

JIM STAMPER: Hello, everyone. Thank you for joining us again, and welcome to our mid-year roundtable discussion to discuss the first half of 2011, and the outlook for the second half of the year. My name is Jim Stamper. I'm the Vice President Client Services here at Keeley Funds. With me today is John L. Keeley, Jr., President and CIO of the Keeley Funds; Bob Becker, our Director of Research; Tom Browne, Lead Portfolio Manager of the Keeley Small Cap Dividend Value Fund; and Brian Keeley, an Assistant Portfolio Manager of the Keeley Small Cap Value and Keeley Small-Mid Cap Strategies. This is being recorded on August 12th. And given the circumstances that have evolved over the past few weeks, we thought it would be prudent to focus the majority of our attention to events that have taken place recently in the equity markets, and provide some thoughts on our outlook going forward.

To begin, despite a strong start to the year, the second quarter was challenging, and then more recently, the market has become extremely volatile, reacting to some challenges both here in the U.S. and in Europe. Can all of you take a minute to summarize the current macro environment?

BOB BECKER: Bob Becker here. I think we're all surprised a bit. Three or four weeks ago, GDP showed signs of slowing down; recast what the prior quarter's GDP was. So we have to be aware that we're hitting a bit of a slow-down in the recovery. And there's a danger we could get to literally a stall rate. We don't think we're going to enter a new recession. We think it's definitely a slow patch that we're going through. But I'd like to remind people that this is not like the Fall of 2008, when we went into a total free fall; credit was quite constrained; inventory was being disgorged. This is a much different period. We're looking at it seriously, but we think we're going to continue, but albeit very slow growth.

JOHN KEELEY, JR.: This is John Keeley. During these times of extreme volatility, there are two things that I would want to pass on to you. One, you've had an enormous amount of margin selling, particularly by hedge funds, as people try to run to liquidity. This has caused extreme volatility in the market, and there's oftentimes questions of whether or not the systems will support such activity. In other words, it almost appears as if the margin clerks are making the investment decisions, not the people in charge of the portfolios. I would emphasize also that during this time period, if you can envision a tennis ball and an egg, dropping them from a height during this time, you're going to find out which tennis balls bounce and which eggs splatter. So this is a time to upgrade your portfolios and find out which are the good companies and good businesses, and eliminate the ones that have not met the mark.

BRIAN KEELEY: I would tend to agree - Brian Keeley here - I think we've had a very violent reaction in the stock market, from what we all generally considered was a slow patch coming. GDP has borne that out. As we talk to our companies post-conference calls and post-earnings reports, we find that their order books are strong; in general, they're getting price in many of these areas. Looking at some leading indicators, like railroad traffic - railroad traffic still continues to be up. There's a little bit of a push-back, perhaps, on the consumer. It doesn't look like the big Chinese shipping season has hit yet. Perhaps that's worrying people. But most people believe it still will hit, and it's going to pull through. So we're very encouraged by the level of insider buy-backs at a lot of our depressed companies, ones that took large hits in the equity values. I'm optimistic for the back half of the year.

TOM BROWNE, JR.: This is Tom Browne. Just following a little bit on what Brian was saying I think our optimism about the back half had really been promulgated on a couple of items. First, in the first and second quarter, we had much worse weather than we usually experience around the world, and that created a lot of disruption and slowed growth. A big part of that was in the auto food chain, where, Japan pretty much shut down, and they've indicated that they're coming back much faster. That had spillover effects into the United States, and so we're looking at, a better economic second half than first half, because of the lack of some of the disruptions in the first half. More recent events may push some of that out, but I agree with Brian that we'll probably still see a lot of that activity in the second half.

Another, point I'd make is the violent reaction we've seen here in the last few weeks is very unusual. It's August 12th and through the first eleven calendar days of August, the Russell 2000 was down about 12 1/2%. In the last 25 years, there have been only ten months in which the Russell 2000 was down more than 10%, and in eight of those ten, the Russell was up in the subsequent six months; and in nine of those ten, it was up in the subsequent 12 months. Admittedly, some of those were 2008, 2009 periods, and you saw lower months after it.

JIM STAMPER: Thanks, Tom. I think that's a good segue for my next question. A lot of our clients asked about our view about small cap versus large cap. Obviously, over the past couple weeks we saw small caps underperform their larger peers. Can any of you comment on the benefits of small cap, what we're seeing from a valuation perspective, and obviously, also opportunities.

JOHN KEELEY: This is John Keeley. I think one of the things you have to remember is that the liquidity in small caps is certainly less than the large caps. Now, this serves us very well in an up market, and it serves us very poorly in a down market. The other thing I would ask you to consider is that these smaller companies are subject to takeovers, especially in this environment, when the larger companies have a lot of cash; the small companies are absolutely on their backs. And this, I think, sets up a lot of M and A activity.

BOB BECKER: John, that's a good point. I'd also point out we like the small caps because of the impact restructuring can have on a small capitalization company. You don't often get it; and on a larger institution, it can have a much better effect on the company. And also, in small caps, we have the privilege of diving deep into a sub-sector of the economy that might be doing well, even with a poor outlook. I would cite our ability to buy something as small as Titan International, which makes agriculture and construction tires, which seems to be a strong portion of that market.

JIM STAMPER: Brian, you mentioned earlier, you were talking about earnings a little bit. And I think one disconnect we've seen, versus market performance more recently, and then some of the fundamentals with respect to earnings, despite some of the macro headwinds, the majority of our companies have posted pretty strong earnings reports. And, if you can comment on the outlook with regard to your earnings prospects for some of our companies.

BRIAN KEELEY: I think in general, that's true. Looking at the reporting season to date, about 50% of our companies held have beat consensus expectations. That's a little better than the benchmark, and I think that makes us feel pretty positive. Additionally, most of those guys have been revising guidance. Another point I'd like to make is our companies are in very good shape from a cash perspective. The debt on the balance sheet is more balanced; it's more spread out. They did a lot of good work restructuring, and really don't have any cliffs in the near term. So I think combined with the balance, the debt load, and the cash on the balance sheet, they're in good positions to take advantage of their drop in equity prices, and we'll be buying back stock in the near future. So that should help, as well.

JIM STAMPER: Corporate spin-offs continue to be an area we focus on specifically here at Keeley. And the number of opportunities have been growing recently. Can you talk about the environment specifically for spin-offs, and what the future looks like?

BOB BECKER: It's been very robust, probably one of our best periods. We've had a number of companies announced - Sarah Lee, Conoco, Marathon, IT & T, Fortune Brands; just the other day, Sears said they're going to spin out their Orchard Hardware division. We're going to look at all these companies. We may not invest in all of them. But it's been one of the most robust periods we've seen for our spinoffs, so we're very encouraged.

TOM BROWNE, JR.: Historically, spinoffs have outperformed the market fairly substantially over the first several years in which they come out. Our research suggests that in the first year a spinoff is out, it outperforms the market by about 13 percentage points.

JOHN KEELEY, JR.: I think the other thing I would add is that during a period of - when everybody is hiding under the desk, these companies that are spun off are probably going to be the least likely to be bid up in the short term. So this gives us considerable opportunities to buy these companies at what is probably going to be a lot less valuation than we could do otherwise. The industrial sector is something we continue to be overweight in; is something that we continue to believe that is going to have a lot of restructuring going on, and we are committed to this space.

JIM STAMPER: The financial sector has lagged for a number of years. It's been talked about by, a number of investment managers. But valuations continue to get attractive. What's our take on this sector, and the potential headwinds or our opportunities?

JOHN KEELEY, JR.: We, during this time period and actually for the last couple of years, we have been - underweight financials, specifically underweight the regional banks and things of that nature. We have put money into what we consider to be sub-financials, such as insurance companies, insurance agencies, money managers, and such. We continue to believe very strongly in the savings and loans that are converting from mutual status, to common stock status. And these often come out below book value. They have probably a 15% capital ratio, and they are probably going to be picked up by larger companies after a reasonable standstill period. The environment for small banks, except for these companies that are being converted, I think is very treacherous from the point of view of Dodd-Frank putting regulation on these banks. So I think there's going to be a tremendous amount of consolidation in this area.

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JIM STAMPER: Can any of you talk about some of the more compelling opportunities in the portfolio going forward - what makes them attractive and I guess more importantly in this environment, has anything changed due to the sell-off, where, some new opportunities have emerged?

BOB BECKER: One of the interesting companies we have is Avis. That's one of the advantages of being in a smaller cap stock; sometimes you can take advantage of what the economic environment is. And we have a situation with a shortage of automobiles coming in from Japan; dealer lots were short. And unexpectedly, used car prices have gone to record levels. Now, this plays in the hands of someone like Avis who buys these cars on a short term basis, and then sells them within two years. And they've had enormous profits from this. Also because of the shortage of cars, they were able to get rates up better, be able to rationalize some of their locations. So that's been an excellent holding. We've also been encouraged lately by a pickup in orders for some of our companies. The use of natural gas around the world to get it to other countries in the form of liquid natural gas is very attractive. And one of the beneficiaries is this holding we have, Chicago Bridge and Iron, orders are picking up for those kind of transformational projects to get liquid natural gas around the world.

BRIAN KEELEY: One of the areas that I'm relatively excited about is the continued cap-ex spending by a lot of large manufacturers, specifically some of the Class I railroad companies. The railroads have been spending money on infrastructure - bridges, rails and rolling stock. We own a number of companies that operate below the Class I level that do repair work, heavy repair work on rail cars, and also assist in the manufacturing of these repair cars. These stocks tend to trade on order book and backlog growth. We've seen very strong backlog growth from them over the past six quarters, really back up from the depths. It's a cyclical business, but we continue to feel that it's in a recovery.

JIM STAMPER: John, you mentioned, our commitment earlier to the industrial space. I know a lot of our clients would like us to talk in more depth about what we like about this space, also - is there anything out there that could potentially change, our thesis on industrials.

JOHN KEELEY, JR.: As we have discussed before, these companies have hunkered down in their hiring. They have margins at peak levels; they have tons of cash. And they are, I think, continue to be M and A candidates. We don't pick stocks because they are M and A candidates, but it's just a byproduct of what we do.

BOB BECKER: I think the one thing that concerned us - and again, it was my comparison with the 2008. When you just shut credit off completely and you go into a deep dive, I mean, that would give us more concern. We don't have those kinds of concerns right now. That really affects the entire market, when credit is not available. We're not in that period. Our companies, as Brian said, are extremely well financed, and actually have a surplus of cash.

JOHN KEELEY, JR.: In addition to that, going back to the M and A comment, the larger companies that would be the acquirers, are getting virtually nothing on their cash. The other day, the two year was down to 17 beeps, and you can borrow money at less than 3% to do deals. So it's almost as if the managements of these companies are going to be forced to do something by their Boards of Directors, rather than sitting on cash, earning less than 25 basis points.

BOB BECKER: And this is where I guess I would compare industrial companies to being the banks of the current environment. The banks are unwilling to make loans because of capital constraints. Our industrial companies are really banks, and they are - they are forced by excess cash, and get great benefits by making investments.

BRIAN KEELEY: I think one thing that could help us change this thesis a little bit is the banks get a little healthy. I mean, we've been fighting a little bit with one hand tied behind our back for a long time because the banks have just been so murky and so difficult to see into. Their earnings power has been vastly depressed. Will that ever be back exactly where it was? That's unknown, but we'd certainly like to have a stronger weighting in the banks, but at this point, nobody feels comfortable doing it.

JIM STAMPER: Merger and acquisition activity continues to be a positive development in a number of our portfolios. What are our expectations, and how do we feel about it going forward?

BOB BECKER: Well, we said, there's just a lot of cash around and the companies finally are warming up to each other, whereas they couldn't decide on adequate prices to make deals. One of the most interesting things we've had is we own Regal Beloit, which acquired the small motor division of A.O. Smith, which we also own. They in turn took that money, it's rather incestuous, and bought a boiler company which fits their business perfectly because they have hot water heaters and water purification systems. Early in the year, there was a failed bid for Ralcorp. It didn't go through, but we took advantage of that in exiting the company. We also took advantage of Exco, which at the time was going to go private. We made some nice money on that. Recently, just actually yesterday, Midas said that they were looking into restructuring their company. Early in the year, in the quarter, Petro Hawk was taken over at a nice premium. So there's just been a lot of things going on

BRIAN KEELEY: I think another think of the M and A puzzle is that some of our smaller companies have been deploying some cash and buying companies from private, privately held companies. They've finally agreed to come to terms on the profit levels and the EBITDA multiples, things like that. So that allows them to do some nice tuck-ins that fit very well into what they do.

TOM BROWNE, JR.: And in some cases that's been very, very good for the acquirer's stock. Rock Tenn, which we own as a dividend fund, got a very nice move when they agreed to buy Smurfit Stone. You also saw BF Corp. get marked up when they bought Timberland. Prices, I think, are good enough to get sellers to sell, but not so high that it becomes uneconomic for the buyers.

JIM STAMPER: Tom, your small cap dividend value fund has held up extremely well in this environment; has posted really strong results since its inception in 2009. Can you comment on your universe to dividend payers, and what you see going forward?

TOM BROWNE, JR.: One of the reasons you want to buy small cap dividend paying stocks is that historically, they've out performed non-dividend paying small cap stocks, by a pretty wide margin. Almost all of that outperformance comes in tough times like we had; we've had this quarter and the second quarter of last year, when the fund really did very well in both periods. The lower volatility and the better, longer returns to recycle, is exactly why you would want to invest in this universe of stocks.

JIM STAMPER: Another question we get with respect to the dividend value fund is there is some skepticism with respect to small caps and dividends in general. Can you comment on this as well?

TOM BROWNE, JR.: Yeah. I mean, I'm glad to hear the skepticism, because as long as there's still skepticism, there's going to be an investment opportunity. That being said, what I think creates the investment opportunity is that in general, you find that the dividend paying small cap stocks are more disciplined with regards to capital. They don't fritter it away on acquisitions that don't make sense; they don't get overly levered. And so that discipline around capital tends to lead to better long term returns. When a small company is in a position to pay a dividend, it generally means that they're generating cash above and beyond their needs, and that they see this as a good way to return that cash to shareholders. Generating more cash than you need is a good attribute of an investment. And the discipline to return it to your owners is a good attribute of a management team and a board.

JIM STAMPER: Thanks, Tom. Lastly, John, since our next scheduled call will not be until the beginning of next year, given the environment over the past few weeks, I'd like to just give you an opportunity to make a few last comments regarding your outlook for the rest of the year.

JOHN KEELEY, JR.: As you know, it's very difficult to project what's going to happen in the stock market. I would only say that we're going to continue to focus on corporate restructuring, which has served us well as an investment for some 30 years. I would also say that the Keeley family and all the employees are certainly aligned with our shareholders, due to our substantial interest in all of our mutual fund products. We will continue to stay the course and continue to look for companies that are undervalued and include them in the portfolio.

JIM STAMPER: Thanks, everyone. We appreciate you taking the time to listen to our call. Please don't hesitate to call in if you have any specific questions on our firm or any of our investment products. Our next call will be in 2012, to wrap up 2011 and discuss the outlook for next year. Thank you, and I hope everyone has a safe and successful end of the year.

IMPORTANT DISCLOSURES REGARDING ROUNDTABLE DISCUSSION

The opinions referenced are as of the date of publication and are subject to change due to changes in the market or economic conditions and may not necessarily come to pass. Information contained herein is for informational purposes only and should not be considered investment advice.

The Russell Index referred to in the discussion is the Russell 2000 Value Index. The Russell 2000 Value Index measures the performance of small-cap value segment of the U.S. equity universe. It includes those Russell 2000 companies with lower price-to-book ratios and lower forecasted growth values. The Russell 2000 Value Index is constructed to provide a comprehensive and unbiased barometer for the small-cap value segment. The Index is completely reconstituted annually to ensure larger stocks do not distort the performance and characteristics of the true small-cap opportunity set and that the represented companies continue to reflect value characteristics.

MAIN RISKS – KEELEY Small Cap Value Fund

The Fund is subject to the typical risks of equity investing, including loss of money, company-specific risks, the effects of interest rate fluctuations, investor psychology and other factors. The value of your investment will increase or decrease so your shares may be worth more or less money than your original investment.

Investing in companies emerging from bankruptcy presents special risks, since these companies often are subject to specific plans imposed by their lenders that they must meet in a fairly short time frame. In addition, such companies must overcome the negative perceptions resulting from a previous bankruptcy. Generally, companies going through corporate restructuring are more likely than others to remain undervalued.

Investing in small and mid-cap securities presents more risk than investing in large-cap or more established company securities. Small and mid-cap companies often have more limited resources and greater variation in operating results, leading to greater price volatility. Trading volumes may be lower, making such securities less liquid.

KSCVX - Top Ten Holdings as of 6/30/2011¹ - % of Net Assets

Robbins & Myers, Inc. 1.32%
Colfax Corp. 1.17%
Wabtec Corp. 1.08%
WR Grace & Co. 1.06%
Genesee & Wyoming, Inc. 1.06%
Titan International, Inc. 1.05%
Trinity Industries, Inc. 1.04%
AMCOL International Corp. 1.01%
Carrizo Oil & Gas, Inc. 0.99%
HCC Insurance Holdings, Inc. 0.97%
Total % of portfolio: 10.75%

MAIN RISKS – KEELEY Small-Mid Cap Value Fund

The Fund is subject to the typical risks of equity investing, including loss of money, company-specific risks, the effects of interest rate fluctuations, investor psychology and other factors. The value of your investment will increase or decrease so your shares may be worth more or less money than your original investment.

Investing in companies emerging from bankruptcy presents special risks, since these companies often are subject to specific plans imposed by their lenders that they must meet in a fairly short time frame. In addition, such companies must overcome the negative perceptions resulting from a previous bankruptcy. Generally, companies going through corporate restructuring are more likely than others to remain undervalued.

Investing in small and mid-cap securities presents more risk than investing in large-cap or more established company securities. Small and mid-cap companies often have more limited resources and greater variation in operating results, leading to greater price volatility. Trading volumes may be lower, making such securities less liquid.

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KSMVX - Top Ten Holdings as of 6/30/2011¹ - % of Net Assets

iShares Total Return Russell 2000 2.10%
Walter Investment Management Corp. 1.17%
EnPro Industries, Inc. 1.12%
WR Grace & Co. 1.09%
TwinDisc, Inc. 1.07%
Red Robin Gourmet Burgers, Inc. 1.07%
Foot Locker, Inc. 1.05%
Hill-Rom Holdings, Inc. 1.04%
Discover Financial Services 1.01%
Penske Automotive Group, Inc. 1.00%

Total % of portfolio: 11.72%

MAIN RISKS – KEELEY Small Cap Dividend Value Fund

The Fund is subject to the typical risks of equity investing, including loss of money, company-specific risks, the effects of interest rate fluctuations, investor psychology and other factors. The Fund's method of security selection may not be successful and the Fund may underperform the stock market as a whole. Investing in small-cap securities presents more risk than investing in large-cap or more established company securities. The value of your investment will increase or decrease so your shares may be worth more or less money than your original investment.

Any repeal or failure to extend the current federal tax treatment of qualified dividend income could make dividend-paying securities less appealing to investors and could have a negative impact on the performance of the Fund. Also, the companies held by the Fund may reduce or stop paying dividends, which may affect the Fund's ability to generate income. The Adviser's approach in selecting dividend-paying securities may go out of favor with investors. This may cause the Fund to underperform relative to other mutual funds that do not emphasize dividend-paying stocks.

KSDVX - Top Ten Holdings as of 6/30/2011¹ - % of Net Assets

Trinity Industries, Inc. 2.18%
Aarons, Inc. 2.17%
Arbitron, Inc. 2.08%
World Fuel Services Corp. 1.93%
iShares Russell 2000 Value Index Fund 1.85%
Textainer Group Holdings Ltd. 1.82%
Berry Petroleum Co. 1.79%
Foot Locker, Inc. 1.70%
Belo Corp. 1.66%
Northwestern Corp. 1.62%

Total % of portfolio: 18.80%

¹ *Portfolio holdings will change, and should not be considered purchase recommendations. Top holdings do not reflect cash, money markets or options/futures contracts holdings.*

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