# Investment Commentary

## 4th Quarter 2012

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"For the first time, a majority of the world's population will not be impoverished, and the middle classes will be the most important social and economic sector in the vast majority of countries around the world."
*-From the 2012 Global Trends Report of the National Intelligence Council*

### RESOLUTIONS FOR THE NEW YEAR

My wife is addicted to sweet tea. Otherwise a very healthy eater, she rarely goes 24 hours without stopping by the McDonald's franchise on Sam Furr Road near our home in Huntersville to place her order for a "large, sweet tea with light ice." Actually she doesn't even place an order any more as the employees know her by name and simply hand her a super-sized serving of the Southern sugary solution when she pulls into the drive-through. As her "tea runs" usually occur when I am at the office, I was unaware of the regularity of her ritual until several years ago when our youngest son, Charlie, let me in on her little secret. Charlie was about 18 months old and barely putting two words together when one Saturday our whole family drove past the Golden Arches and Charlie pointed out the window and started chanting, "Mama-Tea! Mama-Tea!" Well, well. What could Mama say?

For the last two or three years, Alice made it a New Year's resolution to give up the sweet tea. So far she has, shall we say, fallen short of her goal. I noticed that the sweet tea resolution didn't make an appearance on her list of resolutions for 2013 and mentioned it to her. She said, "That's right; I'm not making that resolution again. I don't like failure." Observing the age-old advice to "choose your battles," I wisely chose to leave that one alone. I guess when you grow up in Salisbury, North Carolina you're either hooked on sweet tea or Cheerwine. It could be a lot worse right?

*(Continued on page 4)*

### FOUR IN A ROW

The stock market had a great year! The S&P 500 was up 16% in 2012, making this the fourth consecutive year of positive returns. Including dividends, the market has completely recovered its losses of the financial crisis; it is up 111% since its low of March of 2009. But what an unloved rally it has been! In my almost twenty years at Bragg Financial, I can't remember a time of more worry and dread, a perfect illustration of the market "climbing a wall of worry." Perhaps the best example of this is the fact that Greece's stock market was up 33% in 2012, the highest return of the Euro zone countries. Who would have thought? A good lesson for us all!

*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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*(Continued from page 1)*

## LOOKING AHEAD

| Market Index Returns for Periods ending December 31, 2012 | | | | | |
|---|---|---|---|---|---|
| Index | 4th Qtr 2012 | One Year | Three Years | Five Years | Ten Years |
| S&P 500 (US Large Cap) | -0.4% | 16.0% | 10.9% | 1.7% | 7.1% |
| S&P 400 US (US Mid Cap) | 3.6 | 17.9 | 13.6 | 5.1 | 10.5 |
| Russell 2000 (US Small Cap) | 1.9 | 16.4 | 12.2 | 3.6 | 9.7 |
| MSCI EAFE (Foreign Equity) | 6.6 | 17.3 | 3.6 | -3.7 | 8.2 |
| Barclays Aggregate Bond | 0.2 | 4.2 | 6.2 | 5.9 | 5.2 |
| Barclays Muni Bond | 0.7 | 6.8 | 6.6 | 5.9 | 5.1 |

*Three, Five and Ten-Year Returns are annualized*

### Washington's Grip

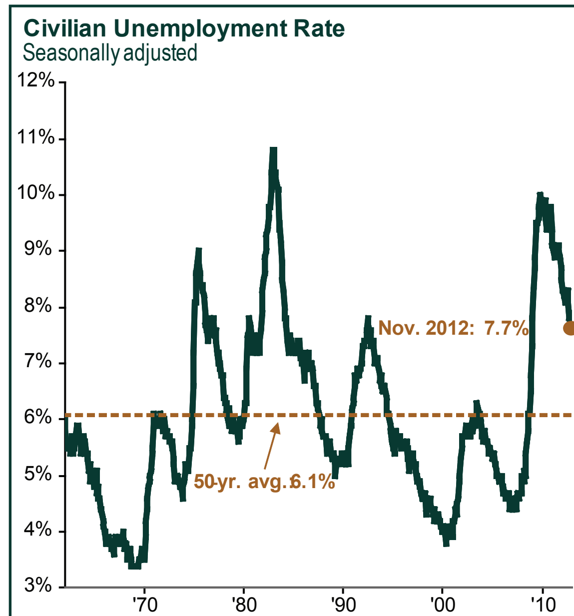
Most recently the market has gyrated around amid the great consternation about the "Fiscal Cliff," the combination of large tax increases and significant federal spending cuts scheduled to be effective on January 1, 2013. As you know, legislation was passed last week that partially addresses the "Cliff" issues. Specifically, taxes are rising for many Americans, especially those with high incomes. We will send out a detailed description of the changes in a separate newsletter. Congress failed to address the debt ceiling or the scheduled federal spending cuts; instead it passed a stopgap measure that defers this fight for the next two months. So the economy and the markets are still very much in Washington's grip for at least two more months and likely for much longer, as our nation's financial problems will take years to solve.

Like them or not, most of the tax measures passed in the recent bill are permanent, a welcome change to the temporary measures that have created tremendous uncertainty for all Americans for the last few years. And while we are not optimistic, we remain hopeful that our elected leaders will soon pass legislation that reins in federal spending, which is currently on an unsustainable path.

### Other Risks

The European Union economies represent over 20% of global economic output and member countries there are still struggling mightily with the debt issues we have written about for the last three years. Economists expect GDP growth of less than 1% for the EU in 2013. This weakness remains a drag on the global economy. Weak demand from the EU and from other developed countries has resulted in a slowdown in emerging economies like China's which remain dependent on exports for growth.

The recovery in the US remains weak. Most economists expect GDP for all of 2012 to come in at about 2% after growing at 2.4% in 2010 and only 1.8% in 2011. This pace is below the 50-year average of 3.2% and substantially below the rate of growth typically seen following a significant recession. The slow growth rate has meant weak job growth and a stubbornly high unemployment rate.




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

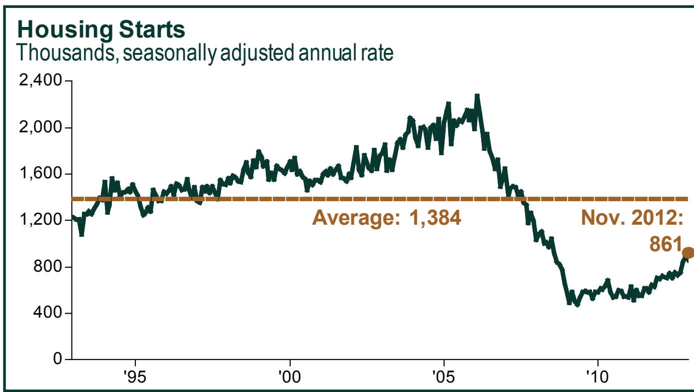
### Opportunities

While economic growth has been weak, the trends are positive. As shown in the charts below and on the next page, housing is finally showing signs of life, vehicle sales continue to climb and the unemployment rate, while still high, has fallen. Government finances remain a mess but consumers have made significant progress in paring back their debt and corporate balance sheets and profit margins have never looked better.

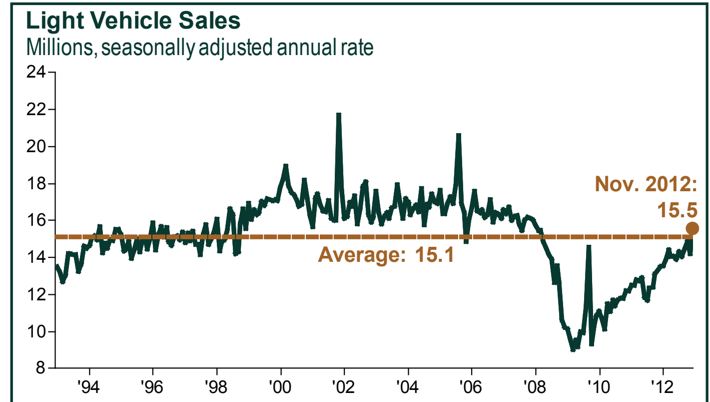
Equity valuations are not unreasonable in our view but top line (revenue) growth will be important to justify higher stock prices. Dividend yields on US large cap stocks have risen over the last few years and now exceed 2% in many cases. This is a welcome reversal of a long-term trend, especially given the low yields offered by bonds and other fixed-income instruments today.

I mentioned earlier that the recent doubling of the market since 2009 has been an unloved rally. Indeed it seems that the severity of the financial crisis marked a major shift in sentiment among investors. The crisis made it clear that big companies can fail, housing prices can fall 30%, US debt can get downgraded and developed countries can default on their obligations. Things that we thought couldn't happen, did indeed happen. These events, perhaps combined with political events around the globe, have resulted in a level of unease among investors and business people that seems to be pervasive. Maybe the unease is justified; maybe our problems are unsolvable and our best days are behind us. But we think not. While there are imbalances in the world economy that are unsustainable (developed country debt and spending levels, central

**Looking Ahead: Opportunities** *(Continued from page 2)*




*Compiled by JP Morgan and used with permission.*
*Source: Census Bureau, FactSet, JP Morgan*




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

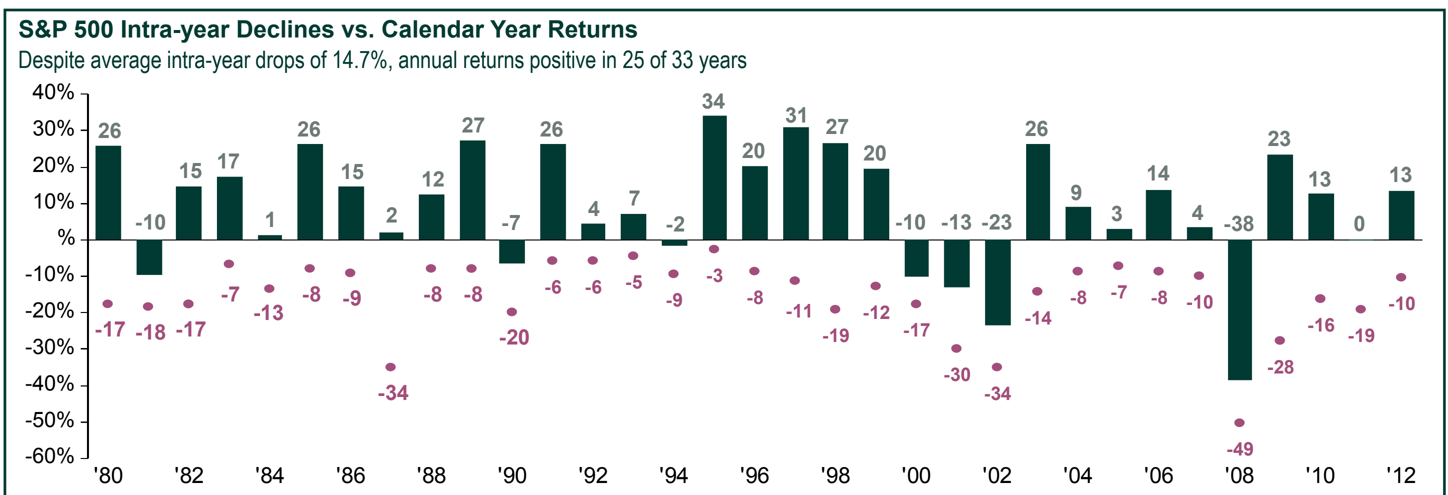
bank actions, trade imbalances) that doesn't mean progress isn't possible. It does mean we face a period of adjustment and it will not be painless. But we'll get through it and in the interim, mankind will make huge progress in the areas of medicine, education, technology and living standards.

In November, the International Energy Agency concluded that by 2020 the US would displace Saudi Arabia as the world's largest oil producer and that by 2035 the US will be virtually energy self-sufficient. The financial and geopolitical implications of this development cannot be overstated.

In December, the National Intelligence Council (NIC), part of the US intelligence community, released its Global Trends report. It projects that in the coming decades, billions of people (mostly in emerging economies like China, Brazil and India) will climb out of poverty and join the global middle class, gaining access to healthcare, clean water, education and technology such as the internet and smartphones. In the words of the NIC, this will be a tectonic shift. "For the first time, a majority of the world's population will not be impoverished, and the middle classes will be the most important social and economic sector in the vast majority of countries around the world."

When we look back twenty years from now, we will likely be amazed at the changes that have taken place in the world. The things on which we are focused today are likely to seem distant and even insignificant. Knowing this doesn't make today's problems unimportant or less difficult, but it does remind us that in the future, as in all of human history, man will make progress. This is good news for investors, especially those who have ownership positions in leading global corporations that are poised to participate in that progress.

In the interim, prepare for bumps ahead. See the chart below for a history of annual returns and intra-year declines.




*Compiled by JP Morgan and used with permission. Source: Standard & Poor's, FactSet, JP Morgan.*
*Returns are based on price index only and do not include dividends. Intra-year drops refers to the largest market drops from a peak to a trough during the year.*
*For illustrative purposes only. Returns shown are calendar year returns from 1980 to 2012.*

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**Resolutions for the New Year** *(Continued from page 1)*

"In the short term, the stock market behaves like a voting machine, but in the long term the market acts like a weighing machine."
*-Legendary value investor and teacher, Benjamin Graham*

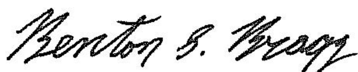
Speaking of resolutions, we want to suggest some for the coming year:

**Resolve to be a long-term investor.** We start the Market Update section of this commentary with a review of recent market returns. Yes, 2012 was a good year. But take a look at the table to the right, which shows year-by-year returns for the stock market since 1926. We hope you'll spend a little time with the numbers; run your finger down the column of equity returns and think about investor fears back in the Thirties (Great Depression), Forties (World War), Fifties/Sixties (War, Cold War), Seventies (Inflation, Interest Rates, War, Cold War) . . . you get the idea. As we turn the page on 2012, we are reminded that life goes on, the economy gets up and goes to work everyday and market prices keep changing. When we build our portfolio it is crucial that we prepare, not for what might happen next week or next month, but for the next decade or so. Own a portfolio that is appropriate for the long term.

**Resolve to think like an owner.** Legendary value investor Benjamin Graham often reminded stock investors to regard stocks not as pieces of paper but as ownership in actual businesses. With that perspective in mind, we shouldn't be too concerned with erratic fluctuations in stock prices, since as Graham said, "In the short term, the market behaves like a voting machine, but in the long term it acts like a weighing machine" (i.e. its true value will in the long run be reflected in its stock price). Graham often spoke of "Mr. Market," a fellow who turns up every day at your door offering to buy or sell your stocks at a different price. Usually, the price quoted by Mr. Market seems plausible, but occasionally it is ridiculous--way too high or way too low. The investor is free to either agree with his quoted price and trade with him, or to ignore him completely. Mr. Market doesn't mind this, and will be back the following day to quote another price. The point is that the investor should not allow the whims of Mr. Market to determine the value of the shares the investor owns. He should profit from market folly rather than participate in it. The investor is best off concentrating on the real-life performance of his companies, rather than being too concerned with Mr. Market's often irrational behavior.

I think it's time for a glass of sweet tea. Thank you for trusting Bragg to help you with your financial planning and investing. I hope 2013 is a great year for you and your family.

Sincerely,



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**S&P 500 Annual Returns**
**Provided by Standard & Poor's**

| Year | Return | Year | Return |
|---|---|---|---|
| 1926 | 11.6% | 1970 | 4.0% |
| 1927 | 37.5% | 1971 | 14.3% |
| 1928 | 43.6% | 1972 | 19.0% |
| 1929 | -8.4% | 1973 | -14.7% |
| 1930 | -24.9% | 1974 | -26.5% |
| 1931 | -43.3% | 1975 | 37.2% |
| 1932 | -8.2% | 1976 | 23.8% |
| 1933 | 54.0% | 1977 | -7.2% |
| 1934 | -1.4% | 1978 | 6.6% |
| 1935 | 47.7% | 1979 | 18.4% |
| 1936 | 33.9% | 1980 | 32.4% |
| 1937 | -35.0% | 1981 | -4.9% |
| 1938 | 31.1% | 1982 | 21.4% |
| 1939 | -0.4% | 1983 | 22.5% |
| 1940 | -9.8% | 1984 | 6.3% |
| 1941 | -11.6% | 1985 | 32.2% |
| 1942 | 20.3% | 1986 | 18.5% |
| 1943 | 25.9% | 1987 | 5.2% |
| 1944 | 19.8% | 1988 | 16.8% |
| 1945 | 36.4% | 1989 | 31.5% |
| 1946 | -8.1% | 1990 | -3.2% |
| 1947 | 5.7% | 1991 | 30.6% |
| 1948 | 5.5% | 1992 | 7.7% |
| 1949 | 18.8% | 1993 | 10.0% |
| 1950 | 31.7% | 1994 | 1.3% |
| 1951 | 24.0% | 1995 | 37.4% |
| 1952 | 18.4% | 1996 | 23.1% |
| 1953 | -1.0% | 1997 | 33.4% |
| 1954 | 52.6% | 1998 | 28.6% |
| 1955 | 31.6% | 1999 | 21.0% |
| 1956 | 6.6% | 2000 | -9.1% |
| 1957 | -10.8% | 2001 | -11.9% |
| 1958 | 43.4% | 2002 | -22.1% |
| 1959 | 12.0% | 2003 | 28.7% |
| 1960 | 0.5% | 2004 | 10.9% |
| 1961 | 26.9% | 2005 | 4.9% |
| 1962 | -8.7% | 2006 | 15.8% |
| 1963 | 22.8% | 2007 | 5.5% |
| 1964 | 16.5% | 2008 | -37.0% |
| 1965 | 12.5% | 2009 | 26.5% |
| 1966 | -10.1% | 2010 | 15.1% |
| 1967 | 24.0% | 2011 | 2.1% |
| 1968 | 11.1% | 2012 | 16.0% |
| 1969 | -8.5% | | |

**Compound Annual Growth Rate: 9.8%**

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