Investment Report And Market Commentary

BRAGG FINANCIAL ADVISORS

Third Quarter 2008

Market Index Total Returns as of September 30, 2008

Market Index	YTD 9/30/2008	1 Year	3-Year Annualized	5-Year Annualized
Standard & Poor's 500 (Large Cap)	-19.3	-22.0	0.2	5.2
Standard & Poor's 400 (Mid Cap)	-14.3	-16.7	1.8	8.6
Russell 2000 (Small Cap)	-10.4	-14.5	1.8	8.2
MSCI EAFE (Foreign)	-29.3	-30.5	1.12	9.7
Lehman Bros. Aggregate Bond	0.6	3.6	4.2	3.8
Lehman Bros. Municipal Bond	-3.2	-1.9	1.9	2.8

Whew! What a lousy month! The financial crisis has taken center stage and the news only seems to get worse. Watching the market fall 3%, 5% even 7% in one day has been painful and if you are like me, you get the sense that there is no end in sight. In times like this, we have to remind ourselves that a day will come when stocks will stop falling and things will get better. We are ready for that day!

To recap recent events: The Emergency Economic Stabilization Act of 2008 was signed into law by President Bush on October 3rd. This bill creates a line of credit of $700 billion for use by the US Treasury to buy the troubled mortgage loans weighing down the balance sheets of banks and other financial firms. The legislation marks the greatest government intervention in our free markets since the Great Depression. Events of the last four weeks made it clear that the markets were not going to be able to right themselves without intervention from the government. On September 7, the government seized Fannie Mae and Freddie Mac, saddling taxpayers with guarantees for more than $5 trillion in mortgage debt. Seven days later Merrill Lynch avoided bankruptcy by selling itself to Bank of America. The next day, September 15, Lehman Brothers declared bankruptcy, the largest in history at $639 billion. Twenty-four hours later the government announced that it was lending $85 billion to huge insurer AIG to prevent its failure. On September 16, Washington Mutual, the nation's largest thrift, was seized by regulators and partially sold to JP Morgan. Finally, on October 4, Wells Fargo announced it was buying Wachovia, potentially breaking up a previously announced government-assisted purchase of part of Wachovia by Citigroup.

All of these events tie directly to the sub-prime lending crisis about which we have been writing for the last year. Banks, insurers and other financial institutions simply have too much bad mortgage debt on their balance sheets. As housing prices have fallen around the country, it has become clear that many of these loans will fail and financial companies find that their balance sheets and liquidity positions are in very bad shape. Market participants, including financial companies themselves, have become extremely worried about having the liquidity (cash) necessary to operate. Banks have stopped lending to borrowers and to one another in an effort to preserve their liquidity and this has caused our financial system to freeze up.

How can our financial system freeze up? When our financial system is operating normally, we deposit cash and the bank lends that cash to borrowers. When we have a crisis and we all want our cash in our hand, we have a problem; the cash simply is not there. This is a simple example but that is basically what is happening today in our financial system. Market participants are hanging onto their cash. When individuals, corporations and municipalities do not have access to cash, the economy is not able to function. Your money market account provides another example. The funds you deposit are immediately borrowed on a short-term basis by corporations who use the funds for operations such as meeting payroll or paying bills. In exchange for the cash, these corporations issue commercial paper, short-term interest-bearing notes, that the money fund holds on your behalf. When you and other worried depositors withdraw money market funds, this source of cash is eliminated and the corporations are unable to meet their obligations.

How did we get here? The blame game is in full gear and it is extremely important that our country understands how this happened so we can make the necessary reforms to prevent it from happening again. As we see it, here is the recipe for a failing financial system:

Washington: For over a decade, Congress failed to implement reforms for the Federal National Mortgage Association (Fannie Mae) and the Federal Home Loan Mortgage Corporation (Freddie Mac). We could write a book about this but suffice it to say that by 2008, these government-sponsored, publicly-traded entities bought, packaged and guaranteed over half of the nation's $12 trillion mortgage market. Political pressure and legislation that encouraged home ownership resulted in massive numbers of new homeowners who qualified to buy homes with virtually no down payment, no income verification and weak credit scores. Beginning in 1992, Congress began requiring that Fannie and Freddie increase their purchases of mortgages for low and moderate income borrowers. By 1996, the Department of Housing and Urban Development mandated that 42% of Fannie and Freddie's mortgage financing go to borrowers with incomes below the median in their respective neighborhoods. Mortgage lenders around the country could originate risky loans and then pass them off to Fannie and Freddie where they would be guaranteed by the government (taxpayers). Our government failed us here.

Low Interest Rates: After September 11, 2001, the Fed lowered interest rates to artificially low levels to stave off recession. It kept them that way for far too long. Cheap debt encouraged massive borrowing by new homeowners, real estate speculators and developers. New neighborhoods and condo towers grew up like weeds and investors made money buying properties with debt and flipping them after a few months with nice gains. This high-risk speculating did well until real estate peaked and interest rates started rising.

Regulation: We've got regulators and we've got regulations but they failed to prevent this crisis. The Fed oversees the national banking system and the SEC regulates the non-bank financial companies. Insurers are regulated by state insurance commissioners and state chartered banks are overseen by state banking commissions. Our financial system has become much more complex even as some financial firms have become supposedly "too big to fail." Our banking and securities regulation has not kept up with this growth and complexity and it is certain that this will be debated in Congress in the coming months. If the taxpayer is to stand behind (and bail out) the banking system, the focus should be on stricter underwriting, transparency and especially on lower levels of leverage in the system.

Profit Incentive: Free markets are smarting from a black eye right now. The conventional terminology is "greed on Wall Street" but the motivation to make money and the reckless behavior that often results from a poorly regulated, highly profitable activity is not limited to those who work for big investment banks. Encouraged by low interest rates, high demand for housing and scant regulation, players including banks, mortgage lenders, homebuilders, developers, hedge funds and investors of all types jumped in and made a lot of money. Sell the people what they want to buy. If almost anyone can qualify to buy a house, line 'em up and we'll sell them one. Package up the loans, pass them off to Fannie and Freddie. Package up just the right combination of quality loans and risky loans to get a decent debt rating from the rating agencies and you've got yourself a nice high-yielding mortgage-backed security you can sell to a hedge fund. The hedge fund borrows money at 3% and loads up on these securities yielding 7%. Easy money. Profit incentive, greed, whatever you want to call it will always be with us and when properly regulated, it can be a wonderful thing. When allowed to run wild, the party often ends with disaster.

Rating Agencies: Standard and Poor's and Moody's are the largest of these third party "objective" firms which provide report cards on corporate debt, mortgage debt and other securities. Investors rely on these ratings when making buy/sell decisions. Debt issuers pay rating agencies large fees to have their debt graded: AAA, AA+, BBB, etc. A favorable rating can lower the issuer's cost of borrowing. This creates a conflict of interest for the rating agencies who value their continuing fees. As sub-prime securities imploded, investors learned they could not rely on the ratings of these firms.

Borrowers: You don't hear a lot of blame directed toward borrowers but we won't leave them out. If borrowers were not defaulting on their loans, we would not be in this situation. Obviously some folks were abused by "predatory lenders" but in many cases, people simply made poor financial decisions. While Wall Street is cleaning up its act, Main Street likewise will be doing the same.

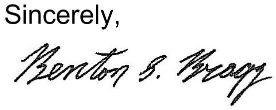
Final Word

You may know that my family lives on a farm just north of Charlotte. You may have also heard that my parents, my three siblings and their families live there as well. I know it sounds like something from a hundred years ago but we liked the family business so much we decided a family farm would surely be a good idea too. On Sunday afternoon as I settled in to work on this report, my dad called and asked me (ordered me) to gather my kids (the labor) and meet him and the rest of the family in the field to "get up the hay." I quickly finished the paragraph about the $700 billion rescue package and went over to the horse pasture where my two brothers, my mother, my dad and about ten of his fifteen grandchildren were busy loading 250 bales of fescue onto trucks. I don't know if you have ever "gotten up hay" but depending on the temperature and the available help, it can either be a joy or it can be something you should avoid. In this case, it was a joy. The sun was going down, the temperature was perfect and the long shadows made for a beautiful setting. Papa was barking orders, kids were throwing hay and clamoring all over the trucks, the menfolk were sweating and my wife Alice, city girl that she is, was playing her role perfectly, telling everyone to "Be careful!" I joined in and we had a fine time sweating, itching, laughing and singing.

The children were turning flips out of the hayloft into a huge pile of hay as my brothers, my dad and I were loading the last few bales into the barn loft. Dad said, "Strong as I am, I admit that these last few bales are much heavier than the first few I heaved into the loft." We boys cut him some slack and agreed that while it was a treat to have this experience once or twice a year, it would be a tough life to do this every day. Phillips pointed out that we might be farming full time if the market doesn't get better. Dad told us that he had often had thoughts about "full-time farming" over the last forty years as the country, the market and the economy struggled with seemingly impossible situations. He encouraged us not to get too mired down in these recent economic events as they too will pass. "Ten years from now, when your children start leaving for college, you'll look back on today's market crisis and marvel at how bad things seemed and how worried you were." Hearing that was helpful to me and I hope it does you some good in the days ahead.

Please let us know if you would like to review your portfolio or your planning. As always, thank you for choosing Bragg.

Sincerely,



Benton S. Bragg, CFP, CFA