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Kiely Financial Services, Inc.

BEHIND THE SCENES

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Opening Thoughts

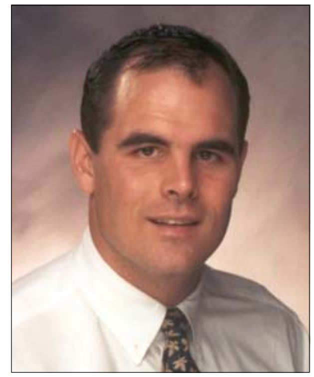
I hope this newsletter finds everyone doing well and enjoying the early days of spring. Spring has always been my favorite season because it brings longer days, warmer weather and a return to gardening. It also brings steady winds to the east coast, which means kite-surfing season is starting up again. As always, there is a lot to look forward to in the spring. And although market and economic cycles aren't always tied to the seasons, it just so happens that this spring we think there is a lot to look forward to on this front as well. As long term investors, it is periods like this - with market dips and all the volatility - where the groundwork for future success is laid. It is also times like this when successful investors separate themselves from not-so-successful investors. To be honest, we embrace periods of turmoil and uncertainty in the markets because these are the times we believe we can make the largest difference in our clients' portfolios. In fact, as you will see shortly, our strategies have already paid off this year. So grab a cup of coffee, settle into your favorite chair, and get ready to read why we think investor success in up markets is directly tied to how well their portfolio was managed during the difficult times. In a nutshell, the theme for this quarter's newsletter is a re-examination of the factors required to be a successful investor - knowledge, preparation, patience and execution.

Problems Require Perspective

Look, we recognize the economy faces some serious problems today, particularly in the mortgage and housing markets. We also recognize that these problems have spread to other sectors of the economy. And although we don't get caught up in definitions and semantics, there is a very real possibility that we are currently in a recession. What is critical to understand, however, is for long-term investors none of this really matters. Remember, we've spent a fair amount of time studying how markets behave in periods like this. We know markets overreact and we know this overreaction is emotionally driven. We also know that it is the investors who make investment decisions based on their emotions who will get hurt in markets like this. Rationally, as long-term investors, we need to recognize these periods for what they are and face them with the wisdom gained from experience, patience and, most importantly, an absence of emotion. Unfortunately, many investors find the latter particularly difficult to achieve.

It's Different This Time

People often say, "This time it's different." And they're absolutely correct. No two periods are ever alike because the global economy is an ever-changing entity. What never changes, however, is the fact that short-run market cycles are driven by fear and greed. These two emotions are responsible for driving prices to irrational levels in both up (greed) and down (fear) markets, just as they have since the first recorded market bubble in 17th century Holland…in tulip bulbs, of all things! And today, with the advent of electronic trading, high speed internet connections to infinite amounts of data, and 24 hour news channels, "fear and greed" influence markets more quickly and easily than ever before. Fear



Dr. Joseph Kiely

Inside this issue:

Annual Compliance Offer:

Enclosed in this Quarter's Newsletter are a few important Compliance Items:

KFS 2008 Privacy Policy

KFS 2008 Annual ADV Offer

Please let us know if you have questions on any of these items or if you would like our ADV sent to you.

and greed are front and center in every bubble, whether it is in tech stocks, real estate, or oil and gold futures. Thus, in this newsletter, we are going to revisit the topic of market overreaction and re-introduce the "Annual Stock Return" table we handed out at the client dinners in January. Why? Because we want to revisit how stocks have been overreacting to good and bad news for decades. Equally important though, we want you to see that the stock market always bounces back from corrections - usually when you least expect it - and usually in magnitudes far greater than seen in the preceding drop.

Other Newsletter Specifics

Of course, we'll also cover the traditional newsletter topics, by taking a look at the broader economy, the markets, our managers, and how each has performed over the past quarter. This quarter was an exceptional one for our managers versus their benchmarks (as you will see when you check out the data that appears in the manager performance tables at the end of the newsletter). As always, we'll end with "Eight Questions with Joe" (he was too long-winded for Ten) and last, provide an update on the educational happenings at Kiely Financial Services. Frankly, we think 2008 will be a much better year than many are expecting. As always, Brownie, Scott, Katie and I look forward to your comments and feedback. Like good gardeners, we want people to enjoy the fruits of our labor, but we need and rely on your feedback to keep improving.

Past Returns & Diversification

The First Quarter of 2008

Looking back at the first quarter of 2008 is much like looking back at 2007, in that it was a tale of two markets. The first three weeks saw a broad, across the board selloff in stocks, without regard for the fundamentals of the companies or industries being sold. During this period, both the S&P 500 (large company stocks) and the Russell 2000 (small company stocks) were down as much as 12% from where they started the year. Since then the markets have mostly meandered sideways, with a small gain since late January. The S&P 500 finished the first quarter down 9.92%, with the Russell 2000 down 10.19%. When you examine performance month-by-month, January was down significantly, but February was actually positive right up until leap day. (Brownie is still miffed about February having 29 days this year - as all our accounts were positive for month until the broad sell off on leap day – and he knows how our clients like positive months.) March finished mixed, with the S&P 500 dropping a bit and the Russell 2000 rising a bit. So basically, most of the decline in the first quarter was attributable to that first three-week span, with the markets generally moving slightly upward since.

We Interrupt This Message…For Some "Common Sense" News

At this point in the newsletter, we usually go on to examine the long term returns of the broader stock market indexes (S&P500 and the Russell 2000) looking back one, three, five and ten years. Why? Because we like to provide some context as to how markets behave over the long and short run and we like to remind our clients/ friends that we are long term investors. Usually, this methodology suffices. However, given the conflicting messages emanating from the media and financial advisors over the last quarter as to how to invest and diversify "correctly", we felt it was important to take a step back and examine "true" diversification. Once we have established some of the common fallacies out there, then we'll look at the long run returns of the stock market over different time periods. Unfortunately, during periods of uncertainty, a lot of misinformation gets bandied about. (Actually, bad information is bandied about all of the time…investors just seem to be more open to listening to bad advice during volatile times) Anyway, if you don't have the background to tell the difference between "good" information and "bad" information, you may draw the wrong conclusions about how the overall stock market behaves over time. Of course, if you are using incorrect data, the odds of making bad choices with your stock portfolio increase. So, reheat your cup of "Joe" and let's take a few minutes to re-examine "true" diversification.

Reaping the Benefits of Diversification

The goal of most investors is to achieve the best possible returns with the lowest possible amount of risk. And we know that the best way to achieve this goal is to identify your investment time frame and allocate (or diversify) your assets across a broad spectrum of asset classes. Unfortunately, few investors are diversified enough. Many, in fact, hold a large percentage of their portfolios in a single asset class, a single industry, or even a single stock. Diversification benefits are gained from the fact that dissimilar asset classes don't tend to move together. In a portfolio, much like in a flower garden, you don't want everything blooming at one time. Instead, good gardeners and good investors prefer to spread things out to prolong the beauty as long as possible. Unfortunately, we rarely see well diversified portfolios outside of our

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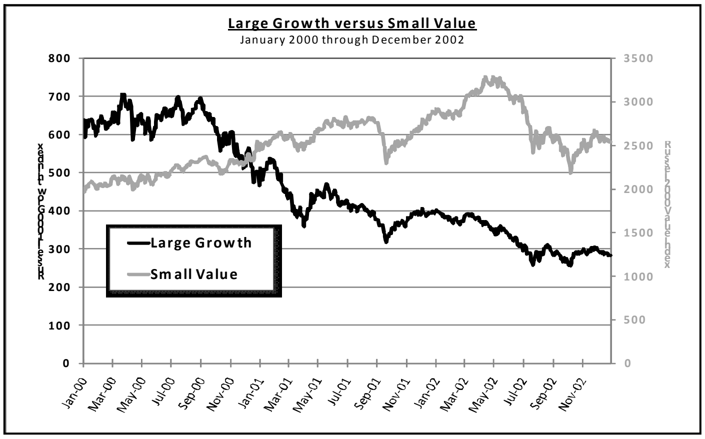
firm. And because of this, we continue to see the same mistakes play out year after year in investor's portfolios.

Revisiting 2000-2002

One of the biggest dangers of under-diversification is when the predominant asset class you hold drops, there's little else in your portfolio to balance out the pain. This situation is illustrated in the chart below, which shows how the value of large growth stocks, as measured by the Russell 1000 Growth Index (black) and small value stocks, as measured by the Russell 2000 Value Index (light gray) changed from January 2000 through the end of 2002.



Large growth and small value are obviously in opposite corners in the nine-box Morningstar style grid, which means they are about as dissimilar as they can get. When you examine the graph, the logic of combining them together is pretty obvious. Small value rose more than 24% over the three-year period, while large growth lost over 55%! In other words, small value was blooming while large growth was wilting. If an investor held only large growth over this period, as many investors did, their portfolio was devastated. In contrast, a portfolio diversified by holding large growth, small value and a variety of asset styles would have taken you through one of the worst bear markets in history largely unscathed. The lesson in all of this is simple - <u>diversification reduces volatility</u>! And this perfectly illustrates why KFS is unwavering in our commitment to diversifying our client portfolios across all stock market sectors. (It's akin to adding annuals to your perennial garden…it provides some "pop" to your garden all year!)

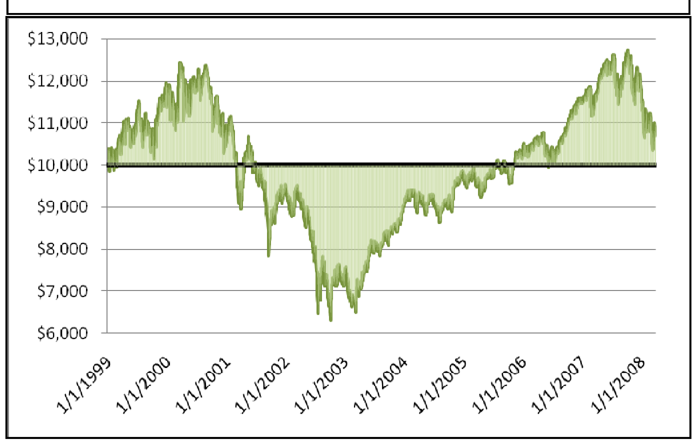
Defining Diversification (The Real Problem)

Another major problem faced by investors with respect to diversification issue is deciding what exactly constitutes proper diversification. Unfortunately, there is a lot of misinformation out there. Many "experts" will tell you that to be sufficiently diversified all you have to do is own the S&P 500 Index (or the Russell 3000 Index or Wilshire 5000 Index which are almost identical from a functional perspective). In fact, John Bogle, the founder of Vanguard, basically built his company on this concept and he has gone on and on about it in numerous articles and books. Unfortunately, he's wrong - and the millions of investors who subscribe to the Vanguard/Bogle philosophy of diversification are paying the price for it. Sadly, John Bogle and Vanguard aren't the only ones dispensing faulty information. Most of the financial press, much of the financial services industry, and even many academics will tell you that the S&P 500 Index (or any other "broad market" index) is well-diversified. But they've all been seriously misled! Keep reading and we'll show you the incontestable proof.

Diversification and the Lost Decade

On March 26, 2008, The Wall Street Journal (WSJ) carried a front page article describing the "Lost Decade" in stocks and claiming that U.S. stocks have now been in their longest funk since the 1970s. That's a serious claim, and whether you believe it or not will depend on your definition of *"U.S. stocks."* As is common practice in the financial press, the WSJ chose to use the S&P 500 index as their proxy for the U.S. stock market, and the results they presented look extremely compelling. They tracked a hypothetical $10,000 investment in the S&P 500 from the beginning of 1999 through March 2008, and the results they came up with looked like those we present in the chart below. Not a very pretty picture, as it shows "stock returns" were basically flat over this near decade-long period.

<u>The Lost Decade? :</u> $10,000 Invested in the S&P 500 Index: Jan. 1999—Mar. 2008



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Unfortunately, the WSJ authors fell into the same trap that most everyone else in the investments community falls into - **<u>they ignored the vast majority of all stocks that trade on the U.S. exchanges!</u>** At last count, there were 7,000+ companies trading on the three major U.S. exchanges. And since the S&P 500 index contains just 500 stocks, we know that by construction it fails to account for more than 6,500 publicly traded U.S. companies! Additionally, since the S&P 500 is comprised only of large company stocks, it ignores every mid-sized and small-sized company currently in existence. It should be obvious that any index (or portfolio) that has zero exposure to more than 90% of the stock market **<u>cannot</u>** be diversified. Keep reading - it gets worse.

Other Slight Omissions

What the WSJ also failed to mention in the article (and what John Bogel failed to mention in subsequent interviews after the article was published) is that by the time the tech bubble burst in early 2000, the weight of tech stocks in the S&P 500 had grown to nearly 40%! In other words, forty cents of every dollar investors plowed into index funds that tracked the S&P 500 was going to buy tech companies. And most of the people investing money in S&P 500 index (or other similar index) funds during that time had no idea any of this was happening. Finally, given the above information (which was conveniently omitted from the WSJ article) it should come as no surprise that when the tech bubble burst the S&P 500 index and its other index brethren got pummeled. It was simply an unavoidable consequence of inadequate diversification. (At this point, it might be a good time to warm up your coffee. We want your brain working on all cylinders for this next part.)

The "Real" Numbers

Perhaps the ultimate validation for our style box diversification approach can be found by simply looking at how the stock universe outside the S&P 500 Index (you know, those other 6,500+ stocks) fared over the past decade. The following style grid shows that as one part of the stock market struggled (i.e. large growth) other sectors were enjoying moderate to terrific success! If you were invested heavily in large growth stocks (like the S&P 500 Index was), the decade has indeed been a disappointment. But at the same time, other areas of the market were anything but disappointing. Note that stocks in six of the nine style boxes increased by more than 9.3% annually over the past decade, with small value and mid value stocks leading the way with returns of roughly 16% per year! Lost decade? What in the world are they talking about?!

The decade was clearly not "lost." In fact, for most sectors it was pretty darn good. The critical factor missed by the WSJ article is that the S&P 500 index represents a very small amount of the overall stock market and as a result, using it as a proxy for the overall stock market is improper and misleading. In reality, the S&P 500 Index is <u>NOT</u> well-diversified, but that won't stop people from using it as such. Next time you read an article or hear a news story that uses the S&P 500 Index as a proxy for the performance of the entire stock market, remember the following: *1) it ignores more than 90% of the overall domestic stock market and 2) it is prone to becoming over-weighted in whatever is currently "hot," as occurred in the late 1990's with tech stocks.*

Disinformation

One of our biggest frustrations as educators and investment advisors is seeing firsthand how much of the investing world approaches diversification. As we've mentioned frequently in the past, the vast majority of portfolios transferring in to KFS are weighted heavily toward large-cap growth stocks. Unfortunately, this is not an anomaly specific to our incoming clients, but the norm across most of the financial services industry. In large part, the pervasiveness of this large growth tilt in portfolios is due to the conventional and wholly incorrect view that the "broad market" indexes (e.g. the S&P 500, Russell 3000, and Wilshire 5000) provide broad diversification benefits. And just in case you haven't been paying attention - THEY DON'T!!! The problem is that each of these indexes is market cap weighted, meaning the largest stocks in the index carry the largest weights. In fact, for each of the "big three" indexes listed above, the largest 50 companies drive

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essentially all of the index's performance. So whether the "broad market" index holds 500 stocks, 3,000 stocks, or 5,000 stocks, the same 50 very large firms are driving the return. And since the largest 50 firms got that way by growing more rapidly than most everyone else, each of these the indexes is, by construction, a large cap index with a growth tilt. So even though these indexes are commonly referred to as domestic "broad market" indexes, they are nothing of the kind. And you thought it couldn't get worse...

Short Term Numbers and Greed

Unfortunately, the problems faced by investors don't end with the diversification issue. Many investors routinely get caught up in current events, which are invariably sensationalized and beaten to death by the media. When combined with the way humans are "hardwired" to overemphasize short term events when making long run decisions, this leads investors to extrapolate current market conditions out into the foreseeable future. And this, in a nutshell, is the mechanism by which emotions like fear and greed are able to drive markets to the point of significant overreaction. Think about it, when things are going really well investors tend to extrapolate their recent successes into the foreseeable future. Greed then takes over, just as it did in the recent housing price bubble, and as it's currently doing in commodity prices. This compels investors to take far more risk than they otherwise would. And just about that time, the current bubble bursts.

Short Term Numbers and Fear

On the opposite side of the spectrum, when things are not going well, the overreaction is in a different direction. Doom and gloom are the order of the day and all the pessimism leads investors to extrapolate the bad times into the future. In this case, fear takes over and triggers the flight response, whereby investors are compelled to dump either all or large portions of their portfolios and flee to "safe" alternatives like cash. Every bear market serves as another example of inopportune, fear-driven selling on the part of investors. And the selling activity invariably peaks about the time the market is getting ready to turn around.

Past Academic Evidence Please

Sadly, academic research finds that individual investors are uncannily reliable contrary stock market indicators (i.e. they tend to buy near market peaks and sell near market bottoms). To illustrate, let's look back at the month of February, 2000, which holds the all-time record for **net cash inflows** into mutual funds in a single month. For several years leading up to this point, tech-heavy indexes like the S&P 500 and NASDAQ were setting new high after new high. As the markets rose higher, investors poured gas on the fire - dumping ever-increasing amounts of money into stocks. And most of this money went into large cap growth, in the form of tech-heavy mutual funds and tech-heavy indexes. And then? Well, we all know the rest of the story and it wasn't very pretty (see the performance of large growth in the previous charts if you need a reminder).

New Recent Evidence

Today, on the opposite side of the spectrum we have observed two troubling trends. First, investors are somewhat hesitant about being in the stock market, when we (KFS) know they are staring at one of the best opportunities to buy in a long time. Second, those who are investing are using short term data to make long run decisions. The following two tables provide a look back at the stock market over the last one and two years respectively. Over the past few years, we have seen a clear reversal in the longer-term market return trends. Specifically, large cap growth has outperformed the other style indexes. Of course, if you focus on the short run data only, you would be lulled into believing that large cap growth is the best place to invest long term… which is both dangerous and incorrect. Such a highly-concentrated strategy has actually led to poor long-term returns (see the WSJ article discussed earlier). It's like an impatient gardener who keeps pouring too much fertilizer on his plants because he wants to see tremendous growth in his garden immediately. The cost of his impatience, of course, is burned plants. Similarly, academic research shows the hazards of chasing recent years hot investments. Instead of burned plants, we end up having a lot of burned investors.

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Myopic Investor Reactions

As long term investors, we need to resist the urge to react to short term trends. Why? Because markets tend to overreact, which implies, last year's darling is likely to be next year's dog. This is why we advocate building well diversified portfolios across all market sectors and maintaining a long term focus, using short term dips to rebalance. Of course, given the performance of large caps versus small/mid cap stocks in the tables above, you can be assured that many investors are chasing recent performance and flocking to large cap stocks. In fact, recent buying activity confirms this. So why do investors continue to make the mistakes over and over again? First, they allow themselves to lose sight of the long run, focusing instead on the recent trends. Then, to exacerbate things, they extrapolate recent history into the future, and using the faulty extrapolations to make equally faulty investment decisions. Sadly, by the time they recognize their mistake it's usually too late for anything but regret. But have no fear. There will always be new short term trends to fixate on and new investing mistakes to make…it's like déjà vu all over again!

Déjà Vu or Déjà Voodoo

In 2006 and 2007, both domestic and international large cap stocks had banner years relative to the rest of the market. So guess where many advisors are suggesting you should be investing your hard earned money? Yep, they recommend the very thing we're warning against, which is chasing returns and buying what's been hot. In fact, there is one national advisor (who coincidently devastated investor portfolios in the early part of this decade chasing large cap growth stocks) who today is being hailed as a genius because he had a couple of good years with highly-concentrated large cap portfolios. (Sorry Mr. Fisher, but we know what happens when portfolios are not properly diversified). Short term thinking, chasing last year's winners, giving in to fear and greed—these same things play themselves out year after year, market cycle after market cycle. The easiest thing for a salesperson to do is sell you the latest fad – which is what separates "salespeople" from "advisors." The former gets compensated in the short run by selling whatever they can, naturally gravitating toward whatever is easiest to sell (like what's been hot lately). The latter gets compensated in the long-run, by focusing on what the best interests of the client and doing the right thing.

January Dinners & Long Run Numbers

When we held our client dinners in January, we knew the news regarding the economy was not exactly stellar. At the same time, however, we knew the three-week sell-off in the market leading up to that point afforded us a great opportunity to reinforce the concepts of sound investing, not the least of which is buying stocks while they are on sale and/or rebalancing your portfolio. We spent the better part of an hour going over the economy and its still solid long term fundamentals. Then we handed out a table containing data on how stocks (measured by the S&P 500 index) have behaved since 1926.

Please see the following page for the Annual Returns Chart

The underlying message in the data is simple - large dips have historically been followed by large rebounds. This is because fear and greed drive stock prices to overreact in the short run. For clarity, the returns in the years where the stock market fell by more than 10% are the dark gray boxes. You'll notice that there are *10* of these data points in the table. In contrast, returns in years where the stock market increased by more than 10%, are denoted in the light gray boxes. You'll notice there are **46** such years in the table. More importantly, you'll see that virtually all the double digit increases in stock prices follow, in close proximity, the dark gray boxes in which there were double-digit declines. Our major goal here is to demonstrate the fear, greed, and the overreactions they foster have been around for a long, long time.

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ANNUAL RETURN AS MEASURED BY THE STANDARD & POORS

YEAR	STOCKS	YEAR	STOCKS
1926	11.62%	**1969**	-8.50%
1927	37.49%	**1970**	4.01%
1928	43.61%	**1971**	14.31%
1929	8.42%	**1972**	18.98%
1930	-24.90%	**1973**	-14.66%
1931	-43.34%	**1974**	-26.47%
1932	-8.19%	**1975**	37.20%
1933	53.99%	**1976**	23.84%
1934	-1.44%	**1977**	-7.18%
1935	47.67%	**1978**	6.56%
1936	33.92%	**1979**	18.44%
1937	-35.03%	**1980**	32.42%
1938	31.12%	**1981**	-4.91%
1939	-0.41%	**1982**	21.41%
1940	-9.78%	**1983**	22.51%
1941	-11.59%	**1984**	6.27%
1942	20.34%	**1985**	32.16%
1943	25.90%	**1986**	18.47%
1944	19.75%	**1987**	5.23%
1945	36.44%	**1988**	16.81%
1946	-8.07%	**1989**	31.49%
1947	5.71%	**1990**	-3.17%
1948	5.50%	**1991**	30.55%
1949	18.79%	**1992**	7.67%
1950	31.71%	**1993**	9.99%
1951	24.02%	**1994**	-1.54%
1952	18.37%	**1995**	34.10%
1953	-0.99%	**1996**	20.26%
1954	52.62%	**1997**	33.36%
1955	31.56%	**1998**	28.58%
1956	6.56%	**1999**	21.04%
1957	-10.78%	**2000**	-9.11%
1958	43.36%	**2001**	-11.88%
1959	11.96%	**2002**	-22.10%
1960	-0.47%	**2003**	28.50%
1961	26.89%	**2004**	10.88%
1962	-8.73%	**2005**	4.90%
1963	22.80%	**2006**	15.79%
1964	16.48%	**2007**	5.49%
1965	12.45%		
1966	-10.06%	**Average**	**12.36%**
1967	23.98%	**Maximum**	**53.99%**
1968	11.06%	**Minimum**	**-43.34%**

<u>KEY for STOCKS Column</u>

Dark Gray Boxes = Returns that fell by more than 10% (10 times)
Light Gray Boxes = Returns increased by more than 10% (46 times)

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Fear and Greed Used as a Gravy Train?

Because fear and greed play such a major role in short run market performance, it is only natural to seek to capitalize on this knowledge wherever we can. The annual returns table above helps us recognize that fear and greed have been around for a long time…and it drives short term prices not only in the S&P500, but in all market segments. So let me be frank here and repeat our consistent long term message one more time. In our opinion, the best ways to capitalize on these well known long term trends are by:

1. Building properly diversified portfolios with assets spread equally across all style boxes.
2. Use the best possible money managers, who have proven themselves with stellar long term track records in all kinds of market conditions.
3. Regularly rebalancing your portfolio, whereby we take money out of areas that have been hot recently (and have therefore become overweighted) and put it in areas that have recently underperformed (and have therefore become underweighted). By rebalancing in this fashion we are always *selling high* and *buying low*
4. Maintaining a focus on the long run (five years or more).
5. Remembering that markets consistently overreact in both directions.
6. Using dips as opportunities to rebalance and/or buy.
7. Keeping emotions in check. If this means avoiding the hyperbole of the news media, then so be it. Switch off the TV and take the dog for a walk instead.
8. Finally, only listen to people who have a long term perspective and understand how markets behave. People like Ben Bernanke, Jack Welch, Warren Buffet, and most any CEO. Ignore the vast majority of the media!

The 2008 Numbers

Since we've already covered how the "broad" market indexes fared during the first quarter, let's re-examine the actual style boxes performed over this time period. Since there were two distinct periods in the first quarter - the first three weeks of the year and the remaining nine weeks - we thought it would be interesting to examine both periods. The top table below shows that during the first three weeks of the year the entire stock market declined in virtual lockstep, which is something that caused our managers to become positively giddy. Why? Because they know a broad selloff without regard to underlying fundamentals presents a rare opportunity indeed. The second table shows that all areas of the market have increased since mid-January with small cap value, which had lagged in recent months, leading the way. As you will see, this dip and the subsequent bounce back, provided a great opportunity for our managers.

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Our Managers

So how have our managers performed this quarter? About as well as one would expect, given a golden opportunity brought on by widespread panic. Nearly all our managers outperformed their specific benchmarks during the first quarter, with our value managers leading the way once again. It may seem like a broken record to be mentioning Excelsior (I mean Columbia) Value & Restructuring (See Page 10_Question 4 for more information) and Keeley Small Cap Value each quarter, but once again these two funds had excellent quarters in a down market. That said, all of our managers had excellent quarters. Considering the S&P 500 (large caps), the Russell 2000 (small caps), and the average style box were all down about 10%, we are extremely pleased with our managers' overall returns. And when you examine the performance of your personal portfolios, we believe you will be pleasantly surprised as well. The majority of our stock portfolios were down significantly less than 10% during the quarter.

Long Term Goals

In up markets, we expect our managers to outperform their specific indexes on the up side, and we expect (and are getting) no less in a down market. Last year our managers had excellent returns in what was basically a flat year for the overall stock market. This year, our managers have more than held their own during the recent decline. Over time, if we diversify correctly and use the appropriate managers, the net result in all of our stock portfolios should be above average returns. This is why we spend so much time working on asset allocation and manager selection. We believe our clients' long term success will be maximized if we can help keep their emotions in check, make sure they stay properly diversified, rebalance their portfolios as needed, and use the best possible mix of money managers. When you examine the long term track record of our managers, you'll see how well they have performed and you'll understand that the last decade was hardly "lost."

8 Questions With Dr. Joe

This has been a very interesting three months for questions…but not in the way you would think. For the most part our clients and friends have remained calm and rational. It's been nice. The questions we have received have been well thought out and most people are focused on becoming better educated in order to avoid doing something rash or shortsighted. As you will see, most of our clients are thankful for our advice, reassuring words, and attentive listening over this most recent time period. As Brownie likes to say, "We need to be good listeners at this time." Katie always follows with, "We need to promise less and deliver more." Based on this quarter's questions, Kellie believes our 8 questions are "a lot like a love-fest." I can assure you not all our calls are rational, but they all have been calm. I can also assure you we appreciate it. Enjoy!

1. Dear Dr. Joe: My mother has a portfolio being managed by a broker that we are about to inherit. The municipal bonds in that portfolio have taken an absolute beating. I thought "muni's" were relatively safe investments. T.K.

Dear T.K. Every investment has some sort of risk exposure. What's unfortunate is that many people focus on things like tax issues or other factors without adequately assessing the potential risks of a particular type of investment. At Kiely Financial Services, we only use professional money managers for this exact reason…they do their homework, they're experts in their chosen areas, and they focus 24/7 on the securities they own. This means they investigate every security thoroughly before they invest our client's money in it. I have no idea how individual brokers or advisors can recommend (or buy) individual stocks or bonds without a team of analysts dedicated solely to that end. The due diligence is simply too daunting. For bonds we use four different managers from three different companies; PIMCO, Loomis Sayles and Vanguard. (By the way, these three firms were just listed as the three top bond fund families by Morningstar.) In the past, we have avoided Municipal bonds because they are like any other individual investment… you can lose all or part of your original investment. Frankly, it's very difficult to build totally diversified portfolio's (which means you must own hundreds and hundreds of individual bonds).

2. Dear Dr. Joe: I called you about a year ago to ask you about investing in a REIT, and you told me to "avoid it like the plague." I really appreciated your explanation at that time and I'm glad I avoided a potential fiasco. Could you please repeat your message in the newsletter? R.M.

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Dear R.M. Thanks for the feedback. Scott and I have published a number of academic articles on REIT's and as such, have come to the conclusion that investors should "avoid them like the plague." As I noted in our conversation, they have always been extremely prone to mispricing. (We believed that before the current mortgage meltdown.) One of the things we have prided ourselves on (at KFS) over the years is avoiding the "big" investment mistake. We believe that there are a number of investments that have no place in most portfolios. Why? Because some investments are priced with little or no regard to the underlying fundamentals. That is, "speculation" drives most of the pricing, not just in the short term but in the long term as well. Things like gold, commodities and REIT's are just too difficult to price accurately because their value is largely the result of speculation. We have come to conclude that the risk exposure in these asset classes is just too high. That's why we gravitate to stocks. Over long periods, the underlying fundamentals of a company will lead its stocks to become accurately priced, because the investors in the stock are the owners of the company.

3. Dear Dr. Kiely: I am a retired investor with you and have always tried to invest on my own until I met you. I like your concept of diversification and I really like the fact that you rebalance when necessary. When the stock market dipped in January, my husband was concerned when you sold some of our bonds and bought stocks. After all he lamented, "We're retired." So, I went back through your notes and found that that's exactly what you said you'd do when our stocks and bonds got out of balance. Your exact words were, "When an area of the stock market dips, that's when we buy." Last week, when we looked at our portfolio values, my husband was pleasantly surprised to see a significant rise in the stock funds you purchased and a decrease in the value of our bond funds since January. Thank you for being consistent…as we would have done the exact opposite and missed the recent run up. E. F.

Dear E.F. Buying into areas of the stock market when they have decreased is the absolute hardest thing for most investors to do. It simply runs counter to what your emotions would have you do. The good news is that over the past 10 years, rebalancing has become second nature to us. Not a day passes that we don't balance someone's portfolio. The better news is, over the past 10 weeks, we have spent a great deal of time rebalancing all of our clients' portfolios to make sure that they are balanced properly and to take advantage of areas of the market that are on sale. Interestingly, our managers have done the exact same thing. I sometimes hear people say, I can't take advantage of the dip because I'm not sending you any money to invest. Actually, nothing could be further from the truth. We rebalance regularly. Our managers rebalance regularly. And investors benefit every time new dollars are added to our managers portfolios…since they buy new underappreciated stocks for all mutual fund owners/investors. It sounds like a win, win, win model to me!

4. Dear Dr. Joe: Recently, I have gotten a number of phone calls about my proxy vote regarding Columbia's purchase of Excelsior Value and Restructuring. How did they get my number, what was I supposed to do and how will this purchase affect Excelsior (now Columbia) V&R going forward? J.G.

Dear J.G. Let me handle the last question first. The purchase of Excelsior will have absolutely no effect on how Excelsior V&R is managed. Simply put, Columbia wanted to purchase Excelsior so they could capitalize on David Williams' excellent track record. He will continue to run the fund just as he always has…autonomously. If there are changes to the way he manages the assets, we will exit the fund promptly like we did at FBR Small Cap. Now let's move to the first part of your question. When you purchase shares of a mutual fund, your name must legally be given to the fund so they can send you a prospectus. It's easy to get a phone number from there, but we do not provide this information to the specific funds. Regarding the proxy vote, we are not allowed to give you any advice (on your potential vote) based on the way we are registered with the SEC. As a registered investment advisor, we are not allowed to influence client's votes on these matters.

5. Dear Dr. Joe: I would like to thank Katie for her excellent work preparing the proper tax documents for me during tax season. The original packet along with your year-end report was a great idea. When I called Katie, she also helped me understand the 1099 forms and patiently answered all of the gains and losses questions I had. In addition, I transferred in a number of stocks which she helped me enter into the appropriate cost basis section. I can't tell you how much time she saved me during what I am certain was a very busy demanding time for her. J.M.

Dear J.M. Thank you for the positive feedback. Obviously, Katie is very devoted to her job and our clients...which

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makes my life that much easier. Over the past few months, I have had a number of positive e-mails and calls regarding Katie's help during tax season and beyond. (Frankly, I have had a number similar e-mails and calls about Brownie, Scott and Kristen. It's clear that they are all dedicated to our mission…which is quite a statement in this day and age.) Truthfully, it is amazing how different all of clients needs are. And every client places a different emphasis on what's important to them. (To me, that's been one of the more interesting things I've learned in this business over time… each person tends to place emphasis on different items) Anyway, we know we are not perfect, but we strive to be as helpful as we can be for everyone, regardless of their specific issue. Frankly, I am more surprised when I get negative feedback…as I know the effort is always going to be there from our team.

6. Dear Dr. Joe, What is your slant on the government bailout of Bear Stearns? R.K.

Dear R.K. I don't believe I'm the one with a slant here, so I'll try to be quick. No government dollars were used in the bailout of Bear Stearns. However, the Federal Reserve Bank did provide "insurance" on the debt used to purchase Bear Stearns stock, which was an astute move as it provided calm during a potentially nasty financial storm. A small lesson may help. The Fed was originally set up (in 1918) to manage the money supply and to regulate commercial banks. Why? Because in the 1800's fear and greed resulted in a number of market panics and bank runs…which led to a number of bank failures, regular recessions, and a highly unstable economy. In fact, the Federal Deposit Insurance Corporation (FDIC) was also established at that time to protect depositor's money. This program has provided stability to banks for 90 years and bank runs are now a thing of the past.

Later, during the Great Depression, the Fed did not yet have the power or authority to use monetary policy as it needed to be to be proactive, which is why we had such a deep depression. Since that time, the Fed has had the ability to intervene when necessary by providing liquidity (cheap money) to banks when they are in need. Over the intervening decades, economists' understanding of monetary policy has also grown exponentially and the Fed has become much more adept at handling potential crises. Today, in a global environment, liquidity needs are greater than ever and more comprehensive regulation is needed. Bank rules need to be updated and different types of banks engage in very complex transactions. In essence, global innovation and the ensuing lending process have grown far more complicated. About a month ago, Bear Stearns, which is an investment bank (not a commercial bank…and as such is not regulated by the Fed) basically had a run on their bank. The Fed, who did not want to see this problem spread, intervened and stated that they would provide short term liquidity to any investment banks in need. This was a smart move. My slant: Thank God we have bright people like Ben Bernankee running the Fed. Given the potentially seriousness of the Bear Stearns situation, I also believe we will see changes over the next few years extending the Fed's role into the regulation of investment banks.

7. Dear Dr. Kiely, Could you take some time to explain the term "forward looking"? I keep hearing this term used by the media to describe the stock market and it sort of confuses me. A.C.

Dear A.C. Excellent question! There is a whole cross-section of academic literature about the efficiency of the stock market. In general, it's agreed that all past and currently available information is already priced into today's stock prices. In essence, today's stock prices reflect the "aggregate expectation" of investors regarding the future performance of a particular company. For example, today, we know JC Penney is going to have more total sales during future holidays (like Christmas) than they are having today. Now, if it turns out that the total sales of a company like JC Penney wind up being less than the market expected, the stock price will be revised downward, reflecting these lowered expectations. If, on the other hand, total sales and profits wind up being greater than expected, the price of JC Penney will increase. This is why the stock market is called "forward looking" - it reflects what the average investor thinks will happen to the company in the future. In fact, since the prices today are based on future expectations, most economists view the stock market as a "leading indicator" of what will happen 3 to 6 months from now. It's not perfect because expectations can be wrong and emotions cause overreaction, but historically it has done a pretty good job.

Let's expand this train of thought from one stock to the entire stock market. Between October, 2007 and mid-January, 2008, our markets went basically straight down. Why? First, the markets are forward looking and investors were expecting the economy to slow down. Second, market participants tend to overreact to bad short term news, which exacerbates the dip. Since mid-January, the economic news has continued to be pretty bad….yet the stock market has moved sideways and even up a little. Why? Because market participants are looking beyond today's data and seeing better times six months from now. This is not unusual. Since 1953, the S&P 500 has averaged a 13.2% increase in the second half of a recession. If we're in a recession now, this bodes well for all long term investors

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looking forward.

8. Dear Dr. Joe, Thanks so much for sending your timely updates which help us to understand the importance of being calm and riding out the ups and downs of the markets. I can't help but sense, however, that we face some unprecedented circumstances nowadays which could potentially threaten the resiliency of both the US and world markets. Could you please view and comment regarding the following short video which features Comptroller General David Walker? Do you consider yourself one who believes that we will "grow ourselves" out of such financial calamities? Thanks T.M.

http://www.youtube.com/watch?v=OS2fl2p9iVs

Dear T.M. I am very aware of Walker and I have heard his message. He is correct on a number of points, but this is not "new" news. There are four areas of concern that most people on Wall Street and most money managers already understand. First, we have baby boomers entering retirement (this year). Second, we have promised too much in terms of Social Security benefits, which are now being partly rescinded (e.g. benefits are being reduced and future retirees will be getting them at a later age). Third, we have promised too much in terms of health care benefits...which without question WILL be rescinded in the future...particularly Medicaid. Fourth, we have a Government that likes to spend more than they take in taxes, because that's what gets politicians elected….no surprise there.

Basically, government tax revenues go up every year...THIS IS A FACT. However, the federal government has a penchant for spending that eclipses the rate at which revenues are growing, which results in large deficits. If we could get the government to balance the budget or even spend less than they take in (what a radical idea!), everything would be fine. This is why Bill Clinton had the last balanced budget. As revenues grew, he and Congress passed spending bills that did not go up as much. It's quite simple; all we need to do is spend less than we take in. And since we've done it before, we know it CAN be done. The question now is whether the commitment of our leaders is sufficient to make it happen.

We all know there will be more people retiring than can be supported by the current workforce. We've known this for years, which is why Social Security benefits have been reduced and pushed back. President Bush (last year) passed a bill that increased the medical benefits given to retirees. Future presidents will be forced to take it back because it is something we will ultimately not be able to afford. The issue is not a large one now, but IT WILL BE if our government does not act. I believe this is why almost every American would like to see a balanced budget and less pork barrel spending. Our government will have to make some very tough choices five and ten years from now, if they don't do it today.

So, in a nutshell, Wall Street knows about the above issues and they are already factored into the pricing of assets TODAY. If the news gets better regarding our deficits, prices will increase down the road. If the news gets worse, prices will decrease. There is no doubt we (our country) will grow over time. The question is whether our government will get their spending habit under control. And that remains to be seen. Don't get too stressed about this yet. As Walker says, this is a long-term issue. Hopefully, we'll get a president that feels sound fiscal policy is a benefit to all in the long run. That would go a long way on many fronts.

An Update on KFS

Every year seems to bring new and exciting challenges and changes at our firm. This year, we have decided to focus our firm's efforts on continuing education. We believe this will only have a positive effect on our clients and our firm over the long run. At the beginning of the year, Brownie continued his financial education by enhancing his designation, Retirement Income Specialist (RIS). This designation is focused primarily on retirement issues and retiree challenges. This continues Brownie's long-term educational commitment towards helping (and understanding) his typical retired client. This designation requires yearly, continuing education classes. It also requires a specific knowledge and understanding tailored to retirees or those who are nearing retirement. I can only hope I have the passion for education and excellence when I'm Brownie's age.

On the opposite end of the investment spectrum is Katie's baby Reese. Reese just turned one in February and is as cute as a button. Unlike Brownie's typical client who is taking money out of his portfolio, Reese is putting money into hers (well her parents are). This year, Katie and her husband started a 529 plan for Reese's education. The long term benefits of starting a 529 plan today when Reese is young is obvious. The fact that Katie practices what we preach makes us proud. And please note, we DO NOT CHARGE clients for assets invested in 529 plans. We feel with the cost of education spiraling upward rapidly, this money should go directly to the kids. Please look into a 529 plan today. Katie also takes regular classes for compliance, administrative and insurance issues which keeps our

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operations efficient and running clean. Her commitment to our firm even brought her to Washington DC, to attend a SEC conference late last year. A conference which gave our firm a great deal of insight into the regulation of Investment Advisory firms by our government and how those regulations can reflect at KFS.

In our main office, our most heavily-used piece of software is Morningstar Workstation, simply because it would be impossible to build well-diversified portfolio without it. Over the last six months Kristen has become extremely proficient at using this software, saving our advisors and clients valuable time. We can now make investment and rebalancing decisions much more quickly due to Kristen's expertise using the software. Now, with the click of a mouse and Kristen's help, we can look at any managers or clients holdings in real time. This is a huge benefit. Kristen is also planning on getting her Notary which should help a number of our clients with their professional needs going forward.

Scott continues his Chair of the Finance Department in the ECU College of Business and as our Chief Investment Analyst. We could write an entire newsletter on his continuing research, his commitment to students, his work with the ECU endowment, his teaching, his work with our client's portfolios and his endless work with helping write our newsletters. But most importantly, his long term commitment to education and thoroughly researched investment strategies benefits our clients each and every day. Let's just say Scott never sleeps!! We are all blessed to have such a wonderful member of our team, who's dedication should not go unnoticed.

As you all now, I believe the day I stop learning is the day I should hang up my investment gloves. This field is just too interesting, dynamic and fun. If you pay attention to the experts in our field, it's hard not to learn. This year, I will make a small commitment to education by teaching a night class for the Economics Department at UNC-Asheville. This, in turn, will keep Kellie plenty busy as my teaching assistant. She will be required to memorize my text book, give exams, grade exams, copy notes, hand out assignments, etc. In fact, if I could work it out, I'd have Kellie teach the class! Truthfully, I'm looking forward to working with students again as I really believe in the teaching mission at UNCA. This is why Kellie is also involved with the scholarship program there…as you can never get too much education.

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 with research-driven asset allocation strategies, has provided excellent returns to all of us over the long term. As we go forward, we remain committed to continuing to refine and improve these proactive strategies. As always, our goal is to provide each of our clients with the best possible mix of assets given their particular situation.

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

Enjoy this wonderful spring!

- Joe and the Gang at KFS

Compliance Notes

A Personal Note From KFS' Chief Compliance Officer

It is that time again to offer our annual Disclosure Document. This document gives a brief overview of our firm, its employees and our practices and policies. If there is anyone who would like to receive a copy of this document, please email me at the address below or call our headquarters office at #877-366-5623. We will be happy to send one to you.

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

As always, we are committed to better understanding your investment objectives and goals and knowing how we can better serve you.

With Best Regards,
~Katie Burr
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Please Remember: *In the event that there has been a change in a client's investment objectives or financial situation, he/she/it is encouraged to advise KFS immediately. Different types of investments and/or investment strategies involve varying levels of risk, and there can be no assurance that any specific investment or investment strategy (including the investments purchased and/or investment strategies devised or undertaken by KFS) will be either suitable or profitable for a client's or prospective client's portfolio.* ***In addition****, the mutual funds depicted are funds that KFS may utilize and/or recommend as of specific date, and are subject to change without notice* ***Accordingly****, no client or prospective client should assume that the above reflected mutual funds serve as the receipt of, or a substitute for, personalized advice from KFS, or from any other investment professional.* ***Information*** *pertaining to each depicted mutual fund is set forth in each respective fund's prospectus, a copy of which is available directly from each mutual fund company or from KFS upon request.*

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Information pertaining *to KFS' advisory operations, services, and fees is set forth in KFS' current disclosure statement, a copy of which is available from KFS upon request.*

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