INVESTMENT COMMENTARY

2nd Quarter 2009

Worldwide stock markets enjoyed a strong rally in the second quarter as investors finally regained an appetite for risk.

We think planning for gradual progress from current market levels makes more sense than pinning our hopes on a quick return to a new market high.

Dear Clients,

How did we survive a week at the beach without sunscreen in the 1970's? It seems like our parents just dragged us out there on the beach to get torched day after day for a week. I remember my mother making me wear a long-sleeved shirt for the last part of the week if my skin was lobster red. These days getting four children out on the beach is quite a production. Swimsuits, swim*shirts*, hats, sunglasses, life jackets, towels, boogey boards, rafts, chairs, shovels, buckets, juice boxes, goldfish, fruit roll-ups, and lots of greasy sunscreen. Pile on the tent and extra swim diapers for little Charlie and I find myself drenched in sweat by the time I finally sit down in my beach chair and open my Grisham novel.

As you might have surmised, I just returned from our annual summer beach trip with my wife's *very* large family. Fifteen children and ten adults under one roof. We had a blast but a small part of me is enjoying being back at my desk.

In our Commentary of one year ago, I marveled at the money spent on fireworks by July 4th beachgoers. I concluded that this was surely evidence (if only anecdotal) that we couldn't be in a recession. I was off by a smidge, wasn't I? Well, now everyone knows we are deep in a recession but once again, we saw plenty of fireworks at the beach. I promise the fireworks show was even *bigger* this year. From Pawley's Island all the way to Myrtle Beach, my fellow Americans were out in force last Saturday night and they were not letting a recession slow them down. The beach was lit up once again by bottle rockets, Black Cats, Roman candles, ground spinners, helicopters, sparklers, Saturday Night Specials and M-80s. I think we can conclude that the amount of time, effort and money we Americans put into our Independence Day celebration is *not* correlated with the state of the economy. Either that or we are just a bunch of pyromaniacs.

Whatever the case, it made me feel good to participate in the celebration. It also reminded me that Americans are a determined lot; we value and celebrate what we have and will work hard to keep it. This makes me optimistic that we'll overcome the troubles we currently face as a nation.

BRAGG Financial Advisors

1031 South Caldwell Street, Suite 200 • Charlotte, North Carolina 28203 • (704) 377-0261 • Fax (704) 334-9754

As you can see, we have expanded our quarterly commentary. This and future issues will include a section that deals with financial planning topics we think you will find useful. We also hope you will find this format easier to read. We welcome your feedback regarding our efforts to communicate with you more often and more effectively. Please feel free to tell us how we are doing.

Tooting our own horn a bit, I want to highlight the continued good performance of our own Queens Road Small Cap Value Fund. On July 6th, the Wall Street Journal again included our fund in their 2009 "Category Kings" listing of the best performing small cap funds in the country. We are proud of Steve Scruggs, CFA, portfolio manager of this fund.

I hope you are having a wonderful summer. Thank you for letting us help you with your financial planning and investing and please call when you would like to review.

Sincerely,

Benton S. Bragg

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

MARKET UPDATE

Worldwide stock markets enjoyed a strong rally in the second quarter as investors finally regained an appetite for risk. Most global market indices are now in positive territory for the year after bottoming out in the first ten days of March. On a total return basis, the S&P 500 was up almost 16% for the quarter as you can see in the top chart to the right. The lower chart puts the rally in perspective, however, making it clear that we have a long way to go. Since its peak in October of 2007, the market is still down almost 40%. On a price basis, the market needs to gain 70% to reach a new high— a painful reality to say the least.

As we discussed in the Special Commentary you received on June 17, "Gardening and the Less-Bad News," we think planning for gradual progress from current market levels makes more sense than pinning our hopes on a quick return to a new market high. If you missed the June commentary where we discussed the headwinds facing the market, please let us know and we will send you a copy or you can find it on our website at www.braggfinancial.com.

The next section gives you an update on the recession compared to recessions of the past. Before we get to that however, the table below includes the total returns of various market indices for periods ending June 30, 2009.

Source: Russell, Standard & Poors, JP Morgan

Market Index	2nd Quarter	YTD 6/30/09	1 Year	3-Year	5-Year
Standard & Poor's 500 (Large Cap)	15.9%	3.2%	-26.2%	-8.2%	-2.2%
Standard & Poor's 400 (Mid Cap)	18.8	8.5	-28.0	-7.5	0.4
Russell 2000 (Small Cap)	20.7	2.6	-25.0	-9.9	-1.7
MSCI EAFE (Foreign)	25.4	7.9	-31.4	-8.0	2.3
Barclays Lehman Aggregate Bond	1.8	1.9	6.1	6.4	5.0
Barclays Lehman Municipal Bond	2.1	6.4	3.8	3.9	4.1

RECESSION UPDATE

The US economy remains in a deep recession, although there have been signs that we may be reaching a bottom. Our nation's output or Gross Domestic Product (GDP) fell by 5.5% in the first quarter, following a 6.3% drop in the fourth quarter of last year. These are year-over-year measurements; said another way, our GDP in the second quarter was 5.5% less than our GDP in the second quarter of 2008. *Overall*, economists estimate that our economy has contracted by 3.1% since the recession began in December of 2007.

The table below compares the current recession to the ten recessions since WWII. You can see that in terms of duration, unemployment and GDP decline, this recession is on its way to breaking some records.

Date of Recession	Duration (Months)	Unemploy-ment (Peak)	GDP Decline %
Dec. 2007 to present	18 months and counting	9.5% current	-3.1% so far
March 2001	8	5.5	-0.30
July 1990	8	6.8	-1.5
July 1981	16	10.8	-3.6
Jan. 1980	6	7.8	-1.1
Nov. 1973	16	8.8	-3.6
Dec. 1969	11	5.5	-0.8
April 1960	10	6.9	-2.4
Aug. 1957	8	6.2	-3.3
July 1953	10	2.9	-2.2
Nov. 1948	11	5.9	-1.1
Average	**11 months**	**6.9%**	**-2.1%**

And in case you are wondering, the recession we call the Great Depression had a duration of over 48 months, a GDP decline of 27% and an unemployment peak above 25%. While many are calling our current economic malaise the *Great Recession*, we are a long way from the hardship endured in the 1930s.

The greatest difference in today's recession and the Great Depression has been the monetary policy response of the Federal Reserve. During the Depression, fearing future inflation, the Fed actually raised interest rates. This starved the economy of liquidity and created a deflationary spiral. In contrast, today the Fed has maintained an expansive monetary policy, keeping rates extremely low and pouring liquidity into the system. This dramatic difference is primarily attributable to Fed Chair Ben Bernanke who spent much of his academic life studying the monetary policy mistakes of the 1930s.

Much of the monetary and fiscal stimulus is just now beginning to affect the economy as there is always a lag of six to eight months before the impact of these measures are felt. While there is a tremendous level of uncertainty today, many economists think the massive rescue of the banking system coupled with the record level of government stimulus will put the economy on a path of resumed growth later this year. We are tuned in.

DOES DIVERSIFICATION STILL WORK?

It has been said that in times of great crisis, all correlations go to one. In other words, the prices of all securities move together...perfect correlation. In the aftermath of the recent market crash it has become quite fashionable for mainstream media talking heads to claim that diversification failed us, that "there was nowhere to hide." This is a vast oversimplification.

While it is true that with many security types, say small cap stocks and foreign stocks, there is *positive* correlation (asset prices generally move in the same direction), there is not *perfect* correlation. Some securities move up/down more than others. So there is a huge difference between positive and perfect correlation. In times of extreme risk aversion (when everyone is scared) the prices of all risky assets fall. Typically however, the prices of riskier assets fall more than the prices of less risky assets. This was true in the latest collapse. In 2008 for example, emerging market stocks fell 54% while US large caps fell 38%. Was there positive correlation in their performance? Yes. They moved in the same direction. Did US stocks fall as much as emerging markets stocks? Not even close. Clearly it was good not to have all of your money in emerging market stocks. The investor who is down 54% must earn 85% to get back to even while the investor who is down 38% must earn 61% to get back to even.

EXAMPLES OF DIVERSIFICATION

At the highest level, owning stocks *and* bonds helped us tremendously in the recent decline. Stocks were down 38% while bonds were *up* 4%. Sector diversification helped in the recent decline. Owning utility, healthcare and technology stocks helped offset the decline in financial and homebuilder stocks. We are glad our clients did not have *all* their money in AIG stock...being diversified helped us. We're glad our clients owned *some* growth stocks (technology) in the nineties and we are glad we owned *some* value stocks (financial, energy) after 2000 when technology collapsed. Small cap suffered from 1996-99 but served us well in 2000-05.

So we will continue to diversify among the major asset classes including stocks, bonds, cash and real estate.

We will further diversify as follows:

- Within Stocks: Large, Mid, Small, Foreign
- Within Equity Style: Value and Growth
- Within Stock Sectors: Ten Industry Sectors
- Within Foreign: Developed and Emerging Markets
- Within Bonds: Treasury, Agency, Inflation Protected, Muni, Corporate, High Yield, Foreign, Short, Intermediate

PLANNING CORNER

Phillips M. Bragg, CFP
Dawn M. Cannon, CPA

TIMELY WEALTH TRANSFER STRATEGIES

One silver lining of a market decline is estate tax savings. For a dollar lost in value, 45 cents are saved in transfer taxes. While at first this may seem like an insensitive comment, taking a long-term view may change your mind. If we tell ourselves that our assets are only temporarily depressed in value and that five to ten years from now they will be worth a lot more, then today's market decline provides a nice window to transfer assets at discounted valuations.

The Grantor Retained Annuity Trust (GRAT) and the Charitable Lead Annuity Trust (CLAT) are two highly favored techniques right now.

GRATs

GRATs come in many shapes and sizes but a simple example may help explain why this may be the best tool in the estate planning shed right now.

1. Client ("Grantor") transfers $3,000,000 of beaten-down securities to a Grantor Retained Annuity Trust.
2. The Trust terms call for the Grantor to receive $1,068,756 of securities and cash back each year for three years—$3,206,268 total. From an affordability standpoint, this return of principal makes this particular strategy more palatable to folks worried about their diminished net worth—a common concern these days.
3. Whatever is left in the trust at the end of the three-year term passes to the grantor's heirs.
4. No gift must be reported because the grantor "retained" all of the value. That is, the present value of the amount projected to pass to heirs is equal to zero.

If the market is flat or down over the three-year term, the children inherit nothing and the grantor gets his capital back as if the GRAT had never existed. If the market is up 10% per year for three years, approximately $450,000 passes to the heirs with no gift tax.

The reason GRATs are popular right now is that the interest rate assumption used to calculate the size of the gift—the expected remainder interest for the children— is currently quite low—3.4%. Therefore, this technique is worthwhile if our investment return exceeds 3.4%.

CLATs

The Charitable Lead Annuity Trust (CLAT) is another strategy from the same toolbox. The CLAT is for folks who have a strong charitable inclination and can afford to forego income from a particular asset for a specified term but desire that the asset remain in the family after the term has expired. A CLAT typically pays an income stream to a designated charity for a term of years with the remaining assets passing to the donor's heirs at the end of the term. Like the GRAT, the value of funding a CLAT in today's low interest rate environment is that the size of the reportable gift to heirs is considerably smaller than in higher rate environments.

There are other techniques like the CLAT and the GRAT that will move the future appreciation of assets out of your estate. This is not legal advice as we cannot practice law. However, we stand ready to work with you and your legal advisor as you explore these options.

IRA REQUIRED DISTRIBUTION OPTIONAL IN 2009

If you are over age 70, you normally must take a "required minimum distribution" (RMD) from your IRA each year. That requirement is waived in 2009! Depending on your specific tax circumstances, you might benefit from not drawing from your IRA in 2009. For example, if you have significant taxable income from other sources, eliminating IRA income might help you avoid the Alternative Minimum Tax (AMT). Or, if you have a modest amount of other income, excluding IRA income might even allow your social security income to go un-taxed in 2009. Naturally, we would recommend you do this only if you have other sources of cash to meet living expenses.

CONGRESS EXTENDS CHARITABLE IRA DISTRIBUTION

IRA Owners aged 70½ can make a direct transfer of up to $100,000 to charity in 2009. While the owner will not receive a tax deduction on the charitable gift, the owner and the charity will avoid tax on the distribution.

CARRY-FORWARD LOSSES—THE SILVER LINING

Please let us know what carry-forward losses you have. You can find this figure on Schedule D of your 2008 tax return. We like to have this number handy when we are rebalancing your accounts and considering the tax implications of trades.

Also, in light of recent events in Washington, it is hard to imagine a world with capital gains rates as low as they are today–15% federal rate. If you hold oversized, appreciated positions in stocks or real estate that you plan to eventually sell, you might consider selling in 2009. You may be able to offset the gain with carry-forward losses and/or available unrealized losses in your portfolio. As for selling while things are depressed, remember that selling today will afford you the opportunity to buy as well. It is likely that the position you sell is not alone in its decline from its peak price of 2007 and the diversified portfolio you build with the cash you raise may have just as much upside with less risk.