Investment Commentary

2nd Quarter 2012

Bragg Building
1031 South Caldwell Street, Charlotte

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"In 2007, five years ago today... most people said there is nothing to worry about; I can't think of a way to lose money. Terribly frightening. Today, most people say they can't think of a way to make money. They can't get over this litany of macro uncertainties out there. And for those of us who look for values, that's bullish."

- Howard Marks, Value Investor

LESSONS FROM LANCE ARMSTRONG

Watching the Tour de France has always been a highlight of my summer. My family has come to expect that the TV will be on for several hours a day during the month of July and that Daddy will be staying up late to watch the Tour. Otherwise, the TV is rarely on in our house (especially since I cancelled the satellite TV...without consulting Alice...but that is a story for another day).

I was never a serious cyclist but I've ridden on and off for the last 25 years so I have a great appreciation for the challenge presented by this century-old race. Over a twenty-day period, approximately twenty teams of eight cyclists each will ride two thousand miles through France and nearby countries. Have you ever ridden 110 miles on your bike? These guys do it every day for three weeks. And on some of those days they climb mountain peaks in the Alps and Pyrenees mountains, gaining as much as 8,000 feet of elevation in one day (Up 30,000 feet and down 22,000 feet for a net gain of 8,000 feet). Grueling! In addition to the competition, the TV coverage by helicopter and motorcycle captures spectacular shots of both the cyclists and the French countryside.

Seven-time tour winner Lance Armstrong has always been a hero to me. Overcoming cancer and then winning a record seven consecutive Tour titles is simply a remarkable feat.

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SECOND QUARTER BREATHER

Stocks had a rough second quarter. US large company stocks as measured by the S&P 500 lost 2.8% for the period while most other stock categories did worse. Foreign stocks posted the biggest decline, dropping 7.1% while small and medium-sized companies lost 3.5% and 4.9% respectively. The quarter was quite volatile; at one point the S&P 500 was down almost 10% from the highs of the first quarter. It's not a huge surprise to see the market take a breather after its steady advance

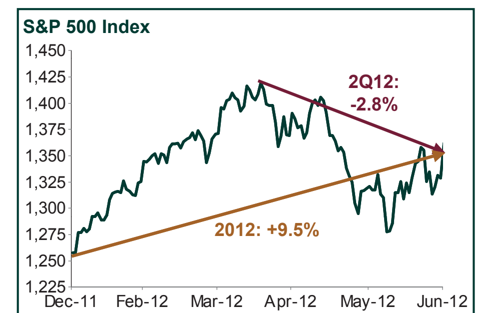

Chart lines reflect index price change only while returns and annotations reflect total return (including dividends). Compiled by JP Morgan and used with permission. Source: Russell Investment Group, Standard & Poor's, FactSet, J.P. Morgan Asset Management

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Second Quarter Breather *(Continued from page 1)*

Market Index Returns for Periods ending June 30, 2012						
Index	2nd Qtr 2012	YTD 2012	One Year	Three Years	Five Years	Ten Years
S&P 500 (US Large Cap)	-2.8	9.5	5.5	16.4	0.2	5.3
S&P 400 US (US Mid Cap)	-4.9	7.9	-2.3	19.4	2.6	8.2
Russell 2000 (US Small Cap)	-3.5	8.5	-2.1	17.8	0.5	7.0
MSCI EAFE (Foreign Equity)	-7.1	3.0	-13.8	6.0	-6.1	5.1
Barclays Aggregate Bond	2.1	2.4	7.5	6.9	6.8	5.6
Barclays Muni Bond	1.9	3.7	9.9	7.6	6.0	5.3

Three, Five and Ten-Year Returns are annualized

of nearly 30% since October of last year. Looking back a bit further, the market has risen more than 100% since the lows of March 2009 but it certainly hasn't been a smooth ride. Measures of volatility have been extremely high and we've endured several 10% corrections and two drops of more than 15%.

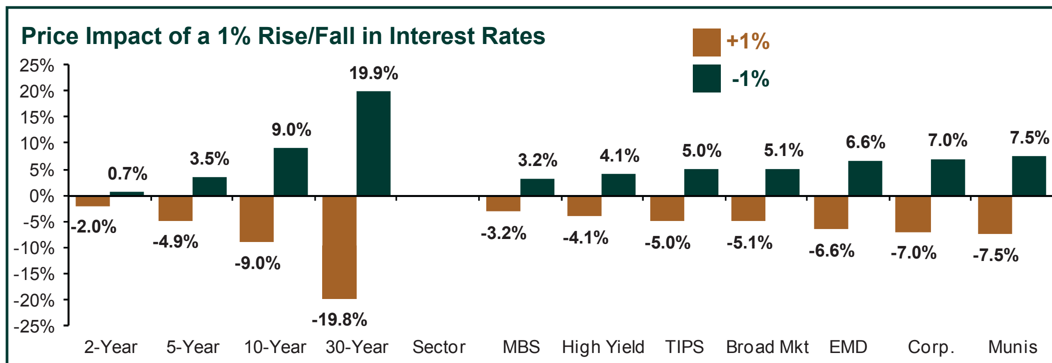
Chief among the market worries in the second quarter was once again the debt crisis in Europe. The continued deterioration of the economies and balance sheets of the southern European countries including Greece, Spain and Italy spooked investors once again, leading to a dash for the exits from most riskier assets. In addition to the situation in Europe, investors worried about the potential for a sharp economic slowdown in China that could potentially disrupt an already fragile global recovery. Finally, in the US, economic reports on jobs, housing, retail sales, manufacturing and consumer confidence were weaker than expected during the quarter. As we have discussed recently, the combination of excessive debt burdens in developed countries and sluggish growth in the global economy has resulted in a fragile state for securities markets around the world. We don't expect this to change in the near future.

Bonds had a great second quarter as interest rates fell even further. The Fed, reacting to weak economic reports, announced that it was extending "Operation Twist" (selling short-maturity debt and using the proceeds to buy longer-maturity debt) in an effort to keep longer-term interest rates low. The Fed's efforts, combined with a general flight to the perceived safety of US Treasuries from riskier assets like stocks and commodities, drove bond prices up and yields down. During the quarter the yield on ten-year Treasuries briefly dipped as low as 1.45% *for the first time ever*, before finishing the quarter at 1.65%. Treasuries weren't alone. Prices on municipal bonds and high quality corporate bonds also rose during the quarter as yields sank to historic lows.

The chart at the bottom of the page illustrates the impact of interest rate changes on bond prices. While bonds are considered "safe" instruments, the chart makes it clear that longer-maturity bonds will suffer significant price declines should interest rates rise in the future. In an effort to hedge against this risk, we have reduced the average maturity in our bond portfolio. When we shorten the maturity, we give up some yield (accept lower returns) and this has hurt us as rates have stayed low or fallen. But we think this shorter maturity will protect us if rates rise in the future.

THAT PESKY DEBT PROBLEM

This is the third summer in a row that we've seen great market volatility and significant market declines primarily due to the problems in Europe. Specifically, government debt problems in Greece and other southern European countries have not been solved despite innumerable European summits, conferences, agreements-in-principle, solidarity pacts and pronouncements. It seems this pesky problem just won't go away. And according to history, this is to be expected. Economists Carmen Reinhart of the University of Maryland and Kenneth Rogoff of Harvard University are the authors of a recent paper called *Growth in a Time of Debt* which highlights what happens to economic growth at certain levels of government debt relative to GDP. The paper concludes that there is a tipping point when debt to economic output exceeds 90%. At levels above 90%, economic growth rates fall as a result of either government austerity measures to reduce the debt (reduced government spending) or tax increases to



Compiled by JP Morgan and used with permission. Source: U.S. Treasury, Barclays Capital, FactSet, J.P. Morgan Asset Management.

That Pesky Debt Problem *(Continued from page 2)*

reduce the debt (reduced consumer and business spending). Greece and Spain now find themselves in this quandary. The burden of debt has resulted in slower economic growth which of course has resulted in lower tax revenues which in a circular fashion has made the problem worse. Reinhart and Rogoff observe that once countries exceed this 90% of GDP debt level, they find it almost impossible to grow out of the problem and usually end up defaulting on their obligations. Greece has already had a partial default and it is expected that a further write-down will be required. European countries are not alone in their struggles with debt. Many other developed countries, including the US, now find themselves saddled with untenable liabilities as shown in the chart to the right. A more detailed look at the US debt is shown in the additional chart below.

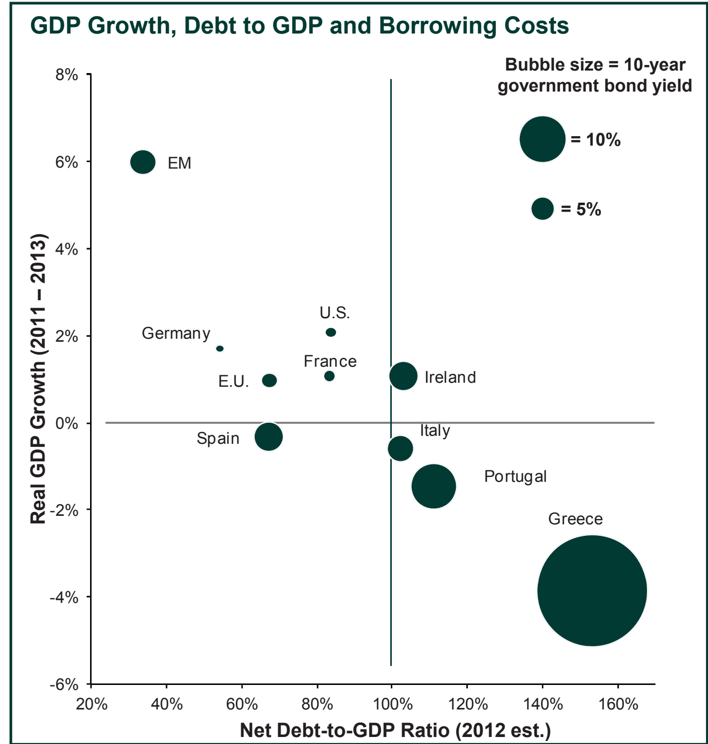
We started this section by pointing out that we are having a *third* summer of volatility resulting from the European debt crisis. It has dragged on for a long time and we would suggest that we'll be dealing with this problem in Europe and indeed in the US for many years to come. It is not like a natural disaster from which we quickly recover, rebuild and move on. Instead the process of deleveraging and the resulting slower economic growth will affect our investment decisions and indeed our investment results for a long time.

In speaking with clients or when reading or listening to the news, we sense that market watchers expect a near-term "shoe to drop" so to speak. "What will happen in Europe? What will happen after the US election in November? Is a day of reckoning imminent and should we try to position the portfolio accordingly?" We think an effort to make significant portfolio moves in anticipation of something definitive happening in the short term can be hazardous. We may be years too early with our efforts to time future events that may never happen. As one of our clients said the other day, "Don't be waiting at the train station when your ship comes in."

Once again, we think taking a long-term view and building a long-term diversified portfolio maximizes the probability that we will achieve favorable results.

A final note about today's investing environment. We're encouraged by the fact that everyone seems worried today. There is a very healthy respect for risk. To quote value investor Howard Marks, "In 2007, five years ago today... most people said there is nothing to worry about; I can't think of a way to lose money. Terribly frightening. Today, most people say they can't think of a way to *make* money. They can't get over the litany of macro uncertainties out there. And for those of us who look for values, that's bullish."

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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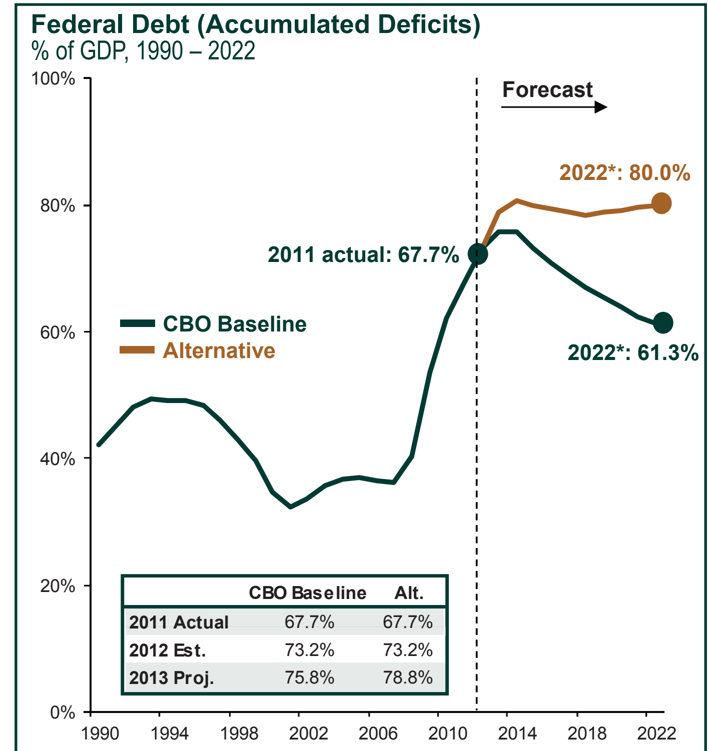


	CBO Baseline	Alt.
2011 Actual	67.7%	67.7%
2012 Est.	73.2%	73.2%
2013 Proj.	75.8%	78.8%

*2011 numbers are actuals. 2012 Federal Budget is based on the CBO's March 2012 Baseline Scenario. *Alternative scenario based on CBO Alternative Scenario for spending and President Obama's budget for revenues.*
Note: Years shown are fiscal years (Oct. 1 through Sep. 30). Data are as of 6/30/12. Compiled by JP Morgan and used with permission. Source: U.S. Treasury, BEA, CBO, J.P. Morgan Asset Management.

Lessons from Lance Armstrong *(Continued from page 1)*

Lance's detractors have long maintained that he used drugs to win and yet he never tested positive despite being the most drug-tested human on the planet. I have always hoped and wanted to believe he didn't use drugs.

And yet as you probably have read, on the eve of this year's Tour, the United States Anti-Doping Agency (USADA) announced that they were charging Armstrong with using performance enhancing drugs during the time he was winning his titles. Apparently ten former cyclists, including four of his former teammates, are prepared to testify against him. "I did drugs, he did drugs, I saw him do it, we all did it. **We all cheated.**" Wow. Is it true? Would his former teammates say that if it wasn't true? It is hard to imagine that they would destroy what Lance created for so many of us if it's not true. And another question, "Does it matter?" Does it matter if he cheated and lied to all of us for all these years? I would strongly suggest that it does matter. If he lied to us, we should take away all the medals and all the yellow jerseys. As much as we hate to do it, we should hold him up as a liar and a cheater. What a disappointment to tell my children that our hero, the guy we cheered for every July, cheated and lied to us. How sad.

Society needs heroes. We need leaders. We need people to look up to and we need institutions founded on truth, honesty and integrity. We need to have faith in our boss, our elected official, our little league coach, our minister, our military leader and our teacher. Society will break apart without this faith. And yet sometimes we are let down. Politicians, priests, coaches, CEOs, teachers...it seems we frequently learn of their failures.

As investors, we need to believe in the integrity of our financial markets if we are to participate. Over the last decade, numerous events and phenomena have tested our faith. For starters, we've endured tremendous volatility and we've made very little money. When hearing about high frequency traders, the flash crash, bank bailouts, Wall Street bonuses, the botched Facebook IPO, Bernie Madoff Ponzi schemes, CEO golden parachutes and insider trading, investors sometimes understandably wonder if the deck is stacked against them, if the game is rigged. Does the small investor have a chance? Are we being cheated and lied to like so many cycling fans? Should we trust the system and participate?

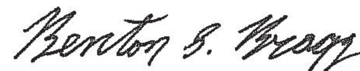
I told my two older children (ages 10 and 12) about Lance Armstrong and the drug charges this week. They were surprised and disappointed but I could tell that they didn't really know what to think about it at their ages. Taking a cue from my father, I thought I would tell them what to think. I found myself quoting Dad when I said. "Most folks are good." Yes, there are some dishonest people out there and you'll often find them on the front page of the newspaper but those people are the minority. Most people do the right thing, work hard, participate in their communities and make a positive contribution. I of course encouraged my children to be that type of person, and I encouraged them to feel good about our society even though they'll be disappointed from time to time. I personally feel this way about our society and frankly I can't imagine how our country would function if this weren't true. Can you?

Although not perfect, we think our financial markets present a great platform for the investing public. With increased competition and smart regulation, markets are more transparent, efficient and cost effective than ever before. There are some bad actors out there and there are certainly things we would change on Wall Street if we were pulling the strings, but all in all, the playing field is level. JP Morgan's recent multi-billion dollar trading loss, Lehman's bankruptcy, the failure of AIG, Fannie Mae, Washington Mutual, Bear Stearns and others during the financial crisis, illustrate quite well that the big guys know how to lose money with the best of them.

We've been through a tumultuous time and it certainly isn't over but we think great opportunities lie ahead. Lance may disappoint us but the overwhelming good surrounding us will propel us forward.

Thank you for trusting 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,



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