Investment Report and Market Commentary

BRAGG
FINANCIAL ADVISORS

Third Quarter 2006

Market Index Total Returns as of September 30, 2006

Market Index	Third Quarter	YTD	1 Year	3-Year Annualized	5-Year Annualized
Standard & Poor's 500 (Large Cap)	5.7%	8.5%	10.8%	12.3%	7.0%
Standard & Poor's 400 (Mid Cap)	-1.1%	3.1%	6.6%	15.2%	13.1%
Russell 2000 (Small Cap)	0.4%	8.7%	9.9%	15.5%	13.8%
MSCI EAFE (Foreign)	3.9%	14.5%	19.2%	22.3%	14.3%
Lehman Bros. Aggregate Bond	3.8%	3.1%	3.7%	3.4%	4.8%
Lehman 3-Year Municipal	1.9%	2.4%	2.7%	1.6%	2.9%

Major Turnaround! The third quarter ended strongly, emerging from a summer slump with vigorous market gains that left the major large-cap indices near their record highs, levels that we have not seen for years. The Standard & Poor's 500 ended the quarter at 1,336, its best monthly close since January, 2001. Its robust return of 5.67% for the quarter makes up a good portion of its total 8.53% gain for the year to date.

Bond prices also rebounded sharply, with the Lehman Aggregate bond index up 3.8% in the third quarter alone. In the table above you can see that small- and mid-cap stocks finally passed the baton to large-cap stocks in the third quarter after leading the way for the last five years. Foreign stocks, bolstered by a weak US dollar, have continued their run and for the last twelve months are up over 19%. Underpinning the good news were two much-welcome factors: a decrease in energy prices and a breather from the Federal Reserve's succession of interest-rate increases.

With the economy showing signs of slowing from its breakneck pace of the last fifteen quarters, major trends of the last few years seemed to immediately reverse. Prices that seemed as if they would never stop rising, like those for oil, gold and money (interest rates) suddenly began falling dramatically. Oil prices are down 24% since their peak in July, gold is off over 20% since March and treasury yields have fallen more than 16% since July. Prices that seemed to eternally languish, like those for large-cap stocks, finally started rising. Sharp reversals like these illustrate the danger in chasing the latest hot asset class (oil, gold, commodities funds) and remind us of the value in remaining diversified.

The suddenness of the turnaround and the unexpectedly strong performance left a lot of people scratching their heads, as it seems that most of the stories in the news lately have been troubling, if not downright dire. **Our founder and chairman Frank Bragg, whom most of you know, addresses this incongruity in the following special commentary:**

How could it be? *How could it possibly be that equity markets around the world are approaching record levels? How can so much wealth be created in a world that the news media says is so bad and getting worse?*

Obviously what worries most people doesn't worry the markets. We constantly see and hear about a long list of problems: the Iraqi war, global terrorist threats, the icecap melting from global warming, illegal immigrants, the federal deficit, the trade imbalance, globalization draining away our jobs, yo-yo energy prices, the widening gap between rich and poor and how the rest of the world hates America. And for some of you, it is becoming worrisome that Carolina can't seem to play football anymore.

While many folks wring their hands about these problems, the stock market is only affected when these issues have the potential to negatively affect the spread of capitalism and the upward trend of earnings. For example, oil at $100 a barrel or a bird flu pandemic would greatly hinder economic growth. Likewise, if some doomsayers are right that global warming is an irreversible reality and the ocean rises 20 feet, well, New York City and many coastal areas may disappear and the economic fallout would be tremendous. If you are concerned about the ocean rising 20 feet, you might want to sell your beach house now and buy cheap land along the fall line. (Imagine, sandy beaches just one hour from Charlotte. But call me first; I know someone who will still pay you 50 cents on the dollar for your beach property.)

The war in Iraq has generated more discussion than most issues. Whatever the reason for the war and however it happened, we are there and the consensus is that we must stay until the region stabilizes. Some say that can never happen, but suppose it could and democracy took hold and economic opportunity provided real hope for millions of unemployed people who could find an alternative to joining terrorist groups that hate the free world. Yes, they hate all free countries, not just America. Terrorism is not new; it is just new to America. Like other things we have endured, terrorism will sidetrack but not stop the march of freedom, capitalism and better lives for millions of people.

Globalization is nothing new. *Marco Polo struck out with his bunch to find new trade routes to the Orient in 1271. In 1805 when Lewis and Clark explored the West, the fastest means of transportation the world knew was the horse. Today things move a tad faster and globalization has lifted millions out of poverty around the world. Of the 194 countries of the world, 175 are stable enough to invite capitalists to set up shop and offer farmers a way to provide more than a meager existence for their families for the first time. If you believe that the agrarian way of life, standing knee-deep in mud and living in a grass hut, was better for these people, just try to talk them into going back to their old way of life. And about those jobs leaving America, it works both ways. According to the Charlotte Chamber, there are 600 foreign-owned firms in the Charlotte region, up from 325 in 1990. The Germans own 169 companies here and the French, yes the French, own 37.*

We're not overly concerned by media reports about how the rest of the world "feels about" America. *How they feel about America is clearly not reflected in their actions. Millions are trying to immigrate to America… over a million come each year (legal and illegal). The rest of the world is desperate to trade with us. They want to buy our products and they want to sell us their products. America is the world's leading exporter and the world's leading importer. Since 9/11, despite all the talk about the way the rest of the world "feels about" America, our imports have increased 44% and our exports have increased 26%. Last year alone, foreigners bought almost one trillion dollars worth of goods and services from the United States. Indeed, the greatest driver of global relations by far has always been trade.*

The emerging economies of the world provide great opportunities for everyone. *Third-world countries like China, India, Russia and Brazil are coming of age as capitalism and economic opportunity transform the lives of their citizens. From reading the newspaper you would think these countries are taking over the world. No doubt there is huge potential; China and India alone represent one third of the world's population. But at this point, we should remind ourselves that the market capitalization of the entire Chinese stock market is less than that of General Electric and Bank of America combined. The Chinese market cap is $600 billion and India's is just half that. The American market capitalization is about $15 trillion. Continued progress for these countries is good for their citizens; it is good for us as consumers of their low-cost products; it is good for us as shareholders of companies that now have new consumers for their products. The world economic pie has the potential to greatly expand and as participants, we will benefit tremendously.*

On income disparity, *for the life of me I can't figure out why some people resent Katie Couric making $15 million or Oprah making $30 million when they send half their income to Uncle Sam. The money they're paid didn't come out of pockets of the poor; shareholders pick up the tab (and they believe it is a good investment). And the rich, as they should, are paying the taxes for many who pay no tax. For a handful of folks in America, income disparity is a real problem but for most folks it is not. Low-income immigrants, riding in their twelve-year-old Oldsmobile, do not resent the guy in the next lane in an $80,000 BMW because the immigrant knows he too has the opportunity to have success. His life is already better than before; he has steady employment, educational opportunities and he owns a vehicle for the first time.*

*Now I do not want to sound like Pollyanna here… we definitely have issues. The violence of terrorism is real and the federal government's unaffordable social programs must be fixed. But I do hope this perspective will help you take a cue from the stock market and see beyond the hand-wringing stuff that seems to be in our faces every day. The nature of mankind is to progress and make the world better. We think that will continue. – **J. Frank Bragg, Jr.***

Thank you for listening and thank you for trusting Bragg Financial Advisors for your planning and investing.

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