KWAG October 2014 Update

Good Afternoon. Every once in a while, an obvious investment opportunity presents itself to investors. Unfortunately, more often than not, the vast majority of investors miss it, even though they know they should act upon it. The reason investors miss most of these obvious opportunities is quite simple…it all comes down to "Behavioral Finance" and/or "Investor Emotions". The truth is, investors tend to be incredibly impatient, they hate rebalancing out of winning parts of their portfolio, they attempt to time the stock markets swings, they chase performance, and they find it all but impossible to buy into underpriced areas of the stock market. All five mentioned behaviors are well-known recipes for long-term stock market underperformance.

The Numbers

During the third quarter, the S&P500 (large company) index experienced a moderate increase in volatility, it hit a number of all-time highs during the quarter (including the last week of September), and it finished up 0.6% or in positive territory for the seventh straight quarter. For the year, the S&P500 index is now up more than 6%. On the other hand, the Russell 2000 (small company) index experienced a much more significant increase in volatility, the small cap index hit a yearly low at the end of September, and it experienced it's second 10% dip (or correction) of the 2014 calendar year. For the quarter, the Russell 2000 index was down more than -7% and is now off more than -5% for the 2014 calendar year. In fact, the Russell 2000 now sits a full 12% behind the S&P500's performance through the end of September.

Some Perspective

To us, the small cap opportunity presents one of the best "relative" buys we have seen in small caps since 1999. However, our perspective seems to be in the minority, which frankly makes us even more confident in our analysis. Of course, we're patient long-term investors who make prudent decisions based on a five-year investment window. If you follow any form of the financial (or main-stream) media, they tend to focus on the short-term performance of the stock market with a pessimistic slant, which is where the term "climbing the wall of worry" comes from.

Unfortunately, most investors focus on the "worry" part, which is why we have fielded a number of questions about 1) the short-term performance of small caps (Irrelevant), 2) whether or not we should increase our "cash" holdings (Ugh!), 3) whether or not we should wait for the stock market to take a normal 10% dip before investing (Hmmm?), 4) what we think about the each of the various global crisis (Not much); and 5) what are our thoughts regarding the current stock market bubble?

Long Term Trends

One of the most important, but often overlooked, keys to successful long term investing is to steer clear of making obvious costly investment mistakes. This is precisely why we build well-diversified stock portfolios with significant exposure to small and mid-caps. We know small and mid-caps outperform large caps over time, so it would be costly to avoid these areas of the market over the long term. This is also why we (and our managers) pro-actively rebalance our portfolios. We know there will invariably be times when the opposite market trends occur. Those specific times provide excellent long-term investment opportunities for those who remain patient, pro-actively rebalance, and stick to a long-term strategy. Finally, this is why we (at KWAG) set up a specific long-term asset allocation models for each client. This allows us the opportunity to rebalance within the stock market, and between stocks and bonds as the financial markets dictate. This has the added benefit of eliminating the need to "time the market", which is virtually impossible to do.

Reversion to the Mean

On Friday, October 17th, we will send out our 3rd quarter newsletter along with quarterly statements. This quarter, we focus on the concept of "mean reversion", which is an academic concept that examines deviations from longer-term economic trends. In essence, when you observe a short-term deviation from the longer-term trend, you can almost always count on a reversal (or mean reversion) of that short-term trend back to the norm. This provides an opportunity. Today, we are experiencing a number of deviations away from the longer-term trends. These deviations provide a great opportunity to proactive investors with long term investment horizons.

Specifically, in the upcoming newsletter, we will examine long-term stock market return trends, typical stock market volatility, expected future interest rate movements, and our manager's performance. At KWAG, we believe it's important to understand how each part of the economy and the stock market behaves over longer periods of time. There are many reasons for this belief, but two primary reasons stand out. First, you can use those longer-term trends to significantly increase your odds of long-term investment success. Second, when the market behaves abnormally in the short run, you can use those longer-term trends as a guide for common sense rebalancing.

In addition to the concept of mean reversion, we will also cover the performance of the stock market over various time periods, our bond portfolios, ex-PIMCO bond manager Bill Gross, the general economy, and ten questions/answers from the Doctors. If you have a specific economic

or financial market question you'd like us to cover in the upcoming quarterly newsletter, please feel free to e-mail me anytime at jkiely@thekielygroup.com or your specific advisor.

In Closing

As usual, if you have any questions about this update, our quarterly newsletters, your statements or our managers, please feel free to call or e-mail us at any time. The recent referrals are very much appreciated, and as always we remain 100% committed to your long term financial well-being.

-Joe & The Gang at KWAG

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