# Investment Report and Market Commentary

BRAGG
FINANCIAL ADVISORS

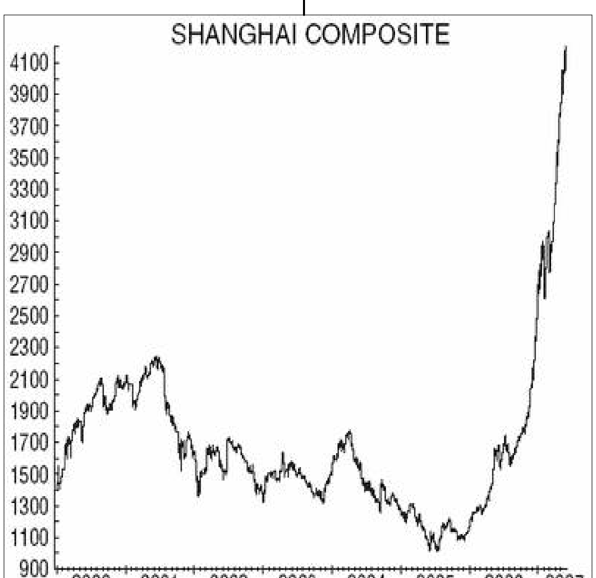
## Second Quarter 2007

**Market Index Total Returns as of June 30, 2007**

| Market Index | YTD 6/30/2007 | 1 Year | 3-Year Annualized | 5-Year Annualized |
|---|---|---|---|---|
| Standard & Poor's 500 (Large Cap) | 6.9 | 20.6 | 11.7 | 10.7 |
| Standard & Poor's 400 (Mid Cap) | 11.9 | 18.5 | 15.2 | 14.2 |
| Russell 2000 (Small Cap) | 6.5 | 16.4 | 13.5 | 13.9 |
| MSCI EAFE (Foreign) | 10.7 | 27.0 | 22.2 | 17.7 |
| Lehman Bros. Int. Gov't./Credit | 1.4 | 5.7 | 3.3 | 4.1 |
| Lehman 3-Year Municipal | 1.3 | 3.9 | 2.4 | 2.6 |

**World stock markets rallied in the second quarter.** Brushing off worrisome news from the housing market and lackluster reports on economic growth, a volatile market delivered good news on almost all fronts. Late in May, the Standard & Poor's 500 index finally broke through its record high close of 1527 last reached seven long years ago in March of 2000. While ending the quarter slightly below that level, the index is up 6.9% for the six months ending June 30th. Mid cap and small cap indices also fared well, with year-to-date returns of 11.9% and 6.5% respectively. Foreign markets generally kept up the brisk pace of the last few years; the MSCI EAFE (Europe, Australia, Far East) was up over 10% in the first six months of the year. There were strong showings across the globe from South Korea and Australia to Germany and Israel.

**In terms of stock market returns, the standout this year is China.** The chart to the right illustrates the exuberance of Chinese investors (foreigners generally can't own Chinese stocks directly), many of whom are investing money in stocks for the first time. While this upward trend in Chinese stocks may persist for some time, it is hard to imagine that we'll see a "soft landing" in this case.




While other global stock markets have not experienced this kind of trajectory, they certainly have participated in a global boom that differs from other periods in our history in a number of ways. The greatest driver of this phenomenon is human capital. Never before have we seen such a huge number of entrants into the global workforce. With several billion workers from India, China, Brazil and Eastern Europe clamoring to join the ranks of the wealthy, the global economic pie is expanding mightily. The winners include these newcomers as well as long-time participants who now have access to cheap labor and newer markets in which to sell products and services. As human capital has expanded, barriers to financial capital have fallen significantly as trade agreements and technology have opened world markets. Low interest rates and low inflationary pressures around the world have resulted in tremendous liquidity and money is flowing to those areas that promise higher returns. A huge benefit to the emerging economies and to us as investors is that the template for success exists: copy the time-tested model of the US and other developed economies and it will be hard to fail in the long run.

**In a vivid example of capital flows,** a buyout binge of enormous deals by private equity firms is making headlines weekly. Driven by the flood of low-cost debt, some of the largest "going private" deals include the purchase of Chrysler by private equity firm Cerberus, KKR's buyout of TXU and First Data and the purchase of Equity Office Properties by the Blackstone Group. According to Dealogic, global mergers and acquisitions surged to a record $2.9 trillion in the first half of 2007, up 55% from one year ago. Perhaps signaling a market top, several large private equity firms, including the Blackstone Group and KKR, have decided to go public, unloading portions of their own companies at premium prices. Caveat emptor!

**Of course, markets can occasionally go too far.** The Securities and Exchange Commission is investigating the slow-motion collapse of the sub-prime mortgage market, as hard-pressed borrowers continue to succumb to higher interest rates and foreclosures mount to record levels. More broadly, recent data show drops in existing-home sales, rising housing inventories and falling prices. There have been eye-catching news items highlighting the risks of hedge funds, limited partnerships that often use significant levels of debt to magnify their investments, unfettered by many of the regulations that constrain mutual funds and other registered products. In June, investment bank Bear Stearns announced a $1.6 billion bailout of one of its hedge funds, due to losses incurred through investment in sub-prime mortgage securities. It remains to be seen if the weakness in housing will spill over into the broader US economy. At this point, it has served as a drag on GDP growth but has not pulled us into recession.

What does this combination of exuberance on the leveraged buyout front and gloom on the housing front mean for the economy? According to the Open Market Committee of the Federal Reserve Bank, the gradual shake-out in housing and the record-shattering transactions taking place in the private equity world are both great examples of our robust and dynamic capital markets system at work. While the bloodletting in the sub-prime lending world and the excitement of a thirty billion dollar buy-out make great news stories, at the end of the day, our markets are working and our economy is plugging along with moderate to slow economic growth, low interest rates and low unemployment. At its last meeting, the Fed appeared to comment as such by leaving interest rates unchanged as it continues to tread the narrow line between controlling inflation by raising rates and stimulating economic growth by lowering rates. It has now been over a year since the Fed last tightened interest rates.

**Fed inaction notwithstanding, interest rates made their own move during the second quarter** and bond prices fared poorly as a result. Nervous bond investors fearing inflation, higher oil prices and a resulting slower pace of economic growth drove bond yields up and prices down in May and June. The ten-year treasury bond yield closed above 5.0% at quarter-end, up from 4.6% in mid-March. This large increase in yields and corresponding fall in prices erased most of the healthy return bonds had racked up prior to mid March.

Higher interest rates make bonds more attractive but also result in slower economic growth as the higher cost of debt puts the squeeze on corporate profits and consumer spending. This is bad news for stocks and investors will be watching rates closely in coming months.

Indeed, while global economic growth and global stock markets have been hot recently, asset prices worldwide for real estate, stocks, oil and other commodities are relatively high right now. A shock to the system resulting from a terrorist act or an oil shortage could have a significant negative impact in the short term. And while the rest of the world is less dependent on the fortunes of the US economy than it used to be, weakness here can still have a dampening effect on the broader global economy.

But we believe the overall economy is healthy, and that the positive trends outweigh the negative trends. In terms of downside risk, the good news is that US stocks are more attractively priced today than they have been in other recent periods such as the late nineties. The price of the S&P 500 index is about 17 times the earnings of the trailing twelve months, just a little higher than the 20-year average of 16 times earnings.

**A word about real estate:** Real estate investment trusts (REITs) have been on a tear for the last few years as cheap debt and high occupancy rates have fattened their bottom lines. However, prices have fallen off somewhat since March as interest rates have risen and some of the frothiness has left the market. We have trimmed REIT positions in many portfolios as price gains have caused them to become overweighted. Real estate typically has a low correlation with other investment asset classes, and thus reduces portfolio risk. REITs have proven to be valuable vehicles for allowing the average investor to buy a stake in a geographically diversified portfolio of commercial properties such as shopping centers, apartments, and office buildings. While we have trimmed exposure, we still believe REITs have a place in most portfolios for several reasons: to lessen volatility, for the steady income stream they typically provide, and for their liquidity, which is far greater than owning actual physical property.

Please let us know when you would like to review your portfolio or discuss your financial planning. We appreciate your confidence in our firm.

Sincerely,

Benton S. Bragg

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President, Bragg Financial Advisors, Inc.

Suzanne Wittebort, CFS contributed to this report.