Fourth Quarter 2007

Market Index Total Returns as of December 31, 2007

Market Index	Fourth Quarter 2007	1 Year	3-Year Annualized	5-Year Annualized
Standard & Poor's 500 (Large Cap)	-3.3	5.5	8.6	12.8
Standard & Poor's 400 (Mid Cap)	-2.7	7.9	10.3	16.2
Russell 2000 (Small Cap)	-4.6	-1.6	6.8	16.3
MSCI EAFE (Foreign)	-1.8	11.2	16.8	21.6
Lehman Bros. Aggregate Bond	3.0	6.9	4.6	4.4
Lehman Bros. Municipal Bond	1.4	3.4	3.9	4.3

Bruised and battered investors were happy to limp across the year-end finish line with a decent gain after all they endured in 2007. It was a year of wild swings in the stock market, with no fewer than eleven one-day declines of more than 2% for the S&P 500, often followed by nearly-as-precipitous increases. Despite the dizzying volatility, at the end of the year all asset classes with the exception of small cap stocks had managed positive returns. Foreign stocks, aided by the falling dollar fared best, continuing their hot streak that began back in 2003. As you can see in the table (right) most market sectors advanced in 2007. Exceptions include consumer discretionary (autos, refrigerators) and notably, financial stocks whose large weighting in the S&P 500 (over 20% at the beginning of 2007) made a significant negative contribution to the overall benchmark return for the year.

S&P 500 Index Sector Returns
As of December 31, 2007

Sector	Sector Weight	MTD	QTD	2007
Energy	12.9%	7.28%	4.07%	32.38%
Basic Materials	3.3%	0.87%	-0.44%	19.98%
Utilities	3.6%	0.04%	6.76%	15.81%
Information Technology	16.8%	1.48%	-0.08%	15.54%
Consumer Staples	10.2%	-1.25%	3.26%	11.60%
Industrials	11.5%	-0.87%	-5.12%	9.83%
Telecommunications	3.6%	3.08%	-5.79%	8.45%
Health	12.0%	-3.10%	-0.46%	5.39%
Consumer Discretionary	8.5%	-4.95%	-10.49%	-14.32%
Financial	17.6%	-5.73%	-15.04%	-20.84%
S&P 500 Price Return		-0.86%	-3.83%	3.53%
S&P 500 Total Return		-0.69%	-3.33%	5.49%

Bond holders, especially holders of high quality bonds, fared well. You can see in the table (top) that the Lehman Aggregate Bond Index was up 3% in the fourth quarter alone. This jump in bond values corresponded with a similar percentage decline in the S&P 500 Index as trading investors abandoned stocks for bonds in a "flight to quality " late in the quarter.

Fourth quarter results were driven by many of the same worries that troubled investors for most of 2007: the spreading sub-prime mortgage crisis, soaring energy prices, a slumping real estate market and increasing fears of recession. The financial sector suffered dramatically as institution after institution announced large write-downs of mortgage-related assets. In just one example, Citigroup, with some $55 billion in sub-prime exposure, predicted an earnings hit of as much as $7 billion, and saw its stock decline nearly 40% in the fourth quarter.

The exact dimensions of the sub-prime mortgage debacle are still unknown. Financial firms simply do not know which of the assets on their balance sheets will have to be written down and by how much. The Federal Reserve has moved to stabilize the situation through lowering interest rates and increasing liquidity in the financial markets, sending a comforting signal that it will take further action if the situation worsens. We don't know how long it will take for these issues to work through the economy. The longer we are students of the market, the more we are struck by how long it takes for cycles to play out. In the late nineties, tech stocks continued to rise for several years after the "smart money" said to short them, as did real estate in 2001-2006, consumer stocks in the eighties and the high-flying Nifty Fifty in the seventies. Trends run longer than one would expect and we can't predict when the corner will be turned. Housing and sub-prime mortgages have been headlines for well over a year now and yet the slow motion unraveling continues. The stock market reaction to the credit crunch and housing market decline might be mostly behind us as the market tends to be forward looking. On the other hand, if the coming months give us economic and earnings reports that are worse than expected, we may see the market fall further.

The question is whether the credit situation will leak into the rest of the economy and cause a recession and if so, how long and how deep it will be. Certainly recent events including rising unemployment rates, a so-so Christmas for retailers, flat corporate earnings and oil hitting the $100-a-barrel milestone all contribute to the sense that the economy is losing steam.

Of course, the news is not all bad. Our economy is extremely resilient; it has endured tremendous shocks in the past. Most folks who want to work are working, interest rates remain low, inflation remains in check, and global trade is on the rise. The weak dollar makes US products attractive to foreign buyers, and as we have discussed before, an increasing number of US companies have substantial overseas markets. Demand for US goods will grow as countries such as China and India become more prosperous. And though the price of gasoline is near its inflation-adjusted historic high of $3.10 per gallon, it has yet to cripple consumers, as fuel expenditures represent a much smaller portion of disposable income than in the past.

But it would be hard to have missed all the media coverage regarding the US potentially being in or perhaps entering a recession. What is a recession and what will it mean for investors? The National Bureau of Economic Research or NBER is considered the official arbiter of recessions and it defines recession as "a significant decline in economic activity spread across the economy, lasting more than a few months." It turns out recessions are far from rare: there have been 21 of them since 1900. In the years before World War II they averaged 19 months in duration, but in the post-war era they have averaged a briefer 10 months. As we have transitioned to a service and knowledge-based economy, we are not as prone to the deep recessions associated with the more cyclical manufacturing-based economy of our past. The intervention of the Federal Reserve to provide liquidity primarily through lower interest rates also has reduced the severity of recessions in recent years. The last recession ran from March 2001 through November 2001, according to the NBER. When 9/11 hit, many economists feared the economy would be thrown into a recession when in fact, we later learned, it already was in recession. Then Fed Chairman Alan Greenspan took immediate action to stoke the economy through massive interest rate cuts. These efforts are believed to have made the recession one of the shallowest and shortest on record.

Snapshot of the Last Ten US Economic Recessions

		Dow Performance		
Recession Dates	Duration in Months	From Beginning of Recession to Market Trough	From Market Trough to End of Recession	From Beginning of Recession to End of Recession
Nov. 1948-Oct. 1949	11	-15%	19%	1%
July 1953-May 1954	10	-6%	28%	21%
Aug. 1957-April 1958	8	-17%	9%	-10%
April 1960-Feb. 1961	10	-8%	17%	8%
Dec. 1969-Nov. 1970	11	-22%	26%	-1%
Nov. 1973-March 1975	16	-39%	33%	-19%
Jan. 1980-July 1980	6	-8%	23%	13%
July 1981-Nov. 1982	16	-20%	34%	7%
July 1990-March 1991	8	-18%	24%	2%
March 2001-Nov. 2001	8	-20%	22%	-3%

Source: National Burea of Economic Research NBER and Dow Jones

Periods prior to 1990 exclude dividends. Returns would be higher if dividends were included.

How much does the market decline during a recession? The table above provides details on the ten recessions we have endured in the post-war era. As you look at the table, you can see that stock market declines definitely have corresponded with these economic downturns. You can also see that the market has recovered sharply coming out of recessions. **Looks like a great opportunity to time the market doesn't it?** Get out just before the recession and conveniently hop back in at the trough. Unfortunately, most recessions are announced by the NBER months after they have already begun. We may be in recession now, only to learn of it six months from now. Short of having a crystal ball, we can't know when the market will bottom, providing that great opportunity to get back in. The market is already about 11% off its recent high reached in the fourth quarter. Will it drop further from here and if so, how much? If we get out now, when will we get back in? If we get out today and the market immediately goes up 10%, what do we do then? You know where I am going with this. Trying to time the market is simply not something we think can be done successfully over long periods of time.

2008 is an election year and we will likely see the gloomy economic news take a back seat to election coverage as the primaries whittle down the field. Not sure if you are a political junkie but I was fascinated by the outcome in Iowa (Huckabee and Obama) and will be on the edge of my seat to see where the country ends up in November. And what will be the impact of the election on the stock market? Regardless of which party takes the White House, the outcomes in the House and Senate races will determine how much change we can expect in the coming years. If the Democrats sweep, we may see significant change with regard to tax policy, regulation, trade policy and health care. Alternatively, if we continue to have a divided Congress, we may see gridlock and a continuation of our current situation regardless of who takes the White House.

Whether 2008 gives us Democrats or Republicans, economic growth or recession, more drought or lots of rain, we plan to help you own a portfolio that is appropriate for your age, risk tolerance and need for return. We'll own bonds to provide a buffer against a downturn, stocks to outpace inflation in the long term and we'll rebalance the portfolio periodically to maintain the target allocations. We will continue to focus on owning a low-cost portfolio and we'll work hard to minimize your tax bill.

Final Word. Some of you may know that I live on a farm. For Christmas this year Santa Claus (yours truly) surprised the children by driving up in the yard in a tiny little cart pulled by two miniature donkeys. You can imagine the reaction of my seven, six and four-year-old children. Baby Charlie (four months) can't yet talk but I just know he was delighted. Thus far Murray and Ethel have provided steady (albeit slow) transportation around the farm and we have yet to have a runaway donkey on the loose, although my wife Alice is convinced it will happen. With oil close to $100 per barrel, I figure that my donkey-drawn cart will not only save me a fortune on gas but I'll also be reducing my "carbon footprint" in this day of global climate change. Now you can join Alice in thinking I've lost it. That's okay—the children think Santa is the greatest. I hope your holidays were bright as well.

Happy New Year and thank you for letting us help you with your financial planning and investing.

Sincerely,

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

Suzanne Wittebort, CFS contributed to this report.