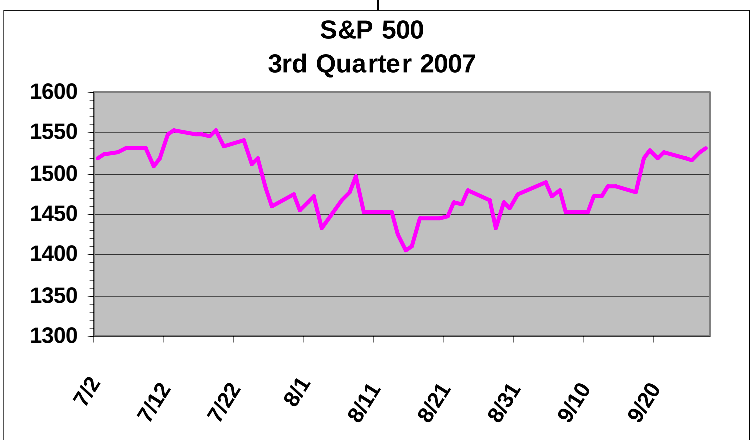
Third Quarter 2007

Market Index Total Returns as of September 30, 2007

Market Index	YTD 9/30/2007	1 Year	3-Year Annualized	5-Year Annualized
Standard & Poor's 500 (Large Cap)	9.1	16.4	13.2	15.5
Standard & Poor's 400 (Mid Cap)	11.0	18.8	15.7	18.2
Russell 2000 (Small Cap)	3.2	12.3	13.4	18.8
MSCI EAFE (Foreign)	13.2	24.9	23.2	23.6
Lehman Bros. Int. Gov't./Credit	4.0	5.1	3.8	4.2
Lehman 3-Year Municipal	3.2	3.8	2.5	2.5

Owning stocks and bonds during the third quarter of 2007 was a bit like watching Wake Forest win the ACC championship in football last year. It felt fantastic when it was over but at points along the way I found myself nervous, scared and wondering if we would make it through. Just as my Deacons pulled out a win, the market actually finished the quarter with a gain after falling off its previous high by as much as ten percent at one point in August.



As the adjacent chart shows, the quarter was a real roller coaster and it all started with the so-called "sub-prime" mortgages that we have discussed in the last few reports. A not-insignificant number of these loans made to unqualified homebuyers started going bad as adjustable-rate mortgages adjusted upward with rising interest rates and as "teaser" rates expired. Many borrowers found that they could no longer make their payments and defaults started rising.

The way the sub-prime debacle is playing out in the financial markets continues to be very interesting. It has never been more evident that we live in a world where the proliferation of innovative new financial instruments has tied markets together around the globe. A missed mortgage payment by a first-time homeowner in Meridian, Mississippi affects the bond portfolio of a retiree in Tokyo, Japan. This is because lenders often do not keep the loans they have originated on their books. Instead they combine thousands of loans into pools and then the pool is divided up into different sections or "tranches" based on the level of risk and other characteristics. Bonds representing the underlying tranches are then sold off to investors including mutual funds, hedge funds, pension funds and even retirees in Japan. Investors buying bonds backed by the riskiest loans receive higher rates of interest and with today's low level of interest rates, these higher-yielding instruments have been all the rage. If owning risky bonds were not enough, many hedge funds have been leveraging their bets on these bonds. Basically they would borrow money at 4.5% and use those funds to load up on bonds yielding 7% or more. This was great as long as rates stayed low and home values continued to move up. And for the last six years this is exactly what happened…rates stayed low and as the chart on the next page makes clear, home values rose.

It all seemed quite stable and while it lasted it was certainly enriching. But as someone once said, stability breeds instability. When things keep plugging along we tend to get complacent and we ignore the risk that conditions might change. Lenders kept lending to borrowers who couldn't pay and investors kept buying the debt. The risk was ignored. When foreclosures started rising this summer, suddenly folks started scrambling around to figure out where all this debt was held and how much of it was on the books. The riskiest debt and even less risky debt and even stocks were suddenly losing value. No one was willing to buy, choosing instead to hold cash and wait it out. Credit markets seized up, bonds fell, stocks fell, lending dried up and yes, home values started falling. Suddenly, and at long last, investors were

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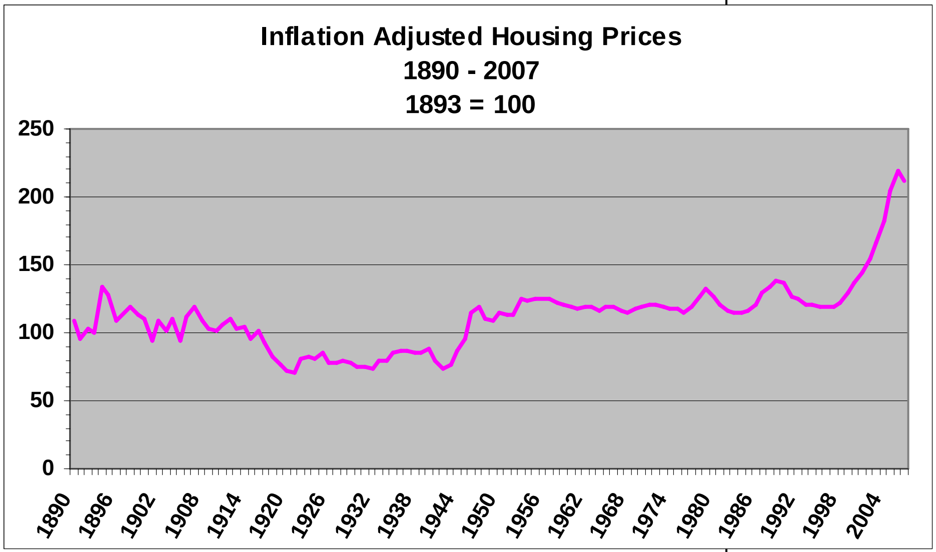
demanding a premium to take on risk; this is how the market is supposed to work.

Hedge funds especially were in a pickle. They needed to repay the money they had borrowed at 4.5% but they could only get 50 cents on the dollar for the risky bonds they had bought with that borrowed money. Many of these funds had huge losses and scores of them closed their doors. The turmoil in the debt market of course spilled over into the equity market as investors reacted to the uncertainty created by the credit debacle.



If you were on vacation or busy working or just ignoring the market this summer, you probably missed all that action and you may have trouble believing that it really happened. **On Monday, October 1, the Dow Jones Industrial Average reached an all time high of 14,047.** The Lehman Brothers Intermediate Bond Index is up 4% year to date. And Benton wants me to believe that the markets were in absolute turmoil just a few weeks ago? They were, and it was actually almost as exciting as the 2006 ACC Championship Football Game.

So what about this new record high for the Dow? It is a bit puzzling. The Dow hit a record on Monday while during the prior week we were treated to the following headlines and economic reports:

- Existing home sales fell 4.3%
- New home sales dropped 8.3%
- Durable goods orders fell 4.9%
- Retail Sales & Consumer Confidence lower than expected
- Greenspan puts recession odds at 50/50 in recent speech
- Dollar hits new low against Euro
- Oil prices hover above $80 per barrel
- Q2 GDP revised down to 3.8% annualized

Not the best week for the economy, was it? Most market participants agree that the economy is still slowing and yet we're still enjoying a good stock market. Is it possible to enjoy a bull market and a recession at the same time? It would be a first and it is not likely. We could still see the housing problem drag us into a recession. In addition to the impact the housing issue is having on certain consumers, it is also causing job losses in construction, mortgage lending and at financial institutions in general. There is more bad earnings news on the way from banks and other financial concerns as a result of their exposure to sub-prime loans and other higher-risk securities. We certainly haven't seen the end of it.

But the market is clearly seeing past these issues and focusing on our getting through this intact. **At its September meeting, the Federal Reserve lowered the fed funds rate by one half percentage point to 4.75% and signaled that it may lower it further in the future.** This was the first reduction in four years and a sure sign that the Fed is willing to take dramatic action to protect the economy from derailment. The market's recent gains make it clear that investors are anticipating continued growth in the economy, fueled in part by lower interest rates. In addition to the stimulus from low interest rates, there is also support from overseas. Foreign economies are steaming along, taking up some of the slack caused by our housing issues. Meanwhile, the weaker dollar makes US corporations' exports much more attractive to foreign buyers. We continue to enjoy low unemployment, low inflation and decent productivity growth. Finally, market valuations in the US are still attractive relative to the last fifty years.

The turmoil of the summer reaffirms our investment philosophy. In particular, it validates our belief that risk is real and it is usually highly correlated with return—there is no free lunch. I am particularly glad that we decided five years ago not to invest in hedge funds.

For the last twenty minutes I have typed with my one-month-old son on my lap. Charlie can't hold his head up, control his hands, smile or even see me clearly. He *can* however make some serious noise and someday maybe he'll make a great little portfolio manager. For now we'll just give him his bottle and hope we all get some sleep.

Thank you for letting us help you with your financial planning and investing.

Sincerely,

Benton S. Bragg, CFP, CFA
President, Bragg Financial Advisors, Inc.