Investment Commentary

Bragg Building
1031 South Caldwell Street, Charlotte

INSIDE THIS ISSUE

"I've been in the forecasting business for 50 years and I'm no better than I ever was and nobody else is either."
Alan Greenspan, Sept. 18, 2007

WEREWOLVES & CANDY CORN WITCHES

I arrived home from work one night last week to find three of my children fighting over a Halloween costume catalogue. Alice informed me that each child was to select a costume that would be ordered online at prices ranging from $19.95 to $25.95 plus shipping. You can imagine the ensuing conversation. Needless to say, my thoughtful suggestion that we make our own costumes to save money during the recession didn't go over very well. I proposed to the kids that I give each of them $10 they could use along with some of their own money to purchase a costume. Alternatively they could put the money in their piggy bank and make their own costume for free. Ben, age 9, said, "Daddy I really want this werewolf suit and I don't really need ten dollars." I was floored. This from the boy who counts the money in his safe each week and demands prompt payment of his wages each month? Ben is paid $10 per month for the daily feeding of our two donkeys and second son Carlton is paid $8 per month for feeding our dog. Carlton exhibits a bit less interest in financial planning than Ben, often leaving his hard earned wages lying around the kitchen for several weeks after he is paid. I wasn't surprised when he wouldn't even look up from the Harry Potter cape and glasses he was eyeing in the catalogue to consider my proposal. And Frances, age 6, just giggled and said, "Daddy, you're so silly."
More determined than ever, I pulled out my Texas Instruments BA II Plus

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"…not a day has passed when someone at Bragg Financial hasn't hollered down the hall, "Can you believe this market?"

MONUMENTAL RALLY CONTINUES

The market rally that began in March persisted in the third quarter. Global equity markets continued to rise dramatically as market participants gained confidence in the nascent economic recovery. While the National Bureau of Economic Analysis has not yet officially decreed it, signs indicate the recession ended in the quarter ended Sept. 30. The S&P 500 gained more than 15% in the quarter. Since the low of March 9, it has risen a stunning 57%. While not unprecedented, a move of this magnitude compressed into such a short period of time has certainly gotten everyone's attention.
I'll go further and admit that over the last 12 months, not a day has passed when someone at Bragg Financial hasn't yelled down the hall "Can you believe this market?" The dramatic swings we've witnessed have been truly amazing.

Market indices are now significantly positive for 2009, erasing the steep drop in the first quarter. As the table on the next page shows, US mid cap stocks and foreign stocks have been the winners this year with gains of approximately 30% while US large cap and small cap stocks have posted gains of 20% or more. As the table makes clear, the recent rally has been significant but it can't mask the fact that it has been a lousy decade for stocks.
For the decade, bond investors fared better than most equity classes and did so with significantly less risk. Does this mean we should give up on stocks? We

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think not. Over long periods of time, and especially those in which interest rates are as low as they are today, stocks have produced better returns than bonds. The fact that we have just come through a twenty-year period where bonds have performed so well can be explained by the fact that at the beginning of this period, interest rates were very high. Bonds have enjoyed a tailwind from high coupons but also price appreciation as interest rates fell. Today, bondholders face the reality of both low coupons and potential price erosion should we enter an inflationary period. This doesn't mean bonds have no place in the portfolio but we think it makes sense to temper our expectations with regard to future returns.

Market Index Total Returns for Periods Ending September 30, 2009

	3rd Quarter	YTD	One Year	Three Years	Five Years	Ten Years
S&P 500 (US Large Cap)	15.6	19.3	-6.9	-5.4	1.0	-0.2
S&P 400 US Mid Cap Equity	19.9	30.1	-3.1	-1.4	4.5	7.5
Russell 2000 (US Small Cap)	19.3	22.4	-9.6	-4.6	2.4	4.9
MSCI EAFE (Foreign Equity)	19.5	28.9	3.2	-3.6	6.1	2.6
Barclays Aggregate Bond	3.7	5.7	10.6	6.4	5.1	6.3
Barclays Muni Bond	7.1	14.0	14.9	5.1	4.8	5.8

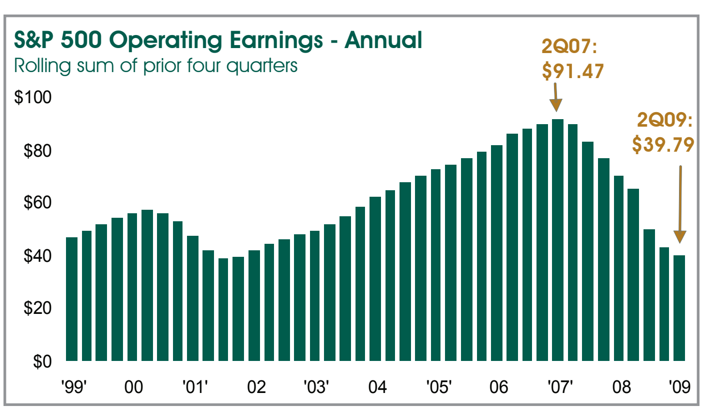
Stocks face headwinds as well in our opinion. Like you, we are delighted with the recent market rally but frankly we are surprised at how much it has risen given the significant weakness in both the economy and corporate earnings. Recall that stock market prices are a function of expected future earnings. As we have discussed before, earnings have taken a significant hit and while they are recovering, they are nowhere near the peak levels of 2007. The two charts below illustrate first, how much earnings have fallen and second, the current price to earnings ratio (P/E). You can see that the market is trading significantly above its historical P/E ratio. Importantly, the 26.6 P/E multiple shown to the right is a multiple of trailing earnings or the earnings of the past 12 months. Arguably the market should trade at a high price relative to the earnings of the past year due to the fact that those earnings look awful as a result of the recession and especially the impact of the huge charges taken by financial firms. As earnings improve, and they are beginning to, the multiple will not look so extreme. How fast they will improve is the question. Standard and Poor's estimates that the S&P will earn $54 in 2009, implying a P/E of about 20 based on today's price level. Assuming earnings continue to grow in future years, one could argue that the market is fairly valued at these levels. But is it cheap? Not unless corporations can sustain their earnings growth in a weak economy. This is a tall order.

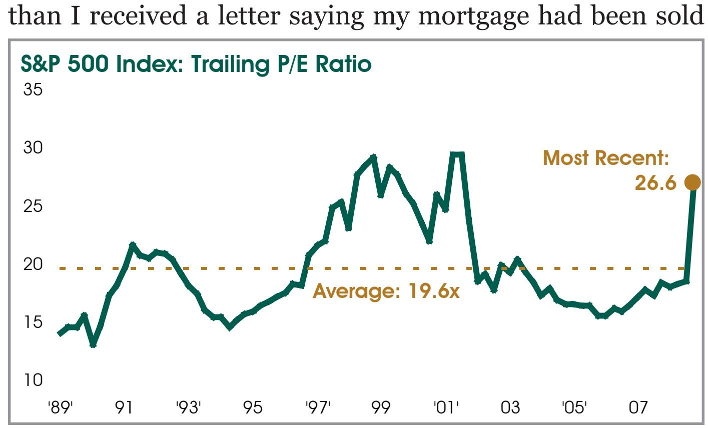
ECONOMIC UPDATE

Living on Stimulus

As mentioned earlier, numerous indicators signal that the economy has bottomed. The fact that a year has passed since the Lehman bankruptcy without a major financial catastrophe has gone a long way in restoring faith in the financial system. This alone has breathed new life into financial markets around the work. A significant portion of the rally in risky assets —stocks, corporate bonds, etc. — can be explained by renewed confidence that we have avoided a total failure of our financial infrastructure. Amazingly, this fear was very real just six months ago. The charts on the next page illustrate signs of life in the economy. Home sales, housing starts, capital goods orders and vehicle sales all appear to have begun turning up, if only slightly. In addition, corporate inventories have been drawn down to extremely low levels, earnings are growing and corporate balance sheets are in relatively good shape. Consumer sentiment readings have risen as consumer debt burdens have fallen from their highs. Finally, lower energy prices, low interest rates and very low inflation are providing a nice backdrop for continued progress in all of these areas.

Much of the progress thus far can be credited to fiscal and monetary policy of the federal government. I recently refinanced my mortgage at what I thought was an attractive rate. No sooner had the ink dried on the closing documents than I received a letter saying my mortgage had been sold





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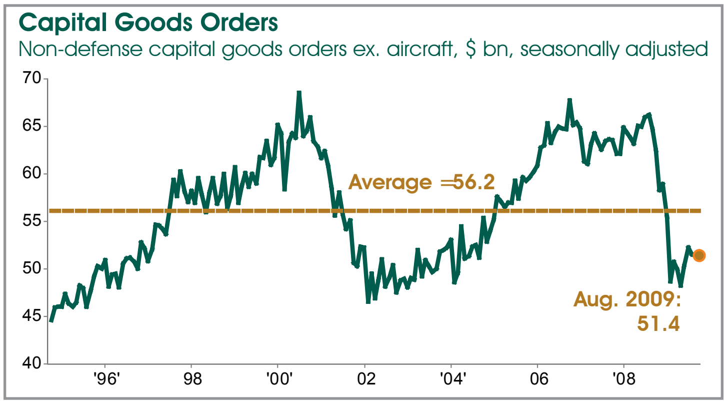
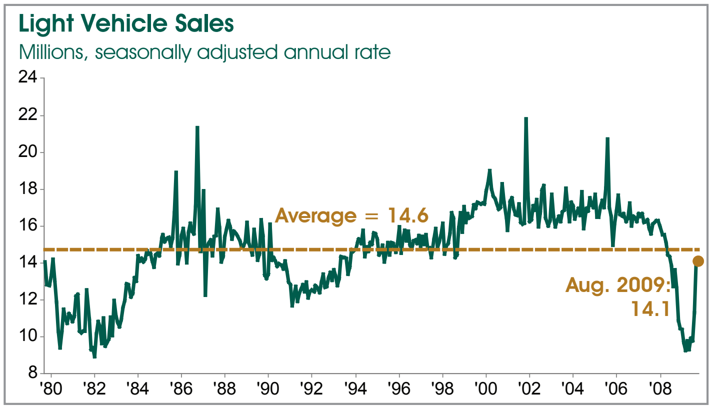
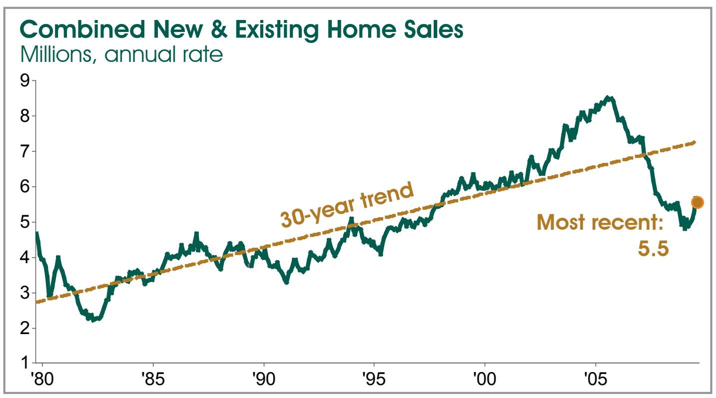
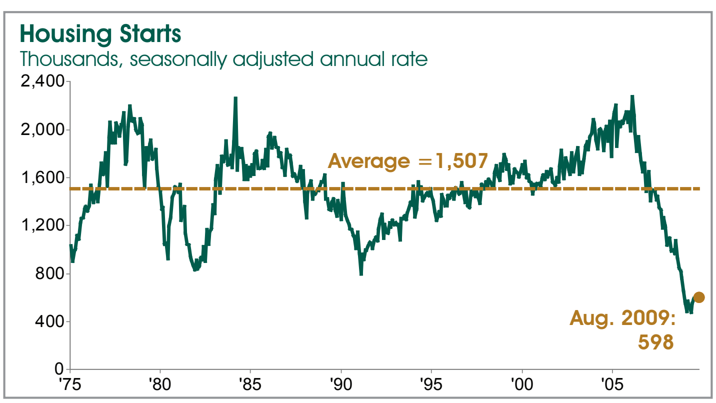






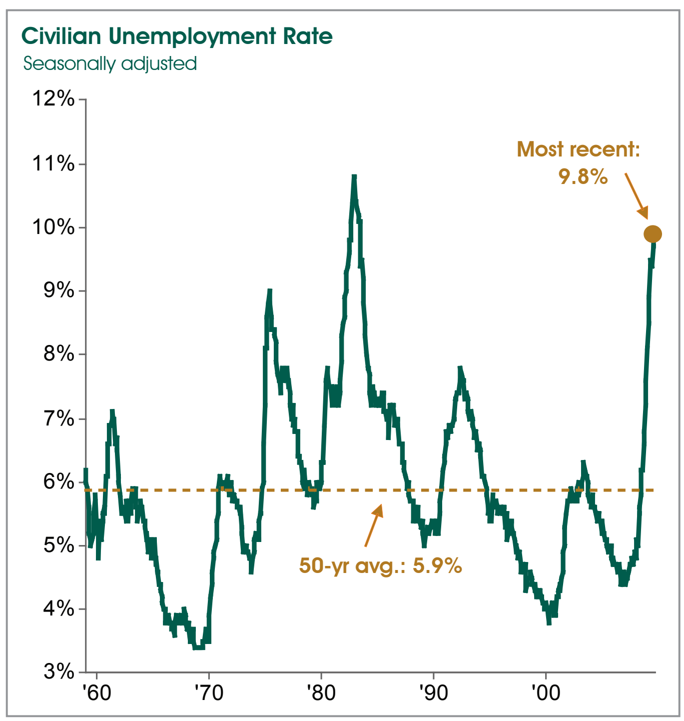


All charts compiled by JP Morgan. Source data from Standard and Poor's, Department of Labor, Bureau of Economic Analysis, Census Bureau, National Association of Realtors and Bureau of Labor Statistics. All charts used with permission .

to Freddie Mac, the government mortgage company. Yep, if I default, you taxpayers are holding the bag. My rate and the rates of most conventional mortgages originated today are only low because the government is subsidizing rates by buying mortgages in the open market. In addition to subsidizing rates, the "first time homebuyer tax credit" has fueled the turn in housing starts and appears to have arrested falling prices in many markets.

Vehicle sales in August reached an annualized rate of 14 million units as a result of the "Cash for Clunkers" program, only to plummet in September when the program ended. It is critical that the economy build enough momentum in the coming months to sustain growth when the stimulus runs out. Organic growth needs to be significant enough to not only wean ourselves from the government subsidy but also to generate enough tax revenues to pay for all of this. We've placed a large, risky bet. As an aside, a wealthy neighbor of mine is sporting a new Chevy pick-up that we taxpayers subsidized to the tune of $4500. Hmmm?

Unemployment reached 9.8% last week, the highest level in 26 years. The Labor Department's jobs report, released October 3rd showed 263,000 jobs were lost in September, a greater loss than expected but significantly less than the peak months of January through March when losses exceeded 600,000 per month. It is expected that unemployment will peak at well over 10% sometime next year. As we have discussed, unemployment is a lagging indicator; during recessions the economy almost always bottoms before unemployment peaks. Despite this, such a high level of joblessness creates a significant challenge for an econ-



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omy on the mend, for obvious reasons. With 15 million Americans out of work, the outlook for consumption, which represents nearly 70% of our economy, is significantly diminished. If the economy continues to strengthen, the job losses will subside. At some point next year we hope to be waiting on the next employment report to see how many jobs were created. We haven't done that in earnest since 2002-2003 when we were all worried about the "jobless recovery" that followed the 2001 recession.

So what is our forecast? Our forecast is worth about as much as the next guy's forecast. As Greenspan said after his storied career as Fed Chief, "I've been in the forecasting business for 50 years and I'm no better than I ever was and nobody else is either." I will say that things look a bit grim and it's time for the USA to work another miracle. We've done it before and I have confidence that we'll do it again. It will be a long slog but we'll get through this.

More important, what are we doing with the portfolio? With a keen appreciation for today's challenging environment, we're managing portfolios the same way we've been managing them since I came to Bragg 16 years ago. On many occasions through the years, we at Bragg have reminded each other that the way we build and manage portfolios has a higher likelihood of working for our clients over the long term than other ways of managing portfolios. And there are plenty of other ways to manage money. We could try to time the market, rotate among sectors, load up on a few of our "best ideas," build a theme portfolio — real estate, solar, water, tech — the list goes on. We might get it right for a while but the one time we got it wrong would cost our clients a lot of money and it might cost us our business. What if we had loaded up on energy in April of 2008 when energy was all the rage? What if we had gone to cash in March? Just a few examples of very tempting things to do that would have wrecked your returns and probably cost us our relationship with you. We remind ourselves that a certain amount of humbleness (we can't forecast the future) and a certain amount of discipline (rebalance the account, don't time the market, don't chase what's been hot) will likely serve our clients well for years to come.

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calculator to show Ben that in just fifty years, his $10 would grow to the princely sum of $1,173 if we compounded it at 10%. I was relieved that he didn't point out that 10% was not realistic in this market, but I digress. The future value calculation did get his attention and I thought I had him turned when his mother stepped in and announced that if Daddy wanted to help the children make Halloween costumes from scratch, she was all for it but she was not participating. I've learned over the years that despite her many, many positive attributes, crafts are not her strongest suit. The children immediately realized that if Daddy was in charge of making costumes they were doomed to be boring old ghosts or something.

Two days later I got home from work and was greeted at the door by Harry Potter, a mean looking werewolf, a precious little candy corn witch and two-year old Charlie dressed up like a Holstein cow. Their excitement made me temporarily set aside my earlier conviction about teaching them the value of a dollar but I'm not done. Wait until next year.

What happened to thrift, creative drive and self-reliance? Is this indicative of America today? Are we spoiled? Have we lost our ability to endure hardship, find a solution and figure out how to make it work on our own? Have we become dependent on the government to solve our problems? Does our insatiable desire for immediate gratification have us addicted to credit? The run-up in consumer debt over the last ten years, the huge expansion of government and indeed my own family's behavior regarding Halloween purchases would imply that all of this is true. I'm not convinced however. We're witnessing a major change in America, not unlike those of decades past. With the exception of government, Americans, at the individual, corporate and non-profit level are tightening their belts and getting their financial houses in order. This will be a painful process in its impact on economic growth as consumption will grow much more slowly as folks reduce debt and rein in lifestyles.

In the long term however, this will be a positive change. Corporations and non-profits are becoming lean, more focused and less wasteful, while households are re-taking control of their financial future. Hopefully Americans will push government to rein in out-of-control spending as well. This will be difficult but I'm optimistic it will happen. In the meantime I'll pay attention to what my elected leaders are doing, vote whenever I get the chance and finally I'll invest the time required to teach my children the satisfaction of working hard and being self-reliant.

As always, thank you for choosing Bragg to help you with your planning and investing. Happy Halloween!

Sincerely,
Benton S. Bragg, CFP, CFA

Benton S. Bragg

President, Bragg Financial Advisors, Inc.