INVESTMENT COMMENTARY

3rd Quarter 2015

Bragg Building
1031 South Caldwell Street, Charlotte

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"Most people get interested in stocks when everyone else is. The time to get interested is when no one else is. You can't buy what is popular and do well."

-Warren Buffett

HIGH SCHOOL MUSICAL

My daughter, Frances (12) dropped a bomb on me last Sunday night. I had just returned home after attending my 25th college reunion and she was catching me up on her weekend. She said the highlight had been watching the movie *High School Musical* with her mother on Saturday night. Readers of this newsletter who have children or grandchildren are likely familiar with this Disney super-hit teen romantic sensation that was first screened in 2006. The film quickly became the most successful Disney Channel original movie ever released. Even the film's soundtrack was a winner; it became the top selling album in 2006.

"Didn't I watch that movie with you a few years ago?" I asked her. "Yes Daddy, I've seen it like ten times." Recalling the never-ending singing and dancing, I asked why she liked it so much. She just shrugged so I pressed her:

Daddy: "Really, what do you like about it? Is it the dancing or singing?"
Frances: "Uhmmm, I like it because of Zac Efron."
Daddy: "What? Who is Zac Efron?"
Frances: "Daddy! He plays Troy, the lead character!"
Daddy: "And why do you like him?"
Frances: "I just do."
Daddy: "Come on Francie, tell me."
Frances: "Daddy, it's because he is SOOO good-looking."

I was stunned! Never had my sweet little girl let on that she was interested in boys. "Ugh, boys!" she would say. Of course I always loved hearing that. I

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MARKET AND ECONOMY

Stocks took a beating in the third quarter. Large company stocks, as measured by the S&P 500, lost 6.4% while small company stocks and foreign stocks gave up almost 12%. The decline in the third quarter erased the prior gains of 2015, leaving the indices in the red for the first three quarters of the year. Bonds held up well during the quarter as the Fed, once again, balked on raising interest rates. The table on the next page provides detailed returns.

The major market drivers during the quarter were as follows:

China

The world's second largest economy dominated headlines in the third quarter. A string of weak manufacturing and industrial output reports highlighted the severity of the slowdown in the Chinese economy. Chinese stocks plunged; the Shanghai Composite lost 25% during the quarter. Compounding the problem, the Chinese government intervened in the market in a clumsy and heavy-handed way, taking steps to prop up falling stock prices. The slowdown in China has significant implications for those countries that depend significantly on exports to China like Australia, Brazil, Chile, Indonesia and Mongolia. And while exports to China are a small percentage of total US exports, the indirect impact of China's weakness is significant. For example, John Deere sells tractors to Brazil, which exports grain to China. China is importing less grain and Brazil is importing fewer tractors.

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

Market Index Returns for Periods Ending September 30, 2015

Index	3rd Quarter	Year to Date	1 Year	3 Years	5 Years	10 Years
S&P 500 (US Large Cap)	-6.4	-5.3	-0.6	12.4	13.3	6.8
S&P 400 US (US Mid Cap)	-8.5	-4.7	1.4	13.1	12.9	8.3
Russell 2000 (US Small Cap)	-11.9	-7.7	1.3	11	11.7	6.6
MSCI ACWI X-US IMI Net (Foreign Equity)	-11.9	-7.8	-11.4	2.8	2.1	3.3
Barclays Aggregate Bond	1.2	1.1	2.9	1.7	3.1	4.6
Barclays Muni Bond	1.7	1.8	3.2	2.9	4.1	4.6

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

Over the last five years, China has accounted for as much as half of global demand for key industrial commodities such as iron ore, coal and copper. As you can imagine, China's falling demand for commodities has had a profound impact on pricing. Again, for commodity exporting countries, this creates a hardship but for users of commodities, from manufacturers to consumers, lower input prices have been and will continue to be a positive phenomenon.

The Fed Decision

After weeks of build-up, the Fed again stood pat on rates at its September meeting. The announcement seemed to surprise the market – many thought the Fed had sent clear signals that it would start raising rates. Instead of cheering the prospect of continued cheap money, the market sold off, perhaps spooked by the Fed's suggestion that global weakness couldn't support higher rates. Many investors, including Bragg, have felt that the Fed needs to return interest rates to more normal levels, but the "can-kicking" continues. The Fed certainly has reasons to hesitate. In addition to global weakness, economic growth in the US continues to be lackluster. As if right on cue, the Labor Department last week released a disappointing jobs report. Employers added only 173,000 jobs in September (200,000 were expected) and the numbers for July and August were revised downward. The unemployment rate remained steady at 5.1% but only because 350,000 workers dropped out of the labor force, driving the labor force participation rate to 62.4%, its lowest level since 1977.

Earnings

Once again we'll make the point that in the long run, stock prices are driven by corporate earnings. Twelve-month trailing earnings for the S&P 500 reached an all-time high one year ago on 9/30/2014. We're still waiting for the 9/30/15 numbers but as of 6/30/15, twelve-month trailing earnings were 10% lower than those of 9/30/14. We may see a further decline for the third quarter. Much of this decline can be blamed on the beleaguered energy sector but the strong dollar has slowed revenue and earnings for many large companies. Swings like these are not unusual and history is on our side. As investors we should remind ourselves that the people working at the companies whose shares we own have a huge incentive to grow--to grow sales, to grow market share, and ultimately to grow earnings. Such is the nature of stock ownership.

Summary

The world economy is intertwined and it's currently dealing with a soft patch. The model of the last ten years has pretty much been for the commodity-exporting nations of the world (Russia, Brazil, the OPEC countries, Australia and Mexico) to extract resources from the ground, ship the stuff to China and let them produce the goods that will be gobbled up by the wealthy nations of the world. The model has worked well and created tremendous wealth in emerging economies. Consumers in rich countries have enjoyed a higher standard of living as low-cost inputs (including labor) have bolstered purchasing power. We're now seeing that emerging economies overbuilt, anticipating that the good times would last forever. Meanwhile developed countries piled up a massive debt burden that has slowed economic growth to less than 2%. The US is one of the few bright spots but with US GDP growth at 2%, carrying the world is a tall order. We are optimistic that the consumer will prove resilient as shopping season approaches but we may see more volatility as we work through this. ■

High School Musical *(Continued from page 1)*

was the only man in her life. In her words, "My sweet Daddy is the BEST!" But alas, I guess those days are fading.

Once I recovered from shock, I remembered my parental role and hastily reeled off a cliché-loaded sermon. "N-Now, Frances, j-j-just remember that beauty is only skin deep, character is what really matters, that guy Zac what's-his-name is just an actor, it's what's on the inside that counts, you can't judge a book by its cover, all that glitters isn't..." and so on. As I rambled, Frances just giggled and dashed out of the room leaving the former Bravest-Man-in-the-World sitting there on the couch feeling sorry for himself.

All that glitters isn't gold...it's true. Of late, it seems investors may have forgotten that important lesson. Specifically, investors have fallen in love (again) with growth stocks. There are a numbers of ways to define "growth stocks." The most common would be that a growth stock is the stock of a company that is experiencing a high rate of sales growth or earnings growth. Some growth stocks don't have earnings but are expected to have great prospects for earnings in the future. Perhaps the best way to define a growth stock is to say Facebook, Tesla, Netflix, Apple, Google, Gilead Sciences and Amazon. That helps doesn't it?

Critical to understanding growth investing is to understand that growth stocks usually trade at very high prices--high multiples of earnings or sales. This is because investors have lofty expectations that these companies will rapidly grow their earnings, thus justifying the higher valuations. For example, Amazon today trades at 92 times next year's expected earnings, Netflix trades at 250 times its earnings of the last 12 months and Tesla, the electric car and battery maker, is valued at $31 billion dollars despite never turning a profit. In contrast to these growth stocks, "value stocks" typically trade at much lower valuations. For example, slow-growing IBM trades at 9 times next year's expected earnings, Wells Fargo trades for 12 times earnings and Exxon trades at 17 times earnings.

I read an article in the *Wall Street Journal* about six weeks ago that noted that just six growth stocks accounted for substantially all of the gain in the S&P 500 in 2015 through the end of July. Five of the six are listed above and Disney is the sixth. As of this writing, the S&P 500 no longer has a gain this year but the point remains that a concentrated number of stocks have experienced gains this year while the majority of companies are lagging. We last saw this phenomenon back in 1998, 1999 and early 2000 during the dot.com, tech-bubble years. At the time, the majority of companies saw their stock prices stagnate or decline while a handful of large technology firms powered the market indices higher. I remember all too well when clients called to ask, **"Why does Bragg own these old-economy, value stocks in the portfolio? The companies of the future seem to be the new-economy, growth firms like AOL, WorldCom, Intel, Cisco, Microsoft, EMC, Oracle and Dell. Shouldn't we buy more of these?"**

The questions started sounding more like demands in 1999 when the tech-heavy NASDAQ soared over 85% in a single year. It seemed investors couldn't resist chasing after these returns. I realized Warren Buffett was right when he said, "Most people get interested in stocks when everyone else is. The time to get interested is when no one else is. You can't buy what is popular and do well." It is hard to believe it has been more than fifteen years since we endured that difficult period. Maybe fifteen years is just long enough for investors to forget the pain they endured when the technology party ended. If you're in the forgetful camp, take a look at the table below.

Growth Dominated Value as the Tech Bubble Inflated. This did not end well.

	US Large Growth	US Large Value	US Small Growth	US Small Value
1996	23.6	22.5	10.7	24.7
1997	33.5	34.2	15.0	31.4
1998	42.2	16.7	5.3	-4.2
1999	36.6	3.1	55.9	0.5
2000	-28.1	8.6	-21.3	19.2
2001	-23.0	-5.8	-8.3	12.8
2002	-29.2	-16.1	-33.7	-5.5
2003	28.5	28.2	49.8	45.3

Large Growth Returns: Average of Dow Jones Large Growth Index and Dow Jones US Large Cap Growth Index. Large Value Returns: Average of Dow Jones Large Value Index and Dow Jones US Large Cap Value Index. Small Growth Returns: Average of Dow Jones Small Growth Index and Dow Jones U.S. Small Cap Growth Index. Small Value Returns: Average of Dow Jones Small Value Index and Dow Jones U.S. Small Cap Value Index.

And take a look at the recent performance of growth and value on the next page. A significant gap has opened up between growth and value. While both are negative, value has fared much worse than growth.

Why is this happening? It may be because investors are getting it right. Maybe Amazon, Facebook, Tesla and Netflix will grow into their lofty prices and therefore deserve to be driven up to these high levels. Or maybe investors are simply gobbling up the only growth they can find. And growth is not abundant these days. As discussed in the Market and Economy section of this commentary, many US corporations have seen their earnings growth slow dramatically or even decline over the last 12 months in the face of a stronger dollar and a slowing global economy. The

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High School Musical *(Continued from page 3)*

We've Recently Seen a Gap Opening between Growth and Value

	US Large Growth	US Large Value	US Small Growth	US Small Value
2012	15.3	17.5	14.6	18.1
2013	33.5	32.5	43.3	34.5
2014	13.1	13.5	5.6	4.2
2015 as of 9/30/2015	**-1.5**	**-9.0**	**-5.5**	**-10.1**

Large Growth Returns: Russell 1000 Growth. Large Value Returns: Russell 1000 Large Value. Small Growth Returns: Russell 2000 Growth. Small Value Returns: Russell 2000 Value. Past performance is no guarantee of future performance.

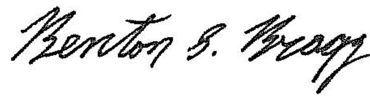
few companies enjoying continuing growth are attracting a lot of attention. Finally, there is the "rearview mirror effect" that leads investors to chase what has been hot. We're likely seeing a combination of these factors at play. Regardless of the reasons why the gap has opened between growth and value, our job is to stick with the discipline of owning a diversified portfolio.

Bragg's portfolio has historically had a "tilt" toward value stocks. Said another way, we've made an effort to construct a portfolio that we believe is more defensive than the market. The goal is to preserve capital in down markets while knowing that in hot growth markets, we may trail the major benchmarks. While there is certainly no guarantee that we'll accomplish this, over full market cycles we hope to perform in line with the market while taking less risk. My father always said, "The goal is to lose less money than the other guys who are out there trying to shoot the lights out." While this likely sounds attractive on its face, history makes the case that investors who followed this approach over the long term fared very well compared to a growth strategy. Spend some time studying the table below, which compares growth and value indices from 1980 through today. In particular, look at the ending value of $10,000 invested over this period assuming one earned the index returns. I think you'll agree, the difference is dramatic. This is why we emphasize value in our portfolios.

If you're still reading, you're to be congratulated for making it through all the charts, tables and statistics. Something tells me tables and stats won't be very effective in teaching my daughter Frances how to recognize true "value" in a boy but hopefully, she's learned something along the way from her mom and dad that will help her invest well for the long term.

As always, thank you for choosing Bragg Financial Advisors for your planning and investing.

Sincerely,



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	US Large Growth	US Large Value	US Small Growth	US Small Value
Year-to-date as of 9/30/2015	-1.5%	-9.0%	-5.5%	-10.1%
10 years ending 12/31/14	8.2%	7.2%	9.6%	7.7%
20 years ending 12/31/14	8.7%	10.1%	9.3%	11.7%
35 years ending 12/31/14	10.5%	12.1%	10.4%	13.9%
Volatility: Lower is Better! 35-year standard deviation using annual returns	20.6%	15.1%	22.8%	17.8%
Growth of $10,000 1980 - 9/30/2015	**$328,813**	**$492,784**	**$299,400**	**$846,611**

Through 2010: Average of Dow Jones Large Growth Index and Dow Jones U.S. Large Cap Growth Index. After 2010, Russell 1000 Growth used. Through 2010: Average of Dow Jones Large Value Index and Dow Jones U.S. Large Cap Value Index. After 2010, Russell 1000 Value used. Through 2010: Average of Dow Jones Small Growth Index and Dow Jones U.S. Small Cap Growth Index. After 2010, Russell 2000 Growth used. Through 2010: Average of Dow Jones Small Value Index and Dow Jones U.S. Small Cap Value Index. After 2010, Russell 2000 Value used. Past performance is no guarantee of future performance.

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