

INVESTMENT COMMENTARY

4th Quarter 2010



Bragg Building
1031 South Caldwell Street, Charlotte

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- Frank Bragg

FATWOOD & OPTIMISM

By Frank Bragg

Southerners call it lightwood, fatwood or heart pine. Deep in Georgia some call it “litter’d.” Webster’s defines it as a coniferous wood having an abnormally high content of resin and therefore easily set alight. When cut into kindling, it makes a great fire-starter and it is found in abundance on our farm outside of Huntersville.

On a cold Saturday morning in December, my son John, his four children and I tried to be positive as we peddled our “farm products” at the Davidson farmers’ market. With no vegetables in season, we had prepared some 20 decorative bags of “lightwood” that we hoped to sell for use as fire-starters. As people strolled by our table, John’s children would offer friendly greetings followed by a pitch for buying a bag of lightwood. John and I coached the children, encouraging them to make eye contact and to remember to say the bags were “only six dollars” and “they make great gifts.”

John and I reminisced about his childhood when he, Benton, Phillips and sister Katie started “Bragg Brothers Enterprises” in the 1970s. We lived on a small farm and if you happened to stop by for a visit you would likely leave with a dozen eggs, a watermelon, tomatoes or whatever we had fresh from the farm and all at a fair price. In winter, lightwood was a big seller as most people had wood burning fireplaces or wood stoves. The children were always selling something and “Bragg Brothers Enterprises”

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THANKS, SANTA

By Benton Bragg

2010 turned out to be a good year for the stock market thanks to the strong rally that picked up steam in the fourth quarter. The S&P 500 was up over 10% for the last three months of the year, bringing the overall return for the year to more than 15%. As shown



in the bottom chart on this page, on a price basis, the market is now up 93% from its low of March 2009. It is still 13% below its peak of October 2007, and reaching a new high will require a return of 24%. As the table on the next page shows, mid- and small-cap stocks had an extremely good year while foreign stocks had a relatively poor showing. Of note, the MSCI EAFE Index shown in the table on page 2 is dominated by the performance of stocks in developed markets like

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Europe and Japan. Emerging Market stocks like China, India, Brazil and Mexico had a better showing; the MSCI Emerging Markets index was up 18% for the year.

We think it is worth noting that the rally at year-end was led by stocks we would characterize as low-quality or higher-risk. Specifically, the best performers were companies with weaker balance sheets, inconsistent earnings, smaller capitalizations and more sensitivity to market risk. Meanwhile, stronger companies or “blue chips” trailed. We find it interesting that just a short time after enduring a 58% decline in the market, investors appear to have shrugged off their fear and embraced risk with enthusiasm.

Bonds finished 2010 with very respectable numbers, but the table above hides the fact that the fourth quarter was not good for bonds, especially treasuries and municipal bonds. Intermediate treasuries lost about 3% during the quarter while intermediate municipals lost over 4%. There were several reasons for this. First, as we discussed last quarter, bond prices had become quite high as investors poured money into bonds throughout the first three quarters of the year. Arguably, they were due for a correction. In September, the Federal Reserve Bank formally announced that it would engage in another round of quantitative easing, basically printing money to buy treasury bonds in an effort to bid up bond prices and keep interest rates low. In our view, many investors saw these actions as inflationary and therefore demanded higher yields on treasuries, which resulted in lower prices.

Municipal bonds were affected by the phenomenon described above but they took an even bigger hit when Congress enacted legislation as part of the recently passed tax bill that effectively eliminates a Federal subsidy that has supported municipal bond issuance over the last two years. When municipalities realized

Market Index Total Returns for Periods Ending December 31, 2010				
Index	One Year	Three Years	Five Years	Ten Years
S&P 500 (US Large Cap)	15.1	-2.9	2.3	1.4
S&P 400 US (US Mid Cap)	26.6	3.5	5.7	7.2
Russell 2000 (US Small Cap)	26.9	2.2	4.5	6.3
MSCI EAFE (Foreign Equity)	7.8	-7.0	2.5	3.5
Barclays Aggregate Bond	6.5	5.9	5.8	5.8
Barclays Muni Bond	2.4	4.1	4.1	4.8

the subsidy would end on 12/31/2010, many rushed to issue debt before the deadline, effectively flooding the market with supply at a time when investor demand for municipal debt was actually drying up. We think we will see continued volatility in the bond market in 2011. This will result in part from aggressive and distortive action on the

part of the Fed as it attempts to manipulate interest rates to support economic growth. On the municipal front, we expect headline risk to have a big impact on bond prices in the coming months. It is no secret that municipalities across the nation are dealing with severe budget shortfalls and there will inevitably be defaults by some of the weakest of the thousands of municipalities in the US. Stories of municipal defaults will make for great headlines in the media and it will spook the bond market. While this will be a difficult period and while we do expect volatility for the reasons listed above, it is our expectation that most municipalities will not default and will instead make the cuts necessary to continue servicing their debt. In the interim, as a result of the sell-off in municipals, yields are significantly higher as shown in the nearby chart. We likely will be writing about this again in the near future.



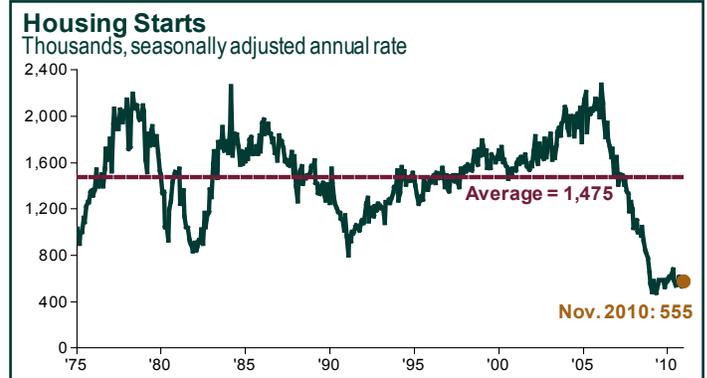
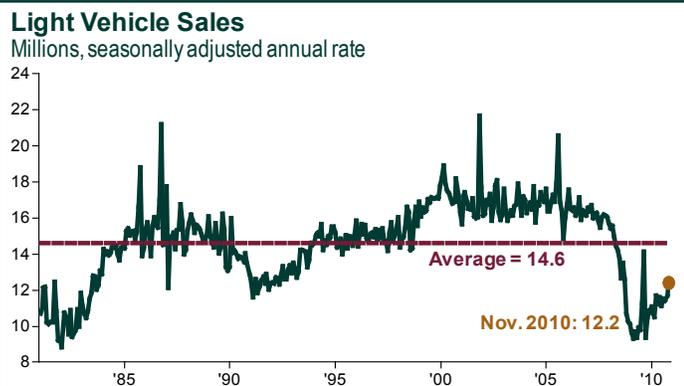
All charts compiled by JP Morgan and used with permission. S&P 500 source: Russell Investment Group, Standard and Poor's and FactSet. Ratio of Municipal Bond Yield source: Barclays Capital and U.S. Treasury. Light Vehicle Sales source: BEA and FactSet. Real Capital Goods Orders and Housing Starts sources: Census Bureau and FactSet. Total Private Payroll source: BLS. S&P 500 Earnings source: Standard & Poor's.

RECOVERY PICKING UP STEAM

Consumers came out in force in November and December and appear to have topped the Christmas spending record set in 2007. The nearby charts show that December auto sales were up 11% year over year and that capital goods orders continue to show strength. Jobless claims fell in December, and a payroll report issued this week indicates that the number of new jobs created last month greatly exceeded expectations.

As you can see in the chart on page 3, corporate earnings have soared and corporate balance sheets are in very good shape. Surveys of CEOs indicate that after two years of cutting expenses and piling up cash, many firms are planning for expansion.

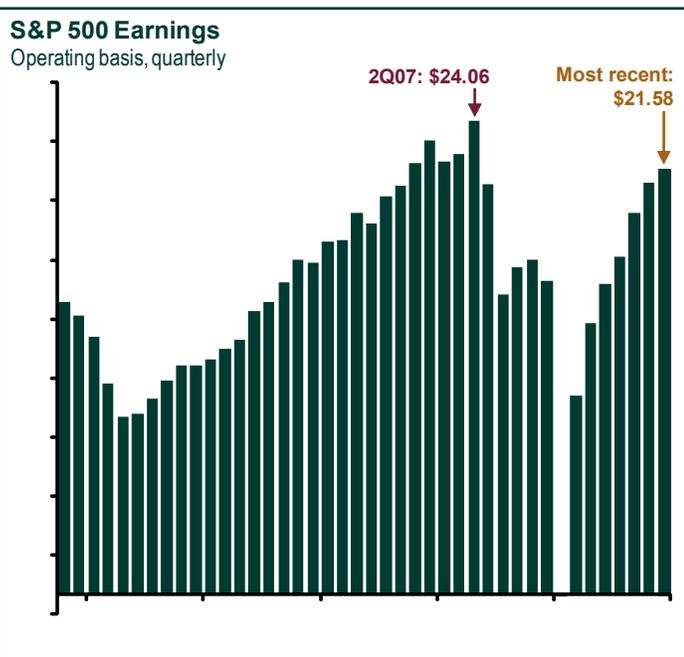
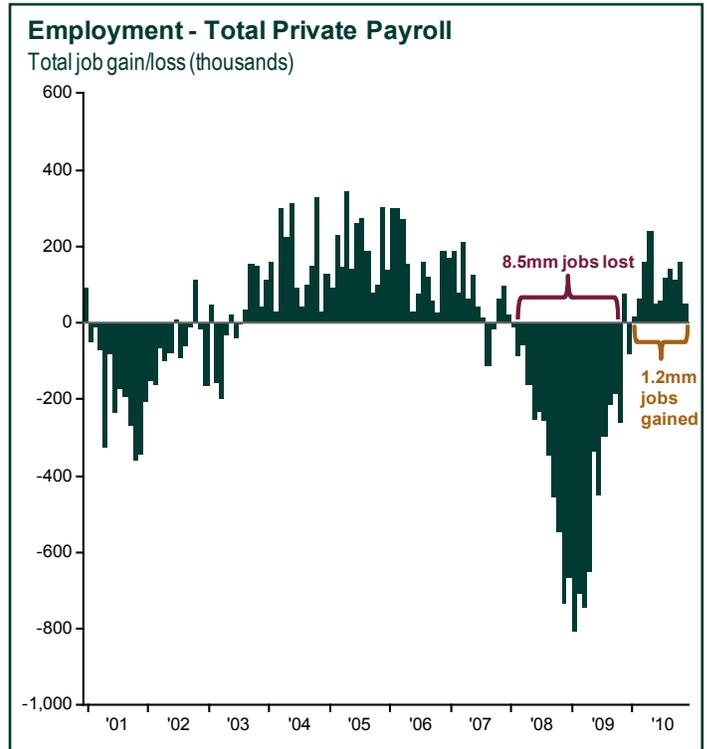
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As we have discussed previously, over 35% of the revenue of S&P 500 companies is generated outside the US and this number is expected to grow significantly as corporations look to the world's emerging economies for growth. For a few examples, consider that McDonalds plans to open 200 new restaurants in China this year, bringing their total there to 1,300. Only KFC, owned by YUM Brands, has more locations in China at 3,200. According to its annual report, Cincinnati-based Procter and Gamble's products are used by 4 billion people worldwide. A full 62% of the firm's revenues come from outside the US and half of that comes from emerging economies. The company has a goal of increasing sales in India and China to reach an additional one billion consumers by 2014.

So corporations are in good shape and that is one reason the stock market is up so much. Even though we have high unemployment and government debt concerns in the US,

This means investment in research, plant and equipment will follow and in many cases it means jobs will be created. To illustrate the significance this could have on employment, consider this example. According to a recent Wall Street Journal article, engine maker Cummins, Inc. is planning to add about 2,500 workers to its existing US work force of 14,800 in 2011. In contrast, Cummins only increased its workforce by 185 workers in 2010. Multiply this example by hundreds of companies and we could have a real expansion on our hands.



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Fatwood & Optimism *(Continued from page 1)*

was no doubt the forerunner of Bragg Financial Advisors as the children learned to settle their differences and work together.

But on this day, some 30 years after the success of “Bragg Brothers Enterprises” we received a healthy reminder that markets change. After three hours of peddling our lightwood the children had only sold six bags as most people would politely say they had gas logs or a built-in gas starter for their fireplace. Several folks told us they now sit on the couch and light their gas logs with a remote control device! I had certainly misread the market. The grandchildren and I had gone to a lot of work to cut, chop and prepare our product even as my grown children had warned me that real wood-burning fires were an anomaly. All was not lost, however, as the grandchildren still learned the value of work, the art of communication and the lesson of failure. It also gave John and me the opportunity to tell the children how much mankind has progressed in just the last 30 years and how they can look forward to exciting changes in their future.

I am optimistic that our lives will be better ten years from now. Mankind will continue to progress. The economic and market events of the last few years have been very difficult and today we face high unemployment, market uncertainty, terrorism, huge pension and medical obligations and massive government debt. There is no question that there will be tough times ahead as we deal with these challenges. But deal with them we will. We'll solve these problems and

we'll move forward. Just as the last hundred-year period brought more technological progress than the thousand-year period that preceded it, we are likely to see the fastest pace of change ever during the next ten years. We'll see advances in energy, healthcare, communications and media that are difficult to even imagine today. Most of these changes will be good for humanity.

While we are optimistic about the future, you have likely learned that all of us at Bragg Financial are also cautious, tempering our optimism with a healthy dose of realism. That remains the formula as we move forward into 2011. We hope to see you this year. And if you still enjoy a good old-fashioned wood fire as I do, stop by and we'll be pleased to give you a bag of the best natural heart pine “lightwood” that nature can offer.

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

Sincerely,



J. Frank Bragg, Jr.
Founder, Bragg Financial Advisors, Inc.

Thanks, Santa *(Continued from page 3)*

corporate earnings have shown great strength and in the long run, earnings drive stock prices.

Does this mean we can relax and laugh all the way to the bank? We think not. As we mentioned earlier, the market has had a huge run since its low in March 2009 and optimism abounds as investors pile into risky companies and show little regard for risk. We fully expect to see some bumps in the coming months. And while corporations are enjoying a tailwind from global growth, they are not immune to the challenges we face here in the US and abroad. As the nearby charts show, slow job creation is keeping the US unemployment

risk of inflation in our future as a result of the Fed's actions.

Outside our borders, the debt crisis in Europe is far from over and China is having to take steps to keep inflation at bay in its overheated economy. Longer-term, we face the reality that we will not be able to meet the obligations of our various governments. It is going to be a long difficult journey and it will have a significant impact on our financial lives. So while we are encouraged by the strengthening recovery, we remain realistic about the risks we face and we keep this in mind as we structure and manage your portfolio.

According to its annual report, Cincinnati based, Proctor and Gamble's products are used by 4 billion people worldwide. A full 62% of the firm's revenues come from outside the US and half of that comes from emerging economies.

rate stubbornly high at 9.8%. Housing remains very weak and government finances at the federal and state level are in bad shape. Government stimulus is running out and the risk of another round of economic weakness (deflation) still exists. Meanwhile, we share the worry of many regarding the

We hope this is helpful and we hope 2011 is a great year for you and your family.