Special Market Commentary

BRAGG FINANCIAL ADVISORS

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Dear Clients of Bragg Financial Advisors,

With the stock market re-testing the lows of last November, we wanted to share our thoughts about the market, the economy and especially the actions we are currently taking as we manage your portfolio.

Although the market enjoyed a nice bounce from Nov. 20 of last year through the first week January, the cascade of worse than expected economic reports during the first six weeks of this year has put a damper on hopes for a turnaround in the economy in the near-term.

The problems with the banks and other financial companies have not been solved. Although the Treasury Department announced a major plan to address the financial crisis on February 9th, the plan was short on details. As of now, investors simply are not confident that the banking system will survive without substantial additional government support. There is growing pressure for the government to consider nationalizing some of the banks as a way to remove the bad loans from the banks' balance sheets and get credit flowing again. This is a major, major step and one that policy makers have tried desperately to avoid. In our view however, the probability that this will happen has increased substantially in the last few weeks.

The American Recovery and Reinvestment Act signed into law this week by President Obama appears to have created more apprehension about the large increase in our nation's debt than it has created confidence that the spending will actually boost the economy. In addition to the burden of debt, a primary concern is that it will take many months, even years, to spend some of this money due to the complexity involved in gearing up the federal government to dispense the funds. Like the Woody Allen joke: "The food here is terrible! And the portions are too small!"

Meanwhile, as in past recessions, the economic news has been grim. Job losses, foreclosures, defaults, corporate earnings, budget shortfalls…and the list goes on. As we have discussed before, this recession will certainly equal if not surpass those of '73-'74 and '80-'82 in terms of severity.

Big issues we face include:

Near-term deflation. Marked by falling prices on everything from goods and services to financial assets, deflation is extremely destabilizing to an economy and a situation that policy makers are working hard to stave off. Efforts include flooding the financial system with money through low interest rates and other actions of the Federal Reserve as well as government spending such as the recent stimulus package.

Longer-term inflation. Past periods in history have shown that massive increases in the money supply through the issuance of government debt have resulted in a devaluing of the currency, or inflation. More dollars chasing the same amount of goods and services makes our dollars worth less.

In response to this difficult environment, the Investment Committee at Bragg has decided to take a more cautious position with regard to managing portfolios. Below we share some of the things we are doing and some of the thoughts we have regarding your holdings.

Cautious Rebalancing

We have stopped short of fully rebalancing portfolios to target stock/bond allocations. With stocks off roughly 50% from their peak and bonds down less than 5%, a portfolio that calls for a 60/40 blend of stocks and bonds for example has become significantly out of balance relative to its target allocation. Normally we would rebalance to our target allocation but in this environment we have been more cautious, maintaining a higher allocation to bonds and cash than normal. We hope we will regret this. Possibly the market is near its lows and we will look back in eight to ten months and wish that we had fully rebalanced to target. But in the event the market moves significantly lower, the higher allocation to bonds and cash will provide liquidity and a buffer. Of all the actions we are taking in this environment, the decision to let bonds and cash build at the expense of stocks is the most significant action. Please know that we carefully considered this plan and decided that the risk of being wrong in doing this is not as expensive as the negative impact of further significant declines in the market and therefore your portfolio.

One other note I'll add here is that due to the highly customized method we use in managing accounts at Bragg, we are doing our best to make decisions that we think best reflect your individual needs and financial situation. Specifically, we rebalance accounts one relationship at a time. We do our best to apply what we know about you when making portfolio decisions for you – your station in life, your other income and capital, even the industry in which you work. We make every effort to weigh these factors as we work on portfolios and submit trades for your account. If you feel that your circumstances have changed and we should take another look at your Investment Plan, please let us know.

Comments about our Bond Portfolio
In turbulent times like these, much attention falls on bonds and their role as relatively stable investments. Treasury bonds and CDs are guaranteed by the full faith and credit of the US government. Due to a flight to quality, they yield less than 3% today. Municipal bonds (most backed by states, counties and other municipal entities) are considered to have more risk than federally guaranteed instruments and so have slightly higher yields today, even before the advantage of being income tax free. In this current environment of state budget shortfalls, many municipals are yielding significantly more than treasuries, obviously reflecting the higher risk of default. Highly-rated corporate bonds take us a step higher on the risk spectrum and likewise offer significantly higher yields. A diversified portfolio of high grade corporate bonds today is yielding more than 6%. Delve into low-rated corporate bonds and you have a significantly higher risk of default reflected in yields of 10% to 15% depending on the issuer. Finally there are TIPS or Treasury Inflation Protected Securities. These are bonds backed by the federal government that offer an annual step-up in your principal equal to the increase in inflation for the past twelve months. In a deflationary environment, TIPS will underperform ordinary treasuries but in long-term inflationary periods, these bonds can outperform and offer a hedge against inflation.

We make an effort at Bragg to diversify among all of these fixed income instruments.
If we had a crystal ball, we would be loaded up on just a few of the instruments mentioned above. For example, if we knew we were nearing a bottom, that the economy would turn soon, we would unload the ordinary treasuries and pile into high-yield corporates, TIPS and higher-yielding municipals. If we were convinced that we would see a much longer recession marked by deflation, we would load up on treasuries and sell the riskier securities. Short of having that crystal ball, we remain diversified.

Some Comments about our Equity Portfolio
At the highest level within the equity portion of your portfolio, our focus is on asset class diversification among large, mid-sized, and small US stocks and Foreign Stocks. Our current targets emphasize large US equities with an approximate allocation of about 65% of the equity portion. Our foreign target is approximately 16%, mid cap 6% and small cap 13%. We have discussed our bias toward large cap US stocks before. Most of these companies are global players; approximately 40% of the earnings of the S&P 500 companies come from outside the US, giving us the benefit of diversification away from the dollar and the potential to tap growth opportunities around the world. We gain significant transparency as a result of these companies

being subject to US accounting standards and we can construct this portfolio with relatively low cost.

Last year when world equity markets plummeted as a result of weakness that originated right here in the US housing market, the S&P 500 and the Dow Industrial Averages outperformed almost every other country index. With a 16% allocation to foreign stocks, we do have a significant exposure to companies based outside the US. While it costs slightly more to maintain this exposure, studies continue to show the diversification benefits of owning these foreign companies directly. This was illustrated quite well during 2004-2007 when foreign stocks outperformed US stocks by a significant margin. Small company stocks typically lead out of a recession and we have a significant allocation to them at 13%. We are especially weighted toward small cap value which historically has had the best risk-adjusted returns of all equity asset classes.

After asset allocation, we focus on being diversified by investment style, specifically growth and value. While there are numerous ways to define growth and value, my favorite is to describe a growth style as a one that focuses on the future – future growth in revenues and future growth in earnings. A growth manager is willing to pay a higher price for a company that is expected to deliver higher earnings in the future. A value style on the other hand is focused more on the present. What are the earnings of the company today and what price am I willing to pay for those earnings. Warren Buffett is more of a value investor, focused on today's cash flows and being careful not to overpay. Both of these investment styles work over long periods of time but they usually are not in favor at the same time. The nineties tech boom was a growth market while value outperformed when the tech bubble burst and the "old economy" stocks came back into vogue. We therefore own both value and growth in the portfolio. This has the result of smoothing our return. We do have a bias for value I should add. Studies have shown that after adjusting for risk, value beats growth over long periods of time. Our portfolio is tilted about 60%-65% toward value and 35%-40% toward growth.

For parts of the portfolio like foreign stocks we use managers (usually mutual funds or exchange traded funds). Some of the things we consider in selecting managers include: risk-adjusted returns, return consistency, manager tenure and cost. We try to select managers that emphasize a time-tested process and a disciplined philosophy.

Delving further into the portfolio we spend a lot of time on sector weights or industry categories like healthcare, industrials, technology, energy, utilities, staples, real estate, commodities and yes financials. As I discussed in the bond section above, one can take a defensive stance with regard to sector weights or one can take an offensive stance. To be specific, one could make the case that now is the time to load up on financials, commodities and consumer discretionary stocks. These sectors have been clobbered in this recession and at some point they will be the leaders by a huge margin. You can buy companies like Home Depot, Best Buy, Bank of America and Target at prices that are a fraction of where they were just six months ago. Likewise, you can make the case that we should avoid those sectors and remain in more defensive sectors like healthcare, defense, utilities and consumer staples. Of course you pay higher prices for these safer more defensive companies.

Once again, without that crystal ball, we choose to diversify among these sectors. We maintain exposure to each of the ten sectors as measured by Standard and Poors. We will never take an extreme position and bet all of our chips on a few sectors based on what we think might happen in the next six months. If we did take bets, we might get it right from time to time, but the risk in being wrong is huge. Historically, we have tweaked the sectors to underweight those that have soared over the past two to three years and overweight those that have languished over the past two to three years. Sell high and buy low.

In this environment, we have been considerably more active with our sector weightings. One area in particular that we have underweighted has been financials. We have always diversified within financial stocks –

deliberately owning a combination of banks, life insurers, property and casualty insurers, brokers, asset managers and credit card companies. But the risk environment in financials has changed to a degree that we think justifies being more selective. Specifically, with the banks in particular, we are no longer worried about them missing an earnings number next quarter. Instead we are worried about whether they will be around next quarter. If the government did nationalize the banks, the equity holders would be wiped out. It is a different environment and we again think the downside risk to some of this exposure is greater than the risk that we miss some upside if financials surprise us and turn up significantly.

A final note on sector weights is that we have decided to increase our weighting to basic materials or commodities including an allocation to gold as a hedge against inflation. This is a departure for us as we have traditionally struggled to justify a price for gold…indeed it has more than tripled in price over the last ten years. Despite this, history has shown that gold provides a good hedge in times of uncertainty and especially in a time of significant inflation and dollar devaluation.

Digging Out of a Hole

Your portfolio value is down of course and we have significant rebuilding ahead of us. How hard will it be to re-build? Take a look at the Wall Street Journal's listing of equity funds and you'll see some that are down 25% and some that are down 45% over the last 12 months. Yes, they have all gotten clobbered but the manager that is down 25% needs to earn 34% to get back to even. Meanwhile the manager that is down 45% needs to earn a stunning 82% to get back to even. A huge difference! The significance of this is not lost on us and that is why we are taking steps to try to limit downside risk in this environment.

This has been a lengthy commentary but we very much want you to know what we are thinking about and especially, what we are doing with regard to the portfolio. Most everyone is reeling from this market decline. Despite that, as always, we must decide where to store our wealth now and over the long term. As we see it, there are four major asset classes - stocks, bonds, cash, and real estate. We think investors should have measured exposure to each of these major asset classes and importantly investors should have a solid rationale for the allocation they hold. Disciplined rebalancing and prudent adjustment as needs change over time should serve us well in the long term.

We are convinced that this will be a very difficult year. As we have said many times in the past, it always takes far, far longer for the market and the economy to adjust than one would think. The months ahead will likely be similar to the few months that have just passed, with rallies followed by declines. Relief followed by more worry. The market is testing the lows of November and it may reach new lows in the coming months. We won't know when the market has bottomed or when the economy has begun expanding until long after those points in time have passed. Importantly, we have great confidence that at some point in the coming months, the market will bottom and the next phase of economic expansion will begin.

Please let us know if you would like to discuss your portfolio or your planning in light of this commentary. As always, we thank you for your confidence in our firm.

Sincerely,

Benton S. Bragg

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