

INVESTMENT COMMENTARY

1st Quarter 2011



Bragg Building
1031 South Caldwell Street, Charlotte

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“We will learn an enormous amount in the very short term, quite a bit in the medium term and absolutely nothing in the long term. That is the historical precedent.”

- Jeremy Grantham,

Successful value investor when asked what investors would learn from the financial crisis...Barron's September 2008.

CHERRY BLOSSOMS

Spring in Charlotte, North Carolina. A city in bloom — what a gift we enjoy each year! I hope you've been out and about to take in this beautiful place we call home. For our clients who live outside of Charlotte, now is the time to come for a visit!

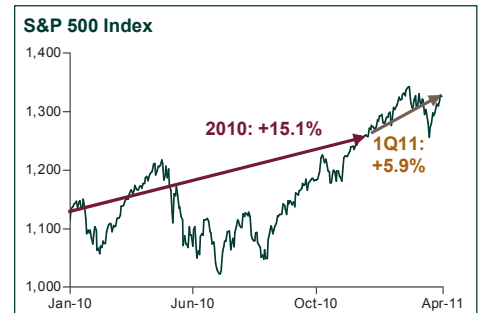
As spring arrived this year, I became keenly aware of the inevitable marching of time. In preparing to write this report, I found myself on the Bragg Financial website reading through the reports we sent out back in the fall of 2008 and the spring of 2009 when the financial system and the stock market were crashing before our eyes. It's hard to believe more than two years have passed since then. Going back in time was an interesting exercise for me and I thought I would share it with you. Here are some selected excerpts from some of those “special commentaries” we sent out during that time of great uncertainty:

October 9, 2008: *“Worldwide stock exchanges plunged again this week after falling over seven percent last week. As of yesterday's close, the S&P 500 is down 36% in price from its peak of last October while foreign markets are down more than 40%. Price declines have not been limited to stocks. Real estate, corporate bonds, municipal bonds and commercial paper have also fallen in value. Worldwide credit markets are not functioning properly. All of us have an uneasy feeling when we see the Dow shed 500, 600, 700 points in one day. It is painful and it is hard to see past this crisis.”*

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WHACK-A-MOLE MARKET

The market had plenty of reasons to retreat into its hole during the first quarter, including unrest in the Middle East, the tragic Japanese tsunami and resulting nuclear crisis, renewed fears about European debt, higher interest rates and signs of inflation, including surging oil prices. But after a brief 5% correction in March, the Dow and S&P ended the first quarter near their highs for the year. Like the mole in the popular Whack-a-Mole arcade game, it seems that you can't find a mallet big enough or fast enough to keep this market down. Of late, whenever there is breaking news, whether about earnings, Egypt, the tsunami, the Japanese nuclear crisis, US politics, inflation, Charlie Sheen's antics...



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Whack-a-Mole Market (Continued from page 1)

whatever the news is, the joke around the Bragg office has been, “I guess the market will be up on that news.” It seems like the market just wants to go up. We’ve been surprised by its resilience but we’re certainly not complaining. As the table above shows, large company stocks as measured by the S&P 500 were up 5.9% for the first three months of the year. Medium sized and small company stocks continued their winning streak relative to large caps and finally, foreign stocks, as measured by the MSCI EAFE index, have lagged on a relative basis.

Market Index Total Returns for Periods Ending March 31, 2011					
Index	YTD 3/31/11	One Year	Three Years	Five Years	Ten Years
S&P 500 (US Large Cap)	5.9%	15.7%	2.4%	2.6%	3.3%
S&P 400 US (US Mid Cap)	9.4	27.0	10.0	6.1	9.4
Russell 2000 (US Small Cap)	7.9	25.8	8.6	3.4	7.9
MSCI EAFE (Foreign Equity)	3.4	10.4	-3.0	1.3	5.4
Barclays Aggregate Bond	0.4	5.1	5.3	6.0	5.6
Barclays Muni Bond	0.5	1.6	4.5	4.1	4.7

On a total return basis, the S&P is now up over 100% since its low of March 2009 (chart previous page). Despite this, it is still 8.5% below its peak of October 2007 and reaching a new high will require a return of 18%.

As we noted last quarter, the market rally continues to be led by stocks we would characterize as low-quality or higher-risk. Specifically, the best performers have been companies with weaker balance sheets, inconsistent earnings, smaller capitalizations and more sensitivity to market risk. Meanwhile, stronger companies or “blue chips” have trailed. We find it interesting that just a short time after enduring a 58% decline in the market, investors appear to have shrugged off their fear and embraced risk with enthusiasm. Other examples of this “risk-embracing” behavior include the rush from bonds to stocks, the rush into emerging markets stocks and finally a seemingly insatiable investor appetite for commodities which tend to be extremely volatile. It’s not the interest in these “riskier” investments that surprises us, but rather it is the *timing* of the interest. Back in March of 2009, you couldn’t interest investors in buying stocks at any price, much less in loading up on corn futures or emerging markets equities. But now that the market is up 100% and commodities prices have tripled or more, investor demand is greater than ever.

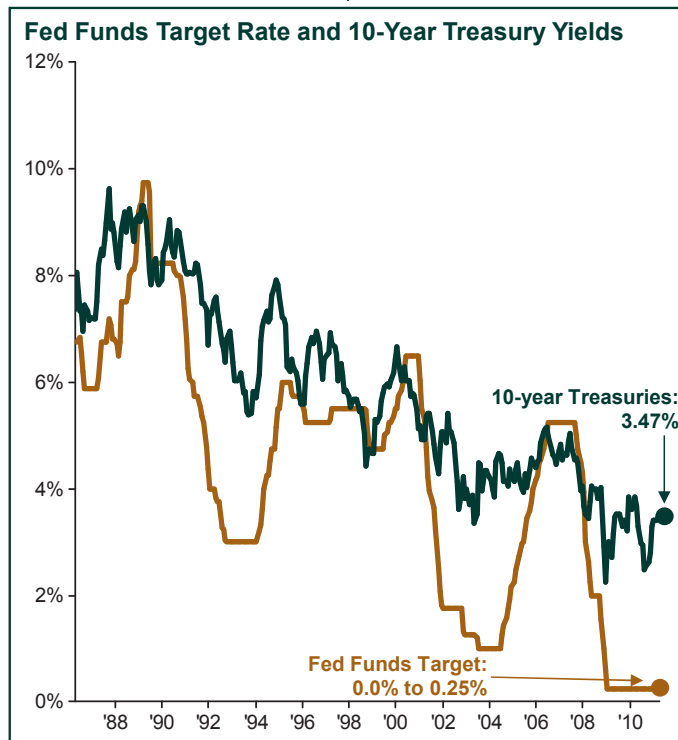
Back in 2008, when the financial system was

falling apart, famed value investor Jeremy Grantham was asked in an interview with *Barron’s* if investors would learn anything from the recent turmoil in the market. He said, “We’ll learn an enormous amount in the very short term, quite a bit in the medium term and absolutely nothing in the long term. That would be the historical precedent.” We’re keeping this in mind at Bragg Financial as we work with the portfolio.

Bonds had a rough quarter. In general, bonds are dealing with the headwinds caused by fears of higher interest rates in the future. You’ll recall that when rates rise, the value of existing bonds falls. Rates have risen somewhat but thus far deflationary pressure (weakness) in the economy has staved off large jumps in inflation and the rate increases that usually follow. Federal Reserve Bank officials are monitoring the recovery and the pace of economic growth for signs of inflation. The Fed hopes to keep adequate monetary stimulus (low interest rates) in place as long as possible to support the recovery but to be prepared to pull back before inflation becomes a problem. This is a tall order given the massive liquidity the Fed has pumped into the economy. The risk is that when the Fed attempts to soak up

the liquidity by selling bonds with higher interest rates, the higher rates will raise borrowing costs and choke off the recovery. A regional executive of the Federal Reserve spoke at my Rotary club recently, and he implied that the challenge facing the Fed was “all in a day’s work,” so to speak. Needless to say, his comments were received with no small amount of skepticism by my fellow Rotarians, many of whom, like many Americans in general, have become more aware of the power and influence of the Fed after the events of 2008 and 2009.

Municipal bonds face the pressure of potentially higher interest rates, but they also are dealing more directly with the risk that some municipal issuers (cities, towns, states, airports, hospitals, stadiums, etc.) may be unable to



All charts compiled by JP Morgan and used with permission. S&P 500 source: Russell Investment Group, Standard and Poor’s and FactSet. Fed Funds Target Rate source: Federal Reserve and FactSet. Federal Budget Surplus/Deficit source: U.S. Treasury, BEA, CBO and OMB. S&P 500 Earnings source: Standard & Poor’s.

Whack-a-Mole Market (Continued from page 2)

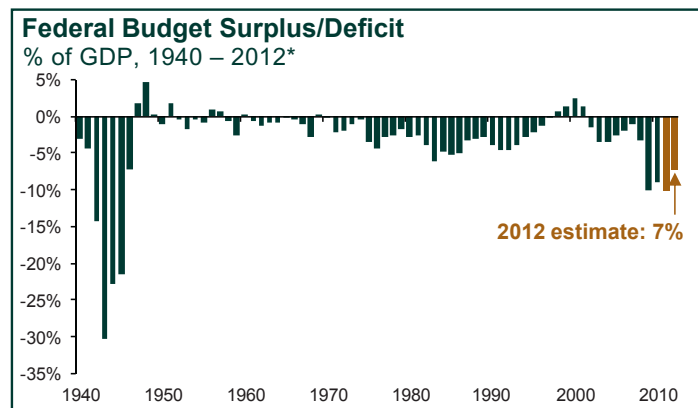
meet their obligations. It is no secret that there is a mad scramble across the country as state and local officials work to get their financial houses in order. You have likely been following the showdowns in Wisconsin, Ohio and other states between governors and public employee unions. The intensity of those struggles is indicative of what lies ahead for almost every municipality in the country and the federal government as well.

We think we will see continued volatility in the bond market in 2011 as a result of these issues. At Bragg, our emphasis in the bond portfolio continues to be on diversification and on quality. Realizing that there is the potential for higher interest rates, we have an average maturity in the portfolio that is shorter than the maturity of the Barclays Aggregate Bond index. This position provides some protection in a rising rate environment since shorter-maturity bonds decline less in a rising rate environment.

If we knew rates were going to rise dramatically in the near term, we would simply go to cash, wait for rates to rise and then buy our bond portfolio back at lower prices and higher yields. But we don't know *when* rates are going to rise. What if after going to cash, rates actually declined and remained low for another 24 months? Would we then feel foolish and buy back in at higher prices or would we sit out the 24 months in a zero-yield money market? Just as with the stock portfolio, we will never take extreme positions with your money. As Mark Twain once said, "It ain't what you don't know that gets you in trouble, it's what you know for sure that just ain't so."

"It ain't what you don't know that gets you in trouble, it's what you know for sure that just ain't so."

- Mark Twain

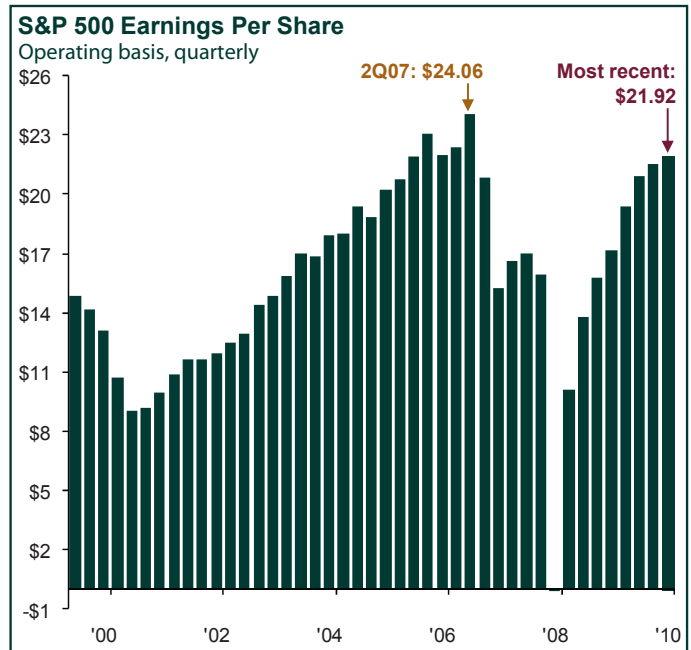


THE THREE LITTLE PIGS

I'm reminded of the popular fairy tale when I think about the US economy. Government (the first little pig) has built its house on a teetering pile of debt and unfunded future

liabilities. Consumers (the second little pig) have homes plagued by unemployment, underemployment, a sense of entitlement and a shortage of the skills needed for today's economy. In contrast, corporate America (the third little pig) has a house built on a solid balance sheet and a well-honed strategy for making profits in a challenging environment. Today, with the consumer flat on his back and governments reeling, corporate America is roaring ahead with huge profits (see nearby chart) and big plans for the future. What

a contrast! Is this sustainable? We would suggest that it is not. We Americans are the Three Little Pigs. We're the shareholders, we're the taxpayers and we're the consumers, and we are obviously mutually dependent on one another. We can't project growth into the future when one in seven of us is underemployed or unemployed, when one in five of us has negative equity in his home, and when we face huge tax liabilities in our future.



We are often asked, "What does your crystal ball say? Will the market move up some more?" It certainly *can* move up some more but at some point we'll have to deal with the debt and the unemployed or we'll get eaten by the wolf. (Did you know that in the original 1843 telling of the story the first two pigs were actually eaten by the wolf? Horrors! Quite different from the Disney version where the pigs simply run away.)

Fortunately, we Americans are human and unlike the two pigs whose houses get blown down, we realize that we've got to rebuild on a firmer foundation. Even as I write, a group of congressmen is taking great political risk by introducing

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Cherry Blossoms *(Continued from page 1)*

Continued Reprint from October 2008: *“While we too are anxious, we are extremely hesitant to sell our stocks or our bonds at these prices. We would rather sell our securities gradually over the twenty to thirty-year period that encompasses our retirement or when the funds are needed to fund college tuition. We could be wrong, but we think these prices are irrationally low and are driven by emotion. At the same time, we know that prices may go lower still. In fact we should tell ourselves they will. We do not have a crystal ball but we think we will look back in a few years and be glad we did not sell our securities at the prices they are trading for today.”*

February 20, 2009: *“With the stock market re-testing the lows of last November, we wanted to share our thoughts about the market, the economy and especially the actions we are currently taking as we manage your portfolio.”*

“The problems with the banks and other financial companies have not been solved. Although the Treasury Department announced a major plan to address the financial crisis on February 9th, the plan was short on details. As of now, investors simply are not confident that the banking system will survive without substantial additional government support. There is growing pressure for the government to consider nationalizing some of the banks as a way to remove the bad loans from the banks’ balance sheets and get credit flowing again. This is a major, major step and one that policy makers have tried desperately to avoid. In our view however, the probability that this will happen has increased substantially in the last few weeks.”

“We are convinced that this will be a very difficult year. As we have said many times in the past, it always takes far, far longer for the market and the economy to adjust than one would think. The months ahead will likely be similar to the few months that have just passed, with rallies followed by declines. Relief followed by more worry. The market is testing the lows of November and it may reach new lows in the coming months. We won’t know when the market has bottomed or when the economy has begun expanding until long after those points in time have passed. Importantly, we have great confidence that at some point in the coming months, the market will bottom and the next phase of economic expansion will begin.”

It takes you back a bit to read that, doesn’t it? Those were difficult days. The dogwood, redbud and cherry trees were blooming back then just as they are today, but it certainly

felt different, didn’t it? We didn’t know what the future held back then. All we could do was try to keep our emotions in check and maintain as much discipline in the portfolio as we could. The same is true today. We feel better in the spring of 2011 than we did in the spring of 2009, but when dealing with the portfolio and our financial decisions, maintaining portfolio discipline and keeping our emotions in check is no less important today, than it was then.

THE BRAGG TEAM IS GROWING!

In our continuing effort to deliver excellent client service, we have hired two new team members.

Marta Brzozka joined our team in March of this year. Marta graduated from UNCC in 2003 with a BS in International Business. She has six years of prior experience in the financial services industry and she joins Bragg as a Client Services Associate.

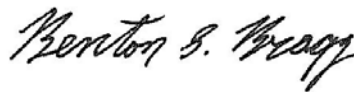
Mary Lou Daly will join our team next month as a Client Relationship Manager. Mary Lou earned her BA in Economics from Davidson College in 1988. She earned her MS in accounting from the University of Hartford in 1991. Mary Lou is a CPA and she recently passed the CFP comprehensive final exam.

In other exciting news, **Susan Dixon** has been promoted to Client Relationship Manager and **Katherine Brooks** has been promoted to Operations Manager.

We recognize that our excellent people are a primary reason you work with Bragg and we are excited to share this news about our growing team of professionals.

Thank you for choosing 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, CFP, CFA
President, Bragg Financial Advisors, Inc.

The Three Little Pigs *(Continued from page 3)*

a proposal that actually cuts entitlement programs including Medicare, Social Security and Medicaid. It also greatly simplifies the tax code and creates limits to future government spending. It’s just a proposal at this point and who knows what will end up passing but it is encouraging nonetheless.

Other signs of encouragement include the fact that private

employers are creating jobs, unemployment has inched down, interest rates remain low, credit conditions are improving for small businesses and consumer balance sheets are in better shape than two years ago. We’ve got a long way to go before our three little pigs are all living in brick houses. The transition will take time and it will likely be an ugly and painful process but as always, we remain optimistic about our future.