

INVESTMENT COMMENTARY



Bragg Building
1031 South Caldwell Street, Charlotte

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“Policymakers find themselves in a position reminiscent of an ‘all-in’ poker player holding a weak hand in a high stakes game.”

Pimco Funds CEO Mohamed El-Erian

POLAR BEARS IN MECKLENBURG COUNTY

Brother John Bragg decided it would be a good idea to ring in 2010 on our farm by having all the Bragg and Scruggs children take an icy plunge in the pond. Now I grant you, Huntersville is not Saskatchewan but as you likely have noticed, it has been darn cold lately and even a farm pond in the South cools right down in January. It is certainly not the time of year to practice your backstroke or settle in for a game of Marco Polo. But we figured a quick dip would surely be tolerable. While Alice was hollering something about the Department of Social Services paying us a visit, we lined up twelve of the fifteen children and marched them off the end of the dock into the frigid brown waters of McAuley Pond. John, Phillips, Steve and I joined the young swimmers while the mommas, toddlers and yes, Papa Frank watched from the bank with cameras whirring. Thus the Ramah Creek Farm Polar Bear Club was born.

Prior to the plunge, most of the children were thrilled by the prospect of swimming in the pond as several months had passed since their last dip. (Yes, we country folk let our young’uns swim in the pond regularly during the summer.) But the winter plunge caught them off guard. I admit I felt a little guilty as each of them surfaced with eyes as big as saucers, gasping for breath. The upshot was how fast they got out of the water. During the summer months, it always takes forever to get a child out of the pond. That wasn’t a problem on New Year’s Day. I’ve never seen them move

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MONSTER RALLY... STILL GOING

The Standard & Poors 500 Index was up 6% in the fourth quarter of 2009 and more than 26% for the full year. From the March low through year-end, it was up a whopping 68%. Despite the recent monster rally, the index is still approximately 25% below its peak of October, 2007.



Charts compiled by JP Morgan. Source data from Russell Investment Group, Standard and Poor’s, FactSet. Charts used with permission.

The table on the next page shows the returns of various market indices for the periods ending 12/31/2009. As we noted last quarter, the recent performance of the stock indices is overshadowed by the extremely weak showing for the three, five and ten-year periods. The ten-year period ending 12/31/2009 includes two

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market declines of over 45%. The 45% decline of 2000-2002 featured the bursting of the tech bubble, the September 11th attacks and the 2001 recession. The more recent decline

Market Index Total Returns for Periods Ending December 31, 2009				
Index	One Year	Three Years	Five Years	Ten Years
S&P 500 (US Large Cap)	26.5	-5.6	-5.6	-0.9
S&P 400 US (US Mid Cap)	37.4	-1.8	3.3	6.4
Russell 2000 (US Small Cap)	27.2	-6.1	0.5	3.5
MSCI EAFE (Foreign Equity)	31.8	-6.0	3.5	1.2
Barclays Aggregate Bond	5.9	6.0	4.9	6.3
Barclays Muni Bond	12.9	4.4	4.3	5.8

of 57% that bottomed in March of last year was the worst peak- to-trough drop since the Great Depression. Of the 75 rolling ten-year periods since 1926, the ten-year period just ended was the worst of all save one. That distinction goes to the ten-year period ending 12/31/2008.

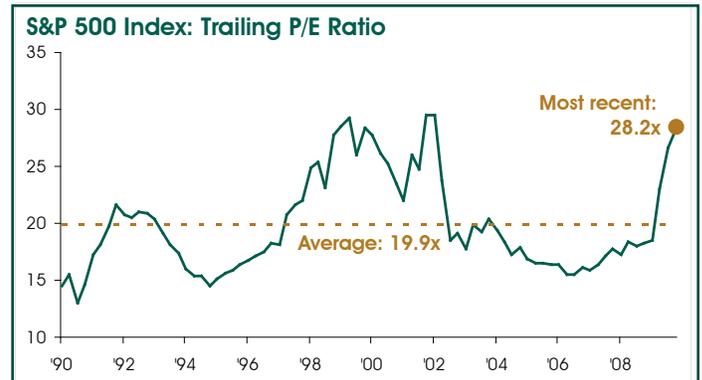
While we've been delighted by the continuing market rally, frankly we have been surprised by its strength and duration. The market seems to be pricing in a very strong recovery in corporate earnings. The charts to the right illustrate first, how much corporate earnings have fallen and second, the current price to earnings (P/E) ratio. You can see that the market is trading significantly above its historical P/E ratio. Importantly, the 28.2 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 are depressed temporarily (hopefully) as a result of the recession and especially the impact of the large charges taken by financial firms. To be sure, earnings have bounced back significantly, in part due to general improvement in the economy but primarily due to massive cost savings resulting from the elimination of millions of jobs. These savings have certainly provided a strong boost for earnings in the third and fourth quarters of 2009 but whether the earnings growth is sustainable in the face of high unemployment and a weak economy is another question.

We want to be prepared for volatility ahead.

We are the first to say that we have no idea how long this rally will last. Twelve months from now you may find yourself reading about the "continuing rally" in our 12/31/2010 report. But if history is any guide, we can expect some bumps in our future. The market has now moved up in a fairly smooth trajectory for nearly ten months. A recent American Funds study of market declines of the Dow

Industrial Average reveals that the market declines 10% or more about once per year, 15% or more about once every two years and 20% or more about once every three and a half years. We think it makes sense to be prepared.

At Bragg, being prepared means rebalancing accounts. After the dramatic rise in stocks, your portfolio has become slightly overweight in stocks relative to bonds per your written investment plan. As we rebalance accounts, we are trimming equities and adding to bonds to restore the proper balance. In many cases, after considering your specific financial position, we may actually rebalance your accounts to slightly below your normal equity target. For example, if your normal equity target is 70%, we may leave your accounts at 67% equity, resulting in a slightly defensive stance. Please let us know if you would like to discuss your investment plan.

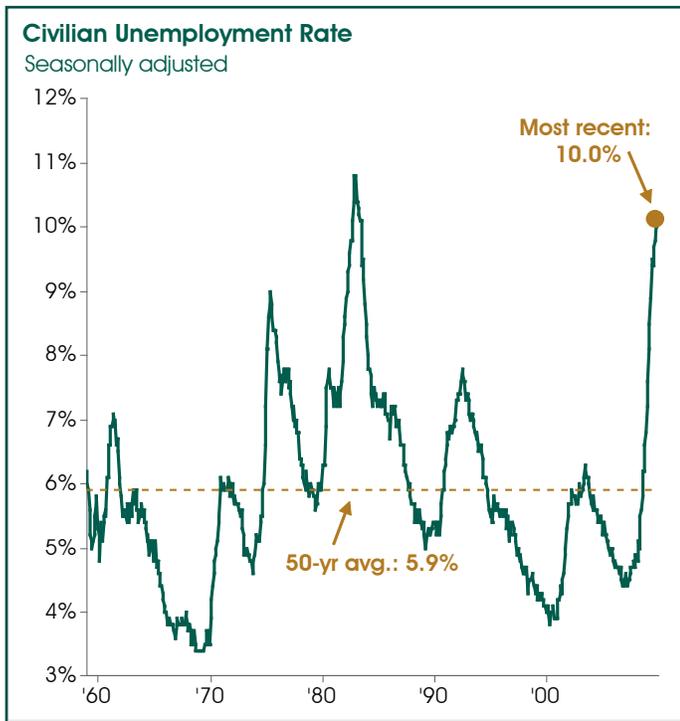


Charts compiled by JP Morgan. Operating earnings provided by Standard & Poor's.

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THE LONG SLOG AHEAD

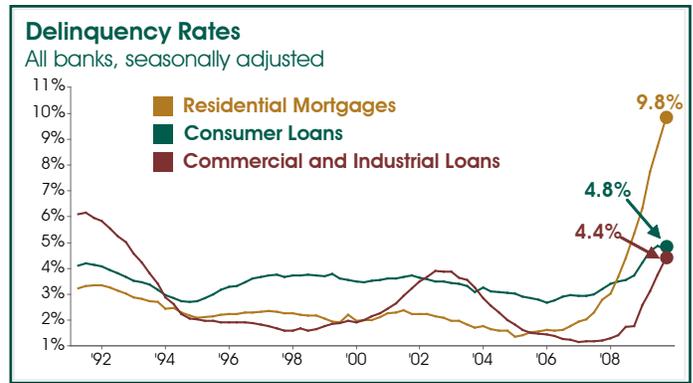
Economic growth appears to be accelerating as we enter 2010, due to a boost from the most cyclical areas of the economy including housing, autos and business spending on inventory and equipment purchases. This cyclical bounce combined with low interest rates and continuing stimulus spending will likely propel GDP growth higher in 2010. While the economy appears to be moving forward again, unemployment will prove to be an ongoing challenge as employers may be reluctant to hire workers due to the uncertain economic, political and tax environment. History suggests that it could take up to five years of economic expansion to bring the unemployment rate back down to 5%. As we have discussed before, persistently high



Charts compiled by JP Morgan. Source: BLS.

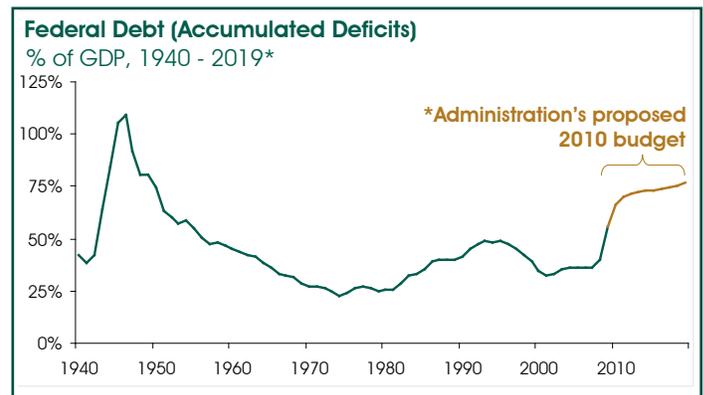
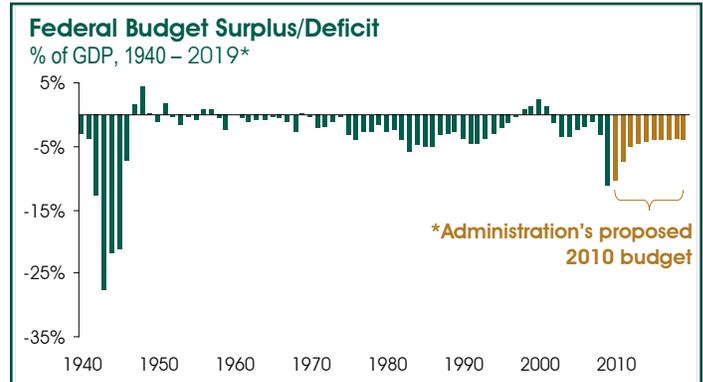
unemployment creates a drag on growth and a severe strain on segments of the economy. Banks in particular are still struggling with capital requirements as more loans become delinquent. Anticipated losses in credit cards and commercial real estate loans have banks and regulators nervous about additional lending. Tight credit restricts job creation and investment as businesses large and small are unable to access the capital required for expansion.

As we have discussed, parts of the economy have been living on stimulus. Housing and autos in particular have enjoyed significant progress as a result of taxpayer subsidies. The banking industry, on the brink of insolvency nine months ago, is now stabilizing after a massive taxpayer funded



Charts compiled by JP Morgan. Source: Federal Reserve, U.S. Treasury, FactSet.

bailout. It is crucial that the economy has enough traction to maintain its momentum when the stimulus runs out. And run out it should. Our current deficit spending is not sustainable. The charts below show the impact of the federal government spending on our nation's financial position. There is a limit to our borrowing. At some point, investors will demand higher interest rates to buy our debt and higher rates will have a further dampening effect on growth. In



Charts compiled by JP Morgan. Source: St. Louis Fed, Bureau of Economic Analysis, Office of Management and Budget.

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addition to federal stimulus spending, we've had massive monetary stimulus from the Federal Reserve. The Fed has flooded the financial system with cash in an effort to prevent deflation and keep the banks solvent. This has resulted in a tremendous increase in the money supply which often is inflationary. Thus far inflation has been a non-issue as the increase in the money supply has not made it off the banks' balance sheets in the form of loans. The challenge for the Fed is to pull back the monetary stimulus before it becomes inflationary without choking off growth. Meanwhile, Congress's challenge is to rein in spending and avoid raising taxes. This is a tall order. As Mohamed El-Erian, CEO of Pimco puts it, "Policymakers find themselves in the position of an 'all-in' poker player holding a weak hand in a high stakes game." We have our fingers crossed that the big bet pays off.

Whenever I think about the challenges just described, I admit I get a bit mired down in it. How are we going to get ourselves out of this pickle? The only solution for me is to think about cheeseburgers. As investors we own stock in a lot of fine companies. One of them is McDonald's. Did you know that the executive team at McDonald's is gathered around the table right now in executive session? They are. But they aren't talking about the deficit or inflation or consumer sentiment or the housing market. Instead, they're hammering out a plan to sell a billion cheeseburgers a month in China this year. They're going to hire six thousand employees and invest millions of dollars in real estate, equipment and commodities. Then they'll lure in the customers, sell them Big Macs and fries, deliver a high level of service and make them come back again and again for more. They're determined to make it happen and they have a huge incentive to make it happen. When they make it happen, they'll make a lot of money and so will we because we own the company. Those folks at McDonald's get up every day and go to work and do that. And so do several billion other folks in the world who have economic opportunity. Remembering that gets me fired up. That is how we move forward. It is human nature to progress. Capitalism and stock ownership allows us as investors to benefit from human nature. The rest of the world benefits as well.

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so fast. I moved fast too. The water cut like a knife. My plan to dive in and swim to the other side of the pond was quickly aborted when I felt the icy water. For an instant I couldn't breathe, couldn't move, couldn't shout "Whooooo-eeeeee" like I wanted to. Momentarily I was filled with doubt. And then I was swimming and then I was safe on the dock, breathing, shivering, howling and laughing with the rest of the polar bears.

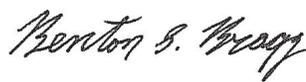
"Now I grant you, Huntersville is not Saskatchewan but as you likely have noticed, it has been darn cold lately and even a farm pond in the South cools right down in January."

You might be thinking, "What does the Polar Bear Club have to do with my portfolio? Benton grew up Baptist...maybe he'll make an analogy about baptism and starting anew here at the beginning of the year." Relax...no sermon, just some symbolism. The icy plunge was the market crash of 2008 and early 2009. It took our breath away, temporarily filled us with doubt and a feeling of helplessness and it made us wonder about the future. The Michael Phelps-like dash back to the dock and lunge out of the water was the surging rally that began on March 9th and continued through the end of the year. Now we are all standing dripping on the dock with our portfolios mostly restored, marveling at what we have endured. We're humbled and a little wet, but we feel stronger, wiser and more prepared for the future after the experience.

Something tells me the children are going to be eagerly anticipating the Polar Bear Plunge next year and the next and the next. I'll join them of course and I'll likely think back to the market crash of 2008-2009 each year as I hit the icy water. And as surely as the pond water will cool off again next fall, we'll see market corrections in our future. Hopefully the market plunge of 2008-2009 is the deepest, coldest water we'll face for a long time.

Thank you for choosing Bragg to help you with your financial planning and investing. We wish you the best in 2010.

Sincerely,



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