Investment Report and Market Commentary

BRAGG FINANCIAL ADVISORS

Second Quarter 2004

The following Investment Report and Market Commentary is for the Second Quarter of 2004. We hope you find this information useful as you make investment decisions. As always, we appreciate your feedback as we strive to provide you with pertinent information and valuable insight.

Market Index Total Returns as of June 30, 2004

Market Index	Year To Date	1Year	3 Year Annualized	5 Year Annualized
Standard & Poors 500 (Large Cap)	3.44%	19.11%	-0.69%	-2.20%
Standard & Poors 400 (Mid Cap)	6.09%	27.99%	6.58%	9.05%
Russell 2000 (Small Cap)	6.76%	33.37%	6.24%	6.63%
MSCI EAFE (Foreign)	4.56%	32.37%	3.87%	0.06%
Lehman Brothers Aggregate Bond	0.15%	0.32%	6.36%	6.95%
Lehman Brothers Municipal Bond	-0.31%	0.62%	3.88%	4.61%

Stocks did very little in the second quarter. The stock market does not like uncertainty and the renewed violence and instability in Iraq have created plenty of uncertainty in the last few months. In addition to the international situation, the market has been focused on surging oil prices, the impending presidential election and the negative impact higher interest rates will have on corporate profits. While equity returns were positive for the quarter, the gains were small; large cap stocks, as measured by the S&P 500, squeaked out the largest gain with a return of 1.74% while the other equity asset classes gained less. This is the first period of out-performance for large caps relative to mid caps, foreign and small caps since 1999, but as the table above indicates, large caps have much ground to cover to catch up with these other asset classes. In fact, the 3-year and 5-year columns above make you want to abandon large caps entirely. Before doing that, however, it would be good to recall that for the five years ending June 30, 1999, large caps were by far the dominant performer relative to bonds, mid caps, small caps and foreign. Each part of our diversified portfolio will have its chance to be our favorite at some point. Our job is to keep the discipline and remain diversified.

Poor bond returns for the first six months of 2004 reflect the pressure of rising interest rates. While the Federal Reserve Board did not raise rates until the end of June, and then only by .25%, investors have been anticipating higher rates for some time now. After reaching a 45-year low of 3.08% in June of 2003, the 10-year US Treasury Bond yield was up to 4.80% by the middle of the second quarter of 2004. Much of this increase in yield occurred in dramatic fashion as rates rose by more than 1% during a mere two-month period ending in the middle of May 2004. This abrupt shift in bond yields and prices reflects a significant increase in investor expectations for growth in the economy and for a higher level of interest rates that will accompany that growth. While we wrote last quarter about our policy of never trying to time the bond market due to the extremely low probability of success over the long term, the two-month period described above would have been a great period to be on the sidelines. Alas, we missed it.

Since bond prices move inversely with interest rates, bondholders saw the values of their securities decline in the quarter as rates increased. For the quarter, the Lehman Bond Index was down 2.50%, bringing the year to date return to 0.15% The Fed has indicated that it will gradually increase rates in the months ahead if necessary to maintain a measured rate of growth for the economy and to keep inflation under control. Bond prices already reflect investor expectations that this gradual increase in interest rates will happen. The worst may not be behind us for bonds but we have certainly taken a good bit of the medicine we've had coming for some time now.

BRAGG
FINANCIAL ADVISORS

What a difference a year can make! The economy has made great strides since our second quarter report of 2003. Economists now project that Gross Domestic Product will grow at the fastest rate in twenty years during 2004. Gross Domestic Product (GDP) measures the total value of goods and services produced in the US and is the best gauge of total economic output. Twelve months ago we wrote about how fears of deflation were taking a toll on stock prices. Economists and other policy makers thought that due to excess capacity in many industries and the inability of producers to raise prices due to intense global competition, the US and other countries would experience deflation. Deflation could create a cycle of falling consumer demand, declining corporate profitability, massive layoffs and falling prices on real estate, stocks and other assets. Today, as a result of the improved economy, policymakers and economists are more concerned with the risk of inflation than with deflation and this fact is great news for job seekers, employers and investors. Inflationary fears exist, in part due to the recent spike in oil prices and higher health care costs but increasingly inflationary pressure is a result of growing global demand for goods and services. Demand is especially high from China, which is experiencing tremendous economic growth right now and where the economy has grown at an annual rate of 7% for the last 25 years. This growing demand from China and the rest of the world is resulting in higher commodity prices, higher capacity utilization rates for industry, and finally, a slightly tighter labor market.

Just three months ago we wrote about lackluster job creation by the US economy. No sooner had we gone to press than the Department of Labor released a fantastic jobs report for March that was followed by equally strong numbers for April and May. Since August of 2003, the economy has created 1.5 million net new jobs. The "jobless recovery" is over. In addition to strong job creation, GDP growth has been strong, consumer confidence (and spending) are very high, housing starts remain near record levels, corporate profit growth remains strong, productivity is high, interest rates are still near fifty-year lows, inflation is in check and the unemployment rate is down to 5.6%.

Will the good news continue? The potential impediments to economic progress in 2004 and beyond include the obvious but acute threats posed by terrorism and the unstable regions of the world. In addition, economic activity is greatly influenced by job creation and we will continue to be challenged to re-train and re-employ workers who are losing their manufacturing jobs to overseas competition. Even as we are witnessing the loss of manufacturing jobs at home, we must continue to remove barriers to global trade to encourage worldwide economic activity. Free trade provides economic opportunity for people around the globe and it is our greatest potential means for creating peace in the world. Folks with something to lose are less likely to choose war and violence. We see these somewhat "heavy" issues as long-term challenges for our economy and our country in general. In the short term, it is anybody's guess but the economic backdrop for continued progress is quite good, especially when you factor in the amazing resilience of the US economy.

Uncertainty, fear and greed have always provided great reasons to abandon a well thought out investment plan. In addition to our emotions getting in the way, we are constantly bombarded with the hype of the media outlets that generate their livelihood by making us think we need to "do something…take action now…make a trade…make a change!" As hard as it may be sometimes, we think it makes sense to turn off the television, put down the newspaper and leave emotion out of the investment process. If your target allocation of stocks and bonds is appropriate for your age, your risk tolerance and your need for return, the best course of action is to maintain discipline in your portfolio and stick to your long-term plan. Let us know if you want to review your accounts.

Thank you for letting us help you with your planning and investing.

Benton S. Bragg

Benton S. Bragg, CFP, CFA
President, Bragg Financial Advisors, Inc.