KWAG August E-mail Update

Good Evening. We hope everyone enjoyed their Labor Day weekend. With the markets closed over the holiday, we also hope you enjoyed a nice break from the often deafening financial and economic news. We like to use the long weekends to assess the performance of our portfolios and fund managers, and this weekend was no different. We also like to use weekends to catch up on any reading we weren't able to get to during the week and three-day weekends like the one just past are particularly nice in that respect. Not only did the long weekend give us a chance to catch up on some material from the previous week, but we also got a chance to go back and reflect on a number of reports we've read over the past several months. Since these come from a very diverse set of economists and money managers, it probably shouldn't be surprising that there's a fairly broad divergence of opinion among them. However, it may surprise you to learn that the economists and analysts we trust the most (who are also generally those with the longest track records) seem to have a fairly consistent view on the economy—and it's positive!

The Bottom Line

The bottom line is that we're pretty much right where we expected we'd be at this point in the economic recovery. Does this mean the economy is perfect? Certainly not, but is it ever? We think the important issues at this juncture are whether we're pointed in the right direction and whether we're growing at a rate that is reasonable for a recovery from a very severe, credit-driven recession. And on both counts, we believe the vast majority of signs indicate we are. So all of the discussion you've been hearing in the media regarding the next great depression; hyperinflation; deflation; and the dreaded double-dip can be largely ignored at this juncture. And going forward please remember that we're in the midst of election season, so the vast majority of opinions you hear on the economy are going to be politically motivated—one way or another. Cutting through all the underlying politics isn't easy, though, particularly since the volume gets turned way up and the degree of accuracy seems to get turned way down. Unfortunately, the end result is that the strong emotions being stirred up in the political arena often trickle down to investors and cause them to alter their well thought-out, long term financial plans. As we've written so many times before,

emotional decisions are rarely good ones when it comes to investing—and there are mountains of excellent research backing us up.

A Small Example

Last month we wrote about how investors generally take a macro view, assessing an economy from the top down and fixating on a few macro indicators like GDP, the unemployment rate, or a country's level of debt. One of the problems with this macro-centric view, is that the firms we invest in aren't necessarily impacted by the macro data. Corporations are more concerned about being productive, being competitive, increasing market share, generating higher profits, and growing their business. Strangely enough, they're managing to do just that in spite of the macroeconomic data. By virtually any measure you choose, individual firms are much healthier today than they were a year or two ago. Firms aren't defined by things like high domestic unemployment or slow growth in the GDP because they compete in a world economy against competitors from all over the globe. Instead, they are concerned with finding and filling the needs of their existing and future customers from all over the globe. They recognize that in a world economy, they can grow their business anywhere and everywhere—and that's exactly what they're doing.

The Disconnect

So while the average investor is pondering the high unemployment rate or the anemic growth in GDP, the average firm is replicating their business model in places like Brazil, China, and India. This means increased profitability, higher cash flows, and healthy growth rates in spite of a stagnant domestic economy. Think back to the 1800's and how the population spread west and opened up markets and opportunities that drove our economy for decades. The same thing is now happening in places like China – only at a much faster pace. American firms are taking advantage of this expansion while many investors obsess over what the next economic numbers will look like. This is where the disconnect lies.

The Bigger Picture

Last year, in the midst of the March decline, we explained how markets typically bounce back with a vengeance after large declines—and we saw just that. In fact, 2009 wound up being a fantastic year for stocks and bonds across the board. Then this year, as the stock market kept growing, we reiterated that volatility was still with us and reminded everyone that the stock market averages

a 10% to 15% peak-to-trough decline in any given year. We also noted that following such declines, it often takes the market a while to consolidate and begin moving forward again. These patterns have repeated themselves in virtually every bear market recovery in history, so making a call like that wasn't too difficult. The difficult part—and the thing that gets many people in trouble—is attempting to time the various declines, consolidations and recoveries. We know these kinds of things will occur with near certainty, but ***no one knows exactly when.*** But that's okay because at least for long-term investors, short-term fluctuations in the market do not matter at all. In fact, all that matters is sticking to a sound long-term investing strategy and not allowing your emotions or the media's fixation on the short-term to sway you from it. Yet for many investors, this is easier said than done.

The Numbers: S&P 500

On 12/31/08 the S&P 500 index closed at 903. It hit a low at 676 on 03/09/09 and then rallied to 1,115 by the end of 2009. For the 2009 calendar year, the S&P 500 index rose 23.5% and from the March lows through year-end the index was up more than 65%. In numerous updates in late 2009 and early 2010, we warned that the market would eventually take a break from its torrid pace. In January of this year it did just that…but then it subsequently rallied up to 1,217 on April 23rd. At that point, the increase in the S&P 500 index from the beginning of 2008, stood at nearly 35%. While the increase from the March 2009 low stood at just over 80%. Once again, we reminded people that markets don't go straight up forever and a 10% to 15% dip was very normal and looking increasingly likely.

Then between 04/23 and 05/26 of this year we got our dip. The market took a breather and the index dropped more than 12%, to 1,068. Then we said a period of consolidation would be typical. As of the close of trading today (09/07/10), the S&P 500 stands at 1,092. So from May 26th through today, the market has basically done a whole lot of nothing…edging up only slightly. Yes, it's been a bumpy ride; but we're virtually unchanged over the last three months!

The Current News

In the meantime, depending on the news you're reading or listening to, you would think we are on the verge of another major collapse. Stagflation, the lost decade, inflation, deflation and double-dip have become household words. Psychologically, investors think the market has deteriorated significantly over the last three months…but that's clearly not what the market indexes show.

The Facts

1. Since the beginning of 2009, which includes both the major panic of Feb/March 2009 and the most recent dip, the S&P 500 & the Russell 2000 indexes are both up more than 20%...which averages out to about 1% per month. This does not include dividends, which would add another 3-4%, depending on the index. One could easily argue that the "worst case" economic scenario is already baked into stock prices. In fact, you could even argue that a "double-dip" is already baked into stock prices, which are absurdly low given the earnings firms are generating.

2. Companies are far healthier today than they were just a year ago. We're seeing corporations with very strong balance sheets, record profitability, stellar productivity levels, and huge amounts of cash on hand. And, their stock is selling at price multiples near record lows! What's not to like?

3. We're currently seeing more merger and acquisition (M&A) activity than we have seen in years and it's approaching record levels. Why so much M&A activity? Because CEOs of publically traded companies know stocks are cheap and they happen to have a lot of cash on hand.

4. In fact, we're now at a point (once again) where many companies are trading at prices below the value of the cash they have on hand. This is called "negative enterprise value" and it's something we've written about in the past. In essence, it means that if you're buying the stock at that point you're getting the assets the company owns (things like inventory, plant and equipment, real estate, and accounts receivable) for free.

We could go on, but you get the idea...

Long Term Investors

Everyone wants to be a successful long term investor but surprisingly few actually achieve this goal. This has always surprised us because successful investing really shouldn't be that difficult. What do you need to become a good long term investor? You need to start by focusing on things you can control, like living within your means, contributing to your investment accounts regularly, and keeping emotions out of your financial decision making. You should also rebalance your portfolio as needed, use only money managers with stellar long-term track records, and diversify across all sizes and styles of stocks and bonds. You also need to choose an asset allocation strategy that fits with you investing time horizon. If you do these things and stick to your strategy through thick and thin, you WILL be successful. Even better, you have total control over every one of these decisions.

On the other hand, investors who lose focus on then things they can control generally do so because they've switched focus to issues over which they have no control. Such as the business cycle, GDP growth, or the unemployment rate. And, of course, focusing on uncontrollable issues tends to elicit strong emotions…and strong emotional responses lead to bad investment decisions.

In Closing

We feel good about the direction of the economy and believe it is right about where it should be given the severity of the recession we've been through. More importantly, we feel good about the health and direction of the companies we invest in and feel at this point they represent an excellent value for long-term investors. We're also certain there will be some tough days ahead…because there always are. But as we stress above, the key is maintaining focus on the things we can control.

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 anytime. Enjoy the rest of the summer and thank you for your continued confidence in our firm. The recent referrals are much appreciated and, as always, we remain 100% committed to your financial well-being.

- ***Joe and The Gang at The Kiely Group***