KWAG October Update

Good Afternoon. On Monday afternoon (September 30th), I received a frantic call from a local businessman that went something like this…

Caller: Dr. Kiely, my name is so-and-so. I read your newspaper articles every week with great interest. What do you recommend clients do tomorrow?
Joe: Tomorrow? What do you mean tomorrow?
Caller: Well, you know the Governments going to shut down tomorrow…right?
Joe: Ah…Yes, I do know that the Government is going to shut down tomorrow. Why does the Government shut down concern you so much?
Caller: I'm worried about a crash. What are you recommending to your clients? Do you think I should sell out of the stock market before it crashes?
Joe: Why do you think it will crash?
Caller: Because everyone is saying the market is going to fall if nothing happens…

As you might imagine I get a lot of these types of calls from clients and random folks who read my weekly articles. People naturally wonder about things like the shut downs, Syria, unemployment rates, and our deficit. They wonder how it will affect their portfolio over the coming weeks and months. The truth is I don't spend a lot of time thinking about those types of things for a number of logical reasons.

Things you can control

First, most of my time is spent focusing on things that I know I have 100% control over. Things like diversification, manager selection, rebalancing strategies and long term planning. Over the last few decades, I have learned these are the things that really affect my portfolio over time. I recognize that the markets could sell off a little if we have a war in Syria or we experience a long term Government shut down. However, I also know we have a rebalancing plan in place to take advantage of any short-term volatility. So, instead of trying to predict which things will lead to short term volatility, I'd rather assume short-term volatility is going to happen at some point in the future, and have a pro-active plan in place to take advantage of it. This way, I don't really have to concern myself with what causes short-term volatility, since I've already embraced the fact that it's going to happen.

Diversification

Over time, I have found one of the primary reasons why people (like the local businessman above) are worried about market volatility is because they are not well diversified, and they tend to be invested in one of the most volatile areas of the stock market. This is a huge problem for most investors. If you are a regular reader of these updates, you know I have spoken at a number of venues up and down the east coast over the last month. I really enjoy these workshops because it gives me an opportunity to educate investors about a number of misunderstood financial issues - including diversification. The truth is we know most investors are primarily invested in large cap stocks with a growth tilt. Why is this a huge problem?

1. We know large cap growth is the worst performing area of the stock market.
2. We know large cap growth is exposed to higher than average risk exposure.
3. We know greater volatility leads to more emotional responses.
4. We know there is no way to effectively rebalance if your assets are clustered.
5. We know lower rates of return compound over time a lot less quickly. And…
6. We know large growth managers have one of the worst overall track records versus their benchmark. Ouch!!!

If you take the time to diversify your portfolio correctly beyond large cap stocks…

1. You will increase your expected returns significantly.
2. You will reduce your risk exposure significantly.
3. You will have less volatility and thus keep more of what you earn.
4. You will have an effective way to rebalance your portfolio. (Lower risk)
5. Your assets will compound much quicker at higher rates of return. And,
6. You will have access to a number of professional managers who tend to outperform large growth managers by significant amounts. Yes!!!

My Point: I understand why people have a slanted view of the stock market. If you've only been exposed to volatile large cap growth stocks,

the stock market can be a scary place. However, if you own a well-diversified portfolio with a group of excellent money managers and you pro-actively rebalance your portfolio, the investment process becomes much less volatile. In fact, not only do you get better rates of return, but you also are exposed too much less risk exposure, and your portfolio compounds at a much faster rate over time. How much faster does it compound over time?

This weeks article is attached and it covers the "Power of Compounding".

The Stock Market

On October 1st, 2013 the Federal Government started the process of shutting down, as our local businessman alluded to earlier. So, how did the stock market react to this news? It reacted in the exact same way it has reacted to all of the other news coming out of Washington over the last five years – it rallied upward. In fact, at the end of trading yesterday, small and mid-cap stocks finished at all-time highs.

Sometimes it easy to forget that we own well run global companies that could care less about the day-to-day drama playing out in Washington. Since corporate executives have no control over the nonsense in Washington, they prefer to focus on things they can control like cost cutting, raising cheap capital, hiring talented workers, marketing to their niche customers, and selling their goods and services globally. They know if they do those things well, profits and cash flows will follow. This is why we remain so confident in the stock market over the

long run…we're investing in talented global companies who have plenty of opportunities to succeed in a global marketplace.

The Numbers

For the month of September, the S&P500 (large caps) increased 2.9%, while the Russell 2000 (small caps) increased 6.6%. (No, that's not a typo.) For the quarter ending September 30th, the S&P500 increased 5.3%, while the Russell 2000 increased 11.7%. For the year through September 30th, the S&P500 is now up almost 18%, while the Russell 2000 is up more than 26%! Clearly small cap stocks make a huge difference in portfolios over both the short and long run.

At this point, we understand that our call for a normal market dip may sound like a broken record. However, we still believe the stock market has gotten a little bit ahead of itself and is thus due for a healthy 10%-15% dip. The problem is we have no idea when the dip will occur. It could happen next week, next month or next year. The good news is, as each week passes, the new economic data that comes out continues to support the notion that both the stock market and corporate America are poised for excellent long-term growth over the next decade and beyond.

The Bond Market

This month of September was also good to the bond market. In fact, we only had one manager who was down and in that case he was only down 0.11%. For the quarter ending September 30th, every single one of our bond managers finished up and few of our managers had significant gains. Specifically, our convertible bond manager (Doug

Forsyth - Allianz) was up more than 7% and our strategic income manager (Dan Fuss – Loomis Sayles) was up more than 3%. These are excellent numbers in a very tough interest rate environment.

As we have said many times, it's impossible to predict short-term interest rate movements. Thus, the biggest weapon in the fixed income market continues to be conservative diversification strategies, and the use of alternative bonds, which are less sensitive to, and in some cases, the beneficiary of interest rate increases.

In Closing

We thank you for your continued support and your kind referrals.
Enjoy your week…and the cooler fall weather.

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