

# KCM'S KOMMENTS—4q07 Strategy Review



KELLY CAPITAL MANAGEMENT, LLC

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## ECONOMIC & MARKET KOMPASS



### Housing—

2007 saw a lot of depressing news about the housing market. Sub-prime lending market problems were felt from late summer through year-end. As a result, we reduced finance sector exposure and that proved to be a correct decision. We expect that in 2008 we will move back into this sector as the valuations improve for the stocks therein. As a matter of investment philosophy we do not invest in mortgage backed securities (“MBO”). The benefit of avoiding this part of the fixed income market was apparent this past year given widespread downgrades and defaults.

### Corporate—

Large, multi-national companies benefited from the weaker dollar and offset some of their domestic margin weakness in 2007. The consumer did not spend heavily during the longer than usual holiday shopping season and as a result, retailers' stocks were hurt. 2008 may see more consumer spending slowdown so we expect to keep our consumer discretionary sector exposure below a neutral weighting for the time being.

### Inflation—

Inflation was not a problem in 2007 and we expect it will not become one in 2008. Last Fall we said that we felt the FED went too far with interest rate increases and was taking too long to cut rates. We said we expected the Fed to cut rates before year-end and we were right. We'll go out on a limb again and forecast more rate cuts for 2008. Historically it takes about 12 months for a FED rate cut (or hike) to fully impact the economy. The first rate cut from last year won't be fully felt until early 2008—an election year!

### Markets—

December was a volatile month as was most of 2007. We know that domestic and foreign equity markets are discounters of future economic activity. As we go through the 2008 slowdown (note we didn't say recession) we expect larger company stocks will tend to fare better than smaller ones until the FED has put in place 2 or 3 more rate cuts. After that, sectors and mid/small company stocks which had underperformed are likely to take off. Experience has shown that as we move through the bottom of economic activity, much like the hour hand of a clock moving from 4 to 8, we will get much conflicting economic news. Our discipline of diversifying across sectors, market caps and styles, as well as across asset classes, should carry us through the coming unsettled market of mid to late 2008.

### Results—

After all is said and done, it's performance you pay us for. We think we did a good job for you in 2007. Based upon the referrals we got in 2007, we think you feel we did well too. Below are some composite results for our strategies.

In 2007 the best place to have had money invested was our Emerging Markets ETF Strategy (+37.6% versus its benchmark index return of +33.0%). Our Global Equity Only ETF Strategy placed 2nd (+13.7% versus its custom benchmark return of +10.7%). Midcap Core came in 3rd (+11.1% versus Russell Midcap Index at +5.6%). Large Cap Core ETF Strategy was 4th (+5.5% versus 5.5% for the S&P 500 Index). All Cap Multi Style ETF Strategy was 5th (+5.2% versus +5.5% for the S&P 500 Index). Large Cap Value came in 6th (+2.5% versus -0.2% for Russell Large Cap Value Index). *All returns shown for our strategies are net of all costs but the benchmark indices have no expenses of any kind imputed to their returns.*

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***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. In 2007, 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 2007. 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.