Investment Commentary

3rd Quarter 2011

Bragg Building
1031 South Caldwell Street, Charlotte

INSIDE THIS ISSUE

QUARTERLY LETTER
Getting Down the River

MARKET UPDATE
Volatility Creates Opportunity

ECONOMIC UPDATE
Bogged Down

One look across the pond at Greece makes it clear that we must go through this painful process. It will get ugly at times. The labor union strikes, the Occupy Wall Street rallies, the political finger-pointing and the name-calling have just begun. We'll get through this but it will be a wild and often unpleasant journey. Buckle up!

GETTING DOWN THE RIVER

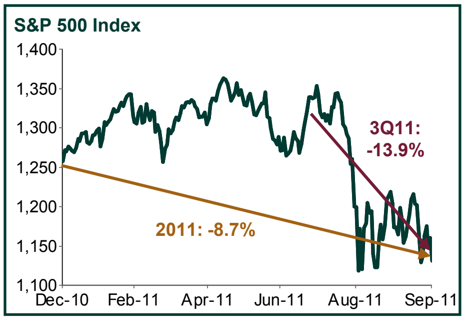
The French Broad River flows Northeast from Transylvania County, North Carolina, through Asheville and into Tennessee. It joins the Holston River in Knoxville to form the Tennessee River. It is big, beautiful water. Early last month, sixty boys and adult leaders from Boy Scout Troop 58 of Davidson headed west to float the river. My brother, John Bragg, Scoutmaster and trip organizer, was operating on all cylinders as we prepared to pull out of Davidson and get on the road. He was dealing with nervous parents, permission forms, equipment, vehicle logistics, lunch plans, maps, late arrivals and of course, fifty rowdy young boys. Somehow, by 7:00 a.m., all was in order and we were on the road.

Three hours later, all sixty of us were crammed in two old school buses retrofitted to carry several massive rafts on top. As we bounced down a steep, narrow, gravel mountain road grasping our paddles, helmets and life jackets, the bus driver told us to be quiet so he could go over the rules and safety instructions. I settled in for a long lecture about keeping fifty children safe on a fast-flowing, whitewater river. Incredibly there were only three rules. First, paddle when your guide tells you to paddle. Second, when you fall out, float on your back with your feet downstream and third, don't try to swim upstream. I overheard one of the dads say, "Is that it? No other guidance?" "Nope, that'll do it," said our driver. "The boys will use their common sense and instinct

(Continued on page 4)

VOLATILITY CREATES OPPORTUNITY

Stocks had a dismal third quarter. The European debt crisis, the debt limit debacle in Washington, the downgrade of US government debt by Standard & Poors and negative economic reports combined to drive stocks to a new low for the year. The S&P 500 index was down 14% for the quarter. As the table on the next page shows, the returns of mid cap, small cap and foreign stocks were even worse. Year to date through 9/30, the S&P is down 8.7%.



The banking sector has been the worst performing sector this year as investors worry that the sovereign debt crisis in Europe will spill over into the financial system. Cyclical sectors like commodities, energy and industrials have also lagged this year as investors

(Continued on p. 2)

BRAGG
Financial Advisors
1031 South Caldwell Street, Suite 200 • Charlotte, North Carolina 28203 • (704) 377-0261 • Fax (704) 334-9754

Volatility Creates Opportunity *(Continued from page 1)*

Market Index Total Returns for Periods Ending September 30, 2011

Index	3rd Qtr 2011	YTD 9/30/11	One Year	Three Years	Five Years	Ten Years
S&P 500 (US Large Cap)	-13.9	-8.7	1.1	1.2	-1.2	2.8
S&P 400 US (US Mid Cap)	-19.9	-13.0	-1.3	4.1	2.2	7.5
Russell 2000 (US Small Cap)	-21.9	-17.0	-3.5	-0.4	-1.0	6.1
MSCI EAFE (Foreign Equity)	-19.0	-15.0	-9.4	-1.1	-3.5	5.0
Barclays Aggregate Bond	3.8	6.7	5.3	8.0	6.5	5.7
Barclays Muni Bond	3.8	8.4	3.9	8.1	5.0	5.1

worry about the higher probability of another recession.

Volatility has been extremely high. During the sixty-four trading days of the third quarter, the Dow had thirty-four daily price moves of more than 1%. There were sixteen moves of more than 2% and eight moves of more than 3%. While volatility like this is not unprecedented, it is pretty rare and for all of us it has been unsettling to say the least.

Some investors, frustrated and weary of the crazy swings in the market, have given up on stocks. Outflows from equity mutual funds have reached very high levels in recent weeks. This has of course created downward pressure on stock prices and it has, in our opinion, created opportunities to buy shares of great companies at reasonable prices. Take a look at the table below which shows the level and valuation (price to earnings ratio) of the S&P 500 at the high in 2000, the high in 2007 and today. Back in 2000, no one was frustrated with the market; everyone was racing

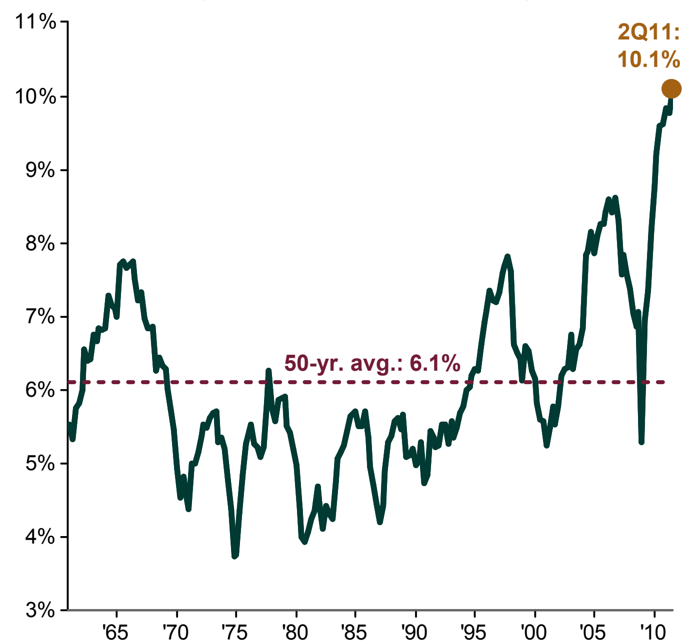
S&P 500 Index

Characteristic	March 2000		Oct. 2007		Sept. 2011
Index level	1,527	→	1,565	→	1,131
P/E ratio (fwd)	25.6x	→	15.2x	→	10.6x
Dividend yield	1.1%	→	1.8%	→	2.3%
10-yr. Treasury	6.2%	→	4.7%	→	1.9%

to buy stocks, especially technology stocks. Remember the "irrational exuberance" of the late nineties? In 2000, if you joined the crowd, you bought stocks at very high prices relative to today's prices. Those selling stocks today are selling at significantly lower valuations. At first glance, the table above makes stocks look very cheap based on a price to expected earnings of 10.6. We think it is important to note that profit margins for US corporations are extremely high right now as shown in the chart to the right. Profit margins have proven to be a mean-reverting measure and therefore while valuations are reasonable, they are not yet in the "pound-the-table" bargain range.

This brings us to bonds. Most folks rushing from stocks today are investing in cash and bonds. As you know, yields on money market accounts and other cash equivalents are just above zero. As I type, the yield on a ten-year treasury bond is under 2%. High-grade corporate bonds and municipal bonds yield more than treasuries but not significantly more. Suffice it to say, yields are extremely low. And yet, we can all agree that earning 2% or even earning zero looks quite good if the alternative is potentially losing money in the stock market. And that is why we own low-yielding bonds for the money we will need in the next five years. For longer-term money, however, we think a compelling case can be made that stocks at today's valuations will be a much better investment than bonds or cash. We think it will take patience and fortitude to reap the rewards of stock ownership. Prices may sink lower from here.

Adjusted After-Tax Corporate Profits (% of GDP)
Includes inventory and capital consumption adjustments



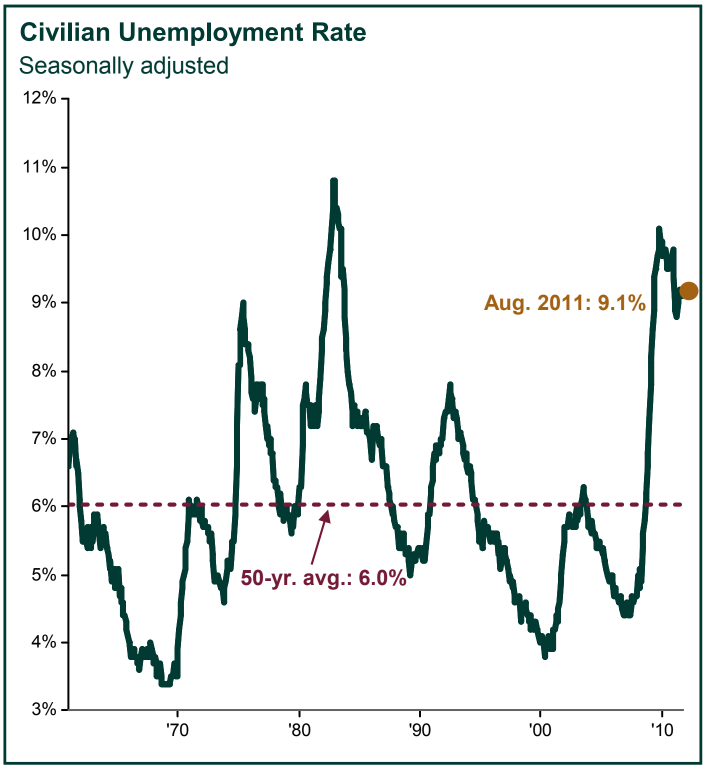
All charts compiled by JP Morgan and used with permission. S&P 500 Index source (p. 1): Russell Investment Group, Standard & Poor's, FactSet. S&P 500 Index Characteristics source (p. 2): Standard & Poor's, First Call, Compustat, FactSet. Adjusted After-Tax Corporate Profits source (p. 2): BEA, FactSet. Civilian Unemployment Rate (p. 3): BLS, FactSet. Components of GDP (p. 3): BEA, FactSet. Personal Savings (p. 3): BEA, FRB. Personal savings rate is calculated as personal savings (after-tax income--personal outlays) divided by after-tax income. Employer and employee contributions to retirement funds are included in after-tax income but not in personal outlays, and thus are implicitly included in personal savings.

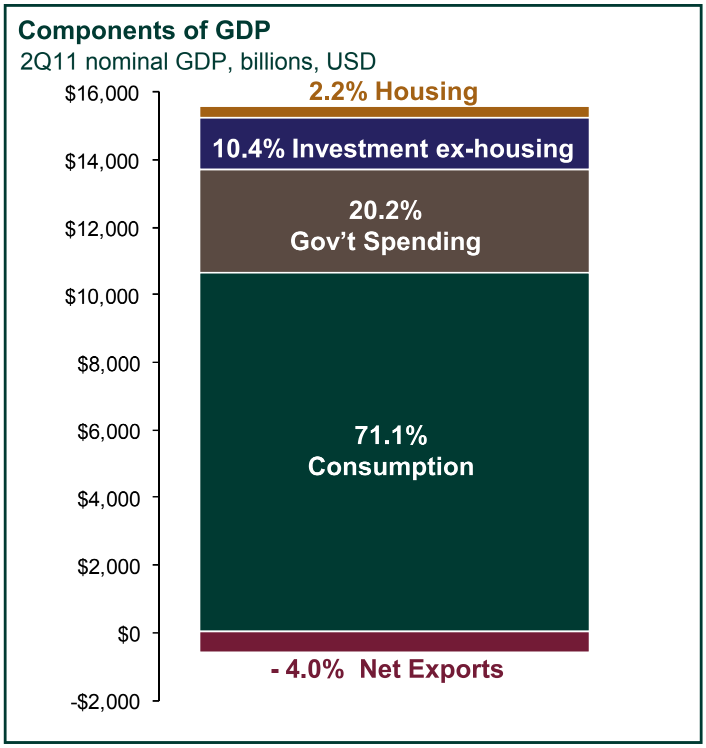
Volatility Creates Opportunity *(Continued from page 2)*

As we have discussed in the past, it almost always takes longer than we would think (or hope) to work completely through market and economic cycles. And history shows that investor sentiment drives prices to extreme highs and extreme lows. Times of extremely high prices create euphoric emotions and times of extremely low prices create gloom, frustration and despair. During times of maximum gloom and despair, it is hard to get excited about buying or owning stocks, but history has shown that this is precisely when our best investments are made.

BOGGED DOWN

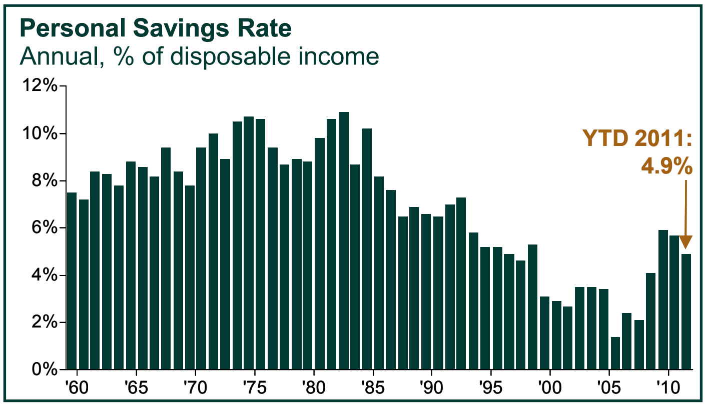
An already slow economic recovery seemed to stall in the third quarter. The Bureau of Economic Analysis announced during the quarter that the economy grew at a rate of 1.3% during the second quarter. This was better than the 0.4% rate of growth of the first quarter but it is a far cry from the type of growth needed to foster job creation, as evidenced by the September Employment Report from the Bureau of Labor Statistics. The report showed that zero net jobs were created during the month of August and the unemployment rate remained at 9.1% (see chart below).
In addition, the report revised downward the net new jobs for the months of June and July. Also, according to the report which you can find at www.bls.gov, 153 million people are currently in the labor force and 14 million of them are unemployed. Another 9 million workers are working part-time, involuntarily (underemployed). With this many workers unemployed or underemployed, you can see why economic growth has been anemic. As the nearby chart shows, consumption represents over 70% of our economic output and people don't consume much when they are not employed.





Another drag on consumption is the fact that the personal savings rate has risen substantially, as shown in the chart below. While paying off debt and saving money is obviously a step in the right direction for a specific individual or family, this responsible behavior is actually a drag on the economy.

Consumers aren't the only ones hunkered down. As we have discussed before, corporate balance sheets are in great shape as companies have cut expenses and piled up cash. So we have a crisis of confidence with both consumers and companies paying down debt and building reserves. Expenditures by consumers are being deferred as are investing and hiring by companies. Government has joined



Bogged Down *(Continued on page 4)*

Getting Down the River *(Continued from page 1)*

for survival and it'll all work out."

Just minutes later, ten rafts packed full of wide-eyed boys and dads were plunging through the rapids of the French Broad River. We were shivering, screaming and laughing as the water tossed us around like little twigs. The calm sections invited horseplay and at times the splash-fights were as drenching as the Class Five rapids. But the calm sections gave way to the dangerous sections. With adrenaline pumping, we navigated tight chutes, huge drops and massive hydraulics that made us focus on the barked orders of our guide, "Right paddle! Back paddle! All paddle, HARD!" Many of us ended up in the river that day and often that meant a wild, bumpy ride through the whitewater until the raft caught up to drag us back in the boat.

We survived. All sixty of us crawled into our sleeping bags that night, exhausted but very happy. No one drowned, no one went missing, indeed we had not even a scratch. The worst we dealt with the entire weekend was a little bit of homesickness from some of the younger scouts.

It turns out that the bus driver was right when he told the nervous dad, "The boys will use their common sense and survival instinct and it'll all work out." His knowledge about getting fifty boys down a river could be applied to our economy and our markets today. Our economy and our markets work amazingly well when rules and regulations are straightforward and government involvement is efficient, effective and minimal. This requires a deliberate balance and at times we get out of balance. The fact that our financial institutions were allowed to become extremely over-leveraged back in 2006 and 2007 is a great example of ineffective regulation.

Today's imbalance is more general. Government's role has gradually expanded over the years and we now find ourselves looking to the government to solve our problems. With regard to the debt crisis in the EU, the world is waiting on the government to find a solution. In the US, economic growth is restrained by our public sector that has grown too much, too fast. That the world economy was held hostage by the debt limit circus created by our government officials this summer is a great indication of our imbalance. Investors are waiting on the Federal Reserve to "save" the markets with monetary policy and many apparently believe it is government's job to reduce unemployment. In reality, the government can't get us safely down the river; that is our job. The government can and should deliver a credible plan for reducing the deficit and the debt. The government can and should provide certainty about tax policy and regulations. The government can and should create an environment that is conducive to job creation and growth. Once these things are in place, hardworking individuals and businesses have the incentive and the survival instinct that ultimately will move us forward and create economic growth.

We don't expect politicians to make much progress on these tough decisions in the near term since 2012 is an election year. More "can kicking" is likely and we think it makes sense to be prepared for more muddle-through on economic growth and yes, volatility in the stock market. In the long run, however, we have confidence in our economic model and the survival instinct and common sense of the American people. We'll make it down the river!

IN BRAGG FINANCIAL NEWS

Queens Road Small Cap Value Fund was named a "Category King" by the Wall Street Journal on October 4th in its quarterly listing of the best performing funds by category. We are proud of Steve Scruggs, Head of Research at Bragg and Portfolio Manager of the fund.

Phillips Bragg will be named an Outstanding Emerging Philanthropist by the Charlotte Chapter of the Association of Fundraising Professionals at their 20th Annual National Philanthropy Day luncheon on November 9, 2011. Phillips is being recognized for his work in building permanent primary schools in South Sudan.

Thank you for choosing Bragg to help you with your financial planning and investing. Please let us know when you would like to visit and review your accounts.

Sincerely,

Benton S. Bragg

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

Bogged Down *(Continued from page 3)*

the party as well. Most of the jobs lost over the last few months have been at the state and local level as states and municipalities have tightened their belts in order to balance their budgets.

Some have referred to this phenomenon as the "Great De-leveraging" or "The New Normal." One look across the pond at Greece makes it clear that we must go through this painful process. It will get ugly at times. The labor union strikes, the Occupy Wall Street rallies, the political finger-pointing and the name-calling have just begun. We'll get through this but it will be a wild and often unpleasant journey. Buckle up!