Investment Commentary

4th Quarter 2013

Bragg Building
1031 South Caldwell Street, Charlotte

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> "Bull markets are born on pessimism, grow on skepticism, mature on optimism and die on euphoria."
> *Famed value investor Sir John Templeton*

MOUNTAINEERING & YOUR MONEY

My brothers, John and Phillips, and I climbed the Grand Teton in Wyoming back in 1988. You're likely familiar with the Teton Range from your travels or from pictures or perhaps from Chevy truck ads on television. The Tetons aren't the tallest mountains in the US, much less the world, but the dramatic vertical elevation gain from the valley floor near Jackson, Wyoming to the top of the jagged peaks makes for spectacular scenery. The Grand itself soars 7,000 feet–almost straight up from 6,700 feet of elevation at the valley floor to 13,770 feet at its summit. Stack up eight of Charlotte's Bank of America towers and that is the vertical rise of the Grand Teton.

At the time of our great ascent, I was holding down a summer job pumping gas in Yellowstone National Park (putting that Wake Forest education to good use). As Yellowstone is just north of the Tetons, I saw the mountains regularly and being a strong, fearless, twenty-year-old, the temptation to conquer the Grand was irresistible. When John and Phillips planned to visit me in Wyoming, I proposed that we climb the Grand. I told them I had a guide lined up so we wouldn't have to worry about getting lost or hurt. Equally young, foolish and fearless, they quickly agreed. I didn't tell them our guide was a guy from Arkansas who pumped gas with me in the park and had only climbed the Grand once before. As I saw it, we were all set!

I'll jump ahead and tell you that we made it to the summit of the Grand and back to the trailhead successfully. But it wasn't pretty. Our guide, Don, truly didn't know what he was doing. He had a one-page map torn from some hiking magazine and some scrawled, handwritten instructions from his last climb. A basic ascent of the Grand calls for the following: backpack halfway up the mountain on day one and spend the night in a relatively flat area called the Morain. Get up early the next morning and begin your climb to the summit so you can be off the mountain by noon to safely avoid the afternoon electrical storms.

Day one was uneventful and everything seemed to be going well for the first half of day two as we climbed the solid exposed granite of the Exum Route. The climb itself is not technical; I would compare it to climbing a very tall tree. But the exposure is significant so we used ropes in several sections where there were sheer drops of over 1,000 feet. It was exhilarating. John Bragg was leading as we made our way up the final section approaching the summit. We were preparing to celebrate when he called down to us, "I think we went the wrong way!" Indeed we had. Our (Don's) chosen route had taken us

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2013 SURPRISE

The Standard & Poor's 500 Index closed at a record high on the last trading day of 2013. After surging 10.5% in the fourth quarter, it finished the full year with a total return of 32.4%. It was the fifth positive year in a row for this broad measure of US large company stocks and as crazy as it sounds, including dividends, the S&P is now up a remarkable 201% since its low of March 2009. Small company

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1031 South Caldwell Street, Suite 200 • Charlotte, North Carolina 28203
(704) 377-0261 • Fax (704) 334-9754

2013 Surprise *(Continued from page 1)*

Market Index Returns for Periods ending December 31, 2013

Index	4thQtr 2013	One Year	Three Years	Five Years	Ten Years
S&P 500 (US Large Cap)	10.5%	32.4%	16.2%	18.0%	7.4%
S&P 400 US (US Mid Cap)	8.3	33.5	15.6	21.9	10.4
Russell 2000 (US Small Cap)	8.7	38.8	15.7	20.1	9.0
MSCI EAFE (Foreign Equity)	5.7	22.8	8.2	12.4	6.8
Barclays Aggregate Bond	-0.1	-2.0	3.3	4.4	4.6
Barclays Muni Bond	0.3	-2.6	4.8	5.9	4.3

Three-, five- and ten-year returns are annualized

stocks fared even better in 2013 with the Russell 2000 Index up 39%. Foreign developed markets as measured by the MSCI EAFE Index trailed the US but still posted a return of 23%. Emerging markets, dominated by China, India and Brazil, were actually down 2%-3% for the year. Bonds had a lousy year as interest rates rose significantly. The Barclays Aggregate Bond Index was down 2% for the year while the Barclays Municipal Index was off 2.6%. The table at the top of this page provides multiple period returns for all of these indices. Note that while the three- and five-year returns look great, the ten-year return column captures the fact that we've been digging out of a deep hole. Since the high of October 2007, the S&P is only up 35% cumulatively.

2013 was a remarkable year for stocks considering the headwinds. The year began with the "fiscal cliff" crisis in Washington and as the year progressed, the market endured political problems and recession in Europe, a shutdown of the US government, the Fed's announcement that it will reduce its bond purchases, a botched rollout of the Affordable Care Act and civil war in Syria. Through it all, the worst peak-to-trough dip the market took was a 5.5% drop after the Fed first introduced the word "taper" to investors back in May. 2013 certainly wasn't kind to those on the sidelines waiting for a "good time to invest."

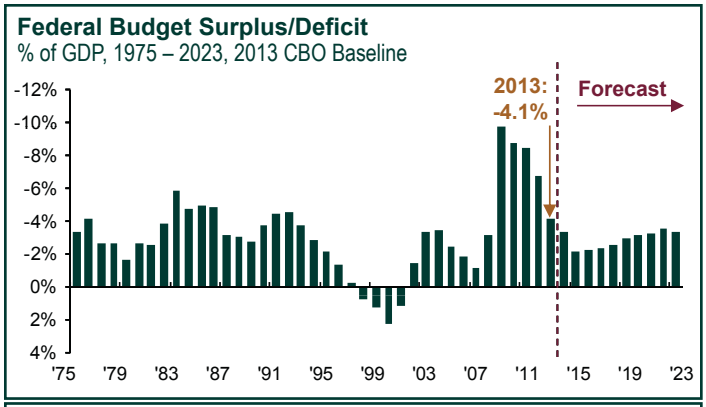
2014 FORECAST

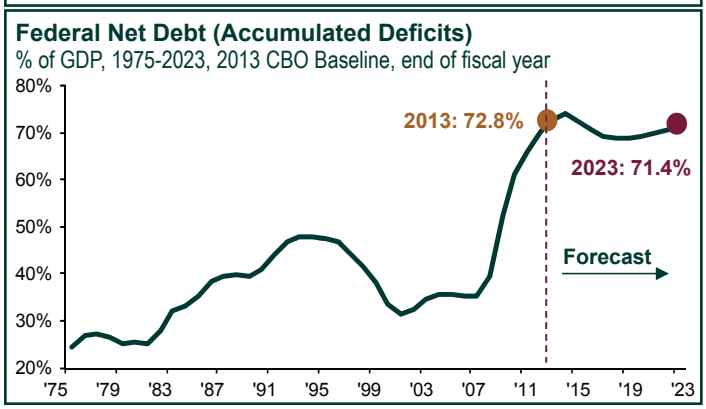
This will be a first! We've never published a forecast. We're the first to humbly tell you that we can't see the future. We think recognizing and acknowledging this is one of our greatest strengths as your investment advisor as it results in our constructing a diversified portfolio that is designed to survive (and hopefully prosper) regardless of what the future brings. But since we are entering a new year, here are our predictions. Don't worry, we won't make big bets based on these, and neither should you.

The Affordable Care Act will dominate the headlines in 2014. Simply put, this is a massive change for our country and it has and will require the attention of almost every corporation and millions of individuals. It's no secret that implementation is off to a rocky start and we're only in the early innings.

The Fed will get its share of headlines as well. Ben Bernanke's eight-year term as Fed Chair ends on January 31st. His replacement, Janet Yellen, will face the challenge of weaning the market and the economy off the massive stimulus the Fed has provided since the financial crisis. Reducing the stimulus will most certainly result in higher interest rates which may put a damper on economic growth. Obviously this is a tough balancing act with a $17 trillion economy.

US economic growth will be below average in 2014. There will be bright spots including an improving housing market, an emboldened consumer, lower energy





Charts compiled by JP Morgan. Source: U.S. Treasury, BEA, OMB, CBO. Note: Years shown are fiscal years (Oct. 1 through Sep. 30). 2013 numbers are J.P. Morgan Asset Management estimates.

2014 Forecast *(Continued from page 2)*

costs, a resurgence in manufacturing jobs, and renewed investment by corporations. Offsetting these positives will be the challenges mentioned earlier (higher interest rates and the implementation of the Affordable Care Act) coupled with the continuing drag from excessive consumer and government debt. All in all, we think the economy will make progress in 2014 but the rate of growth will be similar to the subpar pace of the last four years.

Our elected leaders in DC will continue the battle over spending. First up is another debt ceiling fight that will likely commence later this month. The charts at the bottom of page 2 show that deficit spending is now on the wane after four years of trillion dollar deficits. The deficit reduction has resulted from mandatory spending cuts (the "sequester") as well as higher tax revenues. But while the deficit has been reduced, total outstanding debt has ballooned. According to the US Treasury website, on January 2, 2014, debt held by the public was approximately $12.3 trillion or about 73% of GDP. Intra-governmental holdings stood at $4.9 trillion or 29% of GDP, resulting in a combined total public debt of $17.3 trillion or over 100% GDP. Don't expect the partisan fighting to end any time soon.

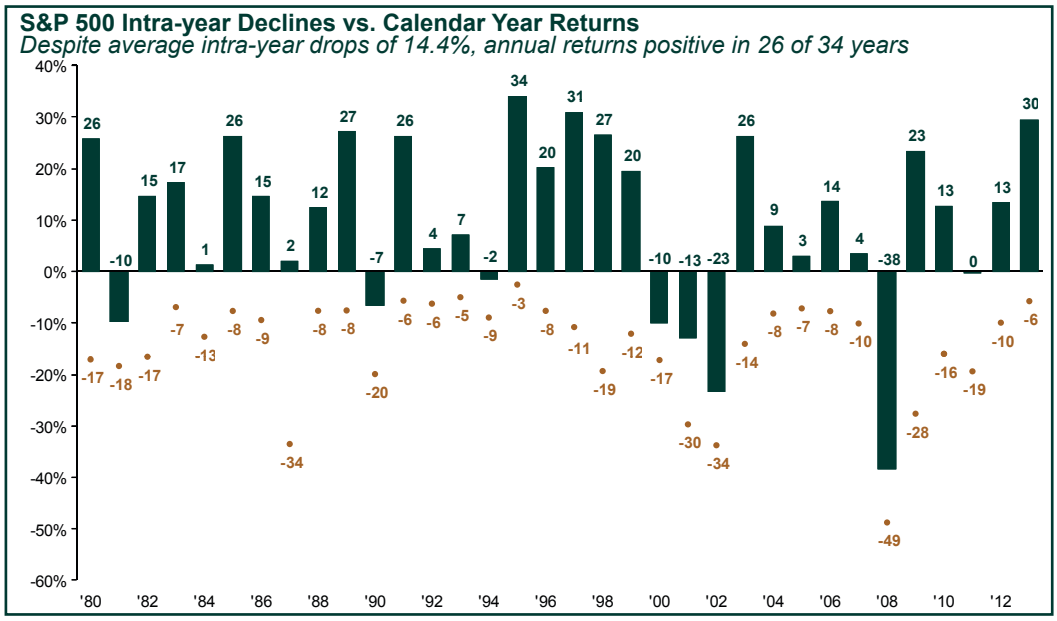
China will continue to struggle. The transition from an investment-led economy to a consumer-led economy will be rocky. Initial efforts to pull back on government-directed investment in infrastructure have resulted in a significant slowdown as the consumer economy is not yet mature enough to fill the gap. We often refer to China's command economy as "nine guys in a room" making decisions for 1.4 billion people and the world's second largest economy. The uncertainty is tremendous. And yet, a good outcome is important to the stability and prosperity of the entire world.

2014 will be a breakout year for the Wake Forest men's basketball team. Coach Jeff Bzdelik's detractors will be silenced when the Deacs knock off the Tar Heels and the Blue Devils and advance deep into the NCAA Tournament.

Bonds will have another below-average year, breaking even or suffering a small loss. There will likely be a lot of talk about bonds getting clobbered as a result of potentially higher interest rates. But based on the weakness in the economy and the Fed's ongoing commitment to remain accommodative, we don't see rates surging so dramatically that bonds suffer large losses.

Stocks are anyone's guess. Sorry. I wish we could do better than that but we put equal weight on stocks doing well as we put on stocks taking a breather. At a minimum, we are due for a correction. According to BTN Research, as of January 5th, 2014, the S&P 500 has gone 825 calendar days (since 10/03/11) without a correction of at least 10%, the fifth longest stretch in the last 50 years. 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 some pain. Headwinds for stocks include relatively rich valuations, higher interest rates, slowing revenue growth for many companies, profit margin contraction, weakness in Europe and slowing growth in emerging economies. Headwinds notwithstanding, we are the first to acknowledge that stocks may power ahead from these levels. As discussed in the Teton commentary, many investors are still on the sidelines waiting to get in and while optimism is in the air, we don't think we are quite in the peaking stage of euphoria just yet.

And finally, 2014 will bring a number of things that have never before crossed our minds. Hopefully they'll be good things. Happy New Year!



Source: Standard & Poor's, FactSet. 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.

Mountaineering & Your Money *(Continued from page 1)*

up the "false summit" of the Grand and the true summit was another 1200 feet above us. We had to backtrack for two hours to get back on the right route. This put us well behind schedule. It was already 2pm and we should have turned back. Instead, we ignored the risk of being on top of an exposed mountain peak in an electrical storm and pressed on. We finally reached the summit at 5:30pm and miraculously the skies were perfectly clear. We traded high fives, enjoyed the view (it is incredible), took pictures and started down. The plan was to descend by a different route, pick up our packs where we'd left them in the Morain, hike six miles to our car at the trailhead and then drive to La Casa Grande Mexican Restaurant in Jackson Hole for a big celebration. Once again, we lost the trail. We went down the wrong canyon and ended up dangling at the end of our rappelling rope when it wasn't long enough to get us to the bottom of a 200-foot drop. In climber's parlance, we "cliffed out." Somehow we clung to a tiny ledge, retied the rope and started down again, only to end up rappelling into a glacial pool fed by an ice-cold waterfall. Drenched, exhausted and cold we stumbled on down the mountain and made it to the trailhead by midnight.

We did it! We conquered the Grand. And we celebrated...raised a glass, called friends and family, the works. But boy did we take a lot of risk. It was pure luck that we didn't get electrocuted on top, stranded in a dead-end canyon or injured while stumbling around in the dark.

Benton, John, and Phillips Bragg with friends atop the Grand Teton.

I was reminded of those mountaineering exploits of 25 years ago as I read the *Wall Street Journal* this morning (Jan. 2). The front page profiled some investment managers who scored big in 2013. "Brave Investors Score Huge Market-Beating Wins!" shouted the headline. The article singled out a Goldman Sachs trader named Chris Tuohy who turned a $10 million bet against gold into a gain of $100 million as gold prices plunged. Also noted was David Tepper, a hedge fund manager with Appaloosa Management who made 48% by timing the market. Back in 2008, the *Journal* and other publications celebrated spectacular returns made by John Paulson and his hedge fund when he bet against subprime mortgages at the peak of the housing bubble. One headline hailed Paulson's bet as "The Greatest Trade Ever!" Paulson reportedly earned over $3 billion himself that year. Absent from these stories is any mention of the enormous risks taken by these managers. They made huge bets and they got it right. Meanwhile, other investors (not profiled in the *Journal*) made huge bets and got it wrong. Someone is making a huge bet today as you read this. Another big bet will be made tomorrow. And someone will end up on the front page of the *Journal* next year. More folks won't. How about the guy on the other side of Chris Tuohy's gold trade? If Tuohy made $100 million, someone lost $100 million. Hmmm. Like our conquering The Grand Teton, these stories make for entertaining reading and they sell newspapers. Who wants to read about my uneventful day hike with the kids at Kings Mountain or the investor with the diversified 60/40 stock/bond portfolio that was up 12% in 2013? Yawn.

In an ideal world people would make rational investment decisions. They would invest only after considering both the risks and the rewards. They would put their emotions aside and invest with discipline. Unfortunately this world doesn't exist. Humans are emotional beings. Whether it is the individual investor, the pension fund committee or the institutional investment consultant, history has shown that emotions drive investor behavior and are a huge factor in the movement of the market. And never is behavior more irrational than at the bottom of the cycle or at the top of the cycle. Famed value investor Sir John Templeton once said "Bull markets are born on pessimism, grow on skepticism, mature on optimism and die on euphoria." Think back to the pessimism of 2009. Every headline was bad. It just felt *terrible*. No one wanted to buy stocks when they were on sale. How about today? Where are we? Are we much more optimistic? Are more headlines good...economy growing moderately, unemployment rate falling, housing improving, stock market at all-time high and so forth? Feels a little better, doesn't it? Probably not euphoria yet but certainly in the optimism stage. And predictably, more investors now say they are comfortable owning and buying stocks.

We may see the market go even higher in the coming months. We may see the news get even better. If so, we'll read more stories about "Brave Investors" and "Market-Beating Wins" and we'll hear of friends who dumped their bonds and increased their allocation to stocks. If we're so unlucky, we may even experience euphoria. If we get to euphoria (think of your day-trading brother-in-law and your condo-flipping cousin), there will be zero bad news and the disciplined investor will be plagued by the feeling that he is being left behind as everyone else makes a killing. At no time is discipline more important. Heed the risk. Beware the summit. Be prepared.

On behalf of everyone at Bragg Financial I wish you the best in 2014! Thank you for choosing our firm for your planning and investing.

Sincerely,

Benton S. Bragg

Benton Bragg, CFP®, CFA
President, Bragg Financial Advisors