Investment Report and Market Commentary

BRAGG
FINANCIAL ADVISORS

Second Quarter 2005

The following Investment Report and Market Commentary is for the Second Quarter of 2005. 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, 2005

Market Index	YTD 6/30/05	1 Year	3-Year Annualized	5-Year Annualized
Standard & Poors 500 (Large Cap)	**-0.81%**	**6.32%**	**8.28%**	**-2.37%**
Standard & Poors 400 (Mid Cap)	**3.85%**	**14.03%**	**13.16%**	**8.49%**
Russell 2000 (Small Cap)	**-1.25%**	**9.45%**	**12.81%**	**5.71%**
MSCI EAFE (Foreign)	**-1.17%**	**13.65%**	**12.06%**	**-0.55%**
Lehman Brothers Aggregate Bond	**2.51%**	**6.80%**	**5.76%**	**7.40%**
Lehman Brothers 3 Year Municipal	**0.45%**	**2.55%**	**2.69%**	**4.38%**

Stocks rode a roller coaster in the second quarter only to end up not far from where they began the quarter and the year. Good economic news and strong earnings reports were overshadowed by worries over oil prices, interest rate increases and Iraq violence. Large company stocks as measured by the S&P 500 actually gained 1.37% for the quarter but their year-to-date return is still slightly negative. Mid and small company stocks as measured by the S&P 400 and Russell 2000 respectively fared better for the quarter, each posting returns of slightly over 4%. Foreign stocks lost about 1% in the second quarter and are down a similar amount year-to-date, with most of that loss attributable to a stronger US dollar.

If you find yourself becoming impatient with the market after six months with no progress, take a look at the 3-year annualized column in the above table. **We have enjoyed great returns over the last three years as the market has rebounded from its lows of the summer of 2002.** We would be very well off indeed if we could always look back on the preceding three years and see returns like those of the last three years.

Stock tip and reality check. If you were thinking about loading up on gold, oil or other commodities today after the fantastic run they have had for the past few years, please remember your temptation back in 1999 or early in 2000 when you wanted to load up on "New Economy" stocks. Had you followed your temptation, your portfolio would have gotten clobbered. Maybe we are not at a high for the price of oil or the price of gold but remember that the market ebbs and flows and our goal should be to maintain reasonable sector diversification and to rebalance the portfolio periodically… forcing us to sell what has run up in price (sell high) and buy what has fallen in price (buy low). The goal is never to "buy high and sell low." Do you recognize these two numbers: **-18.34% and +20.97%**? According to Morningstar, Inc. these are the annualized five-year returns of the technology sector category and the precious metals category for the period ending June 17th. Human nature makes us want to chase what has been hot but logic says we should trim our winners and add to our losers. Hard to do but it works and we are doing just that.

Bonds had a very good quarter as long-term interest rates retreated from the higher levels reached in the first quarter. The Lehman Aggregate Bond Index gained 3.01% in the second quarter bringing the year-to-date return to 2.51%. Government bonds fared better than corporate bonds during the quarter. This was primarily due to rating agency Standard & Poor's downgrading the debt of both Ford and General Motors to "junk" status early in May.

While the Federal Open Market Committee has raised short-term rates nine times since June of 2004, bringing the overnight bank lending rate to 3.25%, longer term rates have not budged from their levels of 12 months ago. In fact, at 3.92%, the yield on a ten-year treasury note is scarcely higher than the yield on three-year and five-year treasuries. While even Fed Chair Alan Greenspan calls this scenario a "conundrum," he and most economists feel that this is being caused by a combination of things. First, our trade deficit – foreigners are gobbling up ten-year treasuries using the dollars we send them when we buy their products. Their demand for treasuries has been driving prices up and yields down. Second, bond investors are simply signaling that they do not expect inflation and therefore higher interest rates in the long term. The Fed is able to control short-term rates to a degree by setting the rate at which banks can lend to and borrow from each other. But long-term rates are set by the market… by investors, and overall, investors (and that includes us) are currently not expecting significant inflation or significantly higher interest rates in the next 5-7-10 years. If bond investors are right, that is good news for the economy and for the stock market.

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Recent headlines have masked very solid economic growth. The disconnect between reality and what the media would have us believe continues to amaze us. Alarmists focusing on the “threat” of rising interest rates and higher oil prices have created the impression that the economy is doing poorly when in fact the opposite is true. A recently released Commerce Department report showed that real gross domestic product (GDP), the broadest gauge of the economy’s health, grew at an annual rate of 3.8% in the first quarter, a strong showing that exceeded most economists’ expectations. In addition, housing remains strong, recent manufacturing reports indicate solid expansion and the just released University of Michigan Consumer Confidence report indicates that consumers are not even close to throwing in the towel on spending. This is important as consumer spending makes up more than two thirds of GDP. Finally, the national unemployment rate is down to 5.1% (historically considered full employment), inflation is low and corporate earnings have continued to grow nicely despite predictions.

While negative news, like GM planning to eliminate 25,000 jobs and oil hitting $60 per barrel, is sure to attract more viewers and readers than positive news, **the plain truth is that the economic news is usually good**. Our twelve trillion dollar economy is usually expanding, creating jobs, and increasing the average American’s standard of living. According to the National Bureau of Economic Research, over the last 25 years, real GDP has declined in 11 quarters and risen in 89. We think it is a pretty good bet that this trend will continue.

“Remember how I said I was happiest when we had nothing?”

Expanding global trade agreements should remain a top priority of the United States. Unfortunately, we seem to be going in the wrong direction right now. With their constituents losing manufacturing jobs, legislators are feeling the pressure to enact protectionist policies on trade to protect domestic manufacturers. China-bashing has become commonplace and World Trade Organization progress on free markets has slowed significantly. Protectionist policies however, fly in the face of years of evidence proving that **free trade is the fastest and most effective way to raise the incomes of all countries that participate.** Currently the powerful sugar lobby is holding up a yes vote in Congress in favor of a Central American Free Trade Agreement (CAFTA). Americans pay triple the price for sugar than we would in a world of free trade… obviously the sugar lobby has a lot to lose with CAFTA but the sugar tariffs are a huge expense to millions of Americans who greatly overpay for sugar and other goods to artificially protect relatively few jobs. Studies show that protecting a job in an uncompetitive industry costs more than twice the salary the worker earns. Our money would be much better spent retraining those workers to prepare them for the jobs of the future.

We have five-star news! You may know that Bragg Financial launched two no-load mutual funds in 2002. These funds just reached their three-year anniversary and were given Morningstar and Lipper’s highest ratings. Morningstar and Lipper are the nation’s leading independent mutual fund research firms. Steve Scruggs, CFA manages the two funds and he credits their success to our disciplined investment philosophy. You can take a look at the funds at www.queensroadfunds.com or at www.morningstar.com (tickers are QRSVX and QRVLX). We are excited about this early success.

Thank you for letting us help you with your planning and investing. Please let us know when you would like to review.

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