

INVESTMENT COMMENTARY

3rd Quarter 2010



Bragg Building
1031 South Caldwell Street, Charlotte

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“Our customers aren’t spending money like they used to. It’s like they’re scared or something. But we’re still in business and things are a little better than last year.”

- Parts Manager, CARQUEST Auto Parts, Huntersville, NC

PAWN SHOPS AND PROBABILITIES

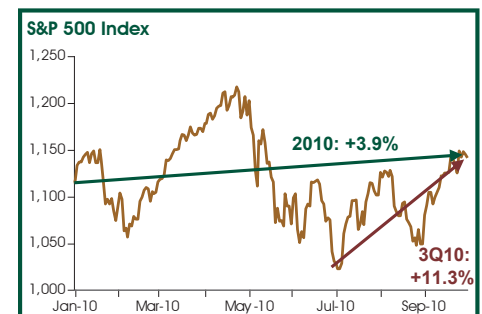
Someone stole my bicycle this summer. I kept the bike in the stairwell at our office and often rode it for exercise on the “Booty Loop” in Myers Park during lunch. Apparently someone had seen it while walking through our parking lot and managed to force the door and steal it. Like most victims of theft, I experienced the usual feelings of anger, disappointment and of being violated. I also felt, perhaps unrealistically, that I would get the bike back. I certainly wanted it back. Being over twenty years old, it wasn’t valuable but it had some history and sentimental value. I purchased the bike in 1994 from a family friend who, as a bike racer, was somewhat of a local legend back in the late eighties. I had ridden thousands of miles on this bike and never crashed, including multiple trips up and down the switchbacks of Beech Mountain. The bike frame itself was made of titanium and I always thought that was pretty cool...isn’t that what they use in the space shuttle? And besides, it was mine! So I decided I was going to try to get it back.

The other folks in my office told me I was wasting my time but I filed a police report and then on four or five different occasions I spent my lunch hour out checking the pawn shops near my office on South Boulevard. I even drove through some neighborhoods near our office figuring I might spot some teen riding around on my beloved bike. Finally, I checked eBay and Craigslist periodically to see if anyone was selling a vintage Giordano 12-speed with a titanium frame. When my father predictably pointed out that

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SO ENDS A SUMMER OF VOLATILITY

The kids are back in school and volatility is back in the market. Since the market abruptly halted its one-direction rally back on April 23rd of this year, investors have endured some significant swings in the value of their accounts. As measured by price changes of the S&P 500, from the April high through the end of the third quarter, the market has had six swings of 6% or more (three up and three down). Three of these swings were of 10% or more and one swing



was greater than 13%. Curiously, the big swings seemed to coincide with the months of the year...May was terrible, July was great, August was a disaster and September was a huge winner. This made the monthly ritual of opening statements somewhat of an emotional roller coaster.

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The market was up 9.8% in September, its best September since 1939 and its fourth best performance for any month in the last twenty years. As you can see in the nearby table, the market is now positive this year through the end of the third quarter. We are now 74% above the low of March of 2009 but we'll need an additional gain of 37% from these levels to get back to the high of October 2007. Given the headwinds the economy faces, it may take years to get back to the old high. Does that mean we should abandon stocks and be done with the volatility? While the gyrations of the summer may have some investors contemplating this, the following paragraph on bonds may make that idea seem less appealing.

Market Index Total Returns for Periods Ending September 30, 2010					
Index	Year to Date	One Year	Three Years	Five Years	Ten Years
S&P 500 (US Large Cap)	3.9	10.2	-7.2	0.7	-0.4
S&P 400 US (US Mid Cap)	11.6	17.8	-1.7	3.8	5.4
Russell 2000 (US Small Cap)	9.1	13.4	-4.3	1.6	4.0
MSCI EAFE (Foreign Equity)	1.1	3.3	-9.5	1.9	2.6
Barclays Aggregate Bond	7.9	8.2	7.4	6.2	6.4
Barclays Muni Bond	6.8	5.8	6.0	5.1	5.7

BOND BUBBLE?

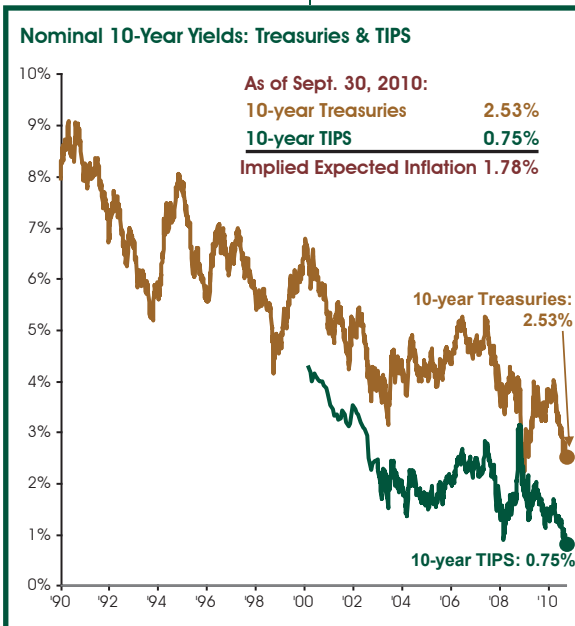
The bond returns in the table above look fantastic. With hindsight we can easily see that we would have more money today had we simply put all of our money in bonds over the last decade. While this is an interesting historical observation, it certainly doesn't tell us where to put our money for the next decade. Is there great potential in bonds? Given today's low yields, it is hard to make the case that there is but many smart, rich people said the same thing back in 2001 and bonds have been a great investment since then. Bond yields today are extremely low. As I type, the yield on the ten-year treasury bond is 2.48%, very close to a fifty-year low. Yields on short-term treasuries, certificates of deposit, money market funds and savings accounts are almost non-existent. Yields on highly-rated corporate bonds and even lower-quality "junk" bonds have fallen precipitously. And that explains the stellar returns above. Recall that bond yields and bond prices have an inverse relationship; yields fall as prices rise. Much of the investment return in bonds over the last decade has come from capital gains resulting from rising bond prices. Investor demand for bonds has caused those prices to rise.

Today, some folks worry that

dollars of bonds are traded by very sophisticated investors. While the talking heads pontificate in front of the camera, these sophisticated investors put down real money to buy or sell bonds. Today as I write, those investors are trading the ten-year bond and according to my computer, they have apparently agreed on a price that results in a yield of 2.48%. If "any fool can see that bond prices are going to fall," why did the folks on one side of that billion dollar trade buy bonds at that price? We may see higher interest rates in the near future but likewise we may see low interest rates for years to come. Take a look at Japan, where interest rates have hovered near zero for more than a decade. So we trust the market price more than we trust the guy on CNBC regarding the correct price for bonds. That means we're not dumping bonds to prepare for an imminent collapse in their prices.

A yield of 2% looks lousy until the stock market starts falling. Then it looks wonderful. I don't say that to suggest we think the market is going to fall. I say it to point out that the market is telling us something when folks value a guaranteed instrument so much they are willing to accept a paltry yield of 2%. The market is telling us there is little risk of inflation at this point; deflationary forces are stronger. The market is telling us there is a huge appetite for a return of principle and less concern about a return on principle. The economic recovery is fragile and in our opinion, bond yields reflect that fragility.

Should we seek more yield by selling treasuries and buying bonds and other instruments that offer higher yields? We certainly could do that but especially in the world of fixed income, there is no free lunch. Higher yields are higher for one reason—higher risk. At Bragg,



All charts compiled by JP Morgan and used with permission. S&P 500 source data from Russell Investment Group, Standard and Poor's and FactSet. Treasuries & Tips source data from St. Louis Fed. Civilian Unemployment Rate source data from BLS. The Great Depression & Post-War Recessions source data from NBER and BEA. Light Vehicle Sales source data from BEA. Median Existing Home Prices source data from National Association of Realtors and FactSet.

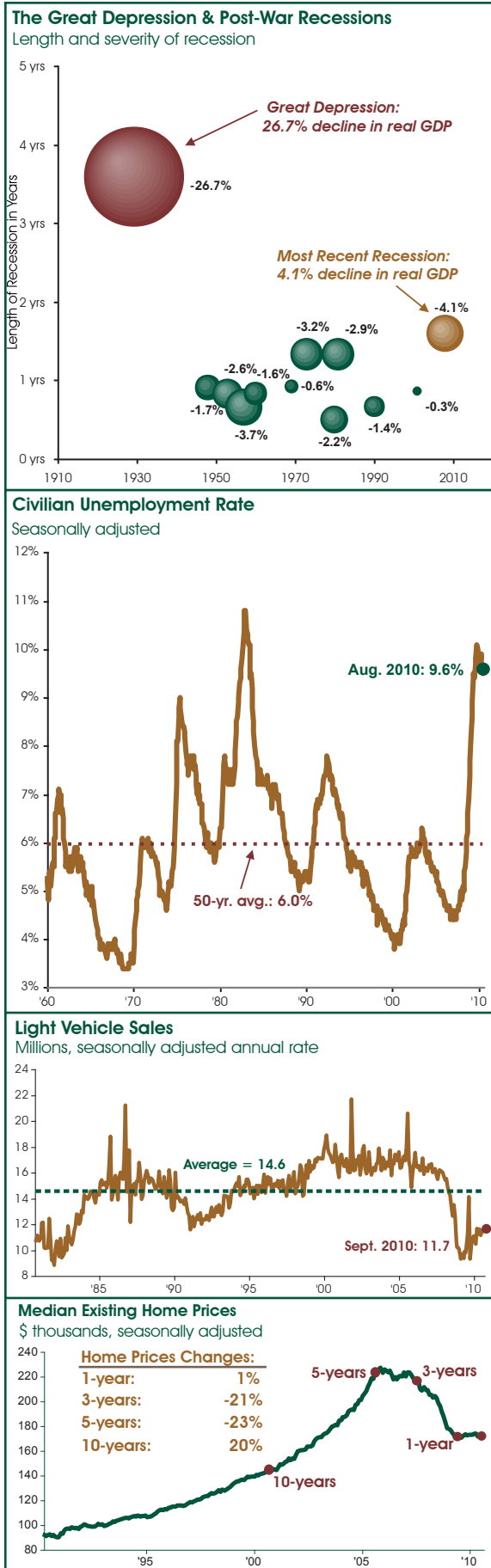
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we are hesitant to risk the principal within the bond portion of the portfolio simply to reach for a little more yield. Back in 2006, yields on sub-prime mortgage bonds looked attractive compared to yields on treasuries but the extra 1.5% in yield seemed far less appealing when the sub-primes defaulted en masse in 2008.

So don't expect bonds to yield much in the coming years but do expect to find them in your portfolio because they will provide needed liquidity and they will provide a return of your principle. Stocks will continue to be volatile in the future and it may be years before we get back to the high of 2007. But they'll be in the portfolio as well. Even if it takes four years from these levels, that represents a return of over 10% annually. We'll take it.

FORWARD BUT FRAGILE

Good news! The recession is officially over. At least that is what the official arbiter of recessions, the National Bureau of Economic Research, announced on September 20th. The downturn which began in December of 2007 officially ended in June of 2009. At eighteen months, this was the longest recession since World War II and as the nearby chart demonstrates, in terms of decline in gross domestic product, this recession was the most severe since the Great Depression. I think we would all agree that it felt severe and I think we would go further and say that it doesn't feel like it is over. The nearby charts of unemployment, vehicle sales and home prices make it clear that the economy is still struggling to get its footing. And yet technically the economy is expanding. Using the definition preferred by the National Bureau of Economic Research, a recession is a period of falling economic activity



spread across the economy, lasting more than a few months, normally visible in real GDP, real income, employment, industrial production, and wholesale-retail sales. The US economy is expanding off a much lower base and we're still hurting. The parts manager at CARQUEST Auto Parts in Huntersville summed it up pretty well last Saturday when my boys and I stopped in to buy a battery for our tractor. I asked him how business was going and he shook his head and said, "Our customers aren't spending money like they used to. It's like they're scared or something. But we're still in business and things are a little better than last year."

Of particular interest to us as investors is the fact that corporations are in very good shape. As we discussed in our last few commentaries, earnings rebounded quickly after the severe plunge in the second half of 2008. As also previously discussed, much of the rebound in earnings can be attributed to cost cutting, including huge lay-offs, and this one-time source of growth is pretty much tapped out. In the case of large multi-national corporations, however, an increasing proportion of earnings growth can be attributed to business conducted outside the US. Even as the US and Europe struggle, emerging economies including India, China, Brazil and Mexico have shown much more robust growth and this is fueling profits for companies with business in those countries. So earnings are up and this is driving the market. Earnings season is upon us again and it will be interesting to see if third quarter earnings continue the upward trend.

Corporations are sitting on massive amounts of cash, cash that could be invested in employees, inventory

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I could have bought a brand new bicycle had I spent that time working instead of visiting pawn shops, I explained that finding my bike was a matter of principle. As a man who cuts and splits his own firewood and has a four-acre garden, my dad shouldn't need to be reminded that some of the choices we make are not driven by financial considerations. But I digress.

After about a month with no luck, I decided to give up the search and buy another bike. Before doing so however, I decided to hit the four pawn shops closest to my office one last time. I had no luck at the first three and was walking out of the fourth when a clerk yelled, "Hey, check out that silver one in the back that just came in yesterday." I walked around a display rack piled high with power tools, entered the back room and there, leaning against a huge stack of stereo equipment, was my bike! After about an hour and some assistance from the Charlotte Mecklenburg Police Department I drove away with a vintage, titanium frame Giordano racing bike strapped to the back of my car.

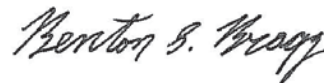
I've told that story to a lot of people and they seem to have very similar reactions. "I can't believe you found your bike! What are the odds of that happening? You got so lucky!" Part of me agrees with those observations. I am lucky to have it back. But I would argue that the steps I took in trying to find the bike greatly increased the odds that I would be successful. If you think about it, you'll agree. I figured there was some chance that a true cycling enthusiast had taken the bike and was enjoying riding it on the Booty Loop but odds were much higher that some non-cycling kid passing through the parking lot stole it. Would he steal it to ride it or would he steal it to sell it? If he wanted to sell it, where would he take it? To the closest pawn shop he could find?

Probably. Sure there was some luck involved but my actions increased the probability of a favorable outcome.

Taking steps to increase the probability of a good outcome is exactly what we want to do with our financial planning and our portfolios. With our financial planning, we want to start young, save and invest regularly, limit the use of debt, live within our means and insure our risks. These steps require action and planning. Just as I couldn't sit and hope for the return of my bike, we can't expect our financial future to turn out well without some effort on our part. With portfolio management we want to consider age, risk tolerance and need for return and then construct diversified portfolios that have a high likelihood of achieving a desired outcome over time. We don't bet all of our chips on one stock, one sector or one asset class. We don't concentrate the portfolio in sub-prime bonds, tech stocks, Florida condos, oil, emerging market stocks or gold. Instead we first make sure we have the liquidity we need and then we invest our long-term wealth in a diversified fashion, acknowledging that we'll take our lumps from time to time but that our actions have greatly increased the odds of a favorable outcome over the long term. If that doesn't work out, talk to me about my new private investigator business.

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

Sincerely,



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

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and equipment. Many CEOs say they are waiting for clarity on taxes, healthcare, political outcomes and government regulations while others simply are waiting for the economy to improve. Obviously this lack of confidence works against economic growth. Couple this lack of confidence with a de-leveraging consumer and an overspending government and our country finds itself in a difficult situation.

As always, we're optimistic that we'll solve these problems and move forward but this process won't be easy and it won't happen fast. For the last thirty years American consumers and our elected officials have enjoyed a credit-driven spending spree that artificially increased our standard of living. The adjustment period is upon us. There is a chance we'll limp along and things will get no worse than that described earlier by the parts manager at CARQUEST. There is also

a chance that we face another round of pain with another recession, further job losses and financial failures by firms and individuals. Finally there is the chance that the economy improves dramatically, unemployment falls, tax revenues rise and the government curtails spending. You can assign odds to each of these scenarios and you can likely come up with additional scenarios of your own. Acknowledging that we can't see the future, Bragg's goal is to construct portfolios that have a high probability of financial success regardless of what the future brings. That is on our minds each day as we make decisions about your money.

We hope this is helpful. Please let us know if you would like to talk about your portfolio.