Investment Report
And Market Commentary

BRAGG
FINANCIAL ADVISORS

First Quarter 2008

Market Index Total Returns as of March 31, 2008

Market Index	First Quarter 2008	1 Year	3-Year Annualized	5-Year Annualized
Standard & Poor's 500 (Large Cap)	-9.5	-5.1	5.8	11.3
Standard & Poor's 400 (Mid Cap)	-8.9	-7.0	7.1	15.1
Russell 2000 (Small Cap)	-9.9	-13.0	5.1	14.9
MSCI EAFE (Foreign)	-8.9	-2.7	13.3	21.4
Lehman Bros. Aggregate Bond	2.2	7.7	5.5	4.6
Lehman Bros. Municipal Bond	-0.6	1.9	3.7	3.9

On April 2, Federal Reserve Chairman Ben Bernanke told a congressional hearing committee that "the US economy is unlikely to grow "much, if at all, over the first half of the 2008 and could even contract slightly." He even went so far as to suggest that "a recession is possible in 2008." This testimony supports what many economists have been suggesting for over a month now. While the statistics are not yet in to prove it, the US economy is very likely in recession right now as the fallout from the housing market is spilling over into the broader financial sector and is now affecting consumer spending, employment and business investment. Stock market returns tell the story quite well. The S&P 500 is down only 9.5% since January 1, but it is down 14% from its October 9 peak.

Institution	Write-down (Billion US$)
UBS	37.10
Citigroup	32.00
Merrill Lynch	24.50
AIG	14.80
HSBC	12.40
Morgan Stanley	11.86
Bank of America	7.90
Deutche Bank	7.50
Ambac	6.30
Freddie Mac	6.00
Wash. Mutual	5.80
Bear Stearns	4.96
Wachovia	4.70
Fannie Mae	4.55
Goldman Sachs	3.84
Lehman Bros.	3.70
MBIA	3.50
Barclays	3.30
JP Morgan	3.20
R. Bank Scotland	3.20

Our last three newsletters document a steady progression of negative events that began with the rising defaults in "sub-prime" mortgage loans and progressed to huge losses in certain investment funds that owned many of these bad credits. With the passage of time we learned that most financial firms had significant exposure to these bad loans and the losses began piling up. The table to the right lists the huge write-offs taken by some of the world's largest financial firms. Throughout this slow-motion unwinding, the question has been whether the losses in the financial sector would leak into the rest of the economy and cause a recession. It now appears that this has happened. Nationwide, housing prices are down over 10% and foreclosures have surged. Jobless claims reached their highest level since 2005, pushing unemployment to over 5%. In addition, lending has been curtailed, oil remains above $100 per barrel and stock prices have fallen worldwide.

Perhaps the biggest story of the quarter was the emergency buyout of Bear Stearns by JPMorgan Chase. With its stock at $159 per share just one year ago, the 85-year old investment bank found itself on the brink of bankruptcy in March and was forced to sell itself for just $10 per share. Significantly, the Federal Reserve provided a guarantee of up to $30 billion to JP Morgan to make the deal go through. Most market participants agree that had Bear been allowed to fail, it would have set off a series of events that would have rocked the global financial system. In addition to facilitating the buyout of Bear, the Fed took other decisive actions during the quarter, including lowering the Fed Funds rate from 4.25% to 2.25%, reducing the discount rate from 4.75% to 2.5% and reducing the capital holding requirement for Fannie Mae and Freddie Mac. All of these actions are designed to shore up a weakened financial system by providing a backstop of liquidity and access to much needed low-cost capital.

Events of the past year have raised questions about the vulnerabilities of our financial system. The sheer size of the losses and the fact that so many large financial institutions were caught off guard when the housing party ended has many questioning the effectiveness of current regulations. In the coming months we will see numerous new proposals, plans and legislation designed to "fix" the financial system. While regulation is crucial to our functioning markets, we hope government does not go too far and stifle our competitiveness in the global marketplace.

When you read about the huge losses suffered by so many investment funds and other financial firms, it makes you wonder how these folks could have gotten it so wrong. I'll add to that question by saying how could they have gotten it so wrong *again*. Many market participants seem to truly believe those dangerous words, "It's different this time." The series of events that culminated in the bursting of the housing bubble follow a familiar pattern that can be seen in the sudden collapse of other asset classes and security types throughout market history.

In just the last 20 years we have witnessed this familiar pattern numerous times. In the eighties, the LBO "junk bond craze" eventually led to huge losses and the demise of a number of storied Wall Street firms. The real estate bubble of the early nineties eventually contributed to the S&L bailout and several bank failures. Just ten years ago when Russia defaulted on its debt, super-sized leveraged positions led to an emerging markets debt crisis and the blow-up of hedge fund

Long Term Capital. Finally, we are all too familiar with the internet bubble and market crash that occurred just eight years ago.

In each of these situations, you'll find a familiar pattern of events. In the early stage, investors in a certain overlooked asset class enjoy fantastic investment returns. Later, other investors rush in, often led by highly motivated sales people, and prices rise even more. And lastly, in the final stage, you read about this investment opportunity in USA Today and "any fool can see that junk bonds, real estate limited partnerships, tech stocks, condo flipping, alternative energy, emerging markets, gold..." (you fill in the blank) "...is an easy way to get rich." At this point, your neighbor and everyone else you know is jumping in with borrowed money and lending standards go out the window. It is during this final stage that the combination of huge leverage and high prices results in tremendous losses, especially for folks who were late to the party. I'll borrow from our friend, Chris Davis of Davis Advisors, who summed up this phenomenon by quoting an old Spanish proverb, "What wise men do in the beginning, fools do in the end."

Table 1: A History of Stock Market Declines* (1900-2007)

Type of Decline	Average Frequency	Average Length**	Last Occurrence
Routine (-5% or more)	About 3 times a year	47 days	Nov-07
Moderate (-10% or more)	About once a year	113 days	Nov-07
Severe (-15% or more)	About once every 2 years	216 days	Oct-02
Bear Market (-20% or more)	About once every 3 1/2 years	332 days	Oct-02

Source: Capital Research and Management Company and Dow Jones

*As measured by the Dow Jones Industrial Average. Assumes 50% recovery of lost value

**Measures market high to market low and excludes recovery period.

S&P 500 Low Date During Recession	Table 2: S&P 500 gain (loss) after			
	3 months	6 months	9 months	12 months
June 13,1949	14.5%	19.20%	26.60%	33.70%
September 14, 1953	9.9	17.7	27.5	38.5
October 22, 1957	6.1	9.8	19	31.5
October 25, 1960	15.9	25.2	27.6	30.9
May 26, 1970	16.9	20.8	38.7	44.5
October 3, 1974	13.5	29.9	51.5	34.6
March 27, 1980	18.3	31.1	39.1	37.1
August 12, 1982	37.8	41.6	61.1	57.7
October 11, 1990	6.7	28.8	28.7	28.8
September 21, 2001	18.0	17.2	2.8	-13.7
Mean	**15.8**	**24.1**	**32.2**	**32.4**

An individual using an interest-only loan and zero equity to buy a home hoping to flip to the next guy when prices rise another twenty percent is certainly among the losers in the real estate meltdown. But his lender is right there with him. Foreclosing on a home is not high on a lender's list of profitable activities, especially when the home has lost thirty percent of its value. In addition to the bad loans on the books, many financial institutions, including hedge funds, used additional leverage to magnify the additional return offered by these higher risk loans. As we look back over the blow-ups of the last twenty years, we are thankful that we have avoided using debt to boost returns.

To understand the extent to which leverage can destroy an investment portfolio, consider a typical hedge fund that uses debt to magnify its investment bets. A fund using ten-to-one debt-to-equity that owns a portfolio that declines by a mere ten percent will find its equity position completely wiped out. The fund is insolvent and will be forced to shut down without immediate contributions of more capital.

This scenario has played out all over Wall Street. It helps explain how Bear Stearns failed and why the market has seen such extreme volatility over the past few months. As prices fall and funds sell holdings to shore up their financial position, the selling further drives down the value of their holdings and the vicious cycle continues.

So how do we justify buying stocks when there is so much pessimism out there? As Warren Buffet once said, "we want to do business in such an environment, not because we like pessimism but because we like the prices it produces." Prices may fall further yet but when building a portfolio with a long investment horizon, we feel comfortable with the investments we are making today.

The tables to the left offer additional perspective on the frequency of market declines as well as market performance during and after recessions. The first table reminds us that declines like the one we are experiencing today are not infrequent. The second table, showing the S&P 500 gain following a low is encouraging, but we think it is also useful to tell ourselves that we may not have seen the low at this point. Indeed, this malaise may drag out for some time before we see the rebound that will come...and yes, it will come.

Final Word. My in-laws generously treated their children and grandchildren to a few days at the beach last weekend. This is no small undertaking as they have four children and fifteen grandchildren, the oldest of whom is thirteen. Now I should have been working on this report but somehow Uncle Ben has become Big-Chief-Sand-Castle-Builder and we continued the tradition this year by building the biggest mountain of sand you have ever seen right in the path of Mother Nature's incoming tide. At 7pm Saturday evening as it started to rain, I stood atop our eight-foot-high sand fortress surrounded by a shivering throng of shovel-wielding sons, daughters, nieces and nephews hollering taunts at the approaching waves and wind-driven rain. You know the rest of the story: we fared no better against mother nature than our Tarheels fared against Kansas later that night. But like the Tarheels (and the Demon Deacons) we're planning to do it all over again next year.

I hope you have a wonderful spring. Thank you for letting us help you with your financial planning and investing.

Sincerely,

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