Investment Report and Market Commentary

BRAGG FINANCIAL ADVISORS

Third Quarter 2005

Buffeted by hurricanes, record high oil prices and rising interest rates, stocks still managed to have a decent third quarter. Large Cap US equities as measured by the Standard and Poor's 500 were up 3.61% for the last three months, while Mid and Small Cap stocks were both up nearly 5% for the period. Foreign stocks as measured by the MSCI EAFE index ran away with the prize however, posting a return of 10.38% for the quarter. The year-to-date column below shows that it has been a mixed bag for stocks for the last nine months, with Mid Cap and Foreign stocks edging out Large and Small Cap stocks.

As you look at the returns in the table below, you are probably pleasantly surprised by the fact that equity returns for the last nine, twelve and thirty-six months look exceptionally good. The combination of the recent terrible images from Hurricane Katrina, record high gas prices and continuing bad news from Iraq gives us the impression that the economy and the stock market have been suffering. In reality, however, both have held up surprisingly well and investors have made good money during this period. We hope that trend will continue.

Market Index Total Returns as of September 30, 2005

Market Index	YTD 6/30/05	1 Year	3-Year Annualized	5-Year Annualized
Standard & Poors 500 (Large Cap)	**2.77%**	**12.25%**	**16.72%**	**-1.49%**
Standard & Poors 400 (Mid Cap)	**8.92%**	**22.16%**	**22.11%**	**7.05%**
Russell 2000 (Small Cap)	**3.38%**	**17.95%**	**24.12%**	**6.45%**
MSCI EAFE (Foreign)	**9.08%**	**25.80%**	**24.62%**	**3.16%**
Lehman Brothers Aggregate Bond	**1.82%**	**2.80%**	**3.96%**	**6.62%**
Lehman Brothers 3 Year Municipal	**2.77%**	**4.05%**	**4.18%**	**6.34%**

Year-To-Date Sector Returns for Standard and Poor's 500 Index

Description	Number of Companies	Market Value of Sector	Percent of S&P 500 Index	Year to Date Return
Energy	29	$1.1 Billion	10%	39.96%
Utilities	33	$0.4 Billion	4%	20.36%
Health Care	56	$1.5 Billion	13%	3.79%
Consumer Staples	37	$1.1 Billion	10%	1.47%
S&P 500 Index	**500**	**$11 Trillion**	**100%**	**1.39%**
Technology	78	$1.7 Billion	15%	-0.53%
Financials	84	$2.2 Billion	20%	-3.50%
Industrials	53	$1.2 Billion	11%	-3.94%
Materials	32	$0.3 Billion	3%	-7.60%
Telecommunication	9	$0.3 Billion	3%	-8.04%
Consumer Discretion	88	$1.2 Billion	11%	-8.06%

Energy and utilities continue to lead the way this year as you can see in the table to the left. Five years ago most folks would not touch those sectors… combined they made up less than 9% of the market value of the 500 firms in the S&P 500. Today they make up closer to 15% and investors can't seem to get enough of them. In a similar example of a swing in value, back in early 2000, **technology** made up 34% of the market value of the index and today it is only 15%! Yes, it fell that far. Keep that in mind. **Note:** A well- diversified investor owned oil, utilities and technology in 2000 and still owns own all three today.

Bonds lost value during the third quarter. The Lehman Aggregate Bond Index declined during the period, basically giving up its gains from the second quarter and bringing the year-to-date return to 1.82%. Strong talk from the Federal Reserve's Open Market Committee about the need for higher interest rates to keep inflationary pressures in check scared bond investors and they drove prices down and yields up. Yields still remain near their lows, however, especially on longer-term bonds where yields are strictly set by the market, not by Alan Greenspan and the Federal Open Market Committee. If you have not refinanced your mortgage, now is the time.

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Hurricane Katrina is putting added pressure on the US economy. The devastation wrought by Hurricane Katrina is affecting our country in many ways. In addition to the human suffering, this storm, one of the worst natural disasters in US history, will likely prove to have a significant impact on our economy. The combination of record global demand for oil and instability in the Middle East had already driven oil prices to very high levels before Katrina knocked out a large percentage of Gulf Coast refining capacity. The resulting high fuel prices have consumers and corporations tightening their belts. High gas prices will hit low income folks the hardest; they will cut back on purchases of clothing, food and other staples. Wealthier individuals may decide to postpone purchases of vehicles, especially SUVs. These actions, even though they are at the margin, will slow the economy. In addition to high gas prices, the storm caused an employment problem. If a significant number of the approximately one million displaced workers remain unemployed, this will affect our national output for the next few quarters. Finally the government spending that has been promised (it is estimated that the government will spend as much as $150 billion dollars in the rebuilding effort) has taxpayers, economists and even politicians worried about the deficit.

On the positive side, **the state of the economy was pretty good before Katrina hit** and this is a good indicator for how we might come out of this. Before the storm, growth of US Gross Domestic Product (our nation's output) had exceeded its long-term average of 3.2% for nine consecutive quarters. The unemployment rate had fallen to 4.9%, with over 2 million jobs created in the year ending August 2005. Inflation seemed to be in check and interest rates remained low. Finally, corporate profits had been growing strongly, exceeding most analysts' expectations handily. In addition to having a healthy economy before the storm, the rebuilding effort that will result from the storm will prove to be a long-term boon to the Gulf Coast area and to the entire US economy as massive expenditures put people to work and soak up enormous quantities of goods from vehicles and heavy equipment to building supplies and commodities needed for infrastructure construction. While it appears that the economy is slowing, the hope is for it to avoid a contraction as we work through the issues on our plate.

"I need some short-term economic stimulus."

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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The decline in US manufacturing jobs masks significant growth in manufacturing output. The oft-heard lament that the US is losing manufacturing jobs is true… according to a study published by The Economist, manufacturing jobs now account for only 10% of total jobs in the US. Manufacturing output, however, is on the rise due to continued gains in productivity. Since 1991, manufacturing output has averaged 4% growth annually. **America is still the world's largest manufacturer, producing about twice as much as China.** America has done this by continually changing the nature of its workforce. With an unemployment rate below 5%, demand for workers results in former textile workers being retrained and hired into more technical positions in healthcare, technology and pharmaceuticals. Meanwhile many stages of the manufacturing process are now automated and much more efficient, allowing the US to remain competitive in the global economy.

While our manufacturing output has grown, the new jobs today are in the service economy. According to the Bureau of Labor Statistics, service-providing industries will account for approximately 20.8 million of the 21.6 million new jobs generated over the 2002-12 period. This is not a bad thing despite lingering beliefs that a person needs to be in the business of making something he can eat, smoke, chew or drop on his toe. How can we remain competitive in the world economy if we are primarily a service economy? We do so by exporting services… think about global companies like GE, Merck, IBM, McDonalds and Citigroup. These companies generate a large percentage of their profits overseas by providing consulting, health care, hospitality and financial services and these companies employ thousands of Americans. **History has proven time and again that countries should specialize in those industries in which they have a comparative advantage.** This means that developed economies will specialize in knowledge-intensive industries while developing countries will specialize in labor-intensive industries. Therefore, for the foreseeable future, China will continue to assemble products that the West has designed. For the US to remain competitive, **we must forget about protectionist trade policies and invest in education and retraining to shift workers to higher skilled jobs.** Resistance to change is normal but we must embrace it if we are to enjoy continued growth.