INVESTMENT COMMENTARY

3rd Quarter 2012

"It's difficult to make predictions, especially about the future."
-Baseball Legend Yogi Berra

"Everyone has a plan, until they get hit."
-Heavyweight Champ Mike Tyson

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INSIDE THIS ISSUE

ROSS PEROT REVISITED

Bring back the flip charts! While watching President Obama and Governor Romney pander, pontificate and obfuscate during the first presidential debate last week, I found myself missing Ross Perot's Texas twang and simple stage props that so clearly illustrated his views when he ran for president back in 1992. Can you believe that was twenty years ago? We're getting old, aren't we?

USA Today ran a story last week about Mr. Perot and his recent re-emergence as a non-partisan crusader for more responsible government. Mr. Perot's message of today is very similar to his message of twenty years ago: America faces a looming disaster as a result of runaway government spending. If you read our commentary regularly, you know that we too have concerns about this issue, and think it is the single greatest threat to continued progress and prosperity for our country. However, that is not why I bring it up today. Today I want to talk about this issue in the context of portfolio management.

One of our clients forwarded the *USA Today* article to us and asked a question that we understandably hear on a regular basis. "Perot, like many others, is predicting a looming disaster. Should we consider doing something different with our portfolio?" It is a great question and it is timeless. As there has always been something

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FED–ENGINEERED DIVORCE

When is this rally going to end? Many investors are asking this very question as stocks have continued to surge even as earnings growth and the economy have slowed. The S&P 500 is up 30% over the last twelve months and 129% since the low of March 2009. Including dividends, the market has now recovered all of its losses since it peaked in October of 2007. You can see this in the charts below. Note that the chart *lines* represent price only while the *returns* shown represent

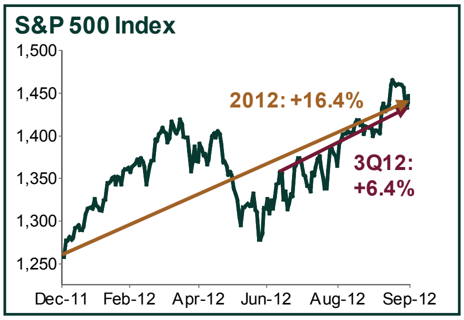

Chart lines reflect index price change only while returns and annotations reflect total return (including dividends). Compiled by JP Morgan and used with permission. Source: Russell Investment Group, Standard & Poor's, FactSet, J.P. Morgan Asset Management

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Fed–Engineered Divorce *(Continued from page 1)*

total returns (including dividends).

So how do you explain the continued run in the market? Perhaps a counter question will serve as an answer. Where else are you going to put your money? When you consider the alternatives to stocks today, the pickings are slim. More on that later. We titled this section "Fed-Engineered Divorce," meaning that in our opinion, the actions of the Fed are driving corporate stock prices to be divorced from corporate earnings. While it is not unusual to see divergence between market returns and earnings growth, today we are seeing an extreme case of this. It is not that valuations are at extremes; in our opinion, valuations look fairly reasonable. Rather, it is perplexing to see stock prices continue to surge in the face of slowing economic growth and dramatically slowing earnings growth.

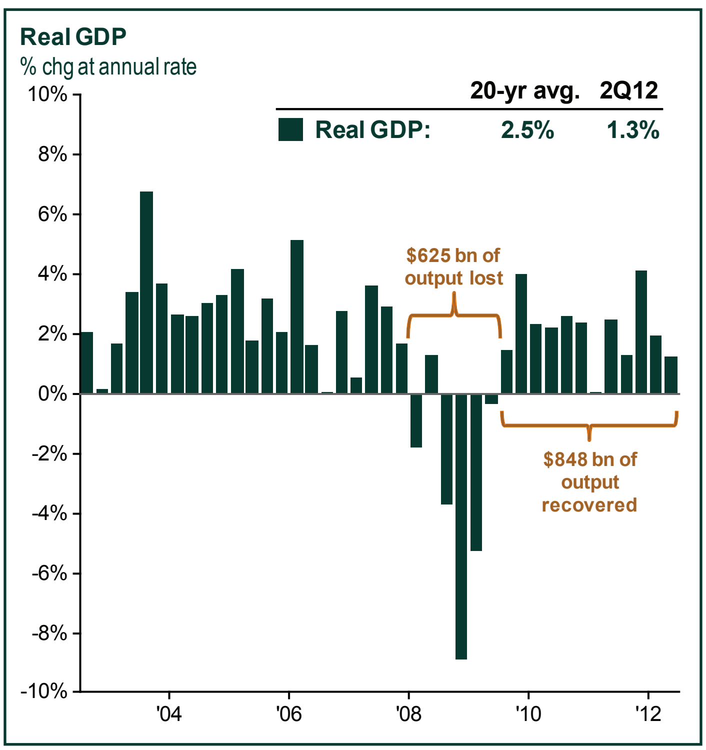
Market Index Returns for Periods ending September 30, 2012

Index	3rd Qtr 2012	YTD 2012	One Year	Three Years	Five Years	Ten Years
S&P 500 (US Large Cap)	6.4	16.4	30.2	13.2	1.1	8.0
S&P 400 US (US Mid Cap)	5.4	13.8	28.5	14.3	3.8	10.8
Russell 2000 (US Small Cap)	5.3	14.2	31.9	13.0	2.2	10.2
MSCI EAFE (Foreign Equity)	6.9	10.1	13.8	2.1	-5.2	8.2
Barclays Aggregate Bond	1.6	4.0	5.2	6.2	6.5	5.3
Barclays Muni Bond	2.3	6.1	8.3	5.9	6.1	5.0

Three, Five and Ten-Year Returns are annualized

The chart below shows that our economy grew at a rate of only 1.3% in the second quarter, about half the 20-year average. Most economists expect comparable numbers through the remainder of 2012.

The chart on the next page illustrates first that earnings growth has slowed dramatically. In addition, you can see that much of the earnings growth of the last few years is a result of companies expanding their margins; companies have enjoyed record profitability through the combination of moderate revenue growth and huge expense reductions (layoffs). As there are fewer and fewer expenses to cut and as the world economy has slowed, companies are finding it more difficult to grow their earnings.



Compiled by JP Morgan and used with permission.
Source: BEA, FactSet, JP Morgan

On September 13th the Fed announced yet another measure designed to support the economy. In this case, the Fed plans to purchase up to $40 billion in mortgage-backed securities per month on the open market. This will serve to push the prices of these instruments up, holding yields down and therefore lowering borrowing costs for consumers and businesses. Here are some key comments from the release:

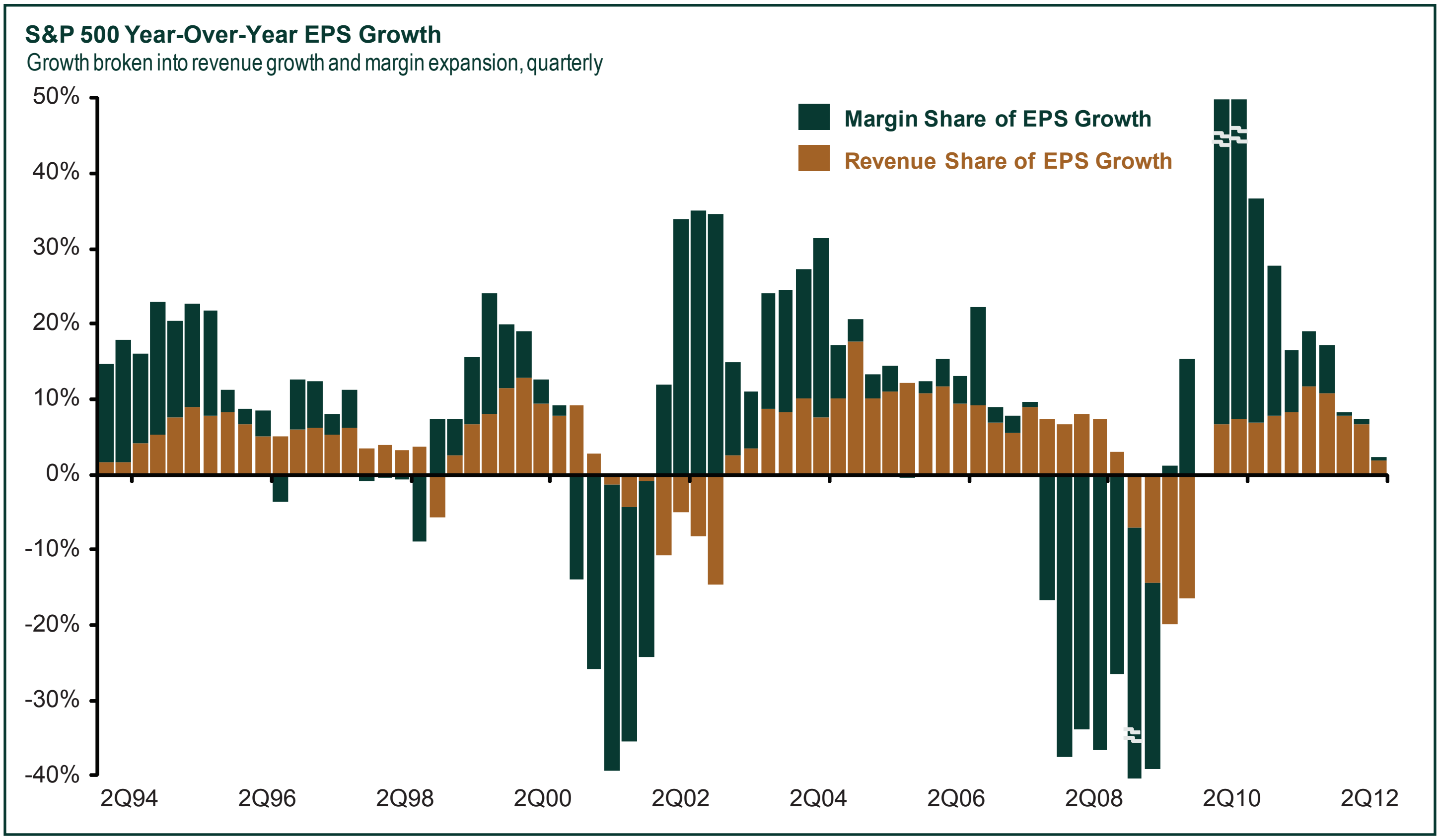
"The Committee is concerned that, without further policy accommodation, economic growth might not be strong enough to generate sustained improvement in labor market conditions. Furthermore, strains in global financial markets continue to pose significant downside risks to the economic outlook."

The $40 billion in monthly purchases is on top of previously announced actions. In the committee's words:

"These actions, which together will increase the Committee's holdings of longer-term securities by about $85 billion each month through the end of the year, should put downward pressure on longer-term interest rates, support mortgage markets, and help to make broader financial conditions more accommodative."

The Dow surged over 200 points on the news. So the economy is so weak the Fed feels it needs to dump another couple hundred billion on the fire and investors cheer? Inflation hawks worry that the Fed's actions to increase the money supply will eventually result in a significant devaluation of the dollar. But Fed Chairman Ben Bernanke has said repeatedly that the Fed has a plan for "removing the punch bowl" and soaking up the excess liquidity in

Fed–Engineered Divorce *(Continued from page 2)*



Source: Standard & Poor's, Compustat, JP Morgan
*EPS levels are based on operating earnings per share. Most recently available data is 1Q12. *2Q12 data are Standard & Poor's estimates. Past performance is not indicative of future returns. 4Q2008, 1Q2010 and 2Q2010 reflect -101%, 92% and 51% growth in operating earnings and are adjusted on the chart.*

the system before it becomes inflationary. This will be a tough balancing act since the only way to soak up the excess liquidity will be to dump these securities back on the market, driving prices down and yields up, thereby raising borrowing costs and choking off a weak recovery. We hope Bernanke's plan will work but we can't help but recall the words of heavyweight champ Mike Tyson when he said of his opponents, "Everyone has a plan, until they get hit."

So far, Fed policy has been very effective at keeping short and even longer-term interest rates low. At quarter end, the ten-year Treasury Bond yield was 1.60% and 30-year mortgage rates were under 3.50%. These low rates are obviously good for borrowers, but for savers who own bonds, CDs or other fixed-income instruments, these low rates have been punishing. Don't be misled by the stellar bond returns shown in the table on the previous page. If ever the statement, "*Past performance is no indication of future performance*" should apply, it is now. Those returns are behind us. Current yields are very low and our expectations for future bond returns should be quite low.

Many yield-hungry investors have looked to stocks as an alternative to money markets, CDs and bonds. In particular, the demand for dividend-paying stocks has driven prices for these companies to historic highs. This is a worrisome development that may not end well when a 20% market correction reminds these investors that stocks are not CDs. We think this yield-chasing phenomenon explains the most recent strength of the stock market. Investors have nowhere else to go.

INVESTMENT COMMITTEE REPORT
HUMILITY REIGNS

We agree with Yogi Berra, who reportedly said, "It's difficult to make predictions, especially about the future." We therefore build portfolios that we think have a high probability of surviving whatever the future brings. In our experience, most portfolio managers who make concentrated investments (big bets) based on a specific view of the future don't fare well over the long term. They may get it right a time or two but when they finally get it wrong, the loss is devastating. There are simply too many alternative futures that may unfold.

Our investment committee does consider the macro-environment as we construct portfolios. We think about (worry about) interest rates, inflation, deflation, geo-political concerns, market valuations, political outcomes, taxes, trade, country risk, currency risk, etc. But we focus more closely on the specific securities in the portfolio; we

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Ross Perot Revisited *(Continued from page 1)*

out there to worry about, investors have always asked this question. My father was asked this question back in 1981 when the prime interest rate was 21% (today it is 3.25%) and the *New York Times* declared that "home ownership is out of reach for most Americans." We heard the question in 1999 prior to the much feared "Y2K meltdown," again just after 9/11 as we waited for "the other shoe to drop," then again in 2003 before the US entered Iraq. More recently investors were spooked in 2010 by fears of a European collapse and a double-dip recession and in 2011 by the Congressional impasse over the debt ceiling. Now we have the looming "fiscal cliff" (higher tax rates and massive federal spending cuts) that we face in January. In all of these cases, investors understandably wondered (and wonder) if portfolios should be adjusted in preparation for these looming events.

The *USA Today* article on Perot presents a great opportunity to discuss this. Some numbers will help: Total government debt outstanding in 1992 was about $4 trillion and today it is $16 trillion. Scared? Me too. But then consider that our GDP in 1992 was $6.3 trillion and today it is $16 trillion. Finally, factor in the market. Steve Scruggs, our Head of Investment Research, calculated that the Dow has returned 513% over the 20-year period. Not too shabby, especially when you recall that this period includes the bursting of the tech bubble (S&P down 49%) and the financial crisis (S&P down 57%). Please note that the figures above (GDP, debt, Dow) are stated in nominal terms (not adjusted for inflation). When adjusted for inflation, the increases for all three measures are less dramatic but I have been consistent and hopefully you appreciate a little drama in an otherwise staid financial commentary.

In hindsight we can easily figure out how we could have made a lot more than 513% since 1992. Buy in January 1992, sell in March 2000, buy in October 2002, sell in October 2007, buy in March 2009. Presto! Our return is many multiples of 513%. But I don't know anyone who did this. Warren Buffet, the world's best known investor, is the first to tell you that he rode it out. In fact he often points out that he knows a lot of rich people but he doesn't know one rich person who got that way by timing the market.

We think Ross Perot is right. We do have a serious problem with our finances at almost every level of government. According to the Congressional Budget Office website, the federal deficit (the money we've borrowed) for 2012 is $1.1 trillion, the fourth year in a row we've borrowed over one trillion dollars to finance our spending. We've borrowed 32 cents of every dollar we've spent for the last three years. You don't need me to tell you that this is not sustainable. Fortunately, solutions to our problems exist and our leaders have the tools to put us back on a sustainable path of progress. We'll see if they have the political courage to make the very tough choices that are required.

But while we agree with Mr. Perot about the need to address the debt problem, we don't think one should make dramatic portfolio changes in anticipation of a looming disaster. Think about what it would have cost you had you gone to cash back in 1992. We do however think you should own an appropriate portfolio. As a result of the debt overhang and the prevailing sense of uncertainty today, the market and the economy are fragile. It is important that you feel good about your liquidity. For those in or near retirement, this means you have 8-10 years worth of annual spending in fixed income. For those who are working, this means you have a strong cash reserve and/or you feel good about the certainty of your paycheck continuing. Beyond this liquidity, we think one should invest for the long term: own a diversified portfolio of the greatest companies in the world, and for many, own some real estate, either personal or for investment purposes. Rebalance regularly and minimize your tax bill. Twenty years from now, we think we'll look back and agree that this served us pretty well.

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,

Benton S. Bragg

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

Humility Reigns *(Continued from page 3)*

want each security we own to have long-term merit while acknowledging that sometimes we are going to be wrong. For example, if the economy slows and we have a recession, certain asset classes, sectors and specific securities will fare far better than other asset classes, sectors and securities that we own. If, on the other hand, we have continued expansion and dynamic corporate earnings growth, the winners and losers will be reversed.

On the whole, our portfolio has a more defensive tilt relative to the market. We think this emphasis on protecting capital will serve our clients well in the long term.