

# KCM'S KOMMENTS—4q06 Strategy Review



KELLY CAPITAL MANAGEMENT, LLC

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**COMBINED 4q06 COMMENTARY & MONTHLY NEWSLETTER**

## HOW TO READ THIS COMBINED REPORT



Typically this is a monthly electronic newsletter. As of 6/30/06, we inaugurated a combined quarterly commentary and monthly newsletter which is being sent electronically to all clients and friends of KCM who have email and in paper form to clients who do not have email capability yet. We encourage all clients to open an email account so we can better, and more frequently, communicate with you. Next month, we will return to our monthly electronic newsletter format. In April 2007, you will again receive a Combined Quarterly Commentary & Monthly Newsletter.

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We suggest you read this document in combination with your personalized quarterly performance report(s).

- First, read the 4q06 Market Commentary to get an overview of what the economy and markets did. Their actions impacted your portfolio.
- Next, read those sections of this report that match the title of the investment strategy printed on your performance report(s).
- Lastly, take a look at other investment strategies discussed herein

which are not currently employed in managing your money here at KCM. You may find something of interest that we should discuss for future use in your portfolio.

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### 4q06 Market Commentary—

The *Wall Street Journal* recently reported that “Among 18 broad market sectors tracked by Dow Jones Indexes, not one finished in the red. The strongest group was telecom, up 32%, while the retail sector fared worst, rising 5.4%. U.S. investors who placed bets abroad took home ample rewards in 2006.” Many people are referring to 2006 as a “Goldilocks” economy: neither too hot nor too cold. Most expect a further slowdown in 2007 but not a recession.

Economists and market pundits seem to agree the FED is finished with rate increases. Overall, the domestic stock markets looked good and the Dow moved up. Bond prices improved a bit in October and November and mortgage rates stabilized. On balance, with the exception of some December weakness in bond prices and higher gasoline prices, everything looked pretty benign as the quarter ended.

We are now 3 months into that limbo-like state between the last Fed rate hike and the first Fed rate reduction. Historically such periods last about 8 months during which commodity prices fall, bond prices rally, small cap and emerging market stocks lag and spreads between bond ratings stop tightening. The lower real interest rates we are now seeing connote future economic slow-

down which will negatively impact growth and cyclical stocks the most. We should expect to see continued negative guidance from companies and a bit more inversion at the long end of the yield curve before things start to improve. We expect stocks will see a bumpy, but positive, road for a while which should offer us opportunities for bargains.

During the quarter large cap stocks lagged midcap and small cap stocks. This is a bit unusual for this point in the economic cycle. We do not expect this trend to persist. All three groups made money for the quarter. From a style standpoint, value beat growth in all three market cap groups. Our 2nd quarter prediction that growth would lag value has come true.

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The remainder of this report will discuss each of the following portfolio strategies:

- All Cap Multi Style ETF
- Large Cap Core ETF
- Emerging Markets ETF
- Global Equity-only
- Global Balanced
- Large Cap Value
- Midcap Core
- Fixed-Income & Balanced

Please review your personalized performance report in conjunction with the appropriate section of this commentary.

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### EXCHANGE TRADED FUND (“ETF”) BASED EQUITY-ONLY STRATEGIES

#### ALL CAP MULTI STYLE—

This dynamic strategy turned in an excellent result for 4th quarter. Our net, total return for the period was 7.2% versus 6.7% for the S&P 500 Index benchmark. For the year this strategy generated a net, total return of 13.8%. Since we opened the doors as KCM (10/31/04) this strategy remains ahead of its S&P 500 Index benchmark, net of all costs, and has turned in an impressive 31.5% total return from 10/31/04 through 12/31/06.

#### LARGE CAP CORE—

For the 4th quarter our net, total return beat the S&P 500 Index benchmark. For the full year this strategy generated a net, total return of almost 13%. Over the long term, this strategy has been an attractive performer in the large cap core manager arena. It is noteworthy to mention that this strategy was the first of its kind and was originally introduced in late 1999 as the Active Index Core ETF Strategy.

#### EMERGING MARKETS—

Our results for both 4th quarter and the full year were excellent. In both periods we handsomely beat our primary and secondary benchmarks. For the quarter, we were up almost 21% versus 17% for the MSCI Index. For the year we generated just over 32% versus just under 29% for the MSCI Index. Since product inception (9/2/05) we have generated an annualized total return of 34.2% per year versus 30.8% per year for the MSCI Index. Our figures are net of all costs, whereas the Index assumes no costs and is therefore only a hypothetical goal.

### INDIVIDUAL COMPANY STOCK BASED STRATEGIES

#### LARGE CAP VALUE—

This strategy finished the year well ahead of the S&P 500 Index. For the quarter we generated almost 7.3% versus the S&P 500 at 6.7%. For the year, this strategy followed the value oriented indexes' trend and moved up. For the full year this strategy generated a net, total return of 16.4%. We expect large company stocks to do well in 2007, taking advantage of their market dominance and presumed pricing power to maintain profits as the economy slows.

#### MIDCAP CORE—

This strategy closed out 2006 at 327 basis points (3.27 percentage points) ahead of its S&P Midcap Index Benchmark, net of all costs. Since we opened our doors as KCM 10/31/04, this strategy has generated a net, total return of 45.2% versus the S&P benchmark return of 37.1%. This 810 basis point advantage means clients in this strategy have realized an 18.4% greater net, total return

than had we just held an S&P Midcap Index fund. In dollar terms this meant almost \$18,400 more per \$100,000 invested over the past 2 years and 2 months ended 12/31/06.

### GLOBAL EQUITY-ONLY & GLOBAL BALANCED ACCOUNTS

Our global strategies employ domestic and foreign equity ETFs along with fixed income securities of various types. We began offering these strategies over the past year and results have been attractive. We beat our tailored benchmark, net of all costs, during 4th quarter for our equity-only accounts by almost 100 basis points.

Our fixed income investments reflected the generally positive bond market which developed during the quarter as FED-watchers realized we are at a pause point in rate changes. Our relatively better bond performance gave us a further edge for the quarter over our tailored balanced benchmark. Overall, our balanced global accounts realized about 130 basis points net advantage over their benchmark for the quarter.

### BOND & BALANCED STRATEGIES

The modest bond price improvement during the 4th quarter came to an end in December. Our strategy of shifting maturities helped to cushion the impact so our bond accounts tended to hold up well in a weak December market. On balance, for the 4th quarter and full year, we made money for our clients in bonds. Individual client's results vary based upon the client's tailored asset mix.

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*KELLY CAPITAL MANAGEMENT, LLC IS A FEDERALLY REGISTERED INVESTMENT ADVISOR WITH AN INTERNATIONAL CLIENT BASE. WE OFFER TRADITIONALLY MANAGED PORTFOLIOS COMPOSED OF 40 INDIVIDUAL COMPANIES' STOCKS IN LARGE CAP VALUE AND MIDCAP CORE STRATEGIES. WE ARE ALSO KNOWN AS PIONEERS IN PORTFOLIO MANAGEMENT BASED UPON EXCHANGE TRADED FUNDS (ETFs). WE OFFER DOMESTIC AND EMERGING MARKET EQUITY PORTFOLIOS EMPLOYING ETF SECURITIES. WE ALSO OFFER FIXED INCOME PORTFOLIO MANAGEMENT USING TAXABLE, TAX-FREE AND ETF-BASED FIXED INCOME SECURITIES. LASTLY, WE OFFER SPECIALIZED PROGRAMS, SUCH AS A "TURNKEY" 401(K) PROGRAM, TO INSTITUTIONAL CLIENTS.*

***REMEMBER, WE ARE NEVER TOO BUSY FOR YOUR REFERRALS!***



### **PARTING KOMMENTS**

For some people, winter is a time of outdoor fun making snowmen and going skiing. For others it's a time of cold boredom which they escape by going to warm places like Hawaii, the Caribbean, Florida, and southern California. For the vast majority of us who live in a cold climate, it's just another season with its own special characteristics. Instead of cutting the grass, we shovel the snow. Our clients are from coast-to-coast and up into Canada so each has his or her own climate to deal with. Hopefully, like looking at the snowflakes in the photo, each of us will take away some sense of the beauty of the season. For some it will be looking at snowflakes, for others it will be watching the bird-of-paradise bloom. No matter where this season finds you, may it and the coming New Year be a happy and successful one for you. We at KCM are pleased that we have turned in a good year of double-digit total returns for our clients. In 2006, KCM continued its growth from both new clients and asset value increases. We are gratified that we have received so many referrals from clients to folks who have become new clients this past year. We thank all of you who have had a hand in introducing us to new clients. Lastly, we can't forget those clients who passed away in 2006. Most of them were clients for a very long time and will be missed. We here at KCM wish the departed eternal peace and to their families and friends we offer, again, our condolences and wishes for a rapid healing to your sense of loss. We too shall miss them.