Investment Commentary

2nd Quarter 2014

Bragg Building
1031 South Caldwell Street, Charlotte

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"Far more money has been lost by investors trying to anticipate corrections than has ever been lost in corrections themselves."
-Famed money manager Peter Lynch

BLACK SNAKES & REBALANCING

Two six-foot-long black snakes chased my son Carlton (12) out of our chicken house one day last week. A third snake greeted him as he stepped into the "feed room" where we keep the donkeys' grain. It's dark in the feed room and he didn't see this fat, black monster coiled up right beside the grain bin until it raised its head into a striking position. Those of you who grew up in the south are likely familiar with the black rat snake. According to the Davidson College Herpetology website, the black rat snake (Elaphe obsoleta) is the most common large snake encountered by people in North Carolina. These non-venomous constrictors prey on mice, rats, birds and their eggs, including those of chickens. They're excellent climbers and can climb trees or walls simply by holding onto the rough surface with their belly scales. They are commonly found in and around human dwellings and survive well in established neighborhoods, sometimes turning up in chimneys, attics, garages and basements.

My sons are accustomed to seeing snakes in our chicken house as they do their daily chores of feeding the animals and collecting the eggs. With freshly laid eggs and a huge family of mice there for the picking, you can't reasonably expect a hungry snake to stay away, can you? But seeing three snakes in one day and especially encountering one up close in the dark must have pushed Carlton a bit far. Apparently the boy was trembling all over when he dashed into the house that afternoon. I learned this from my wife, Alice, who met me at the door that night when I arrived home from work. "This is child abuse! I'm calling DSS! You can't send your children down into that snake pit every day; they're terrified! No child should have to endure that level of fear in his own backyard. And they might get bitten!"

Alice did calm down...she always does. I am a very fortunate husband. And the boys have returned to their normal summer routine of *slowly* entering the chicken house and feed room only after carefully looking around. They are especially careful to look *up* before stepping *in* because the snakes often hang out above the door jamb. There's nothing worse than having a big black snake drop from above right onto your shoulders.

Seeing the first snake of the year is always the biggest surprise for the boys. They simply aren't expecting it. The warm spring weather lulls them into a sense of complacency as they breeze through the routine of their chores. This spring was especially welcome after the exceptionally cold winter we endured. The freezing temperatures

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MARKET & ECONOMIC UPDATE

The stock market had a strong second quarter, building on the gains of the first quarter. The S&P 500 was up 5.2% for the quarter, bringing the year to date total return to 7.1%. The rally continued even in the face of continued Fed tapering in the US, the lingering effects of the cold winter on the US economy, weakness in Europe, a slowing Chinese economy and continuing unrest in Iraq, Syria and Ukraine.

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Market & Economic Update *(Continued from page 1)*

Market Index Returns for Periods ending June 30, 2014

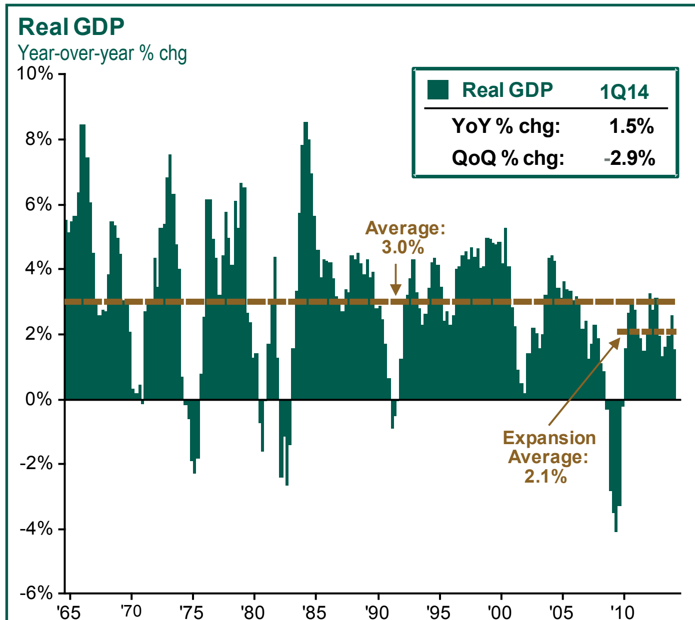
Index	2nd Quarter	Year to Date	1 Year	3 Years	5 Years	10 Years
S&P 500 (US Large Cap)	5.2	7.1	24.6	16.6	18.8	7.9
S&P 400 US (US Mid Cap)	4.3	7.5	25.2	15.3	21.7	10.7
Russell 2000 (US Small Cap)	2.1	3.2	23.6	14.6	20.2	8.9
MSCI EAFE (Foreign Equity)	4.1	4.8	23.6	8.1	11.8	6.9
Barclays Aggregate Bond	2.0	3.9	4.4	3.7	4.9	4.9
Barclays Muni Bond	2.6	6.0	6.1	5.4	5.8	4.9

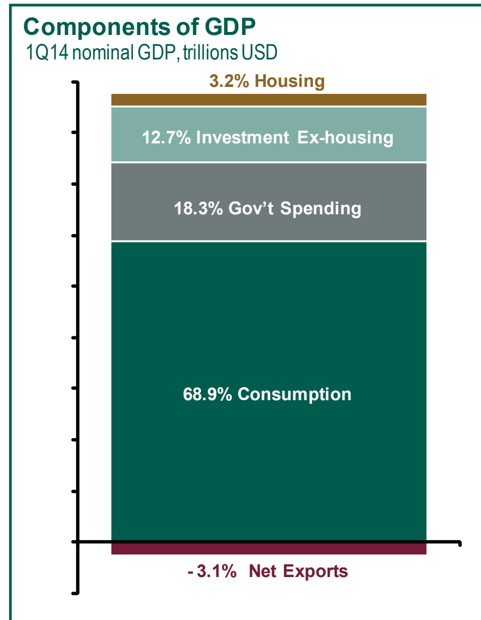
Three-, five- and ten-year returns are annualized. Past performance is not an indication of future performance.

Perhaps the biggest surprise of the second quarter was the strength of bonds. While the "experts" warned of higher interest rates and falling bond prices, the opposite happened. Rates fell and prices rose. The Barclays Aggregate bond index rose 2% for the quarter, bringing the year-to-date return to almost 4%. The Barclays Muni Index did even better, gaining 2.6% for the quarter and 6% year to date. Not too shabby! We must sound like a broken record with our bond commentary but we'll say it again. Don't expect bond returns like these to continue. We'll feel great if our bonds give us 3% annually over the next five years.

Revised government reports showed that economic growth in the first quarter was actually down 2.9%, a large contraction, blamed mostly but not entirely on the long and very cold winter. GDP was likely much stronger in the second quarter but economic data has been mixed for sure. The chart of Real GDP (bottom, page 2) illustrates the below-average economic growth we've experienced since the Great Recession. On the bright side, the labor department reported last week that 288,000 jobs were created in June and the unemployment rate fell from 6.3% to 6.1%. By any measure, June's labor report was a shot in the arm for the economy as employment equals income for consumers and consumption makes up nearly 70% of US economic output (see chart on Components of GDP, below). Importantly, the labor force participation rate held steady in June - a welcome reprieve from an alarming trend over the last fifteen years as millions of Americans have dropped out of the labor force (see chart on Labor Force Participation, page 3). In addition to the good news on the labor front, other positives include continued strength in manufacturing activity and auto sales and an uptick in consumer sentiment which we hope will translate into growing consumption.

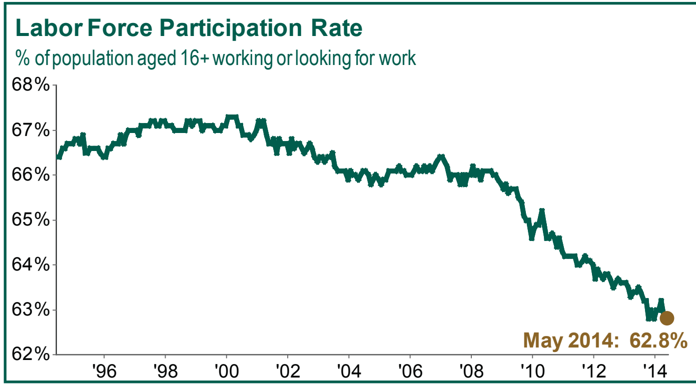
On the negative side, housing continues to be sluggish and inflation readings have ticked up slightly. The inflation numbers are definitely something to watch. As we have





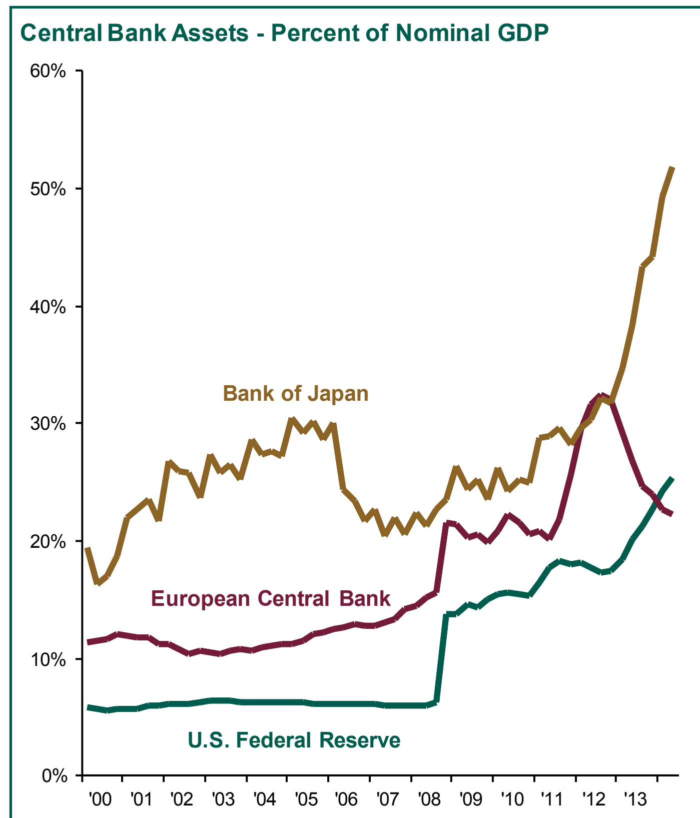
Charts compiled by JP Morgan. Source: BEA, FactSet, J.P. Morgan Asset Management. Values may not sum to 100% due to rounding. Quarter over quarter changes are at an annualized rate. Average annualized growth rate for the full period and the period starting in the second quarter of 2009.

Market & Economic Update *(Continued from page 2)*



Source: BLS, FactSet, J.P. Morgan Asset Management

discussed before, aggressive monetary policies have the Fed walking a tightrope. Through its bond buying program (Quantitative Easing) it has pumped trillions of dollars into the financial system. It is currently in the process of gradually reducing (tapering) the amount of those purchases from $85 billion per month at the peak last year to zero by October of this year. That is the plan anyway. The Fed has left the door open to change that plan depending on what the economy does. I describe it as a tightrope because if the Fed leaves the monetary stimulus in the system too long, it risks creating inflation. If it pulls the stimulus out too soon or too fast it risks slowing the economy and pushing us into recession. We have written a lot about this and it indeed is the 800 lb. gorilla that market watchers are concerned about. The US is not alone in this aggressive policy. Japan's Central Bank and the European Central Bank each are engaged in similar monetary schemes in an effort to stimulate growth in their fragile, indebted economies (see chart on Central Bank Assets, below). The combined economies of the US, Japan and the EU represent over half of global GDP so this is a grand experiment and history (see Japan 1989 -2014) makes it clear that it's no simple matter to get this right.



Source: J.P. Morgan Global Economics Research, J.P. Morgan Asset Management.

We have written about global monetary actions a fair amount in past commentaries and you have likely followed this phenomenon through other outlets as well. Whenever you read or hear about it you certainly come away with the question, "How does this end and how do I invest in this environment?" We think the answer is that we should invest as we currently do. We should maintain adequate liquidity (a significant bond portfolio or a highly certain income stream from work or other sources) to protect ourselves from a deflationary environment. We should own stocks and real estate (our home, investment property, REITS) to protect our wealth from an inflationary environment. If inflation appears to be a significant risk (at this point it does not), more of the portfolio should be exposed to instruments that offer a hedge against inflation. This is something that we are watching.

Importantly, over the long term, ownership of common stocks has been a far better investment than government bonds, corporate bonds, gold or other precious metals and oil or other commodities. This is because share ownership represents ownership of a productive asset. As owners of companies, we're able to harness the power of human ingenuity. 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 own shares in leading global corporations that are poised to participate in that progress.

Black Snakes & Rebalancing *(Continued from page 1)*

last winter required the boys to get up early in the morning before school to break the ice on the animals' water troughs. On the coldest days the water was frozen solid and the boys carried jugs of hot water from the house down to the paddock so the animals could get a drink. Now I know what you're thinking and yes, I did help them with this and I must say, it was a real hassle! I don't know how people live in Montana or Minnesota where it stays cold for seven or eight months of the year. In contrast to the challenges of winter, the chores became easy this spring; the goats and donkeys grazed in the pasture, eliminating the need to put out hay, and no ice breaking was required. All was well in the world and the boys grew complacent, even bored. And then one day when casually reaching for an egg…**YIKES!** There's our thick, dark friend coiled up just inches away. A new season is here!

Just as my boys grew complacent in their daily chore routine, it's our sense that investors today have grown a bit complacent as the market has marched upward. As the months and years have passed since the turbulent days of the financial crisis, we've come to expect another monthly account statement with even higher values shown on it. The repeated string of record highs for the Dow and S&P 500 are becoming old news. As I type (July 3rd) the Dow is closing above 17,000 for the first time ever. Another record high? Yawn.

According to research by Charles Schwab, it has been almost 1,000 days since the last market decline of 10% or more. The current rally of over 78% represents the fifth longest of all time, just behind the period from 1984 to 1987. But it's well short of the longest rally of all time, which was 233% from October 1990 through October 1997. Now, we're not predicting a major correction in the near future; for all we know the market could continue this streak for months or even years. But history says we're due for a pullback and we think it makes sense to be prepared. How do we prepare? As we've often said, it's not by going to cash or by making a drastic move in the portfolio. As esteemed money manager Peter Lynch once said, "Far more money has been lost by investors trying to anticipate corrections than has ever been lost in corrections themselves." Instead, a portfolio should be appropriately invested at all times. "Appropriate" means the allocation of the portfolio should reflect the needs of the investor. At Bragg, we like to say you should own the right allocation (the right blend of stocks and bonds) given your risk tolerance, your need for liquidity and your need for return.

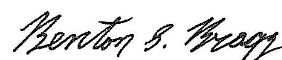
Expanding on those a bit: To us, having a *high tolerance for risk* is really a measure of behavior. One with a high tolerance for risk will stay the course when he sees his portfolio decline. He'll tolerate the volatility. One with a *need for liquidity* is either making significant withdrawals from the portfolio (a retiree perhaps) or expects to possibly need to make significant withdrawals due to job uncertainty or a pending life change. And finally, *need for return* refers to the necessity to make the money grow. How much does my portfolio need to earn for me to retire and maintain my standard of living for the next thirty years? How much return is required in order to maintain my standard of living and also leave specific bequests to my heirs and to my favorite charities? How much risk must I take in the portfolio for it to earn that required rate of return? Answering these questions helps us guide you in determining an appropriate allocation.

Once the appropriate allocation is determined, our job is to invest the portfolio per the written plan and to *periodically rebalance* the portfolio to the target allocation. The importance of rebalancing the portfolio can't be overstated. In the case of a rising market like we have just experienced, rebalancing the portfolio prepares the portfolio to withstand a market decline. For example, consider a portfolio that was worth $100 five years ago in July of 2009. If the target allocation was 70% stocks and 30% bonds, that means $70 was in stocks and $30 was in bonds. Today, after the huge rally in stocks and moderate returns in bonds, that portfolio, *if rebalanced regularly*, is worth about $190 and because it is on target at 70/30 stocks/bonds, there is now approximately $133 in stocks and $57 in bonds. At a basic level, the portfolio is obviously worth significantly more…woo hoo! But importantly, as a result of the regular rebalancing (trimming stocks and adding to bonds periodically as the market rallied), the portfolio now has significantly more liquidity ($57 in bonds compared to $30 in bonds) than it had five years ago. In our view, as a result of the much higher level of liquidity (or staying power), the portfolio is already prepared or positioned for a market decline. Unless the circumstances of the investor have changed, there is not a need to make drastic changes to the allocation in anticipation of a market decline. The obvious risk in making drastic changes (like going to cash) is that your timing is wrong and you sit in cash for two years as the market marches even higher.

I apologize for dragging you through all the numbers here and hope this exercise will give you some comfort as you think about your own portfolio today with the market at an all-time high.

Thank you for choosing Bragg Financial Advisors for your investing and planning. Stay cool this summer and watch out for those black snakes!

Sincerely,



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