INVESTMENT COMMENTARY

3rd Quarter 2014

Bragg Building
1031 South Caldwell Street, Charlotte

"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

LIMITED VISIBILITY

Now that our children are a little older, my wife Alice and I have committed to taking them on an annual "big trip." This year we went to California. Specifically, the plan was to fly to San Francisco where we would spend a few days doing the big-city thing, and we'd then rent a car to begin making our way down the Pacific coast. We would enjoy the beaches and dramatic scenery of Big Sur, stop off to visit family in Santa Barbara, then hit Sequoia and Yosemite National Parks, visit more family in San Carlos and then fly home. After months of diligent preparation we thought our plan had the makings of a perfect trip. You can probably guess that things didn't turn out exactly as we had planned.

Let me tell you about it. Our first big day in San Francisco got off to a rocky start when the much-anticipated cable car ride didn't happen because the "under-street cable was broken," or at least that was the rumor circulating around in Union Square. Undeterred, the six of us jumped on rented bikes and headed off for the Golden Gate Bridge. Our plan was to join the hundreds of other tourists who ride across the storied bridge to the quaint town of Sausalito where we'd eat a bite of lunch and then catch the ferry back across the San Francisco Bay to Fisherman's Wharf. Things were going swimmingly as we eased along the shoreline on our bikes; the kids were all smiles and even seven-year-old Charlie was peddling away and keeping up just fine. Then suddenly, as we approached the foot of the bridge, four heavily-armed law enforcement officers blocked our path and told us the paths leading to the bridge were "CLOSED DUE TO NATIONAL SECURITY!" Closed? National security? What!? As it turns out, our Commander-in-Chief was visiting San Francisco on official presidential business (a fund raiser, according to the *San Francisco Chronicle*), and the Secret Service chose to have him land his helicopters at the base of the Golden Gate Bridge at

(Continued on page 4)

MARKET AND ECONOMIC UPDATE

Key Points

- **Upward market momentum has paused and a pullback is overdue.**
- **Despite its sluggishness, the US economy continues to move in the right direction.**
- **Interest rates remain very low but with the Fed tapering and forecasting rate increases, volatility should be expected.**
- **Outside the US, both Europe and Japan are taking extreme measures to avoid recession and falling asset prices.**
- **Chinese growth is slowing from the torrid pace of the last decade.**

Stocks were mixed in the third quarter. US large caps eked out a gain of about 1% while small caps and foreign stocks lost more than 5%. The pause was long overdue and we wouldn't be surprised to see a larger pullback in the near term if only because the market has run for so long without one. Including dividends, the S&P 500 cumulative

(Continued on page 2)

BRAGG Financial Advisors | 50 Years of Service
1031 South Caldwell Street, Suite 200 • Charlotte, North Carolina 28203
(704) 377-0261 • Fax (704) 334-9754

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

Market Index Returns for Periods ending September 30, 2014

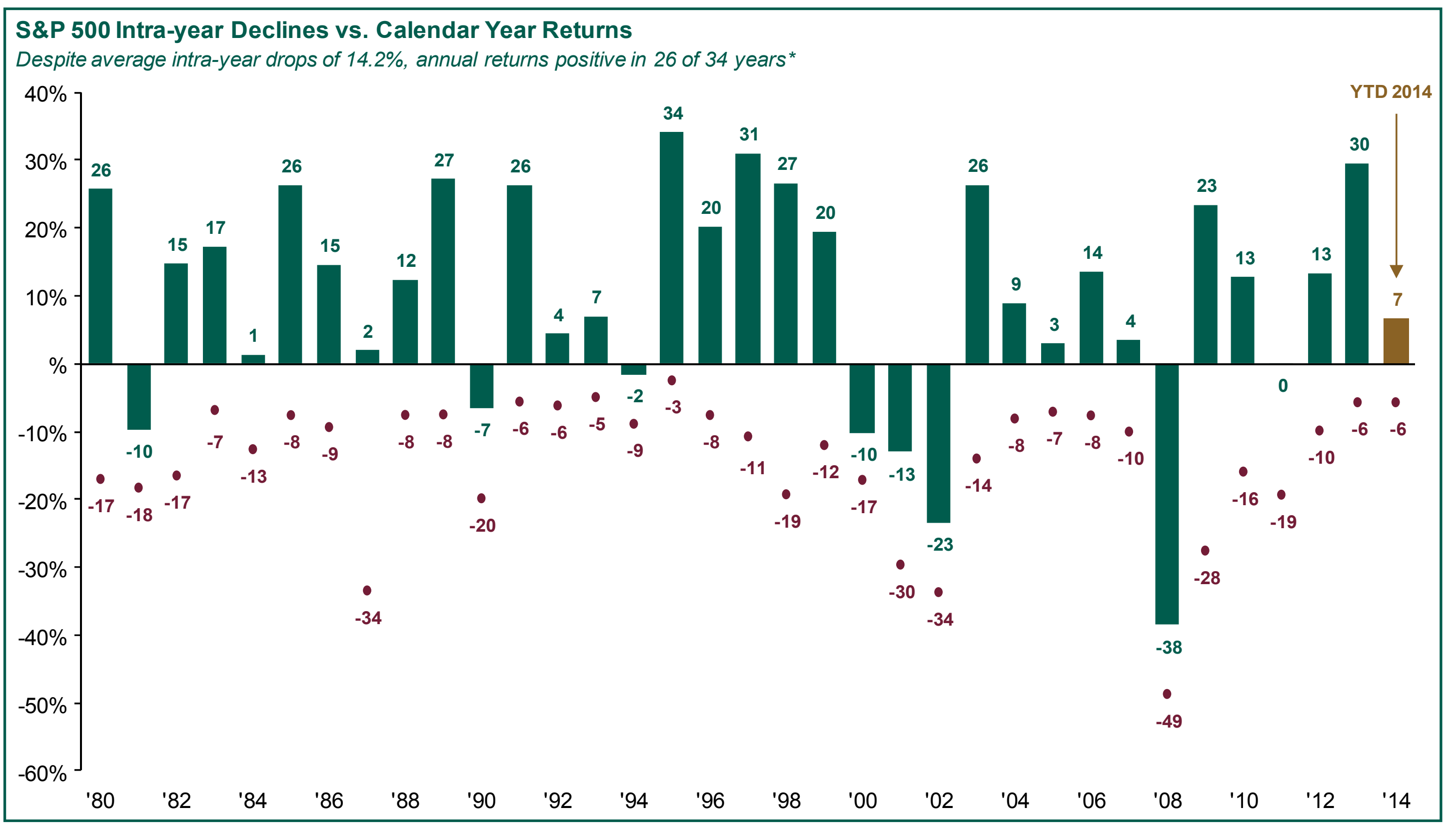
Index	3rd Quarter	Year to Date	1 Year	3 Years	5 Years	10 Years
S&P 500 (US Large Cap)	1.1	8.4	19.7	23.0	15.7	8.0
S&P 400 US (US Mid Cap)	-4.0	3.2	11.8	22.4	16.4	10.1
Russell 2000 (US Small Cap)	-7.4	-4.4	3.9	21.3	14.3	8.0
MSCI EAFE (Foreign Equity)	-5.9	-1.4	4.3	13.7	6.6	6.2
Barclays Aggregate Bond	0.2	4.1	4.0	2.4	4.1	4.7
Barclays Muni Bond	1.5	7.6	7.9	4.6	4.7	4.8

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

total return since the low of March 2009 is a whopping 228%! The chart below shows that while annual market returns have been positive for 26 of the last 34 years, intra-year declines have averaged 14%. We're due for one.

The US economy has continued its tepid recovery. Much has been written about how the current economic expansion (job creation, GDP growth, investment) has been weak when compared to past expansions. Despite the weakness, many economic indicators are positive. Second quarter GDP growth bounced back strongly after a decline in the first quarter. Monthly job numbers continue to meet or exceed forecasts and the most recent release from the Bureau of Labor Statistics showed the unemployment rate at 5.9%, the lowest it has been since 2008. Other reports have been mixed. Retail sales have slowed, wage growth is treading water and housing continues to struggle. The greatest uncertainty with the US economy concerns the market and economic reaction to the Fed's plan to end its bond-purchasing program (quantitative easing) and eventually begin raising interest rates. We hope the economy and markets will have the resilience to move ahead even in the face of higher borrowing costs.

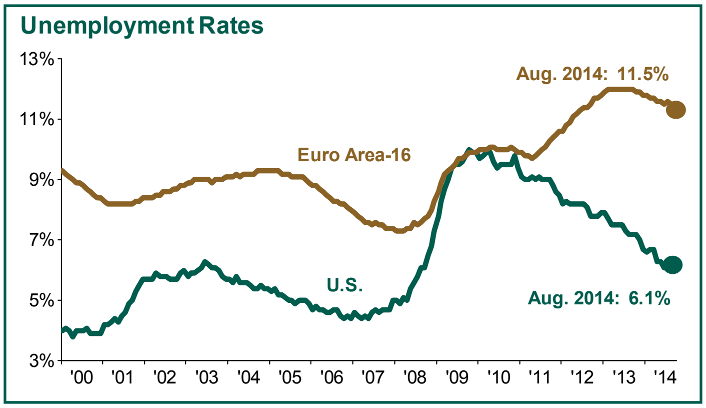
While our recovery has been disappointing, it is important to note that the US, with a five-year real annual growth rate of approximately 2%, is doing significantly better than much of the rest of the world. The combined economies of the European Union have a gross domestic product equal to that of the US and represent 23% of global economic output. The EU member economies grew by only 0.1% in 2013 and many forecast that GDP growth in 2014 won't



*Charts compiled by JP Morgan. Source: Standard & Poor's, FactSet, J.P. Morgan Asset Management. 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 2013 excluding 2014 which is year-to-date.*

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

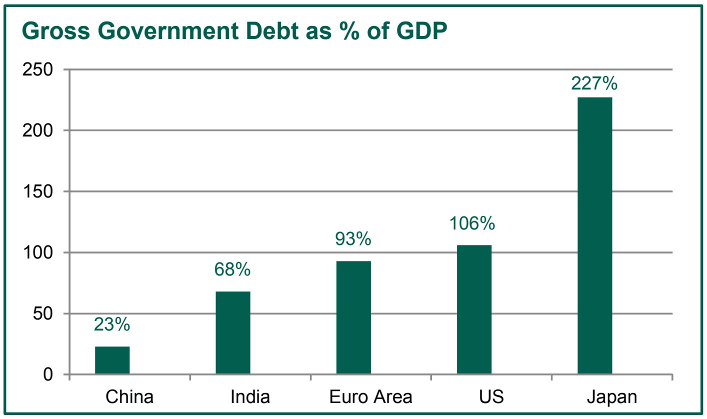
be much higher. With worries of deflation threatening several member country economies, the European Central Bank (ECB) announced new stimulus measures last week including imposing a negative interest rate on banks for their deposits—in effect charging lenders to park money with it. The ECB becomes the first major central bank to impose negative interest rates. While some EU member countries such as Germany and the UK are doing well, other members such as Italy, Spain, Portugal and Greece continue to struggle. The next chart compares the unemployment rate in the EU to that of the US.



Source: Eurostat, BLS, SIFMA, ECBC, FactSet, IMF, J.P. Morgan Asset Management. Unemployment rate levels for the U.S. and Euro Area-16 are not directly comparable due to calculation differences.

Japan, the world's third largest economy, has struggled with deflation and negligible growth for the last fifteen years. Its struggles continue, even as it employs the most aggressive fiscal and monetary stimulus in its history. Japan's deficit spending (borrowing) in 2014 will equal almost 8% of its GDP, the fifth straight year of deficits exceeding 7.5% of GDP. As the chart of government debt to GDP (above, right) shows, if meaningful growth doesn't materialize, Japan is in a pickle. On the monetary front in Japan, even as the Fed in the US tapers its bond purchasing program, Japan's central bank is in the early innings of its own bond purchasing program which dwarfs that of the US. This program will inject an unprecedented amount of liquidity into the Japanese economy over the next two years.

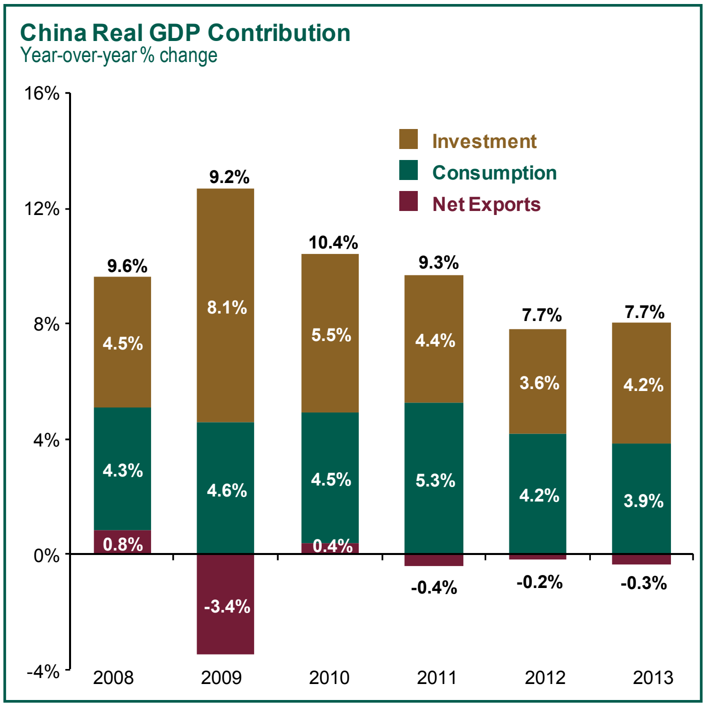
Finally, China, the world's second largest economy, is slowing down. After growing at a blistering rate of approximately 9.5% annually for the ten years ending in 2012, growth for 2013 was 7.7% and is expected to be about 7.5% in 2014. China's leadership learned from the failure of the Soviet Union that there is a limit to an investment-driven economy and after years of massive outlays for highways, bridges, rail and other infrastructure, they are working feverishly to rebalance toward a consumer-driven economy. For comparison, consumption makes up almost 70% of GDP in the US and only about 35% of GDP in China. The chart to the right shows the contribution of consumption and investment toward GDP growth and



Source: IMF International Monetary Fund - April 2014 World Economic Outlook

makes it clear that while consumption is growing nicely, continuing investments are still being required to keep up the pace of growth.

The US, the EU, Japan and China – 66% of the world economy neatly summed up in a few pages. Not quite! To re-use a quote by Charlie Munger, Vice Chairman of Berkshire Hathaway and Warren Buffett's right-hand man, "If you're not confused, then you don't understand it very well." There is indeed a lot going on in the world economy and the future is unknown. As always we recommend that investors have a strong liquidity position (cash, bonds or highly certain income sources) for the near term and a diversified portfolio of ownership positions (stocks, real estate) for the long term.



Source: National Bureau of Statistics of China, The People's Bank of China, EM Advisors Group, FactSet, CEIC, J.P. Morgan Asset Management. Values may not sum to 100% due to rounding.

Limited Visibility *(Continued from page 1)*

the very moment the Bragg family was innocently peddling through. The place was swarming with all kinds of security personnel brandishing machine guns, binoculars, bomb sensors and German Shepherds. Alice stepped up to the officers and tried out some Southern charm (as in Salisbury, NC, Southern charm) but it was to no avail. "Ma'am, I don't care if you've traveled 2,800 miles to see the Golden Gate Bridge, you will not enter this closed area!" Bummer! No cable car, no Golden Gate Bridge. Hmmm.

We were relieved to get out of the city the next day and begin the long, peaceful drive south, down Highway 1. I'm sure some of you have made this drive. Highway 1 parallels the Pacific coast for several hundred miles and offers incredible views from high above the rocky coastline. At least that is what the tour books, websites and brochures say. My family never saw the ocean! The fog was so thick I could barely keep the car on the road. We certainly couldn't see the Pacific crashing on the rocks a thousand feet below us. For three straight days we felt like we were in an airplane flying through an enormous cloud bank! Apparently this fog is fairly common and is caused by the mixing of the warmer inland air with the cooler air off the ocean. While Alice and I were disappointed, the kids really didn't even seem to notice. If you've never driven the Pacific Coast Highway, I strongly recommend it...they say the views are incredible.

Alice and I figured the scenery would improve dramatically when we got away from the fog-obscured coast and into the national parks. Then we learned about the "El Portal" forest fire that had already burned more than 4,000 acres in and around Yosemite. We noticed the smoke as soon as we got into Sequoia National Park. Our pictures of the children standing at the base of the giant Sequoia trees look like scenes from the movie *Backdraft*. We could barely see the tops of the mighty trees. Yosemite was far worse! The whole family coughed and sputtered as we rode our bikes along the smoky trails on the floor of the world-renowned Yosemite Valley. Visibility outside was limited to a few hundred feet but the posters of the waterfalls and of the dramatic peaks, El Capitan and Half Dome, in the visitor's center were amazing! One of the Park Rangers told us, "It's beautiful out there, I promise it is!" Alice and I just had to laugh. What choice did we have? Once again, the kids had no complaints.

Despite the obstacles, we had a wonderful time. Simply being together for ten days made the trip worthwhile. And while actually getting to *see* the state of California was made challenging, we did just fine in the end. Heck, we even made it over the Golden Gate Bridge on our bicycles. This required creativity and diligent planning on the part of your portfolio manager. Alice let it be known that she thought my carefully-calculated risk taking was excessive. "Honey, we are not riding our bikes across this 6-lane freeway." "Sure we are...we'll be fine...PEDAL CHARLIE, PEDAL!" The kids loved Alcatraz and before we left San Francisco the cable car was repaired and we rode it all over town. And though we couldn't see the Pacific Ocean from the cliffs high above, we certainly saw it up close; we even swam in it at some of the prettiest beaches in the world – though they're no match for the beaches of North and South Carolina, of course! And while the smoke limited our visibility in Sequoia and Yosemite, we had experiences we'll never forget. In Sequoia we saw the General Sherman Tree. With a circumference of 102 feet and at a height of 275 feet, it's the largest tree in the world. In Yosemite, we hiked 7 miles round trip (such a big boy, Charlie!) to the top of a 317-foot waterfall (Vernal Falls) and we swam in the Merced River. Did I mention visiting my aunt and uncle in Santa Barbara? Mountains, beaches, perfect weather every day all year. Whew! That's where I'll live in my next life.

The limited visibility we experienced in California is analogous to the limited visibility we feel right now with regard to the future direction of the economy and the financial markets. As you likely know, the US stock market finished the third quarter very near an all-time high. While this is great news, one's head would need to be deep in the sand to miss recent headlines dominating the news: the EU flirting with recession (again), Japan using desperate measures to revive a long-sputtering economy, China slowing down, and of course, the US facing challenges regarding monetary and fiscal policy. Pile on the headlines about Islamic State beheadings and the Ebola virus and there is quite a stew of worrisome information to digest.

In our view, this is a particularly delicate time for the global economy and for investors. There are some fairly large "it-might-work" scenarios in play and they happen to be in play in the largest economies in the world. The EU *might* turn the corner, Japan *might* finally gain traction and move forward, China *might* be able to pull off the transition from an investment-driven economy to a consumer-driven economy and the Federal Reserve *might* be able to gradually return us to a normal (higher) interest rate environment without pushing our economy into recession.

Any portfolio manager will tell you that an "it-might-work" investment is less attractive than an "it-will-work" investment. High visibility is preferable to low visibility and when visibility is low, we think caution is prudent. For this reason our portfolios continue to lean toward more defensive allocations and holdings.

Please let me know if you would like travel tips for visiting California or if you would like to discuss your portfolio or your planning. As always, thank you for choosing Bragg Financial Advisors.

Sincerely,

Benton S. Bragg

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