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

Short-term movements in the financial markets frequently take investors - including the majority of professional investors and economists - by surprise. For example, in early May, the monthly jobs report came out surprisingly strong, indicating the economy was improving more than most had predicted. That same day economists and the financial media, seemingly in lockstep, warned that a stronger economy would lead to rapidly rising interest rates and higher inflation. Except, of course, it didn't.

Interest actually rates fell that day and have continued to decline ever since…even as the economic and the job pictures have continued to improve. This has confounded both economists and industry professionals, which is nothing new. The truth is, short-term movements in the financial markets are virtually impossible to predict. In fact, academic studies have found the track records of professionals attempting to predict short-term outcomes like interest rate directions are no better than those made by flipping a coin.

The Point: What seems obvious, even to seasoned professionals, is frequently wrong.

One needs to look no further than the current stock market to witness this concept in action. We don't currently know anyone who is a raging bull and we are aware of a number of money managers who have become increasingly cautious, believing stocks are overdue for a normal dip in the range of 10% to 25%. In fact, one well-known small cap trader called for small caps to "get killed" in mid-May. Instead, the Russell 2000 small cap index has rallied 10% since May 15th after first experiencing a normal 10% peak-to-trough dip. In the meantime, we've seen large cap stocks hit 24 separate all-time highs this year, with the latest occurring just before July 4th. By the way, we're not poking fun at our peers by pointing these things out, since we've been saying the exact same thing for over a year now. The difference between us (at KWAG), and many of our peers, is we like to stress that there's no way to know when the actual dip will occur.

The truth is, dips in the range of 10-15% are a normal part of stock investing and they happen quite frequently. In addition, we know an increase in interest rates of 1% (or more) is also inevitable, and for certain types of bonds this will be quite painful. As a result, an investor would be foolish not to position their portfolio with an expectation that these events are going to occur—because we know they will. We just don't know when. This "timing" issue is where many investors, even the professionals, frequently get tripped up. They become convinced that whatever event it is they're expecting is so long

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overdue that it's imminent, prompting them to make wholesale portfolio changes to protect against the event. More often than not, time passes and the expected event doesn't occur, which means the portfolio changes they made cost them more and more money. Meanwhile, other investors continue to profit from riding the current wave. Eventually, the market timers become so disillusioned and tired of losing that they throw in the towel, undoing all the changes they originally made…just before the long-awaited event finally occurs. We've seen this scenario play out time and again over the last few decades.

The Point: Timing the market is impossible and more often than not it's also painful, costly and wrong.

This is precisely why we stress that investors are best served by holding a well-diversified portfolio of both stocks and bonds over time and maintaining their target allocations by rebalancing as needed. Academic studies overwhelmingly back up this "target allocation" approach by showing overwhelming evidence that those investors who frequently make decisions driven by short-term expectations, are almost always wrong, which means their decisions are counterproductive**.** On the other hand, when investors stick to a predetermined asset allocation strategy and rebalance as needed, it forces them to buy low and sell high and, even more importantly, keeps them from doing the exact opposite.

Most of our time at KWAG is spent focusing on things that we know we have 100% control over. Things like proper diversification, manager selection, asset allocation strategies, pro-active rebalancing, and long-term tax planning. Over the last few decades, we have learned that these are the things that have a material impact on our clients' portfolios over the long run.

The Point: Don't be afraid to admit that it's impossible to time the market and recognize there are some things no one will ever be able to accurately predict. Then, focus on the things you CAN control.

As long-term investors, we clearly recognize that any part of the financial markets could sell off at any time. However, we also know that predicting selloffs is like predicting earthquakes. We know they will occur, but don't know when or how big they will be. So instead of wasting time trying to predict the unpredictable, we have a rebalancing plan in place to help us take advantage of unexpected short-term volatility. Short-term volatility is as inevitable as it is unpredictable so it's critical to have a proactive plan in place to take advantage of it whenever it does occur.

This is why investors are best served by holding a well-diversified stock portfolios designed for the long run. We define the long run as at least five years, but prefer to think in terms of ten years or longer. In addition, we recommend our clients maintain a consistent allocation between their stock and bond holdings based on their investment needs, their time horizon, and their level of risk tolerance. Any short-term market dips can then be used to rebalance between stocks and bonds in order to get back to the original target asset allocation.

The Point: Proper diversification and pro-active rebalancing plans eliminate emotional decisions and they allow you to take advantage of changing market conditions without having to predict them.

For example, let's assume an investor starts out with 50% of their portfolio in stocks and the other 50% bonds, with the bond allocation primarily intended to provide for monthly cash flow needs. If stocks then rise significantly in value relative to bonds, the weight of stocks in the overall portfolio will grow and exceed the 50% target weight. In this case, the investor should either rebalance away from stocks (i.e. selling some of their stock holdings and using the proceeds to buy bonds) or, if income is needed, sell stocks in order to meet their monthly income needs. Conversely, if stocks were to experience a dip like we alluded to earlier, their portfolio would become underweighted in stocks and the investor should then rebalance back to their target allocation by either selling bonds and using the proceeds to buy stocks or, if income is needed, selling bonds and using the proceeds to meet their income needs. In either case, investors would rebalance back to their original 50/50 target allocation.

The Point: Appropriate asset allocation and proactive rebalancing forces you to behave correctly and (more importantly) it forces you to act in your own best interests.

In Sum

We know most of you are catching on to the obvious conclusion that the current news cycle and recent economic events have virtually NO bearing on the strength and/or success of your investments over the long-term. Any doomsday prognostications about your children's or grandchildren's future are just that - prognostications - which should carry no importance. We personally have learned to embrace such outrageous prognostications with a smile on our face…and a sense of humor. Based on the feedback we get from 99% of our clients and friends…you get it! Thanks!

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In addition, any prognostication that is promoted with a "high conviction" should be treated as either overconfidence or overzealousness. Behavioral research has shown that strongly held beliefs often lead to overconfidence and that overconfidence, or hubris, is a dangerous emotion for investors. It's far better to remain humble and actively seek evidence that provides a counter view than to hunt like mad for something/anything that supports what you already believe. As poet W.B Yates once said, "The best lack all conviction, while the worst are full of passionate intensity."

The Point: It's okay to examine other viewpoints and challenge your beliefs. We believe this approach reduces the likelihood of a significant error on our part, which means we keep more of what we earn.

THE STOCK MARKET

The bull market rally is now entering its sixty-fourth consecutive month. From the bottom, which occurred on March 9, 2009, all segments of the stock market have exploded upward, led by mid-cap value, which according to the Russell Group is now up a whopping 317% from the low. Even the worst area of market, large cap growth, is up an impressive 226%. This has been amazing run but it has not come without some significant and much-needed healthy pullbacks in 2009, 2010 and 2011. In 2012 and 2013, we experienced three smaller magnitude pullbacks, however each dip was under the all-important 10% number. At this point, we have now gone more than 1000 days without a normal 10% dip in large cap stocks - which has some investors concerned. Many of these investors have missed the significant run-up in stock prices over the last year and a half, because they believed they could time the markets swings. This has been a costly lesson.

So far in 2014, we have continued to experience steadily rising stock prices with relatively little volatility, at least in large caps. On the other hand, we have experienced a healthy 10% pull back in small cap stocks (as measured by the Russell 2000) between March and mid-May. As you might imagine, we have used this small cap pull back as an opportunity to rebalance those over-weighted portfolios that became out of balance, by purchasing small caps while they were relatively speaking, on sale. By doing so, we have captured the upside return and pro-actively taken advantage of the volatility. That common sense strategy beats trying to predict an unknowable future.

Post-Crash Recovery for Russell Style Indexes 03/09/2009 — 06/30/2014

Value	Blend	Growth	
238%	232%	226%	**Large**
317%	294%	273%	**Mid**
266%	274%	281%	**Small**

At the beginning of this year, we made a case for why we were optimistic about the stock market over the long run. However, we also provided a variety of valuation measures that mostly indicated the stock market was "fairly" priced, at least in the short-term. Then, going out on a limb, we boldly wrote that this meant the stock market could easily finish the year in either positive or negative territory (we hope this sort of insight proves valuable to our readers). Seriously, the first quarter of this year validated our noncommittal stance on stock direction, as stock prices vacillated back and forth across their 2013 year-end values, with every style index eventually finishing the quarter up modestly.

The first six weeks of the second quarter further reinforced our views as the Russell 2000 small cap index experienced its first 10% peak-to-trough dip in several years. Over the same period, the S&P 500 index (large cap stocks) managed to stay in positive territory, although just barely, reaching a point where it was up just 1% for the year. Clearly, as of mid-May the stock market lacked conviction in either direction.

Then in mid-May, a slew of positive economic data came out, led by data indicating significant job creation. From that point on all segments of the stock market have rallied significantly. In the second quarter, the large cap style indexes were all up more than 4%, while small cap indexes, rallying from their selloff in May, finished the quarter up roughly 2%. Hidden within these numbers is the healthy 10% dip experienced by small caps that ended on May 15. Since that time, small caps have gained more than 10% through quarter-end.

Morningstar Category Average 2nd Quarter 2014

Value	Blend	Growth	
4.53%	4.63%	4.18%	**Large**
4.67%	3.90%	2.66%	**Mid**
2.91%	2.31%	0.57%	**Small**

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We regularly discuss the well-documented "value" and "size" premiums that have existed in the stock market over the long run. In the second quarter, value stocks outperformed growth stocks by a fairly wide margin, reversing the recent surge we'd seen in growth stocks over the last year or so. This rotation away from growth and into value has worked out well for our clients, since we have been regularly rebalancing out of growth and into value since the beginning of the calendar year.

Morningstar Category Average
YTD through 06/30/2014

	Value	Blend	Growth
Large	6.96%	6.39%	4.68%
Mid	7.79%	6.47%	3.97%
Small	4.69%	3.81%	0.87%

When you examine small cap stocks over the first half of the year, it's clear they have underperformed both their large and mid-cap peers. Even though small stocks tend to outperform over longer periods, they can (and do) trail over shorter periods of time, providing proactive investors a good opportunity to rebalance. As we mentioned earlier, small stocks experienced a healthy 10% dip that ended in the middle of May and since that time have rallied 10%. For clients whose portfolio had become underweighted on the small cap side, we used this recent period as an opportunity to rebalance towards small caps.

Examining the one-year and three-year periods, there is little evidence of the "size" and "value" premiums. As we've said before, this happens occasionally and is why we prefer to equally weight our portfolios across the size and style spectrum rather than simply overweighting smaller stocks and value stocks. By equally weighting, we're not betting on which asset class will outperform in the near term, but instead are letting the market determine that for us. Then, when one sector has outperformed, we rebalance, which means we sell some of what's been hot (most recently larger stocks and growth stocks) and buy what's on sale (most recently smaller stocks and value stocks).

Market pundits like to cite periods where the longer-term size and value trends are reversed as evidence that such "premiums" no longer exist, but they clearly haven't done their research. Academic studies show very convincingly that over longer periods, small stocks beat larger stocks and value stocks beat growth stocks. In addition, the research shows this has occurred throughout the entire history of financial markets—not just in this country, but in every country that's ever been studied. In the first-quarter newsletter we included a table examining stock market returns over the last four-plus decades, since 1970. The evidence behind a "value" and "size" premium in that table is overwhelming. So even though growth has beaten value fairly convincingly in the last 12-18 months, we're now starting to see a shift back to value.

1-Year Morningstar Category Average
Performance ending 06/30/2014

	Value	Blend	Growth
Large	22.21%	23.65%	26.22%
Mid	25.44%	24.74%	23.98%
Small	23.58%	23.78%	22.40%

3-Year Annualized Morningstar Category Avg.
Performance ending 06/30/2014

	Value	Blend	Growth
Large	14.88%	14.86%	14.42%
Mid	15.33%	14.15%	12.59%
Small	14.50%	14.25%	12.73%

On March 9, 2014, we celebrated the five-year anniversary of the market lows reached following the credit crisis. As shown in the table below, small and mid cap stocks have outperformed large caps stocks over the last five years, although the difference between value and growth has been negligible (which is largely due to the major decline and slow recovery in financial services stocks following the credit crisis).

5-Year Annualized Morningstar Category Avg.
Performance ending 06/30/2014

	Value	Blend	Growth
Large	17.27%	17.47%	17.64%
Mid	20.46%	19.76%	18.98%
Small	20.13%	19.87%	19.88%

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Going back even further in time, we can see that over the past decade small and midcap stocks have again outperformed large cap stocks. Interestingly, once again we don't observe a significant "value" premium over this period. The absence of the value premium over such a long period is unusual, which is being driven by a combination of factors, including the severe oversold state in the growth-oriented tech sector 10 years ago. In fact, between early 2000 and late 2002, the tech-heavy NASDAQ 100 index lost a whopping 82% of its value and is still more than 20% below its all-time high. Since tech stocks are heavily growth oriented, the tech recovery from the depths of that epic selloff has provided a strong tailwind for the growth indexes over the last decade. In addition, value stocks underperformed during this period due largely to the aforementioned selloff in financial services stocks following the credit crisis in 2008. When combined, these factors have created a rare decade-long period where the difference between value and growth has essentially been indiscernible (the average difference between value and growth across the three size categories in the table below is just 0.10% annually, in favor of value). However, if the first half of 2014 is any indication, it looks like value may once again be ready to lead the way.

10-Year. Annualized Morningstar Category Avg. Performance ending 06/30/2014

Value	Blend	Growth	
7.30%	7.32%	7.77%	Large
9.01%	8.73%	8.83%	Mid
8.79%	8.73%	8.72%	Small

Our Stock Market Outlook

Over the last few months, one of the most frequently asked questions from our clients is whether we believe the stock market is "overvalued", especially after the run-up we saw in 2013 and again over the last few weeks of the second quarter. The short answer is, "No, we don't believe it's overvalued." However, we don't believe the market is undervalued either. Remember, the value of any investment is a function of the "cash flows" it generates over time. Thus, if stock prices increased without an increase in underlying corporate cash flows, then we would be concerned about overvaluation. Thankfully, this has not been the case. There are a number of different ways to assess the value a company, but the most common measures are ratios of a firm's stock price to their earnings, book value, free cash flows (our favorite), sales, or earnings growth rate. Last quarter, we included a table, which examined current valuations versus their longer-term 15-year averages. The numbers were almost identical. Today, each of these measures remain very close to their long-run averages and are little changed from where they were a year ago. So overall, we think the broader markets remain "fairly" priced.

CHALLENGES IN FIXED INCOME INVESTING

For several years now, we've been saying that the period we're in now is as challenging as it's ever been for fixed income investors. We've also stressed that this doesn't mean investors should abandon bonds and bond funds in their portfolios, since bonds play such an important role in managing risk, generating short-term cash flows, and reducing longer-term volatility. To us, the biggest issue—particularly given our bond managers' excellent performance over the last few years—is managing investor expectations. Given the real-world constraints we currently confront, investors need to moderate their expectations on bond returns relative to the recent past. This doesn't mean the answer is lightening up on bonds, because as we've already mentioned, they play such a critical role in most people's portfolios. What it does mean, however, is that the 10%+ annual returns we've seen in recent years from our bond portfolios are unlikely to be repeated, at least in the near term. Still, we expect the bond funds we use to generate positive returns going forward while continuing to provide a high degree of safety. As a result, we think changing target asset allocations based on reduced expectations of returns in bonds would be a mistake. History is littered with the rusted-out shells of portfolios that were destroyed when investors became either too fearful or too greedy and deviated from the tenants of prudent long-term asset allocation strategies.

The Point: Predicting short-term interest rate movements is basically impossible.

Over the last few years, we have seen numerous instances where interest rates have moved opposite to the expectations of most bond professionals and economists. Two recent dramatic instances stand out. First, in June 2013, then Fed Chairman Ben Bernanke laid out his plan to begin tapering the controversial bond-buying program known as "quantitative easing". His remarks at the time were nearly identical to those made by John Williams, Head

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of the San Francisco Federal Reserve, a month earlier—which were met with no market reaction whatsoever. Regardless, Mr. Bernanke's comments triggered a sharp bond selloff and interest rates spiked upwards. **The net result:** Bond investors who followed the "herd" by betting on stable or falling interest rates, got crushed.

Then in early May of this year, the monthly jobs report came out much stronger than expected and economists and market professionals immediately began warning of rapidly rising interest rates and the dangers of inflation. Instead, of course, the exact opposite has occurred. **The net result:** Bond investors who followed the advice of the professionals and bet on rising interest rates have missed out on a nice bond market rally as rates have actually declined.

One lesson to take from all of this is that markets are emotional entities and sometimes ignore the context of the message, instead hearing only what they want to hear. In 2013, nothing Mr. Bernanke said was unexpected and therefore should not have sent both the bond and stock markets into a tailspin. But it did. Similarly, the bond market reaction to last May's jobs report left many economists and market professionals scratching their heads and has even gotten a few of them fired.

The Point: The best course of action is building a well-diversified portfolio of alternative bonds and rebalancing that portfolio as the markets dictate.

KWAG Strategies

If you're a long-time reader of our newsletters you know that we began talking about the dangers of rising interest rates since 2011. Until last year, we'd yet to see any meaningful upward momentum. The key thing to recognize about interest rates is that everyone knows they will eventually go up—but no one knows when! This uncertainty in timing causes difficulty for investors and bond fund managers alike, at least over the short run. This is precisely why building well-diversified portfolios is so important. While we occasionally make incremental changes to our portfolios based on our expectations for the future, we will never deviate from the long-term fundamentals of proper diversification and strategic asset allocation.

Over the last few years, as interest rates have shown signs of stabilizing and beginning to inch back up, we've stressed the importance of diversification across the ENTIRE fixed-income spectrum. Specifically, our conservative core bond strategy involves a number of pillars, each critical in achieving the kind of diversification benefits we're looking for. Holding a variety of dissimilar fixed-income securities is key, because each asset type reacts differently to specific economic events. For example, some fixed income securities are more sensitive to the stock market moves, while others are more sensitive to interest rates. A fixed-income portfolio is a single entity that is comprised of many interlocking parts, and care needs to be taken to avoid focusing on the performance of any single piece in the mix over a short period of time. Each fund (or fund manager) in a diversified portfolio is intended to fulfill a specific role within a specific market environment, meaning the whole of a properly constructed portfolio is greater than the sum of its parts. Therefore, portfolios should be evaluated in their entirety as opposed to their individual pieces.

The Point: We want our clients to look at the big picture and recognize there are many unknowns. Their fixed income portfolios are constructed with these unknowns in mind.

The Fixed Income Numbers

The performance of an equally weighted portfolio of KWAG core bonds is displayed in the table on the next page. As you can see, this portfolio is made up of different types of bond funds, which span the entire fixed income spectrum. In addition, you will observe a diversified portfolio – which embraces a variety of bond funds – significantly outperforms the broader bond market averages. We use this table ONLY as an example of how a well-diversified fixed income portfolio should work. It's important to note that each client's fixed income portfolio is tailored to their specific needs and may differ from the composition of the portfolio shown below. Each advisor (at KWAG) uses our "core" portfolio of bond funds as a starting point, and makes adjustments based on the specific needs of each individual client. Clients with a greater need for current income will hold more conservative bond portfolios, which will be expected to have lower long-run returns but expose their nest eggs to less downside risk. Clients who are still working or are not currently taking distributions will tend to have more aggressive bond portfolios, which are expected to generate higher returns at the expense of higher downside risk exposure. All of our clients typically have a portion of their portfolio allocated to each type of bond fund. The weight of each piece is determined your specific situation, taking into account your age, income needs, risk tolerance and any other relevant factors. Clearly, more aggressive holdings like NEFZX and ANNPX have the highest returns over the past three and five years, which is why many investors naturally gravitate towards them. However, both of those aggressive funds also have significant downside risk exposure, which is why we like to hold them within a well-diversified portfolio.

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KWAG CORE BOND FUND ANNUAL RETURNS

KWAG Core Bond Funds	2014 YTD	2013	2012
Oppenheimer Floating Rate (**OOSYX)**	2.15%	6.70%	8.75%
Allianz Convertible (**ANNPX)**	7.83%	25.58%	11.96%
Loomis Sayles Strategic (**NEFZX)**	7.28%	10.87%	13.56%
PIMCO Total Return (**PTTRX)**	3.70%	-1.92%	10.39%
Doubleline **(DBLTX)**	4.49%	0.02%	9.18%
Average Fixed Income Return	**5.09%**	**8.25%**	**10.77%**
Barclays US Aggregate Bond Index	3.93%	-2.02%	4.21%

The Silver Lining

If the recent bout of volatility taught us anything about our bond portfolios, it's this: **Patience, Diversification, and Sound Investing Fundamentals matter.** When you examine the big picture within the context of what happened over the last few years, our biggest take away is that we have an excellent mix of bond funds and bond fund managers, and we believe they will be able to weather any type of future interest rate movements. In addition, a diversified portfolio of bond funds provides an attractive alternative to cash, CD's and/or a money market account, since it's liquid, safe and it pay's a higher rate of return.

Our Point: If you have a significant amount of cash sitting in a bank account earning next to nothing, our bond portfolios provide an excellent safe alternative to your idle cash and/or money market fund.

Finally, just as our bond fund managers have made changes to their portfolios in response to the inevitability of rising interest rates, we at KWAG have also altered the composition our bond portfolios over the last several years. We've done this by lightening up on or totally eliminating bond funds with less flexibility to react to rising rates and have added funds that give their managers more flexibility. We have also added some alternative types of fixed income securities to the mix (where appropriate for the client's risk tolerance and income needs), including floating-rate funds, convertible bond funds, and even master limited partnerships. We have long argued that diversification in fixed income investing is just as important as in stock investing, and the previous few years are perfect examples of why we feel this way.

One Final Note

A year ago, as interest rates were increasing, we made the following observation which, given the uncertain path interest rates are on, we think is worth repeating. We wrote, *"We don't believe interest rates are going to increase very much over the remainder of the year. In fact, we believe interest rates are actually more likely to decline in the short term, with domestic rates likely finishing the year below where they ended the second quarter (of 2013). There are number of reasons we feel this way. If we are correct, the recent trend of rising interest rates could be expected to reverse itself, and bonds and bond funds would be the beneficiaries. Of course, nothing is certain in the financial markets over the short term, which is why proper asset allocation is paramount at all times."*

Last year, we got lucky with our assessment of the direction of interest rates. However, since short term movements in any financial market are impossible to predict, rather than relying on luck, we'll keep our portfolios well-diversified and continue using managers who have a great deal of flexibility in their investing approach. These things, in addition to remaining humble, pro-actively rebalancing, and using excellent money managers, remain paramount in this type of market environment.

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QUESTIONS WITH THE DOCTORS

Q1: Dear Dr. Kiely: What are your thoughts regarding the acrimony and discord associated with our Federal Government? Don't you believe they are making it more difficult for the average person to succeed? J.J.

Joe: Hey J.J. That's a loaded question! While it's undeniable that some government policies are controversial - whether its American involvement in the Middle East or changes in the health care policy – I still believe we can all agree on one thing. We live in the best country in the world! I don't want to go off on a tangent, but I'll mention a few examples of why I feel that way. First, we are the world leader when it comes to innovation. Over the last several years we have led the world in innovative products and services in the fields of energy, computing and biotech. Nobody could have predicted the incredible growth we have had in the energy sector, as we are now an exporter (yes, exporter) of energy and sit on the largest reserves of oil and gas on this planet. All three of these industries have created thousands of jobs, significant tax revenues and domestic stability on a number of fronts. For those people who gravitate towards these industries, I would argue it's a lot easier to succeed.

Scott: The U.S. is also home to the majority of the top universities in the world. Fifteen of the top twenty universities are based in the U.S. and our universities educate a bigger proportion of the global population than any other country. This attracts the most talented minds to our shores, which gives us a huge advantage on a number of fronts. On the other hand, when you examine the public school system, any parent will tell you we can do better. However, we do have a literacy rate of 99% for citizens over the age of 15, which is critical and no small achievement. So although we have things we can improve on, the current educational system does provide virtually everyone with an opportunity to succeed.

Joe: That's true. Education is an important part of our nations framework, which naturally leads to innovation and competition. One of my favorite global statistics is the IMD World Competitiveness Scoreboard. This scorecard measures how an economy manages the totality of its resources and competencies to increase the prosperity of its entire population. The United States is the world leader at 100. Switzerland is next at 92. Singapore and Hong Kong come in at 90, while Canada, Sweden and Germany score 85. In essence, our economy provides more opportunity and a higher standard of living than any other country on this planet. So, I agree, we can always do better and we should always strive to improve. However, let's not lose sight of how fortunate we are.

Q2: Dear Dr. Joe: I read with great interest about your educational trip to Spain. Can you share some of the highlights of your trip? How healthy is Spain and the European Union (EU)? K.B.

Joe: Dear K.B. I had a great trip to Spain and I loved the food, wine, people, history and particularly the architecture. Unfortunately, my visit reinforced much of what we already know about Spain and the EU. Spain…particularly cities in the south…are hurting. The overall unemployment rate is over 20% and if you're between the ages of 20-30, the rate is closer to 50%. There are two main industries – agriculture and tourism. Both industries are keeping the country afloat, but just barely.

The woman who led my tour group spoke six languages and had three degrees. She could only find work as a guide in Spain. Although (in theory) the EU is supposedly open, she had a hard time finding a job anywhere outside of Spain. In fact, she said each country tends to protect it's own. So, although you can move anywhere freely across Europe, the truth is your future is predicated mostly on your birthplace.

Scott: This is exactly what we try to stress to our undergraduate and graduate students at ECU. In this country, hard work and initiative are still the keys to success. It doesn't matter what state you were born in or whether your parents are wealthy and connected. Not many countries can say that. I grew up in rural South Dakota and learned the value of hard work from my parents and grandparents. Now, I have the privilege of working two jobs that I love and earn a comfortable living in North Carolina, a long way from where I was raised. I think this speaks volumes about the role mobility plays in allowing Americans to achieve their career aspirations. I could have ended up anywhere after earning my PhD, but ECU was the type of school I was looking for and it was a perfect fit, even though I'd never set foot in North Carolina prior to my campus interview in 1993.

Q3: Dear Joe & Scott: I hope you plan on providing your usual insights about our economy in the upcoming newsletter. I'm worried that rising interest rates will put a damper on the economic growth and stock prices. What's your view? B.M.

Joe: One of the biggest reason's we have not seen a normal 10% dip in the S&P 500 has to do with the American economy. At this point, we believe there's little doubt that an economic recovery is underway. What is debatable is the strength and sustainability of the current expansion. Of

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course, we've been saying the domestic economy would recover slowly in "fits and starts" for over five years now. We still believe this is true. For example, economic activity during the first quarter was off 2.9%, due to weather anomalies and overextended corporate inventories. However, in the second quarter there has been an encouraging uptick in economic activity, led by significant job growth over the last three months. This current expansion in job growth has pushed the unemployment rate down to 6.1% - it's lowest level since September 2008, or just before the economic credit crisis. Unfortunately, the yoyo-like first and second quarters reinforce our observation that the economy will grow in "fits and starts". It would not surprise us if the economy behaved this way for another two to three years, given the structural damage caused by the 2008 credit crisis.

Scott: Even though the Federal Reserve will stop buying bonds in October, they have made it clear they intend to keep interest rates low for as long as it takes to get the overall economy back to some semblance of normalcy. We're getting there, but growth in GDP is still well below the long-term average and the unemployment rate is still too high. In addition, the Fed believes the official unemployment rate makes things look better than they really are because it doesn't account for the tens of thousands of people who have simply stopped looking for work. Of course, the unemployment rate also doesn't measure the millions of Americans who are underemployed because they've been forced to take lower-level jobs just to make ends meet. The Fed watches wage levels very carefully and when they begin to see wages rising they will become more aggressive on raising interest rates. Given the current economy, I think we've still got quite a way to go, which means I don't see rates rising materially for quite a while.

Joe: Keep in mind, the health of Corporate America (and thus stock prices) are driven by the entire global economy…not just the U.S. economy. As long as corporations can use low interest rates, an inexpensive educated labor pool and new technologies to expand their balance sheets worldwide, American companies (and corporate cash flows) will be just fine.

Q4: Dear Joe & Scott: There seems to be a number of significant economic headwinds, which could reduce or hinder global growth. Can you guys examine a couple of these global headwinds and comment on how you think they'll affect the economy and our stock market? J.W.

Joe: When you examine the global economy, there are a lot of interesting issues. Europe has near record unemployment in many regions and we don't see that changing anytime soon. (See Question 2.) In China, growth is still significant, but there is also a developing bubble in real estate. Finally, when you examine the emerging market countries like Brazil, Egypt and India, its no secret that they have a number of social issues, which will impact their growth trajectory. So, there some very specific headwinds that we need to overcome.

Scott: The good news is, central banks across the globe are following the lead of our Federal Reserve and using accommodative monetary policy to help their respective economies grow. Overall, we think the global economy will continue to grow and this supports a theme of growing companies, increased cash flows and rising stock prices. This isn't going to happen without the normal bumps in the road, of course, but at present we don't see anything that has us holding our breath about corporate cash flows or profits.

Q5: Dear Dr. Joe & Scott. I tend to agree with you and Scott, and believe overall stock market valuations are fairly priced. That said I have to believe there are some areas that are in bubble territory. Can you comment on those specific areas of the market? P.K.

Joe: Dear P.K. Like you, we believe the overall market is fairly priced…even after the last month's run-up in prices. However, we also agree that there are some potential bubbles, which each of our managers are trying to avoid. Stocks tied to hyper-growth themes like biotech, cloud computing, and social media have been bid up excessively due to the excitement about their disruptive platforms. (Note: These bubbles were reinforced in a speech by Janet Yellen on Tuesday, July 15th, 2014.)

Scott: That's true. Social media is the preferred method of communication for many Americans and it offers businesses a more effective way of targeting advertising toward a specific audience. Meanwhile, cloud computing offers cheaper, faster and more effective delivery of software solutions. We don't dispute the game changing nature of these industries, but investors should be careful about the current valuations (stock prices) assigned to virtually every company tied to these industries. Today, they all seem to be valued as if they are going to be BIG winners, but we know that won't be the case. Some will survive and thrive but many will not, and picking the ultimate winners at this point is probably more luck than skill. There's clearly a lot of uncertainty, so our managers are limiting their exposure to these areas and focusing on areas where they think the valuations are more attractive.

Joe: Of course, there are also potential bubbles in the bond market as well. If interest rates increase 1% between now

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and the end of the calendar year, long term treasuries could lose up to 16%, mid-term treasuries 8%, municipals and corporate bonds more than 7% and that doesn't even include emerging market bonds, agencies and high yield bonds. A significant increase in interest rates is still one of our primary concerns…although we do not believe this is going to occur any time soon.

Q6: Dr. Joe: Can you comment on the significant lack of volatility in the stock market? To me, it feels like the calm before the storm. Do you think we should be worried about another 2008 dip? V.C.

Joe: Well, we've mentioned it a couple of times now, but the last time a 10% dip in the S&P 500 occurred was over 1000 days ago…and counting. This is the fifth longest correction-free run in the last 50 years. Obviously, the probability of a normal 10% correction increases with each passing day.

Scott: Of course, investors should expect a 10% dip each and every year because that's the norm. We have seen a 10% dip in small caps this year, but they also snapped back to hit all time highs at the beginning of July. So, it would not surprise us in the least to see a 10%-15% dip in large caps at some point this year, which would probably also mean a second dip in small caps.

Joe: Speaking of volatility, one of the more interesting stat's I saw recently was the fact that the S&P500 had not had a 1% move in either direction (up or down) for over six months. That's amazing to me. Three years ago, the stock market moved more than 1% in one direction or the other almost every day. So, yes, there has been a significant lack of volatility. But no, we don't believe it's the calm before the storm. A 10%-15% market dip should always be considered normal.

Q7: Dear Scott & Joe: Do either of you guys see any signs of core Inflation? G.M.

Scott: There are three areas that most people monitor to get a sense of future inflationary pressures: Employment and Wage Growth; Money Velocity; and Bank Lending. The employment picture, while improving, is still relatively weak and we're not seeing much in the way of wage growth. Until we begin to see significant wage growth I don't think there's much to get excited about on the inflation front.

Joe: Money Velocity (or the speed with which money changes hands) is measured by looking at consumption, household leverage and general bank loans. Consumption is increasing, but at a very moderate rate. Households are also (finally) beginning to take on more leverage, but again it's at a tepid pace which is not the least bit concerning. Although we're seeing more bank loans, the rate of growth is very low. So, core inflation is not a real concern at this point.

Q8: Dr. Joe: Can you guys provide an update on your broad macro-economic themes for long-term growth? Has anything changed there? B.S.

Scott: The macro-economic themes we focus on are interest rates or capital costs; the quality and depth of the labor force; the impact of technological advances; changes in the global quality of life; the flow of capital; a growing global middle class; and energy costs. At this point, every one of those factors looks positive for the continued long-run growth of the global and domestic economy. In other words, our long-term view remains unchanged and optimistic.

Joe: Exactly. Long term, if our macro-economic themes stay in place we would expect the overall stock market to grow at somewhere between 8%-10% annually. Usually, there is one significant game changing industry (or innovation) that drives the markets for a number of years. Today, there are so many positive changes happening (on a regular basis) in so many different industries, that we already may be in the midst of a game changer…and just haven't recognized it. An example of this is energy. Five years ago, nobody thought we would be producing more oil than we have in 25 years, and nobody thought we (in the US) would be a net exporter of oil. And yet, here were are. Frankly, if you objectively look at all of the macro-economic data, I have a hard time understanding why anyone would be pessimistic long term. We will certainly have our share of short term bumps and bruises over the next ten to twenty years, but the gains in every industry should significantly outweigh those bumps and bruises.

Q9: I always enjoy your thoughts and insights into Investor Psychology. Any new interesting studies you can share with us readers?

Joe: I personally love articles or theories that take a complex subject and break it down into a simple understandable theory. A recent article on "loss aversion" caught my attention. Basically, in previous studies it has been shown that losses have a much larger psychological effect on people than gains. In fact, several experiments have found a "loss aversion ratio" of 2.0 - 2.5 to 1, which implies investors have to have 2.0-2.5 pieces of good news to offset one piece of bad news.

Clearly loss aversion can have a profound effect on how you view your portfolio, particularly when it comes to stocks. Most investors claim to be unfazed by uncertainty, but we know everyone hates to lose money. Its one of the reasons why crash predictions and negative thinking always seems to sound more intelligent and make more sense. Psychologically,

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our DNA is set up to flee from potential danger. Lets examine the following table, which provides a historical look at rolling performance numbers over a short and longer-term perspective. Specifically, the table provides a snapshot of how often we see positive and negative returns (in percentages terms) over various rolling time periods.

S&P 500 (Since 1928)	Daily	Month	Qtrly	1-yr	5-yr	10-yr	20-yr
Positive Returns	53%	62%	68%	72%	87%	94%	100%
Negative Returns	47%	38%	32%	28%	13%	6%	0%

As you can see, the daily returns are more or less a 50-50 proposition. If you are affected by loss aversion and you check your portfolio values on a daily basis, you are going to feel pretty bad all of the time, since you get an equal amount of good and bad news. As you lengthen the time horizon for how often you check your portfolio, the effects of "loss aversion" fade, and the stock market as an investment looks more enticing. Of course, this is precisely why we constantly promote examining your portfolio over the long run and NOT checking the value of your account each day. We know it will affect your emotions and your ability to think logically about the markets. Now you know why many investors and people (in general) either fail to invest in the stock and/or completely avoid looking thinking about their portfolio. They view investments from a short term perspective.

Scott: I think the instructive thing about this study, is that it reinforces many of the things we write about. It's impossible to predict how the market will behave over the short run. However, over the long run, the probability of success increases significantly. That's why we say you need a 5-year minimum horizon to buy stocks, but 10-years is even better. If over that 10-year period you use excellent managers, include small and mid-cap stocks, and proactively rebalance, the odds are even more in your favor.

Q10: Dear Dr. Joe, I just wanted to take a few moments and thank you for everything your firm does for my welfare. I appreciate the quick responses, the sincere concern for my well-being, and the patience you and you staff give me when I ask questions. Thank you for making me feel secure. – M.J.

Joe: Dear M.J., Thank you for the kind note. I can say with complete honestly that everyone on our staff loves their job and they really enjoy making a difference in people's lives. On an ongoing basis, we spend a great deal of time trying to improve every one of our functions from the way we handle calls to the way we rebalance portfolio's. All of us (at KWAG) know that we have the ability to improve, so we try to replicate the things we do well and eliminate the things we do poorly. Clearly, you don't want to make the same mistake twice!

On the operational side, there are a number of compliance issues that continue to bog us down. It's unfortunate because many of the compliance rules make no sense and have nothing to with how we manage money or people. That said, we try to make the best of bad situation and we try to limit how it affects our client interactions. On the investment side, the world is ever-changing, so we have to constantly read, research, ask good questions, remain humble, be open-minded and work longer hours. It is truly a 24/7 job that you really have to love and embrace.

Thanks for noticing our efforts! It means a lot to us.

A Final Note

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

Enjoy the remainder of the Summer!

~ Joe and The Gang at KWAG

THE GANG AT KIELY WEALTH ADVISORY GROUP

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

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