INVESTMENT COMMENTARY

2nd Quarter 2013

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"If you're not confused, then you don't understand it very well."

Charlie Munger, Vice Chairman of Berkshire Hathaway and Warren Buffett's right-hand man, when speaking recently about today's economy.

BOAT TRAILERS AND BULL MARKETS

I've always been nervous about the axle bearings going bad on my boat trailer when I'm far from home. If you've ever pulled a trailer, you know that this is a risk. When a bearing goes bad, it can mean you are stranded on the side of the road until you can get replacement parts—not the way you want to spend five hours on a hot summer day, especially when your wife and children are in the car. For the last five years my family has enjoyed pulling our boat down to Edisto Beach where we primarily use it inshore for fishing, tubing, exploring islands and general sightseeing. For you boaters out there, our boat is a 1997 model, 19-foot Scout center-console fishing boat—nothing glamorous and yes it has some age on it. With four growing children it is starting to get a bit cramped on board, but thus far it has added tremendous fun to our annual week at the beach.

Our 2013 beach week was perfect—we had good weather, the kids got along, no jellyfish stings and we even caught a few fish! It wasn't until the trip home last Sunday that my luck ran out. Now being the model Boy Scout, I was prepared for the drive home with my aging boat trailer. I had three sets of extra bearings, a grease gun, four tubes of grease, a box of tools, two pumps, spare tires, flares, jack...you name it. After we got underway, I kept my eyes trained on the trailer wheels in the side-view mirrors and I even stopped a few times to feel the hubs for excessive heat (friction).

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MUCH NEEDED JUNE SWOON

From the end of May through the end of June, investors endured a choppy ride in stock and bond markets. US stocks (S&P 500) finished the quarter with a gain, but only after a peak-to-trough drop of about 6% during the last five weeks of the quarter. Bonds fared much worse. The Barclays Aggregate Bond index was down more than 2% for the second quarter. The Fed's announcement that it will likely begin to withdraw support for low interest rates in the near future triggered the sell-off in stocks and bonds. The drop in bond prices and corresponding spike

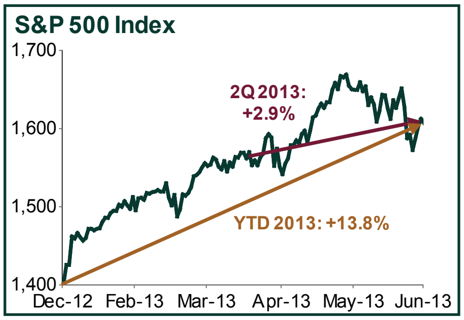

Chart lines reflect index price change only while returns and annotations reflect total return (including dividends). Compiled by JP Morgan and used with permission. Source: Russell Investment Group, Standard & Poor's, FactSet, J.P. Morgan Asset Management

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Market Index Returns for Periods ending June 30, 2013						
Index	**2nd Qtr 2013**	**YTD 2013**	**One Year**	**Three Years**	**Five Years**	**Ten Years**
S&P 500 (US Large Cap)	2.9%	13.8%	20.6%	18.4%	7.0%	7.3%
S&P 400 US (US Mid Cap)	1.0	14.6	25.2	19.4	8.9	10.7
Russell 2000 (US Small Cap)	3.1	15.9	24.2	18.7	8.8	9.5
MSCI EAFE (Foreign Equity)	-1.0	4.1	18.6	10.0	-0.6	7.7
Barclays Aggregate Bond	-2.3	-2.5	-0.70	3.5	5.2	4.5
Barclays Muni Bond	-3.0	-2.7	0.2	4.5	5.3	4.4

Three, five and ten-year returns are annualized

in yields may be the start of a longer-term trend of rising interest rates, but then again we may see rates stabilize at these levels or even drift back down after the spike. The chart below from the Wall Street Journal shows multiple occasions over the last four years when yields spiked only to fall back to new all-time lows as investors realized that the economy remained weak and inflation was far from a threat. The recent increase in yields was not spurred by an increase in inflation; year-over-year consumer and producer prices, as measured in May, only increased 1.7%, well below the Fed's target of 2%. And economic growth remains sub-par; first quarter GDP was revised down to 1.8%, unemployment remains well above the Fed's target of 6.5%, and strong job creation remains elusive.

Source: Wall Street Journal

So why the strong market reaction to the Fed's comments? We think it is because much of the recent frothiness in stock and bond markets has been driven by extremely low interest rates and investors may now perceive that we are nearing the end of that party. This is healthy and that is why we describe the recent market decline as a "much-needed swoon." At some point the economy must stand on its own and market prices must reflect the underlying fundamentals of the real economy, rather than reflecting investors' expectations of what the Fed might do. This may be wishful thinking given the weak economy; indeed the Fed made it clear that it would only taper its support for low interest rates if economic conditions warrant their doing so. We'll see.

Should we find that we are indeed entering a sustained period of rising interest rates, we likely will continue to see volatility in both stock and bond markets. We think it is a good time to keep a long-term perspective. Periods of rising rates are usually marked by volatility but as the table below shows, the stock market doesn't always perform poorly during these periods. The worst performances for stocks are during those periods of rising rates that are coupled with significant increases in inflation—the first half of the seventies being the poster child for this. As mentioned, we have thus far not seen signs of inflation in the US. As for bonds, we think regardless of the direction of interest rates, investors should have low expectations for bond returns in the near term purely due to today's low-yield environment.

Stock Performance in Rising Rate Environments					
		10-year Treasury Yield			
Begin	**End**	**Begin**	**End**	**Yield Change**	**S&P 500 Change**
Dec-62	May-70	3.8%	8.2%	4.4%	10.6%
Nov-71	Sep-75	5.7%	8.6%	2.9%	-12.7%
Dec-76	Feb-80	6.8%	13.7%	6.9%	6.1%
Jun-80	Sep-81	9.5%	15.8%	6.3%	0.1%
May-83	May-84	10.1%	14.0%	3.9%	-9.5%
Aug-86	Oct-87	7.0%	10.2%	3.2%	19.3%
Oct-93	Oct-94	5.2%	7.7%	2.5%	-3.2%
Oct-98	Jan-00	4.4%	6.8%	2.4%	36.4%
Jun-03	Jun-07	3.2%	5.2%	2.0%	50.0%
				Average	**10.8%**

S&P 500 change is cumulative. Source: Birinyi Associates, Inc.

LOOKING AHEAD

We've written a fair amount about the overhang of government debt that serves as a drag on economic growth. When we look at the unsustainable financial position of our federal and municipal governments we consistently conclude that the only way out of this pickle is for economic growth to significantly exceed consensus expectations. History tells us that this has happened before and we are optimistic that it will happen again. Here are a few bright spots out there that give us hope.

Housing, Energy, Manufacturing and Globalization *(Continued from page 2)*

Housing

Housing is finally making a positive contribution to the economy. Inventories of unsold homes have fallen back to the lowest level of the last twenty years. Home prices for all twenty major cities included in the S&P/Case-Shiller Home Price Index have risen in each of the last four months and consumers have gotten their debt burdens back to manageable levels.

Energy

The International Energy Agency recently 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. From the International Energy Agency (IEA) last month: "The supply shock created by a surge in North American oil production will be as transformative to the market over the next five years as was the rise of Chinese demand over the last fifteen."

Manufacturing

Over the last thirty years, the US has seen the elimination of thousands of manufacturing jobs as domestic workers were replaced either by technology or by the outsourcing of jobs to lower-wage emerging economies. Despite the reduction in the workforce, US manufacturing output is at an all-time high. And importantly, manufacturing jobs in some parts of the country are coming back. The table on this page was compiled by Liz Ann Sonders of Charles Schwab. It lists the most manufacturing-oriented states in the country. As you can see, job growth in these states has been significantly above the US average for the last 3 years. And early indicators show that we are seeing a slowing of the outsourcing movement. A survey by the Boston Consulting Group (BCG) in April 2012 showed that 37% of American manufacturers with annual sales above $1 billion said they were planning or actively considering shifting production facilities from China to America. The most common reason given was higher Chinese labor costs. According to The Hackett Group, a research firm, the cost gap between the US and China shrank by more than 50% since 2004. Other reasons for "re-shoring" jobs include abundant cheap energy in the US, the weaker dollar, more attractive US labor costs, US rule of law and the uncertainty associated with doing business in emerging economies.

Global Expansion

The Global Trends report of the National Intelligence Council (NIC) 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." The US economy, with its highly productive manufacturing sector and access to low cost, plentiful energy is well-positioned to capitalize on this phenomenon. Translation: Jobs and Growth! Obviously the manufacturing revival, the re-shoring of jobs and the transition to energy independence are long-term trends– certainly not a quick fix for the problems facing our economy. There will be no quick fix but the long-term trends are encouraging.

Top Fifteen Manufacturing States in the US

		Change in Manufacturing Employment (Jan. 2010-Apr.2013)	Current Overall Unemployment Rate	Change from Recent Peak Unemployment Rate
1	Michigan	19.7%	8.4%	-40.8%
2	South Dakota	15.7%	4.1%	-24.1%
3	Wyoming	12.8%	4.8%	-36.0%
4	North Dakota	12.6%	3.3%	-21.4%
5	Washington	11.5%	7.0%	-31.4%
6	Kentucky	11.1%	7.9%	-26.2%
7	Indiana	10.9%	8.5%	-21.3%
8	Idaho	9.4%	6.1%	-30.7%
9	Iowa	9.4%	4.7%	-26.6%
10	Ohio	9.0%	7.0%	-34.0%
11	Wisconsin	8.3%	7.1%	-22.8%
12	Utah	7.9%	4.7%	-44.0%
13	South Carolina	7.6%	8.0%	-32.8%
14	Nebraska	7.3%	3.7%	-24.5%
15	Oregon	7.1%	8.0%	-31.0%
	US	4.4%	7.6%	-24.0%

Source: Charles Schwab, Cornerstone Macrop LP, Department of Labor, FactSet, as of April 30, 2013. US data as of May 31, 2013.

Risks Remain

In the near term, we should expect bumps. The emerging economies are slowing and dealing with inflationary pressures. Europe remains fragile with its debt problem and weak economies. The violence, instability and protests in Turkey, Syria, Egypt, Iraq, Afghanistan and Brazil remind us regularly that we live in a changing and uncertain world.

It's July 4th as I type. I just read about the coup in Egypt. The military ousted the first democratically elected president in the country's history. I think I'll take the children outside and march around with the American flag. We are most fortunate, aren't we?

Boat Trailers and Bull Markets *(Continued from page 1)*

As prepared as I was for a *trailer* incident, it was a bit ironic that we had a flat tire on the *Suburban*. We were on I-26 near Columbia when the tire indicator light flashed and said we had eight lbs. of pressure in the right front tire. I pulled onto the shoulder of the interstate and we all piled out of the truck. Alice led the kids through a patch of poison ivy and fire ants, climbed a barbed-wire fence and waited in the Columbia humidity about 150 feet off the road. I worked on the spare. Alice later confessed that she was convinced that a texting truck driver was going to run me down in plain view of my children. She said our son, Ben (13), had worked very hard to convince her she was being irrational. "Mom, what is the probability that a truck is going to run off the road right here in the next twenty minutes?" I was pleased to hear that he was talking probability...maybe he'll make a good analyst someday.

Happily back on the road, Alice and I were discussing the irony of the *truck tire* failing when I had been so obsessed with something happening to the *trailer*. We laughed and agreed that it would make a good story for the quarterly commentary. It was right then that KAPOW!! The trailer tire blew out and it sounded like a bomb exploding! The kids all screamed as we swerved back onto the shoulder of I-26. The trailer tire was a mess of twisted steel belts and grease, and the lug nuts were almost rusted tight from being in salt water. Just as I got to work changing the tire, there was a huge clap of thunder and the heavens opened up. It poured—thunder, lightning, wind, the works. I was drenched! To add insult to injury, while crouched there beside the boat, straining with the lug nuts, the boat bilge pump came on and doused me with about 3 gallons of rainwater that had accumulated in the bottom of the boat.

I finally got the spare on but noticed that it would not spin without hitting the now bent wheel well. I took the spare back off and pounded the bent wheel well back into shape with the heaviest wrench I had, put the spare back on and then noticed that even with lugs tight, the wheel was very wobbly. The bearings!! Why did I feel a sense of joy? We limped to the nearest exit and found a Lowe's Home Improvement parking lot where I could work safely. Alice and the kids killed time (and stayed dry and cool) wandering around Lowe's drinking Cheerwine. Meanwhile out in the rain, I removed the wheel, replaced the bearings, pumped in the grease, replaced the wheel, climbed back in the truck (soaking wet), picked up my family and drove the remainder of what became an eight-hour trip home. Little Charlie (5) cheered me up on the way home, insisting that I look carefully at each of the colorful paint chips he had selected in the paint department at Lowe's.

After the flat tire on the truck, I had planned to use this story to demonstrate that when building a portfolio, we should remember that the risks we're not even considering often are the ones that blindside us. I was prepared for the trailer failure when the truck tire went flat. Back in 2001, we were worried about tech stocks declining further when the terrorists hit us on 9/11. In March of 2009, our greatest fear was that stocks would fall even further. It was hard to realize that the greatest risk one faced then was missing the 150% rise in the market over the next four years. The second tire blow-out and the ultimate failure of the trailer bearings kind of throws a wrench into my original analogy, doesn't it? Indeed I *had* considered the axle bearings risk and sure enough, it happened as feared. Perhaps our takeaway is that when constructing the portfolio, we should simply be prepared. We should prepare for the known risks (deflation, inflation, terrorism, financial system weakness, debt-driven instability, rising interest rates, market overvaluation, volatility, etc.) and build the portfolio with these risks in mind.

> "The supply shock created by a surge in North American oil production will be as transformative to the market over the next five years as was the rise of Chinese demand over the last fifteen."
>
> *The International Energy Agency (IEA) May 2013*

But we should also acknowledge that there are unknown risks and that we can't see the future. It's a confusing world out there. How do I invest my wealth in this global economy where information moves faster than ever before? We would suggest that it is perfectly normal to be confused. As Charlie Munger, Vice Chairman of Berkshire Hathaway and Warren Buffet's right-hand man, said recently about the economy, "If you're not confused, then you don't understand it very well." So we are all confused. But we still must have an investment philosophy... we've got to store our wealth somewhere. At Bragg, we think the approach that has the greatest likelihood of working over the long term is to maintain plenty of liquidity (income from employment and/or cash and bonds). Then take the rest of your wealth and *own* stuff for the long term. Buy "pieces" of real estate (home, investment property) and "pieces" of great companies (shares of stock) and own them for the rest of your life. Put yourself in position to say, "I can live off my income, cash and bonds for ten years without selling my stock or my home. Beyond my ample liquidity (income, cash, bonds), my wealth is invested in ownership positions in real estate and stocks and I'll own them until I die." If you can get comfortable with that philosophy, we think it can reduce stress and help you through the tough markets which surely will come.

We hope this is helpful. Please let us know if you would like to discuss your accounts or your planning. Have a great summer and thank you for choosing Bragg Financial Advisors.

Sincerely,

Benton S. Bragg

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