Investment Commentary

1st Quarter 2012

Bragg Building
1031 South Caldwell Street, Charlotte

"Indeed, we think the discipline that we bring to your portfolio, with rebalancing, with diversification and with keeping emotions out of the process, is the single most important thing we do at Bragg to earn the fee you pay us each year."

BILLY GOAT BLUES

Life on the farm got a little more exciting over the last 12 months as we significantly expanded our barnyard herd. Daughter, Frances (8), received three goats for her birthday and son, Carlton (10), became the proud owner of three pot-bellied pigs. Add in our two miniature donkeys and eight chickens and suddenly there is a lot going on. Alice, of course, thinks I'm crazy, and she is probably right.

Fudge, one of Frances's goats, almost pushed me to the edge in December. To prepare for the arrival of the pigs, I built a 30' by 40' pen within our existing paddock where the goats and donkeys live. This pen was to separate the pigs from the goats and the donkeys, primarily for feeding and safety purposes. The walls of the new pig pen were only about thirty inches high and Fudge soon discovered that he could easily leap into the pig pen. This he did each time Carlton fed his pigs. Carlton would come back to the house complaining that Fudge was eating all the pigs' food. I taught him how to chase Fudge out of there with a stick, but I realized that he would be late for school if he had to stand guard in the pig pen every morning while Rosebud, Sweet Tea and Little Blaze finished their morning meal. So the children and I spent the better part of a Saturday afternoon pounding in new fence posts and stretching three strands of wire above the pig pen walls in order to keep the darn goat out.

With perfect timing, my father stopped by just as I finished the job and was

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GREAT EXPECTATIONS

Stocks are up almost 30% since the low of last October. The last three months were the best first quarter for the market in fourteen years. US large company stocks as measured by the S&P 500 were up over 12% for the period. The table on the next page shows the returns for various market segments; stocks did well across the board in the first quarter and, indeed, for the last three years as the market regained ground lost during the 55% decline that bottomed in March of 2009. As shown in the charts below, including dividends, the S&P is now

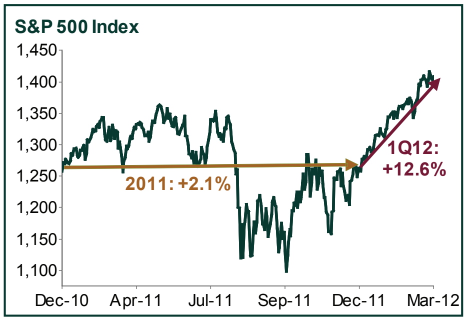

Chart lines reflect index price change only while returns and annotations reflect total return (including dividends). Compiled by JP Morgan and used with permission. Source: Russell Investment Group, Standard & Poor's, FactSet, J.P. Morgan Asset Management

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Great Expectations *(Continued from page 1)*

up 112% since the low of 2009 and again, including dividends, it has recovered almost all that was lost during the decline that began in October of 2007. The last six months have been quite remarkable. The negative headlines of last September seem quite distant now, don't they? Back in September, Europe was in crisis (again), Standard & Poors had just downgraded US government debt and many were talking about another recession. The market had swooned some 20% from its recent April high. So what happened to cause the blockbuster rally?

Market Index Total Returns for Periods Ending March 31, 2012

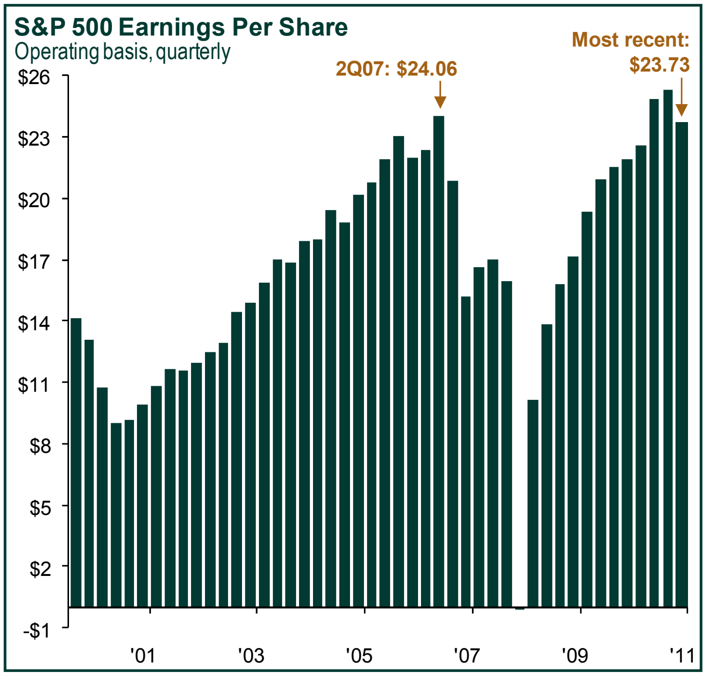
Index	1st Qtr 2012	One Year	Three Years	Five Years	Ten Years
S&P 500 (US Large Cap)	12.6	8.5	23.4	2.0	4.1
S&P 400 US (US Mid Cap)	13.5	2.0	28.5	4.8	7.7
Russell 2000 (US Small Cap)	12.4	-0.2	26.9	2.1	6.4
MSCI EAFE (Foreign Equity)	10.9	-5.8	17.1	-3.5	5.7
Barclays Aggregate Bond	0.3	7.7	6.8	6.2	5.8
Barclays Muni Bond	1.8	12.1	7.7	5.4	5.5

Three, Five and Ten-Year Returns are annualized

The short answer is: not a lot. Perhaps more important is what did not happen. US Treasuries didn't tank. The S&P downgrade had no negative impact on Treasury bond prices; they actually rose after the announcement. Europe did not implode. Heads of state in Europe addressed the debt crisis there by releasing a statement that, in our view, was long on generalities about "solidarity" and short on concrete details that actually address their debt imbalances. Nonetheless, investors seemed to be satisfied enough with this "solution" to turn their attention to US economic news. The US economy did not go into recession. Economic news was generally positive during the fourth quarter of 2011 and the first quarter of 2012 and investors seemed to gain confidence that the economy is expanding, albeit slowly.

As the market is a forward-looking indicator, we can surmise that investors have great expectations for continued positive economic news in the coming months and, even more important, for continued strong earnings from corporations. We face headwinds for sure, including potential contagion from Europe, a major slowdown in China, generally lackluster growth in our own economy, rising energy prices and the ever-present burden of debt that we have written about previously. At the same time, as mentioned, economic measures including employment reports, capital goods orders, vehicle sales, housing starts, household debt ratios, inflation and interest rates have continued to show modest improvement.

While any and all of these variables affect short-term market movements, in the long term, earnings drive the market. As we have discussed over the last few quarters and as shown in the chart of S&P 500 operating earnings (below left), corporate earnings have been very strong. But



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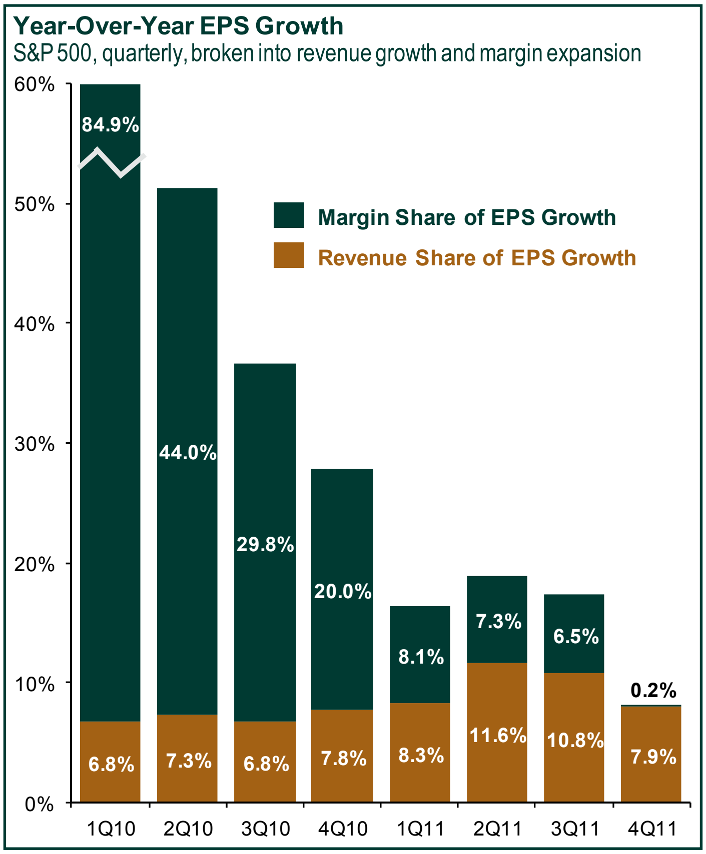

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Great Expectations *(Continued from page 2)*

while earnings have grown significantly, a great percentage of that growth has been fueled by profit margin growth. After massive layoffs and expense reductions, companies are simply extremely profitable today. The chart of year-over-year earnings per share growth (page 2, bottom right) illustrates that not only has earnings growth slowed in recent quarters, but the percentage of that growth attributable to margin expansion has plummeted. As profit margins can't expand indefinitely, future earnings growth will primarily be driven by revenue growth and this is a tall order in this sluggish economy. We are not suggesting that companies can't continue to grow their earnings or that stock prices can't advance from these levels. We are suggesting that in light of slowing earnings growth and a market gain of over 100% over the last three years, we think the "easy money" has been made. Tempering our expectations is very much in order.

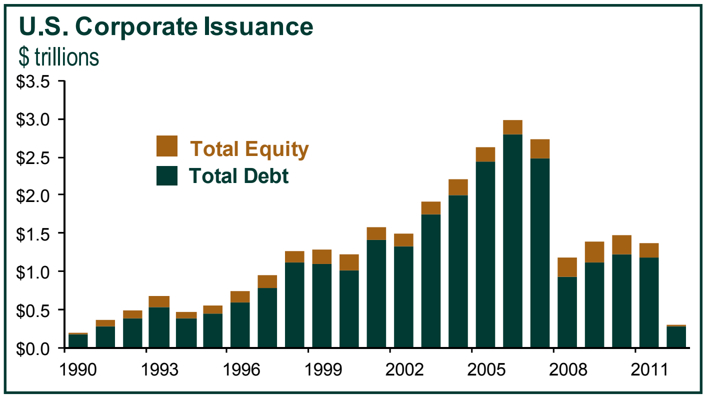
This brings us to bonds, which have done incredibly well. As the Market Index Total Returns table (page 2, top) shows, we have made great money in bonds over the last one, three, five and ten years as interest rates have gradually fallen to historic lows. Recall that bond values rise when interest rates fall. Rising bond prices have been driven by numerous factors. First, demand for bonds has been great and this has pushed prices up. Greater demand has come from investors seeking higher-yielding alternatives to money market funds or less-risky alternatives to the stock market. The Federal Reserve has also been a huge buyer of bonds through Quantitative Easing and now Operation Twist, both efforts to keep interest rates low. A second driver of high bond prices has been limited supply. Fewer bonds have been issued. This has especially been the case with corporate bonds since the beginning of the financial crisis and more recently with municipal bonds, as shown in the charts below. When demand exceeds supply, prices rise. That has certainly been the case lately; much of our return in bonds over the last few years has been driven by capital gains or price increases as opposed to interest payments. Bonds today yield very little and the potential for further price increases is limited by this very fact. We have low expectations for bonds going forward, yet bonds remain a tremendously important part of our diversified portfolio. Money that we may need in the next five years should be in relatively stable instruments.

TIME TO REBALANCE

We are rebalancing accounts. After the run-up in stock prices, your portfolio is likely to be slightly overweight in equities and underweight in bonds, relative to the target allocation called for in your written investment plan. Additionally, most portfolios are slightly underweight in foreign stocks relative to US stocks as a result of the better relative performance of US markets over the last twelve months. It is worth pointing out that while the US market was up 8.5% over the last 12 months, foreign developed markets were down 5.8%, and emerging markets as measured by the MSCI BRIC Index (Brazil, Russia, India, China) were down 15%. Finally, within industry sectors (technology, health care, energy, utilities, etc.), we are trimming those that are overweight relative to target and adding to those that have become underweight relative to target.

Rebalancing forces us to do something that typically is at odds with human nature. It forces us to trim our winners and add to our losers. It requires that we sell what has done well to buy what has done poorly. While "sell high and buy low" is the oldest rule in investing, most investors find this to be a tough discipline to live by when managing their own money. Nobody likes selling winners and buying losers. History shows that most investors do the opposite, chasing "what was hot" last year. Warren Buffett calls it "rear-view mirror investing." Fortunately you have Bragg to enforce this discipline on your portfolio. Indeed, we think the discipline that we bring to your portfolio, with rebalancing, with diversification and with keeping emotions out of the process, is the single most important thing we do at Bragg to earn the fee you pay us each year.

Please let us know if you have questions about our portfolio management process or the investment plan that governs your accounts.



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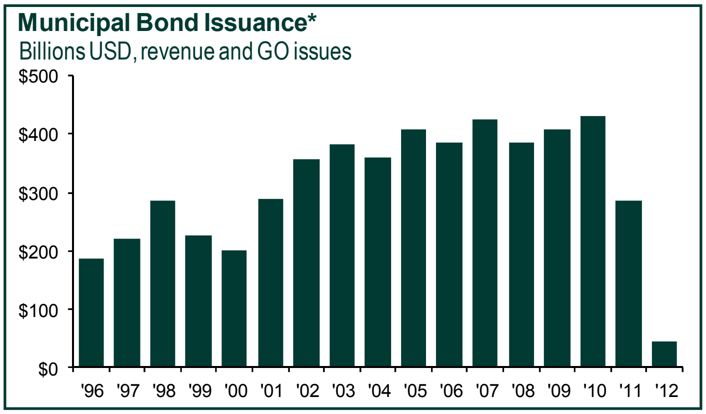

**Excludes maturities of 13 months or less and private placements. 2012 issuance data is as of February 2012. Compiled by JP Morgan and used with permission. Source: SIFMA, J.P. Morgan Asset Management*

Billy Goat Blues *(Continued from page 1)*

putting the tools away. Noticing that I appeared exhausted, he said, "You should have asked me to help you with this project; it looks pretty darn sloppy." Not wanting to admit that it did look quite sloppy, I started to point out that it really didn't matter how it looked as it was a pig pen, for Pete's sake. But I didn't get a chance to answer him because right then, Fudge walked up to the newly reinforced pen and effortlessly jumped over the now four-foot-high fence and began eating the food Carlton had just put out for the pigs. You'll have to imagine what came out of my mouth next because I can't print it. And yes, Dad had a great laugh and I did too once I calmed down.

And that was just the beginning. Fudge suddenly realized that he had serious athletic ability. As they say on the basketball court, "the dude has hops!" He promptly jumped the four-and-a-half-foot fence that enclosed the goats and donkeys and was free in our backyard. First stop, my just-planted rose bushes; he ate twelve of them down to the nubs. Then he found Alice's pansies. Gone. The next day as we ate breakfast he came up on our back patio, jumped up on his hind legs and started banging his head against the picture window, presumably wanting to come in for a bowl of cereal. I got a call from Alice that same day as I drove to work and she said, "Fudge is trying to get in the car with the children to go to school." Needless to say, we all learned how to "yell in a mean voice" and chase Fudge with a stick until he jumped back into the paddock.

While this was creating some great stories that the kids could write about in school, I was actually at a loss for what to do. I tried tying him to a cinder block with a length of rope to slow him down some but I gave up on that when he refused to move at all for several hours. I'd feel awful if he died from thirst. I figured I could put up a strand of electric fence but I hated to spend more time and labor on this crazy goat. There is a limit, right? Besides, I didn't want little Charlie (4) to get shocked by an electric fence. I knew that when I planted the spring garden, Fudge would eat all the lettuce, broccoli and kale as soon as I got it in the ground. I had to have a solution before then. So I called Kelly Foster, the woman who sold us the goat, and asked her for ideas. She said, "I'll pick him up tomorrow after lunch if that works for you." I said, "That's it? You'll take him back? It's over?" She said, "Yep, problem solved." When I got home from work the next day, the goat was gone. Frances cried herself to sleep each night for the next three days but I was a very happy man.

Fudge and his exploits are analogous to the debt burden weighing down the economies of the US and other developed countries. Like my varied and fruitless efforts to keep Fudge in his place, policy makers around the globe have struggled to contain the crisis of too much debt. We've witnessed bailouts, bankruptcies, government takeovers, massive stimulus, austerity measures, partial defaults, Quantitative Easing I and II and even "Operation Twist." Despite these responses, we still find ourselves in a deep hole with regard to our debt and deficit spending. It is worrisome but we think the problem is solvable. It won't be as easy or quick as calling "Kelly the goat lady" but with time, spending restraint and policies that encourage economic growth, we can grow our way out of this problem.

Unfortunately, when an economy, a corporation or even a household has too much leverage, it results in a much more fragile state of existence. External shocks, such as spiking energy prices, a natural disaster, war, terrorist activities or economic events around the globe (a recession in China, for example, or further fallout in Europe) can more easily derail an economic expansion. In general, there is a higher level of uncertainty, the recent market rally notwithstanding. This will continue to bring volatility to our portfolios. We remain cognizant of this and are managing accounts accordingly.

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.