# Investment Report and Market Commentary

BRAGG
FINANCIAL ADVISORS

## Second Quarter 2006

**Global fears of higher interest rates and inflation served as a major headwind** for both stocks and bonds as each lost value during the quarter ending June 30th. World equity markets gave back much of their gains for the year during the six week downdraft that began in the middle of May. While emerging market stocks were hit particularly hard, developed markets including the US suffered as well. After a six week slide, the last minute market rally at the end of June served as a dramatic conclusion to a volatile few months in the markets that were littered with confusing signals. Such times serve to underline the importance of some of our favorite investment principles: diversify, look at the big picture and keep a cool head.

### Market Index Total Returns as of June 30, 2006

| Market Index | YTD 06/30/2006 | 1 Year | 3-Year Annualized | 5-Year Annualized |
|---|---|---|---|---|
| Standard & Poor's 500 (Large Cap) | 2.71% | 8.63% | 11.21% | 2.49% |
| Standard & Poor's 400 (Mid Cap) | 4.24% | 12.98% | 18.12% | 9.29% |
| Russell 2000 (Small Cap) | 8.21% | 14.58% | 18.70% | 8.50% |
| MSCI EAFE (Foreign) | 10.16% | 26.56% | 23.94% | 10.02% |
| Lehman Bros. Aggregate Bond | -0.72% | -0.81% | 2.05% | 4.97% |
| Lehman 3-Year Municipal | 0.46% | 0.88% | 1.35% | 3.01% |

**Results for the quarter ended June 30 turned on two separate interest rate hikes by the Federal Reserve.** On May 10, the Fed lifted its short-term target rate a quarter point to 5%, sending stock markets into a long slide, including the foreign sector, which had been enjoying a dramatically strong run. The Nasdaq market alone lost more than 10% over the next several weeks. But on June 29, another quarter-point interest rate increase by the Fed had the opposite effect. It acted like a tonic on the languishing markets, which sprang back to life and racked up their best day in over three years. The S&P added 2% that day alone, and the Nasdaq market shot up 3%. Markets around the world reacted with similar enthusiasm.

Nevertheless, even after the surge, the S&P 500 fell slightly for the quarter with a negative total return of 1.44%. Despite its bold comeback on June 29 the Nasdaq also closed lower on the quarter. The Dow Jones World Index (excluding the US) fell almost 1%. As for sector performance, stocks in the energy and consumer staples sectors were strong performers, while information technology and health care companies lagged the field. For the first six months of the year the picture is brighter: the S&P 500 is in positive territory for the year with a +2.71% total return. The MSCI index of major companies in Europe, Australasia and the Far East is up 10.16% year to date in dollar terms. Backing up still further, it's helpful to look at an even bigger picture: the June 30 closing level for the S&P is about 60% higher than market levels just three and a half years ago.

**Similarly, bonds have been on a roller coaster this year** but recently, as rates have risen, yields have settled higher and prices have fallen. The ten-year Treasury is down 3.83% year to date, and is now yielding 5.15%, up dramatically from 4.05% a year ago. Though higher yields make holding bonds more attractive today, the decline in the value of our bond holdings has been painful. Of interest, the yield curve is still virtually flat – that is, on an income yield basis, investors are not being rewarded for holding bonds with longer maturities. The June 30 yield on the three-month Treasury was 5.00%, just a bit lower than the ten-year note.

**Why the difference in market response to the Fed's two actions?** Simply put, the May 10 announcement was interpreted as indicating that the rate hikes would continue for longer than previously expected as the Fed attempts to quash inflation. Higher interest rates mean costlier capital and expensive capital plus the threat of inflation are bad news for investors, so prices sagged. But the Fed's statement last Thursday took a softer tone. Though inflation pressures remain, the Fed noted that economic growth is moderating. It vowed to weigh both inflation and growth when considering further actions. A subtle point, but it was interpreted to mean the end of rate hikes may be in sight. That was enough to send investors charging back into the markets.

In truth, if you put the two statements from the Fed side by side, they are all but indistinguishable, but the markets are adept at interpreting the most delicate of nuances in the Fed's arcane language. However, for us as investors it makes little sense to focus too much on individual events, exciting though they may be. Market volatility is a fact of life, but it's the big picture that's important. As investors in equities we own pieces of the economy (businesses), which continues to grow at a robust rate. According to final figures announced last week, real gross domestic product increased at a 5.6% annual rate in the first quarter of 2006, up from a mere 1.7% in the fourth quarter of 2005. More recent readings indicate some moderating of that growth rate, which should lower inflationary pressures. The Department of Commerce cited an upturn in consumer demand for durable goods and computer equipment and software, as well as increased government spending. It's worth noting that real exports grew 14.7% in the quarter, outpacing growth in imports, which increased 10.7%.

**Meanwhile, corporate profits and dividends, as well as personal income, are expanding at a healthy clip**. As for inflation, which we're all experiencing at the gas pump, the Fed has reassured us that it will continue to take appropriate measures to crush it if circumstances warrant. Furthermore, the spread in yields between traditional treasuries and the yields for inflation-protected bonds, or TIPS, would seem to indicate that true investors putting up real money – as opposed to pundits talking on the TV – do not perceive much of an inflation threat. Finally, according to the Conference Board's June Consumer Expectations report, the all-important consumer is still spending and is optimistic about the future.

When the market behaves like a yo-yo, it is crucial to remember the importance of sticking with our investment plans rather than trying to anticipate and capitalize on every gyration. When your portfolio is diversified, some segments will benefit even as others suffer. But the point is, you're always poised to take advantage of whichever way the market swings, whether it's large cap stocks, foreign holdings or bonds that are the current favorite. Studies have shown this diversification is key to long-term investing success, and it is a cornerstone of our investing philosophy. This strategy of asset allocation calls for rebalancing of portfolios back to target allocations from time to time. This action is designed to lighten up on appreciated positions – a recent example for many is foreign stocks -- and invest those profits in sectors that have lagged and likely are more reasonably priced. Thus we are forced to trim our winners, "sell high" and add to our losers, "buy low." This requires that we leave emotion out of the equation, ignore the noise and maintain our discipline.

As always, please let us know when you would like to review your planning and investments. Thank you for your confidence in Bragg Financial Advisors.

Sincerely,

Benton S. Bragg

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Suzanne Wittebort contributed to this report.