Bragg Thoughts about the S&P Credit Downgrade and the Market
August 9, 2011

Rating agency Standard & Poor's (S&P) downgraded the credit rating of the US government last Friday. This news on top of poor economic reports over the last two weeks has roiled global stock markets. The S&P is down over 15% since June 30. The decline has been dramatic, with single-day drops of over five percent on two of the last three trading days.

Credit Downgrade Confirms What We Already Knew
While there will be some repercussions from the lowered credit rating, the event itself simply highlights something we have all known for a long time now. Our federal government is on an unsustainable financial path due to deficit spending. The debt ceiling agreement reached last week is but a small step in the direction of getting our fiscal house in order. As we have written on numerous occasions, our elected leaders face a significant challenge and the process ahead will be painful. Importantly, we can fix this problem and we are encouraged that the process for doing so has begun.

Economy is Driving the Market
While much attention has been centered on S&P's downgrade, we think the larger issue of economic growth is the primary driver of the market's recent plunge. On July 29, the government announced that the economy grew at a less-than-expected rate of 1.3% in the second quarter and first quarter growth was revised downward to a paltry 0.4% from 1.9%. On top of that, last week's ISM Manufacturing Report showed that manufacturing activity for July took a steep drop. The economy appears to be in a stall and the market is reacting negatively, fearing another recession. Add in the debt woes in Europe and a downgrade for the US and the backdrop for a market sell-off is complete.

How can the market fall 600 points in one day?
Prices are set at the margin. For example, IBM has 1.2 billion shares outstanding. On Monday, 15 million shares changed hands. The other 1.185 billion shares did not trade. You and I didn't sell our shares and neither did the folks who own almost 99% of the outstanding shares. But folks owning 1.3% of the shares were trading and they set the price. This is how the entire market is traded and priced. And unfortunately, we see the price changes in real time. Does that lower price mean we should unload our shares? "I'm getting a low-ball offer today so I'm selling." We think not. It was Warren Buffett who said, "Be fearful when others are greedy and greedy when others are fearful." Mr. Buffett's quote is famous because history has shown this to be good advice. However, most investors find this advice very hard to follow.

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Dealing With Fear - Confirm Liquidity First and Then Make Good Long-Term Investments
Amid falling stock prices and terrible headlines, it is tempting to take action. We think it makes sense to set aside your emotions to think about your financial planning first. Specifically, ask yourself the following question: "If the market falls further, am I going to be okay financially or will I find myself in the position of having to sell stocks or real estate when they are down?" For those who are employed, confirming liquidity means being confident that your income from your job is secure. For those who are retired or nearing retirement, confirming liquidity means knowing that you have ample liquidity in bonds or cash equivalents to support your spending needs for many years. Specifically, we think folks in retirement should have at least five years worth of their annual spending requirement in bonds or cash equivalents. This liquidity lets you ride through the difficult times without selling stocks when they are down.

Once you are confident in your liquidity, we think it makes sense to invest your long-term capital in "ownership" assets. That means owning real estate (your home in most cases) and it means owning stocks. When we own a diversified portfolio of stocks, we own small pieces of actual companies that employ people who go to work every day to make money, to grow revenues, to grow profits...in short, to make progress. Today the yield on a ten-year US Treasury bond is 2.34%. Meanwhile, many US blue-chip companies are paying dividends of 2% or more and are trading at or below their long-term averages on the basis of price-to-earnings ratios or other valuation measures. These stocks could certainly trade at even lower prices in the days, weeks or months ahead but we would prefer stocks to bonds for our long-term money.

A Philosophy We Think Will Work
Is there an alternative to this emotional roller coaster? Is there another investing philosophy we could embrace that would generate reasonable returns and remove the emotion? You probably ask yourself questions like this during times of market stress. We do too. Back in 2008 and early 2009 as stocks fell more than 50% and the financial system was on the verge of total collapse, we asked ourselves these very questions. And because we are an independent firm, we have the ability to change the way we manage portfolios. There are many alternative approaches available to us. We could short the market, time the market, rotate among sectors, concentrate your money in just a few of our "best ideas," and the list goes on. Any one of these approaches might work but we think the likelihood of these approaches working consistently is quite low. The bets are too big and the one time we got it wrong could wreck your portfolio and our relationship with you. Time and again we have concluded that the process we use for managing your money has the greatest likelihood of working for you in the long term. If you would like to discuss your portfolio or your planning, please let us know.

A number of you have called over the past few days, some of you to buy stocks and some of you to let us know that you are worried. We can appreciate the sentiment behind both of those calls. Dad has always said that we get paid to worry so our clients don't have to, and he's right. Please know that we remain confident that we'll get through these difficult times.

We hope this is helpful. Thank you for choosing us for your financial planning and investing and do let us know if you would like to discuss your portfolio.

Sincerely,

Benton S. Bragg

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