Investment Commentary

1st Quarter 2014

Bragg Building
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"You don't know how easy this game is until you get into that broadcasting booth."
-Mickey Mantle

RIGGED MARKETS & THE TOOTH FAIRY

My youngest son, Charlie (age 6), lost another tooth this week. This one had been loose for some time, dangling around in plain view whenever he smiled. We finally got it out while he was brushing his teeth before bedtime. After spitting blood into the sink for about five minutes, Charlie looked in the mirror and saw that he now had only two teeth remaining in front on the bottom row. He looked at me, bared his two snaggled teeth, declared that he was a tiger and ran off down the hall to terrorize his sister. "I'm a tiger, Frances! ROOOOAAARRR!" The fun continued until Charlie dropped his prized tooth down the drain in the bathroom sink. Uh oh. The boy stood there and cried the biggest tears you've ever seen. "I dro-opped my too-oth down the dra-ain and now the tooth fairy won't co-oo-oo-me," he sobbed. Hmmm. Think, Benton, think!

I first considered opening the drain trap to retrieve the tooth but that sounded like a lot of trouble. Why bother with all of that? If we're going to lie to our children about the tooth fairy, why not make up a whopper? So I told Charlie that *of course* the tooth fairy would still come. "We'll leave a detailed note for the tooth fairy directing her [him?] to the bathroom sink drain where the tooth can be found. The tooth fairy will simply go down the drain and retrieve the tooth...she can swim and uh, breathe underwater...no problem at all...happens all the time...please stop crying." Charlie believed me. All was well. As an aside, according to Wikipedia, a 1984 study conducted by Rosemary Wells revealed that 74

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A RETURN TO NORMALCY

Major US stock indices were up less than 2% in the first quarter. While nothing to sneeze at, the advance is a far cry from the 10% gain in the fourth quarter of last year which capped a total return of over 30% for all of 2013 and an astounding 200% cumulative return since the low of 2009. The table at the top of page 2 illustrates these remarkable returns. We've also included a chart on the next page we call the "Cardiac Chart" which showcases the roller coaster investors have endured since 1997.

The first quarter of 2014 was volatile, with multiple triple-digit days for the Dow as investors reacted to a multitude of issues including mixed US economic reports, comments from the new leadership of the Federal Reserve, emerging markets weakness and escalating tensions in Ukraine. We welcome this return to a more "normal" market environment where investors appear to have a healthy respect for risk. Long-lasting, one-direction market rallies usually bring out the worst in investor behavior. And while the market was volatile during the quarter, stocks remain very close to all-time highs.

Bonds had a huge quarter, reversing much of the decline of 2013. Taxable bonds, as measured by the Barclays Aggregate Bond Index, were up 1.8% while municipal bonds were up over 3%. These gains were driven primarily by the comments of Janet Yellen, the new Chair of the Board of Governors of the Federal Reserve System. Yellen assured investors that while the

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A Return to Normalcy *(Continued from page 1)*

Fed will continue to reduce its purchases of Treasury and agency bonds ("the taper") it has no intention of actually raising interest rates in the near future. On cue, both stock and bond prices rallied on this news. Since the depths of the financial crisis in December of 2008, the Fed has maintained a target for short-term interest rates of 0.00% - 0.25% in an effort to stimulate the economy. As an aside, you might find it interesting, indeed remarkable, that the Fed Funds target rate during the inflationary early eighties was 18%-20%!

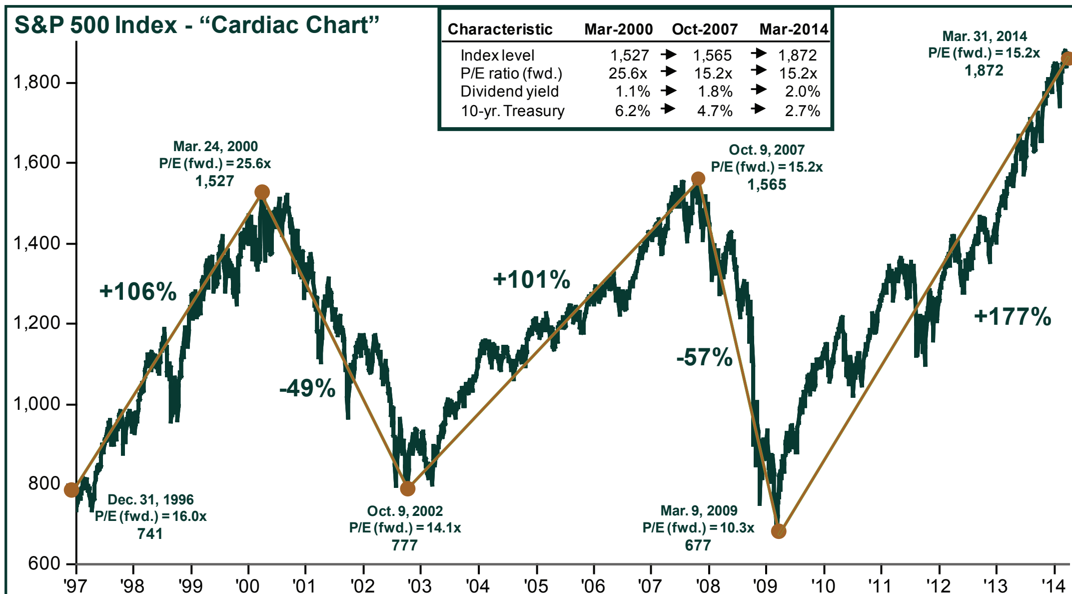
Cumulative Total Returns

	1st Quarter 2014	2013	Since Market Peak of 2007	Since Market Low of 2009
Large Caps	1.8%	32.4%	37.9%	208.3%
Mid Caps	3.5%	34.8%	55.5%	275.2%
Small Caps	1.1%	38.8%	51.9%	266.3%

Source: Russell Investment Group, Standard & Poor's FactSet, J P Morgan Asset. All calculations are cumulative total returns, including dividends reinvested for the stated period. Since Market Peak represents period 10/9/07 – 3/31/14. Since Market Low represents period 3/9/09 – 3/31/14. Returns are cumulative returns, not annualized. Total return is based on Russell-style indexes with the exception of the large blend category, which is reflected by the S&P 500 Index. Past performance is not indicative of future returns.

While short-term rates have remained low, yields on intermediate- and long-maturity bonds have risen since the lows reached in 2012. As I type, a ten-year Treasury bond yields 2.7%, significantly above the low of 1.40% reached in July of 2012. But while yields have risen, they are still quite low and we continue to expect only modest returns from our bond holdings. We think an appropriate philosophy when determining your allocation to bonds and stocks is as follows: "The portion of my portfolio that is invested in bonds will yield very little. But I will hold my nose and own enough bonds to provide the liquidity and stability that I require. Beyond my need for liquidity and stability, my portfolio is invested in stocks which are much more volatile but should allow me to outpace inflation over the long term." Depending on your age and the certainty of your income sources, you may need more/less of your portfolio in bonds.

The returns of stocks and bonds in the first quarter remind us that no one can see the future. Back in December of 2013, I must have heard a hundred different pundits/economists/market strategists/talking heads offer up something like this: "We see stocks having a strong first quarter and we expect further weakness in bonds." That was the consensus. The consensus was wrong, again. Stocks started out with a 5% dive before finishing with a lackluster gain. Meanwhile, bonds knocked the cover off the ball. As Warren Buffett recently said, "Forming macro opinions or listening to the macro or market predictions of others is a waste of time. Indeed, it is dangerous because it may blur your vision of the facts that are truly important." (When I hear TV commentators glibly opine on what the market will do next, I am reminded of Mickey Mantle's scathing comment: "You don't know how easy this game is until you get into that broadcasting booth.")



Charts compiled by JP Morgan. Source: Standard & Poor's, First Call, Compustat, FactSet. Dividend yield is calculated as the annualized dividend by price, as provided by Compustat. Forward Price to Earnings Ratio is a bottom-up calculation based on the most recent S&P 500 Index price, divided by consensus estimates for earnings in the next 12 months (NTM), and is provided by FactSet Market Aggregates. Returns are cumulative and based on S&P 500 Index price movement only, and do not include the reinvestment of dividends. Past performance is not indicative of future returns.

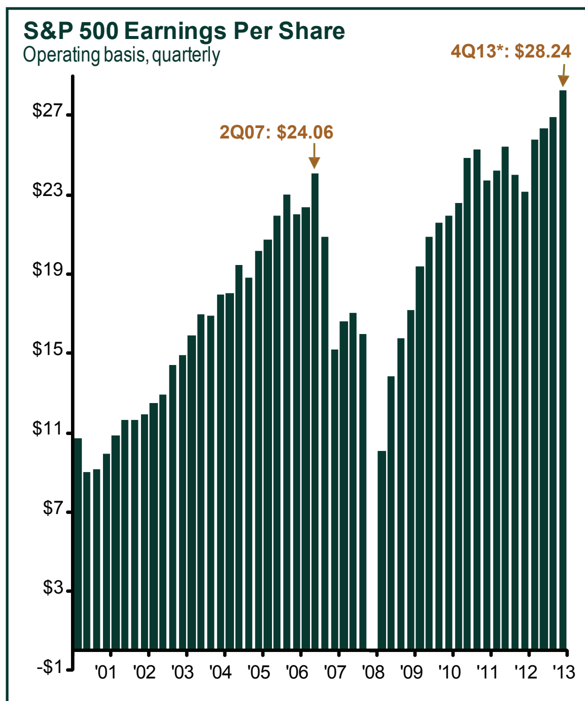
In the end, stock prices are driven by corporate earnings. As you can see in the chart of S&P 500 operating earnings per share on the next page, corporate America continues to squeeze out higher and higher numbers. The next chart, however, demonstrates that a huge source of those higher earnings of late hasn't been higher revenue but rather cost cutting or margin expansion. Top line revenue growth has been elusive for many companies as the US economy continues to drag and as emerging economies have slowed. There is a limit to cost cutting. And as the market has reached new highs, valuations

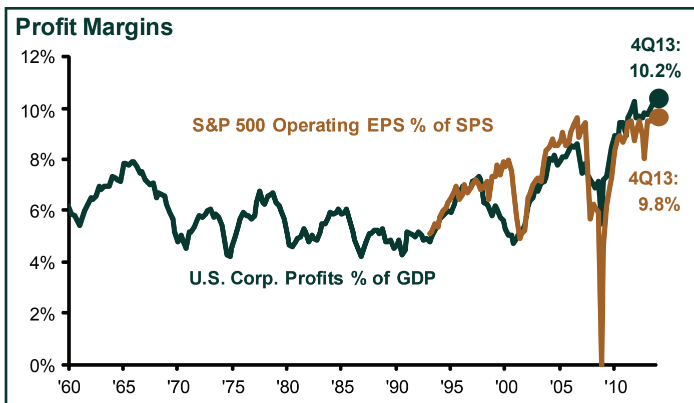
A Return to Normalcy *(Continued from page 2)*

Market Index Returns for Periods ending March 31, 2014

Index	Year to Date	One Year	Three Years	Five Years	Ten Years
S&P 500 (US Large Cap)	1.8%	21.9%	14.7%	21.2%	7.3%
S&P 400 US (US Mid Cap)	3.0	21.2	13.4	24.9	10.0
Russell 2000 (US Small Cap)	1.1	24.9	13.2	24.3	8.3
MSCI EAFE (Foreign Equity)	0.7	17.6	7.2	16.0	6.4
Barclays Aggregate Bond	1.8	-0.1	3.8	4.8	4.6
Barclays Muni Bond	3.3	0.4	5.8	5.7	4.6

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

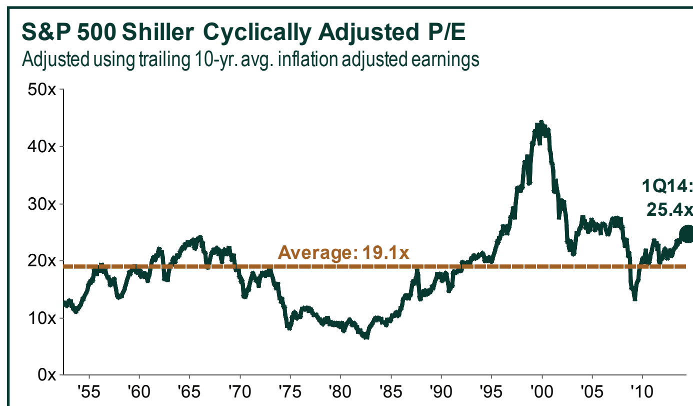




*Earnings per share (EPS) as a percentage of sales per share (SPS). Source: Standard & Poor's, Compustat. EPS levels are based on operating earnings per share. *Most recently available data is 3Q13 as 4Q13 are Standard & Poor's preliminary estimates. Past performance is not indicative of future returns.*

have gotten rich by some measures. The final chart depicts valuation using the Shiller method which uses ten-year average earnings instead of one-year forward earnings or one-year trailing earnings, each of which make current valuations look a bit more moderate.

As we have concluded in newsletters past, the way forward depends on economic growth; a rising tide will float all boats. Headwinds to growth include fiscal woes at the state and federal level, the implementation of the Affordable Care Act, a falling labor force participation rate, slowing emerging economies, Russian aggression and other geopolitical instability. On the flip side, consumers have reduced debt, the housing sector is creating jobs, the US energy sector is booming, corporations are sitting on piles and piles of cash, interest rates and inflation remain low, a new global middle class is emerging, the pace of technological innovation continues to accelerate and finally, *AT LAST*, the weather is getting better. At Bragg we remain cautiously optimistic. And as always, we are rebalancing portfolios and preparing for the bumps that are sure to come.



*Source: Standard & Poor's, FactSet, Robert Shiller Data. Cyclically adjusted P/E uses as reported earnings throughout. *Latest reflects data as of 3/31/2014.*

Rigged Markets & the Tooth Fairy *(Continued from page 1)*

percent of those surveyed believed the tooth fairy to be female while others believed the tooth fairy was neither male nor female. Wells found that most people envisioned a basic Tinker Bell-type tooth fairy with the wings, wand and whatnot. But others think of the tooth fairy as a bunny rabbit or a mouse. Less common were depictions of the tooth fairy as a child with wings, a pixie, a dragon, a flying ballerina, two little old men, a dental hygienist or a potbellied flying man smoking a cigar. But I digress. Thank goodness Charlie can't read yet or he would certainly read this and know the game is rigged.

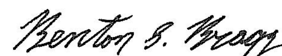
Speaking of "rigged," last Sunday's *60 Minutes* episode on CBS featured a story on high-frequency trading in the securities markets. Center stage was a book just released by author Michael Lewis called *Flash Boys*. A former Wall Street bond trader himself, Lewis is a great writer; we highly recommend his earlier books including *The Big Short*, which delves deeply into the inner workings of the financial crisis, and *Moneyball*, a book about the Oakland Athletics professional baseball team, which used probability and statistical analysis to assemble a super-talented winning team despite an extremely low personnel budget. The lessons of *Moneyball* are applicable to investing as well as baseball. In *Flash Boys*, Lewis makes the case that the market is rigged against the average investor and in favor of a growing number of rapid-trading hedge funds that enjoy an unfair advantage through their access to pricing data prior to other investors. According to Lewis on *60 Minutes*, "They're able to identify your desire to buy shares in Microsoft and buy them in front of you and sell them back to you at a higher price. That's called front-running. The speed advantage that the faster traders have is milliseconds... fractions of milliseconds." Lewis is not alone in identifying this phenomenon. Much has been written about computer-driven trading over the last few years as it has emerged that some of these practices not only manipulate markets but have contributed to market instability such as that seen in the "Flash Crash" of May 6, 2010, when the major indices fell almost 10% in mere minutes before recovering. It is estimated that high-frequency traders are now responsible for more than half the daily volume of trades on the major exchanges each day. The practice is currently being investigated by the FBI, the Securities and Exchange Commission and the NY Attorney General's Office. We anticipate positive changes in coming months.

"Rigged" is a strong word however. It implies that we are all being duped like the child who believes the tooth fairy is coming tonight. The United States capital markets have been the envy of the world in creating a robust, efficient and fair system supported by broad public participation for decades. Technology and the creation of electronic exchanges have played a central role in that positive story, with enormous benefit to the individual investor. Are the markets rigged? Are we getting fleeced? We think not. We're witnessing regulation struggling to keep up with innovation. Using lightning-speed technology, some investors have figured out a way to make a pile of money by making millions of trades with profits of a penny or less per trade. Short-term trading is a zero sum game; someone wins and someone loses. Slower traders who trade against these fast guys are indeed losing the game. If your goal is to buy 200 shares of McDonald's at 10 a.m. today and sell them thirty seconds later for a profit, you're at a disadvantage when these high speed guys can see your order coming. And these slower traders are furious. But we're not short-term traders. As we see it, shares of stock are pieces of real businesses. We want to own these businesses for years and years. Whether we paid $56.67 per share or $56.69 per share to buy shares of McDonald's five years ago is immaterial to us when the stock is trading at $98 today. So while we want to see changes that level the playing field for all investors, we feel strongly that this phenomenon is of little concern to our clients.

And while we're talking about investing for the long term, consider that in the case of most companies, the vast majority of outstanding shares *rarely* trade. Most shares sit in lockboxes, retirement accounts and brokerage accounts. McDonald's, for example, has just under a billion shares outstanding and yet the average daily trade volume is less than 1% of outstanding shares. And the majority of the shares that *do* trade are traded by the aforementioned high-frequency traders. But because prices are set at the margin, this crowd of speculators sets the price for the entire company. The tail wags the dog. The last thing we should do is worry about these short-term price movements in the shares of the companies we own. Ignore the fluctuations and the chatter of the media where a steady stream of salespeople try to convince you that you've got to "do something" in your portfolio. "Your first 100 trades are free," was the offer I heard on CNBC from some discount brokerage the other day. We don't have to play that game. Tying our fate to the progress of American businesses has been a good investment over time and we think that will continue to be the case. In the 20th century, the Dow Jones Industrials advanced from 66 to 11,497 excluding dividends. We think long-term investors in a diversified portfolio of quality companies will see further advances in the 21st century. There will be difficult periods ahead of course, but for those who keep emotions in check and rebalance with discipline, the game is rigged in your favor.

On behalf of everyone at Bragg Financial, I want to thank you for choosing our firm for your portfolio management and financial planning. We greatly appreciate the trust you place in us, and we hope the long-awaited spring is wonderful for you and your family!

Sincerely,



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