INVESTMENT COMMENTARY

1st Quarter 2010

"There are two rules to investing. Rule number one is never lose money and rule number two is never forget rule number one."
-Warren Buffett

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FISHING BOATS & MARKET FORECASTS

Sometimes things turn out differently than we expect. That is often the case with the stock market but it's true in other parts of life as well. I bought a used fishing boat last week. I purchased the boat from a friend who kept the boat at Holiday Marina on Lake Norman so it was already in the water when I showed up on Good Friday to take possession of it. All I had to do was load up my family, apply some sunscreen, crank the motor and cruise out onto the lake. Now if you are like my father, you're wondering why in the world a rational, clear thinking, practical man like Benton Bragg would buy a twelve-year-old motor boat into which he'll pour money and time. I'll explain that another time. For now, just shake your head and feel sorry for me if you must.

As we cruised the lake under a clear blue sky, I found myself getting a little apprehensive about the prospect of putting the boat on the trailer at the end of our maiden voyage. You see, I have never owned a boat and I have never put a boat on a trailer. I imagined the worst but I did not share my apprehension with Alice or the children. I couldn't bear to hear her say, "Do you know what you're doing?" Instead we had a chilly swim, ate our picnic lunch and generally enjoyed a nice day on the water.

And then it was time to head back to the marina where the truck, trailer and boat ramp were waiting. The boat ramp was sandwiched between the marina and the Rusty Rudder Bar & Grill. My stomach knotted up as I realized that

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MARKET REGAINS LOST GROUND

The Standard & Poor's 500 Index was up another 5% in the first quarter of 2010. Since the low of March 2009,

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

the market is up more than 75%. Despite this strong rally, the market still hasn't made up all of the ground lost with the 57% decline that began on October 9th 2007. So the market was down 57% peak to trough and now it is up 75% trough to recent peak. Why are we not even? This is a result of the arithmetic of loss and recovery. A fifty percent decline reduces a million dollar portfolio to five hundred thousand. To then get back to one million, one needs a return of 100%! The nearby table makes a great case for avoiding large percentage losses. As Warren Buffett once said, "There are two rules to investing. Rule number one is never

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Back in the Black	
If your investment declines	To get back to even you'll need a gain of
-10%	11%
-20%	25%
-30%	43%
-40%	67%
-50%	100%

lose money and rule number two is never forget rule number one." The market certainly broke Buffett's first rule during the recent decline. To fully recover from its loss of 57% the S&P 500 needs a gain of 132%. We're not there yet.

The table below shows the returns of various market indices for the periods ending 3/31/2010. The strength of the market continues to surprise us. As we discussed last quarter, market multiples such as price to earnings or price to cash flow are high relative to historical averages. Corporate earnings have bounced back significantly from the lows of early 2009 but

Market Index Total Returns for Periods Ending March 31, 2010					
Index	Year to Date	One Year	Three Years	Five Years	Ten Years
S&P 500 (US Large Cap)	5.4	49.8	-4.2	1.9	-0.7
S&P 400 US (US Mid Cap)	9.1	64.1	-0.8	5.2	6.0
Russell 2000 (US Small Cap)	8.9	62.8	-3.9	3.4	3.7
MSCI EAFE (Foreign Equity)	0.9	54.4	-7.0	3.8	1.3
Barclays Aggregate Bond	1.8	7.7	6.1	5.4	6.3
Barclays Muni Bond	1.3	9.7	4.6	4.6	5.6

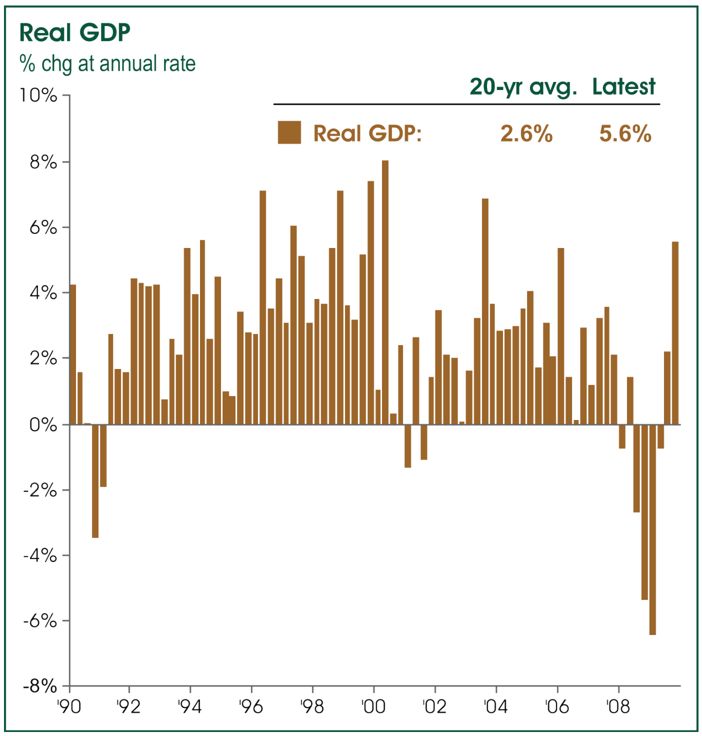
sustaining that rate of growth will be a tall order in the face of high unemployment and the other headwinds facing the economy (more on that in the next section). So while we will happily take the gains the market has given us, we remain apprehensive about the sustainability of this rally.

At Bragg, we are rebalancing accounts. As we mentioned last quarter, the dramatic rise in stocks has left your portfolio 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.

THE GOOD & THE BAD

On April 2, the Bureau of Labor Statistics reported that the economy created 162,000 net new jobs during the month of March. While 162,000 is a statistical blip in a labor force of 154 million workers, it is still a positive number and it is the largest monthly gain in three years. For comparison, for the five months beginning November of 2008 and ending March of 2009, the economy shed more than 600,000 jobs per month. Things are looking better. Nevertheless, the unemployment rate remains elevated at 9.7% and most economists expect this rate to remain stubbornly high for many months.

US economic output or Gross Domestic Product (GDP) was positive in the second half of 2009 and is expected to be positive in the first quarter just ended. Overall, GDP declined by 3.8% during the recent recession, the steepest decline since the Great Depression. Historically, deep recessions have been followed by somewhat strong bounces in economic growth as a result of pent-up demand and inventory re-stocking by corporations. Like a coiled spring that has been depressed, the economy often surges in the initial phase of a recovery and usually, the deeper the recession, the greater the surge. Given the severity of this recession, the initial rebound has been weaker than many economists expected. For example, consumer confidence readings are trending higher but they are still low on an absolute basis. Retail sales have shown solid growth but personal income has been absolutely flat. Housing appears to have bottomed in some markets but the slight uptick is just that, slight. As mentioned, jobless claims have fallen but companies still are not creating many jobs. Fully 30% of the 162,000 jobs created during March were temporary census-worker jobs. Auto sales are trending up but we are still well below pre-recession levels. Auto sales in March were 11.8 million (annualized). This was an improvement but during the previous expansion, anything below 16 million would have been considered a disaster. So our recovery is still



Charts compiled by JP Morgan. Source data from BEA.

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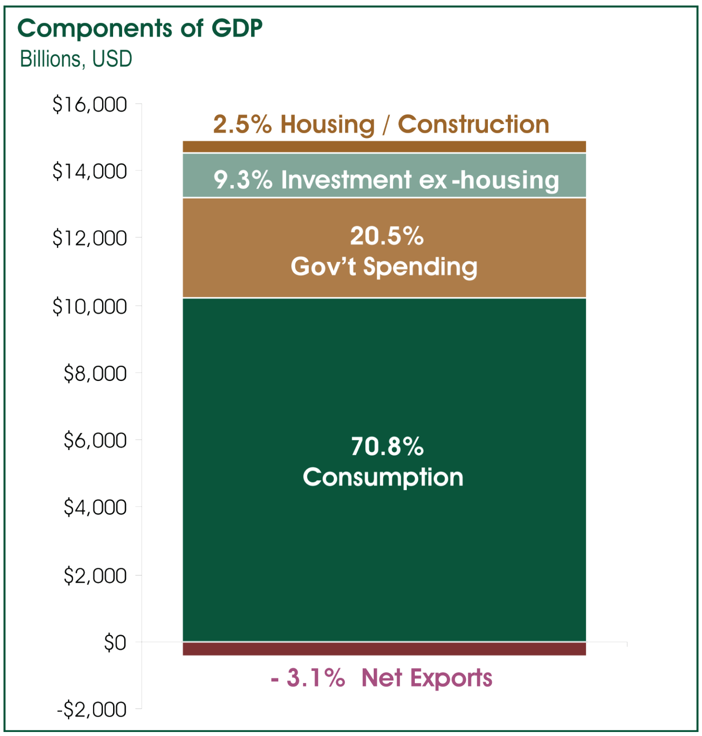
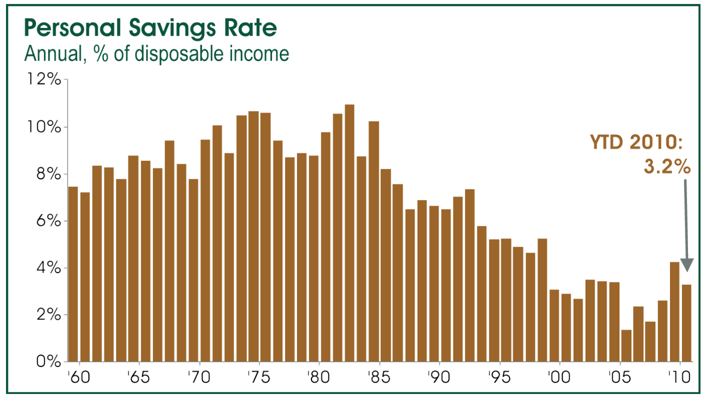
shaky.

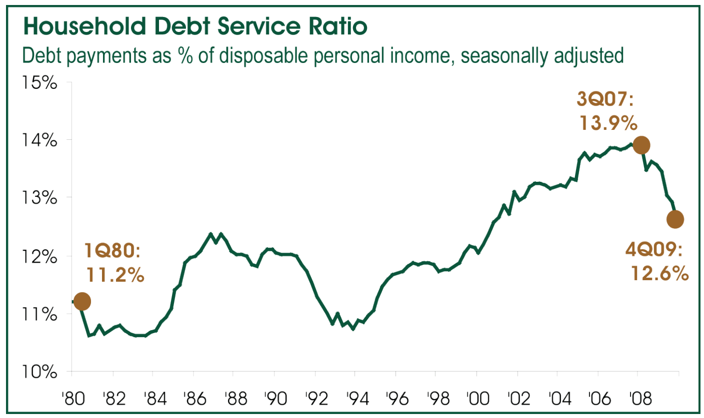
The next chart breaks GDP down into its component parts. As we have discussed before, consumers play a huge role in the economy, making up more than 70% of the total. Back in the fall of 2008 when the economy and the market seemed to join hands and jump off a cliff, many economists predicted that the consumer was dead, maxed out on credit cards and finished with conspicuous consumption. For a while there, that seemed to be the case. The savings rate rose and consumer spending fell. But as the two charts to the right show, the consumer seems to be coming back. The savings rate is already falling and folks have really made progress reducing their debt. Throw in last week's strong retail sales number and we might be seeing a new trend. Boy, memories are short. Seems like just the other day I was telling Alice, "Just don't spend any money!"



Charts compiled by JP Morgan. Source data from BEA.

Need some good news? Look at corporate balance sheets. With the exception of banks and insurers, companies are in very good shape. After cutting expenses to the bone, most firms are piling cash, funding their operations with internal funds (not borrowings) and paying down debt. Corporate spending should be a major factor in a continuing recovery. Even the banks have made progress; their balance sheets are in much better shape than twelve months ago. Despite this, the banks have hurdles ahead in the form of commercial loan defaults and additional mortgage defaults. Thousands of commercial loans and subprime mortgage are up for renewal or rate adjustment in 2010 and 2011. Banks face another round of loss taking; hopefully taxpayers won't have to foot the bill this time.





Charts compiled by JP Morgan. Source data from BEA & FRB.

I mentioned that the recovery is still a bit shaky. What could derail it and cause the feared double-dip recession? Lots of stuff, some of which is on our radar and some of which we probably haven't even considered. The main things that are on the radar include terrorism/Iran/North Korea, an oil spike, inflation, deflation and perhaps the most worrisome to us, the government debt crisis.

How can we not have inflation when the government is printing money? We are all hearing a lot about this. Inflation may in fact be in our future. In the near term however, deflation still appears to be the greater threat. The Fed may be printing money, but very little of it is making its way into the economy. Banks are not lending, folks are not borrowing. The "velocity of money" or rate at which money flows through the economy has slowed significantly despite the Fed's best efforts. In addition, wage pressure is non-existent at this point and there is tremendous excess capacity. Simply put, prices are not yet rising.

I could fill several pages talking about the debt crisis, the greatest threat to our future prosperity, but I'm out of space.

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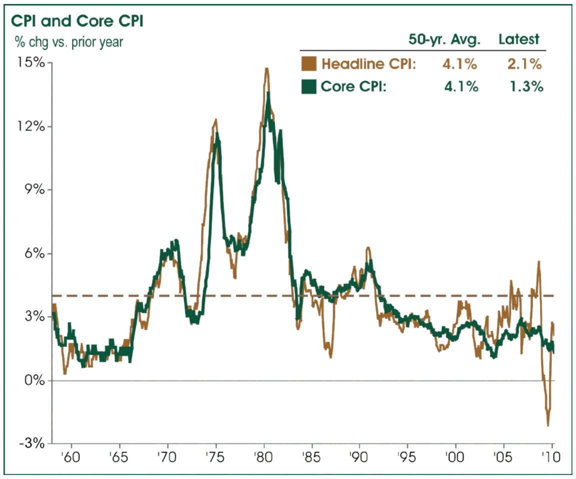

Charts compiled by JP Morgan. Source data from BLS.

But don't worry, this problem is not going away; we'll have plenty of opportunities to discuss it in the coming quarters.

Now that the dust has somewhat settled on the stimulus, the financial bailout, the Fannie/Freddie bailout and the automaker bailout, we can see clearly that we have just witnessed the greatest transfer of debt from private balance sheets to the public balance sheet in history. Before we even start "saving" money on the new health care plan we've seen our federal debt rise dramatically.

Consider these few facts you can easily find at www.treasury.gov. On March 31, 2008, the federal debt in the hands of the public (our net government debt) was $5.3 trillion. On March 31, 2010 it had increased 57% or $3 trillion dollars to $8.3 trillion! The Obama administration estimates the debt will be $18.6 trillion by 2020 and the Congressional Budget Office estimates $20.2 trillion by 2020. How much is $20 trillion? My trusty Texas Instruments BA II Calculator was short three zeroes so I had to use a spreadsheet to figure out that $20 trillion is $65,000 owed by each American. Even Charlie Bragg, my little two-year old, is already on the hook for $65,000. He's a little short; he'd best get out of that sandbox and go find a job. I'm being a little silly here - perhaps that is my way of dealing with something that truly has me worried about our future. Going from $8 trillion in debt to $20 trillion in debt means someone has to lend us $12 trillion. It won't happen. This situation is not sustainable. More on this later.

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the outdoor deck of the Rusty Rudder was packed with folks drinking beer and enjoying live music on a Friday afternoon. The guy picking the guitar and singing Jimmy Buffett songs was sitting on a stool no more than 15 feet from where I had to put the boat on the trailer. Jeez! I could see the folks on the deck look in our direction with gleeful anticipation. "Hey, check it out...this guy's gonna try to get his boat on the trailer...this should be good." I asked Alice to stay with the kids while I ran to get the Suburban and trailer which I backed down to the water before carefully applying the parking brake. Sweating now, I ran back out on the dock to plan my next move. Deciding the trailer needed to be a little further in the water, I asked Alice to back it down a bit. Alice figured out I was a bit stressed when I barked at her, "Please go back up the truck 18 inches and then stop and then put the brake on and do not drive into the lake!" "Would you please calm down?" she said. "Why would I drive into the lake? What is wrong with you?" I lowered my voice, "Just be careful not to drive into the lake. People do it all the time." She looked at me like I was crazy and went and backed up the truck without a hitch. Then, with my bride, my four children and a few dozen drunks sitting on the deck watching, I cranked the motor, tossed the line, eased the boat gently onto the trailer, hopped off the bow onto dry pavement, cranked the boat into place, jumped in the truck and drove safely up the ramp. Perfect! I couldn't believe it!

The guy picking the guitar and singing Jimmy Buffett songs was sitting on a stool no more than 15 feet from where I had to put the boat on the trailer. Jeez!

I never imagined things would go so smoothly. Likewise, I never imagined the stock market would be up more than 75% since last March. Indeed, I never imagined the market would have gone down 57% from the peak of October 2007 to the low of March 2009. I'll go further and say that no one would have predicted this dramatic turn of events. But it happened and we can learn from this experience. First, these events reinforce the notion that things often turn out differently than we expect. We therefore should structure our portfolios and financial plans to be prepared for various outcomes. Second, allowing our emotions to influence our investment decisions at times of great stress can wreak havoc on our wealth. A simple comparison of your March 2009 account balance to your March 2010 balance drives this point home better than anything else I can say about it.

Now I might make the case that I was able to put that boat on the trailer because I thought through the various potential outcomes and was prepared for whatever came my way. Who knows? Maybe it was just beginner's luck and next time I'll sink it. That would certainly make a good story, wouldn't it?

Thank you for choosing Bragg to help you with your financial planning and investing.

Sincerely,

Benton S. Bragg

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