

KAY INVESTMENTS

SEC REGISTERED INVESTMENT ADVISOR

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“Do you pray for the Senators, Dr. Hale?” someone asked the Chaplain. “No, I look at the Senators and pray for the country.” Edward Everett Hale, American Author, Chaplain of the US Senate and great grandnephew of famous patriot Nathan Hale.

“Our view remains that the U.S. economy will expand at a sluggish pace but that recession will be avoided.” BCA Research, 1/7/2008

2007 In Review

I'll begin by reviewing the year 2007 partly because so many of you want to know how profitable the year was and partly because our strong returns validate the approach and methods I've developed and followed. However, I will be brief about looking backwards because in the business of managing money, an adviser must be 100% forward looking at all times.

Our aggressive model portfolios earned returns in the range of 15% to 20% for the year, net of advisory fees¹. The moderate and conservative portfolios earned proportionately less, since they are blended combinations of the aggressive with bond and other “safer” funds. The S&P 500 earned 3.5% for the year. We achieved our results by actively exposing the portfolios to the market sectors, world regions and management styles that were most productive and rewarding. Examples included energy services, consumer staples, industrial equipment and a heavy dose of foreign funds, especially those focusing on the “developing/emerging” countries in such regions as Asia and South America.

Looking Ahead to 2008

The financial news has been bad for a quite a few months and in only the first three trading days of the year, the S&P 500 has already given up nearly all of its 2007 gains.

The financial press is harping on recession risk, fear has created a bunker mentality in nearly every quarter, the dollar has taken a beating, housing prices are tumbling, oil is topping \$95 per barrel, credit markets have been seized up, the economy is definitely slowing down, geopolitical risks abound and bird flu H5N1 has been confirmed somewhere in Pakistan. So how come I feel optimistic about 2008?

For starters, the bad news is getting “old”. Surprises move the markets more than widely known information. Second, systematic interest rate cuts by the Fed will likely put the markets and the economy back on track in 2008. Such cuts practically always work. It was actually a Fed surprise in October that began the current market correction – lowering rates by only 1/4% and then releasing minutes that showed many Fed governors did not see a reason for ANY rate cut – now or in the future. When solid, creditworthy companies cannot borrow for legitimate business reasons, they start to downsize and lay people off.

The Fed has been seriously behind the curve but it has tasted credit market dysfunction and understands finally that its hand is forced. While it could be argued that rate cuts only postpone certain problems (excess personal, corporate and government borrowing, overextended borrowers etc.), I do not believe that a serious market decline will occur before sometime perhaps in the next presidential term. On the other hand, we should not expect a sharp turnaround over the near term. It will likely be halting and volatile.

Strategy

I notice that most of our international funds, even emerging markets funds, have stayed ahead of the S&P 500 during this recent decline. It's unusual for inherently more volatile markets to drop LESS than the US markets during a correction or decline. This is telling and likely validates our weighting there. We also have continuing exposure to health care, energy services, industrial equipment and consumer staples (companies that produce goods that are ALWAYS needed). All of these holdings have held up well since the decline. I've reduced technology holdings, which took a beating. The portfolios have naturally become somewhat more defensive, an outcome that is baked right into the cake, based on the recipe I use.

A number of you have contacted me to ask if you should change your investment profile to become more conservative in light of the recent trauma. Although I have offered up an optimistic view for 2008, I do NOT believe that my view answers that question. For one thing, I could be wrong. The answer is that your risk reward profile needs to be your profile for all seasons – at least until your financial situation or status changes. It is not a question of whether the markets might torch part of your principal, only a question of when. If the markets weren't so highly volatile and so short term unpredictable, we'd be averaging only 5% per year and I'd be out of a job. Fortunately, I eat market volatility for breakfast. But if it ever becomes my job to advise when it's time to get out and then back in, or in and then back out, I'll be crashing the unemployment line.

The goal is to position the portfolios for solid returns when the markets are moving sideways and up (MOST of the time, MOST months, MOST years) and hopefully not lose quite 100 cents on the dollar when they drop. This is the way things played out in 2007. Human nature is such that the pain of losing a dollar is greater than the pleasure of making a dollar, so investors will always face temptation to pack it in and get out of the markets. I would like for you as clients, investors and retirement plan participants to settle on a risk orientation that you can live with and sleep with – and then proceed to live with it and sleep with it. I pledge to do my best to make it a Happy New Year.

Please Contact Me If...

Please contact me if you would like to discuss your risk profile, your investment model or if you would like to open an account!

¹ Stated returns (rounded to nearest percent) are based on all accounts under management for which the "aggressive strategy" was used for the entire calendar year 2007 and for which not more than 15% of the account was added or removed in a lump sum during the year. The aggressive strategy means that the adviser invested all of the account in growth oriented investments using the adviser's discretion. Dividends and other earnings were assumed to remain in the account.

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