexibility to our menu of options. We believe we have a nice mix of managers who can create positive returns going forward. However, in this environment we don't believe it's wise to be overly aggressive on the fixed income side. We've had two tremendous years in both stocks and bonds, and at this point we think it's prudent to focus on retaining principal on the bond side while seeking upside potential primarily in stocks. In a few years, once interest rates have risen, our opinion may change. But for now we think the risks of chasing yield in the bond market far outweigh the potential rewards.

## **Q & A WITH DR'S JOE & SCOTT**

One of our favorite parts of money management is the educational aspect. The questions we receive each quarter are interesting, provocative, insightful, and at times unpredictable. Frequently, the questions we get are driven by a news story a client has seen or read. And given the media's penchant for hyperbole and the fact that most journalists have little formal education in economics or finance, the questions keep us on our toes. Let's be frank: The global economy is complex, making it difficult for the average investor (or journalist) to understand the intricate relationships between exchange rates, debt, monetary policy, fiscal policy, balance of trade, political machinations, and any number of other economic variables. The media (and many supposed market experts) prey on this lack of understanding to create connections and conspiracy theories that in many cases do not exist. We've devoted years to formal education in finance and economics and spent much of our lives engaged in financial research. Yet, even for us, making sense of a constantly evolving global economy remains a daunting task – although one we thoroughly enjoy. So, we want to encourage your continued questions, as we love to educate our clients. However, we also ask that you take most of

what you read and hear (at least when it comes to the financial markets) with a grain of salt.

### **The Big Picture**

In most cases, we find the issues investors worry about the most tend to be the things they have the least control over. These things generally wind up having little long-term impact on the performance of their portfolios. Alternatively, some of the things investors tend to focus on the least, tend to be factors that are critical to their investing success. The keys to long term investing success are actually pretty straight forward. First, you have to determine your investment time horizon and then arrive at an appropriate asset allocation strategy. Once that is done, you need to stick to it! Determining your investment time horizon and an appropriate asset mix are the biggest decisions investors make - but they're the ones they also most often neglect. Sticking to a predetermined time horizon for your investments will prevent you from making the kinds of emotional decisions that doom so many investors to failure, like selling out during major market downturns or putting all your assets in what's hot (like tech stocks or real estate). Once you have determined an appropriate asset allocation, then you can peck away at other factors, such as which managers to use, when to rebalance, how to eliminate fees, reduce taxes, etc.

Scott and I have been managing money for decades, and we very rarely get into discussions about politics, exchange rates, the deficit, or the value of our dollar. We're generally more concerned with issues like the independence of the Federal Reserve; the free flow of capital; the lack of trade tariffs; and the rate of globalization. These are the issues that are going to affect all of our portfolios over time. We know our clients are naturally concerned about the future of the United States going forward...and this is where most of our questions come from. Hopefully, we can provide some reasoned perspective and insight on these issues.

**Q1. Several countries (most recently France) have expressed a wish to replace the dollar as the world's foremost reserve currency. Do you think it's likely and how will it affect our economy? E.F.**

**Joe:** I believe the dollar will remain the leading reserve currency for some time to come. At this point, most countries hold the great majority of their reserves in dollars. They do so for a number of reasons. First, we have the advantage of having very deep and liquid markets. Second, our economy is still three times as big as

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the next economy. Third, we have an immaculate history of honoring our debts. Fourth, our economy has been the most stable economy over the last century. Fifth, to change it to another currency would take a herculean effort, and there are very few choices. So, in my opinion, the dollar as a reserve currency is here to stay - at least over our lifetimes. Other countries will occasionally challenge that view in the media, but it's posturing at this point.

**Scott:** Given the issues plaguing the Euro, I find the French comments farcical. The only currency that could conceivably replace the dollar is the Euro, but at this point there are significant doubts whether the Euro will even survive. When the rest of the world panics, they still buy dollars and dollar-denominated assets and I don't see that changing anytime soon. On the other hand, if we want the dollar to retain its status as the world's reserve currency, we need get our house in order with respect to deficits we've been running. Fiscal responsibility is something that needs to be addressed immediately and, as Americans, we all have to recognize that some of the requisite spending cuts will impact us. Until now, most Americans have only been in favor of spending cuts that didn't impact them - but it's clear that model is untenable. Fortunately, it appears that more and more Americans are beginning to realize that the problem needs to be addressed sooner rather than later, and that fixing things will require some sacrifice on everyone's part. I find that encouraging.

**Q2: Why is the Federal Reserve printing money to keep interest rates low? Won't this strategy lead to inflation? B.M.**

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

mongering. (As a side note, I would encourage our readers to go out to You-tube and enter Bernanke and 60 minutes. Then you can watch both of his interviews over the past year and draw your own conclusion.)

**Scott:** What the Federal Reserve is doing is called "quantitative easing" (QE) which almost no one understands but nearly everyone seems to hate - which is an interesting dynamic. Essentially, the Fed is creating money out of thin air and using it to buy bonds from banks. This has two impacts, both of which are designed to stimulate the economy. First, QE acts to keep longer term interest rates low by driving up the price of long term bonds (remember that bond prices and yields always move in opposite directions). Lower long-term interest rates stimulate demand for big ticket consumer purchases, like housing and automobiles, and encourage business expansion, which in turn should have a positive impact on unemployment. Second, QE increases the money supply because the "cash" the Fed uses to buy the bonds from banks goes on the banks' balance sheets, thereby making them more willing to make loans. The Fed used QE aggressively in late 2008 and early 2009 and it seemed to help, so now they're trying it again, which is why this time it's being called QE2. Of course, there are risks to everything the Fed does (or doesn't do) but at this point I don't see much threat of QE2 being inflationary. For that to occur the economy would have to begin growing too rapidly for its own good and we've got a long way to go before that becomes a concern. When the economy has strengthened sufficiently, the Fed will sell the bonds back, which will act to raise long-term rates, decrease the money supply, thereby slowing the economy and retarding inflationary pressures. In other words, QE2 is easily reversed if things begin to change, which should help comfort those who are worried about it.

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

**Joe:** Personally, I am debt - averse. That is, I prefer less debt to more and I believe we need to get back to having a balanced budget. That said, if debt is used correctly, it can be a very powerful tool. For example, almost every business, home and car is purchased using debt. In addition, many Americans, get an education through the use of debt. Almost every wealthy person I know used debt to get there. So the key is identifying the appropriate amount of debt that a country should hold. Then the question is, how



do you use that debt? I'll focus on the debt amount, and leave how we use that debt to politicians.

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

Over the past few years, the surge in debt has been a result of lower tax revenues and higher federal spending related to the severe recession and financial crisis. Today, gross public debt is around 90% of GDP and net debt (a better measure) is around 62% of GDP. The good news is, the low interest rate environment held down interest costs to \$147 billion or 1.4% of GDP, one of the lowest as a share of GDP in the entire decade. So, in my opinion, we do have a debt problem. However, interest rates have given us a window to deal with the deficit before it gets worse.

**Scott:** I agree. I think things our debt is manageable right now, but we need to act aggressively on our annual deficits before it's too late. I think Americans need to collectively recognize that we are the government and that the officials we elect to office generally do what they think their constituents want them to do (lest they be voted out in the next election). For decades, what we as Americans myopically voted for was lower taxes and increased government spending – and that is exactly what we got. In other words, we have seen the enemy and it is us. Now we need to fix the mess we've created. The good news is that the budget problems are very fixable. The bad news is that the remedies have some

uncomfortable side effects. In order for fiscal reform to work, everyone will have to feel at least some pain and the American people will need to get used to the idea of doing more with less. If you want an excellent outline on the kinds of things we will need to do in order to fix our budget problems, go to the website of the National Commission on Fiscal Responsibility and Reform ([www.fiscalcommission.gov](http://www.fiscalcommission.gov)) and read their report titled, "Moment of Truth." The NCFRR is a bipartisan commission co-chaired by Erskine Bowles and Alan Simpson and the commission's report is the most comprehensive analysis of our budget situation I've seen.

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

**Scott:** Consumer spending is obviously important, but in the long run consumers can't spend what they don't earn. As a result, I would argue that personal income and unemployment are even more important variables to look at. Putting more people to work means greater disposable income and, in turn, increased consumer spending. Increased consumer spending then leads to business expansion, which in turn creates more jobs, resulting in more disposable income and the process just continues. We'd like to see the rate of jobs increase at a faster pace, but that's probably not going to happen for a while. In my opinion, the biggest drag on unemployment continues to be in the construction industry. Construction jobs will eventually come back, but given the glut of unsold homes and unoccupied commercial office space it is just going to take some time. The Fed thinks it will take five years before we get back down to 5%-5.5% unemployment and I think that's a reasonable estimate.

**Joe:** That's true. I should also point out that this is one of the "disconnects" we've discussed in the past. Even though the unemployment rate is over 9% and our economy is growing at a lower rate than we would like, it does not mean the stock market can't increase. Remember, the global economy is what drives our stock market today and it does not look like the global economy is going to slow down for the foreseeable future.

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

**Joe:** Good question. Right now, most of our stock portfolio's have between 10-15% of direct stock exposure. However, this perspective only gives you half of the bigger



picture. We estimate that over 50% of the revenues generated by our large cap companies come from overseas. That adds another 16% to our overall global exposure. In today's global environment, we also believe the revenues generated by mid and small cap companies are not far behind. So, we probably have closer to 50% foreign exposure when you look at both foreign stocks and/or foreign revenues. We're comfortable with that.

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

**Scott:** I agree. I would also add that because of globalization, the benefits of foreign diversification aren't as great as they once were. Correlations between foreign and domestic stocks have been rising steadily for a couple of decades, especially among developed nations, and the higher correlations make foreign shares less attractive from a diversification standpoint. Emerging markets have lower correlations and higher expected returns, but they are also extremely volatile and I worry about their valuations at this point. Emerging markets stocks have been extremely hot in recent years, so while we have some emerging markets exposure in our core portfolios we're not adding to it at this point. We will eventually add more emerging markets exposure, but for now we're concerned they may have gotten a bit ahead of themselves.

**Q6: Over the last few months I have seen a gloom and doom report from Meredith Whitney and a more upbeat assessment of the economy from Ben Bernanke. Both aired on 60 minutes. Did you see them? Where do you think our economy stands?**

**Joe:** I saw both of the reports. Meredith Whitney believes that state governments have overspent over the last decade. And as a result, she believes there will be a severe strain on many communities. In addition, she believes a number of communities will declare bankruptcy. I agree. However, we need to keep this issue in context. Even during good times, we have municipalities that overspend and declare bankruptcy. Given the higher rate of unemployment and thus the lower tax base, it makes sense that we would see more bankruptcies than normal. Frankly, Scott and I see this as an opportunity. When a few bankruptcies occur this will likely lead to indiscriminant selling. This creates an opportunity for our

well trained managers who understand not all bonds are created equally.

**Scott:** State and local governments have some problems right now, but for the most part I think they're manageable. We will see some defaults in munis, I think, but we also have a pretty good idea which munis those will be. The state of North Carolina, for example, is facing a budgetary shortfall but thinks it can be managed with spending cuts alone. We feel the pain in the UNC system, but everyone needs to do their share until conditions improve. At ECU, where I'm chair of the finance department, we've implemented countless cost cutting measures over the past few years and have developed contingency plans for various levels of additional spending cuts going forward. It's not an ideal situation for the university system, but we're in the same boat as every other state agency. The good news is that we have been able to continue providing students with the same high-quality educational experience that they've always received. We've just had to adjust to doing more with less.

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

**Joe:** Thank you for the compliment. I am definitely an optimist, but I also believe that optimism is rooted in the strong belief that our country and our citizens can overcome anything. We have a pretty darn good track record overcoming much greater obstacles than the ones we face today. I just think the media makes things seem worse than they really are. For example, yesterday, a lot of media was getting into a frenzy about how 10% of Americans are going into default. Immediately, I thought "what about the 90% that are current on mortgage and credit card payments?" 90% sounds good to me. If I were going to generalize about Americans, I'd say the vast majority are living within their means, taking on debts they can afford and spending responsibly. However, that statement seems to fly in the face of conventional wisdom today. So, we try to look at most problems from a common sense standpoint.

**Scott:** Joe is a natural optimist, but we do our best to keep him grounded. Seriously, though, it's hard not to be optimistic about the future. What is happening today, with the spread of capitalism across the globe, is unprecedented in our history and I don't think most Americans appreciate



the positive impact this will have on our future. In recent years, technological innovations, globalization, and increased competition have led to tremendous breakthroughs in virtually every field and we're just getting started. So maybe Joe's optimism is warranted.

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

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

**Scott:** My biggest concern is whether we have the willpower and resolve to fix our budgetary problems. I'm confident we can do anything if we put our mind to it, but the question is whether the American people comprehend the gravity of the situation and have the willingness to do what is necessary to put things right. If not, it will just continue to be business as usual, which is clearly unsustainable. I see encouraging signs that people are beginning to understand that we have a patriotic duty to pull together, put politics aside, and do the right thing for our country and future generations. Let's just hope it's not an illusion.

**A FINAL NOTE**

**Thank You**

*As usual, if you have any questions about this update, our newsletter, your accounts or our managers, please feel free to call or e-mail us at anytime. The recent referrals are much appreciated and we thank you for your continued confidence in our firm and our services. As we go forward, we remain committed to continuing to refine and improve our proactive strategies and portfolios. As always, our goal is to provide each of our clients with the best possible mix of assets given their particular situation. If you need anything or your goals or time horizons have changed, please do not hesitate to call or drop an e-mail to set up an appointment. We are here to serve your financial needs, whatever they may be.*

*We wish you and your family a happy and healthy New Year!*

**~ Joe and The Gang at KWAG**

**2011 KIELY GROUP CLIENT APPRECIATION DINNER SCHEDULE**

<b>Ocean Isle, NC</b>	Monday, January 24 <sup>th</sup>	Sea Trails Convention Center 6:00-8:30PM
<b>Greenville, NC</b>	Tuesday, January 25 <sup>th</sup>	Brook Valley Country Club 6:00-8:30PM
<b>Asheville, NC</b>	Wednesday, January 26 <sup>th</sup>	Asheville Country Club 6:00-8:30PM

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

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



THE GANG AT KIELY WEALTH ADVISORY GROUP



Left to Right: Brownie Cordell; Katie Burr; Joe Kiely; Kellie Kiely; and Scott Below

**\*IMPORTANT DISCLOSURE INFORMATION**

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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 KWAG. KWAG also maintains all information supporting the reflected mutual fund performance results.

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