

# INVESTMENT COMMENTARY

## 2nd Quarter 2010

*"You can tell a lot about a man by looking at his garden."*

*- J. Frank Bragg*



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### STAYING AHEAD OF THE WEEDS

Last Saturday was a satisfying day on the farm where we live outside of Huntersville. My four children and I spent the day building a chicken house for the baby chicks we gave my daughter Frances for her seventh birthday. It was hot work — 95 degrees and no shade. The kids are really too young to do much so they messed around with the tools, banged some nails into boards and endured their daddy's never-ending lectures about life.

After about three hours, my wife Alice popped out and announced that she was taking the kids over to cool off with a swim in the pond. I kept working until about 5 p.m. at which point I was really drained and decided I would join the family at the pond. I was making my way over there when I came upon my father working in one of his gardens. (For some reason Dad has multiple gardens spread around in different locations on the farm. He says he is diversifying for the moisture content in the soil but I think he just likes to drive around on his Kawasaki Mule.)

When I happened upon him on this sweltering afternoon, he was manually hoeing out his corn patch. This stand of corn has twelve rows, each of which is about forty yards long. I asked him why he didn't use the tiller and he grumbled something about lousy machinery and this being just as quick. As I mentioned, I was really tired but I couldn't very well just walk on by without offering to help. He declined my offer but I wasn't about to catch heat for the rest of the year for leaving a seventy-one-year-old man toiling away in the field while I went swimming.

### MARKET TAKES A BREATHER

The monster rally that started early in 2009 ran out of steam in the second quarter of 2010 as investors worried about a slowdown in the economic recovery, and the implications of government debt. After surging more than 80% from the lows of March 2009, the S&P 500 reached a high for the year on April 23 and has since fallen almost 15%. For the full quarter ending June 30, the market was down 11.4%, bringing the year-to-date return to -6.7%.



*Charts compiled by JP Morgan. Source data from Russell Investment Group, Standard and Poor's, FactSet. Charts used with permission.*

As the table at the top of the next page shows, the damage was widespread. Prices for large US companies fell more than the stocks of small and mid-sized US companies. Foreign company stocks fell the most however, with the MSCI EAFE index down over 13% so far this year. Some of the poor performance of foreign stocks is attributable to a

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stronger dollar while some of the weakness is tied to the ongoing debt crisis in Europe. Bonds have held up well in the face of the recent weakness in stocks. The Barclays Aggregate Bond Index is up more than 5% so far this year and nearly 10% for the last twelve months. The strong performance of bonds (particularly corporate and municipal bonds) is noteworthy and a significant contrast to the performance of these bonds back in the fall of 2008 when asset prices tumbled across the board. This stability in the bond market is comforting and gives us reason to believe that while the market remains volatile and the economic recovery remains fragile, the liquidity issues and calamitous conditions of the financial crisis are behind us, or so we hope.

Before we celebrate too much about recent bond performance, we should consider what the future holds for fixed income. As a result of their stellar performance of late, bond prices are now high and therefore yields (bond coupon divided by market value of bond) are quite low on a historical basis. This is particularly true of bonds backed by the federal government but it's also true of corporate and municipal issues. The bellwether ten-year treasury bond now yields under 3% (2.97% as of June 30) and short-term treasuries yield less than 1%. Investment grade corporate and municipal bonds yield about 3.5%. One can find higher yields of course but one must also take more risk. For example, bonds of corporations or municipalities that are at risk of default have significantly higher yields than the bonds of highly rated issuers.

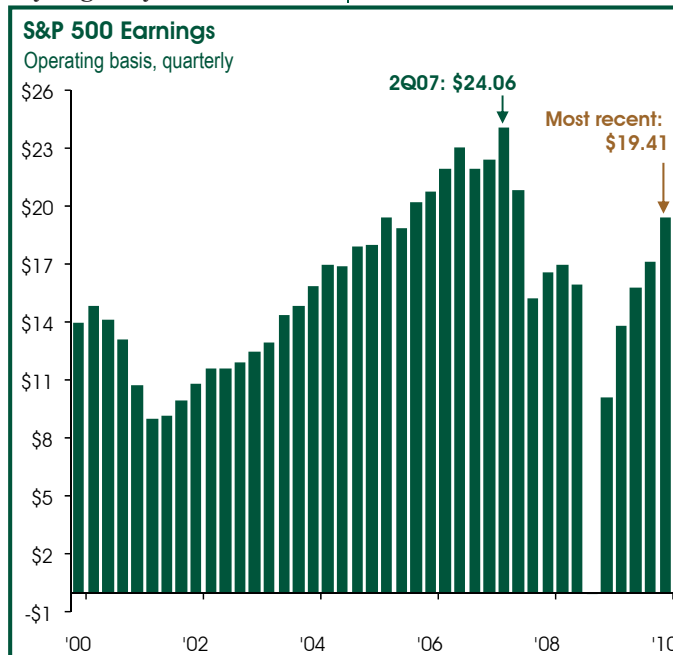
After the recent decline in stock prices, equity market valuations in our opinion look more favorable. As we have discussed in the past, in the long run, stock prices are a function of corporate earnings. The chart to the right makes it clear that earnings have made a strong comeback after collapsing in 2007 and 2008. The S&P 500 earned \$19.41 in the first quarter on an operating basis and second quarter earnings will likely be even higher. On an annualized basis, this puts the market multiple fairly close to its long term average.

Market Index Total Returns for Periods Ending June 30, 2010					
Index	Year to Date	One Year	Three Years	Five Years	Ten Years
S&P 500 (US Large Cap)	-6.7	14.4	-9.8	-0.8	-1.6
S&P 400 US (US Mid Cap)	-1.4	24.9	-5.9	2.2	5.3
Russell 2000 (US Small Cap)	-2.0	21.5	-8.6	0.4	3.0
MSCI EAFE (Foreign Equity)	-13.2	5.9	-13.4	0.9	0.2
Barclays Aggregate Bond	5.3	9.5	7.6	5.5	6.5
Barclays Muni Bond	3.3	9.6	5.5	4.4	5.6

will challenge companies to find top line revenue growth in coming quarters.

**EXPECTATION ADJUSTMENT**

After a round of negative reports on the economy in recent weeks, many economists are scrambling to make downward adjustments to their projections for economic growth for the second half of 2010. As we discussed last quarter, the economic recovery has been less than robust when compared to typical recoveries following recessions. Thus far, the recovery has been driven by strong capital spending from businesses, very modest consumer spending and massive government stimulus. Since the government stimulus is on its last legs, and we are still seeing only weak job creation, many economists have become convinced that their earlier forecasts were too optimistic. Economic reports released in June underscoring this include a weak consumer confidence report, weak housing reports and most important, a lackluster employment report. As the non-farm payroll chart on the next page shows, the economy had begun creating jobs after the massive losses of 2008 and 2009 but that trend appears to have stalled.



Charts compiled by JP Morgan. Source data from Standard & Poor's.

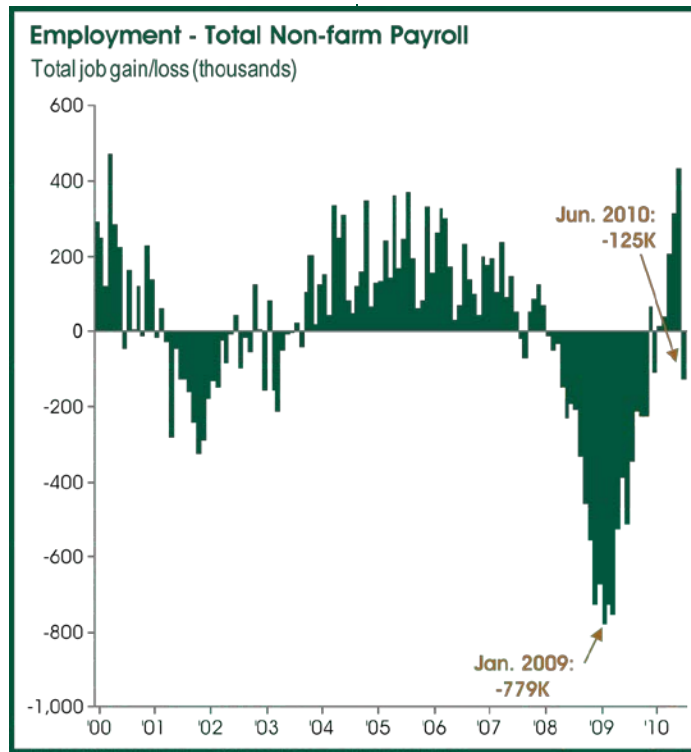
The private sector created 83,000 jobs in May but the government eliminated 225,000 temporary Census worker jobs, resulting in a net loss for the month. Recall that the economy needs to create about 200,000 jobs per month to keep up with population growth. Despite the loss of jobs, the unemployment rate declined from 9.7% to 9.5%. This is because the labor force declined as thousands of workers stopped searching for jobs and dropped out of the labor force.

So the market has fallen

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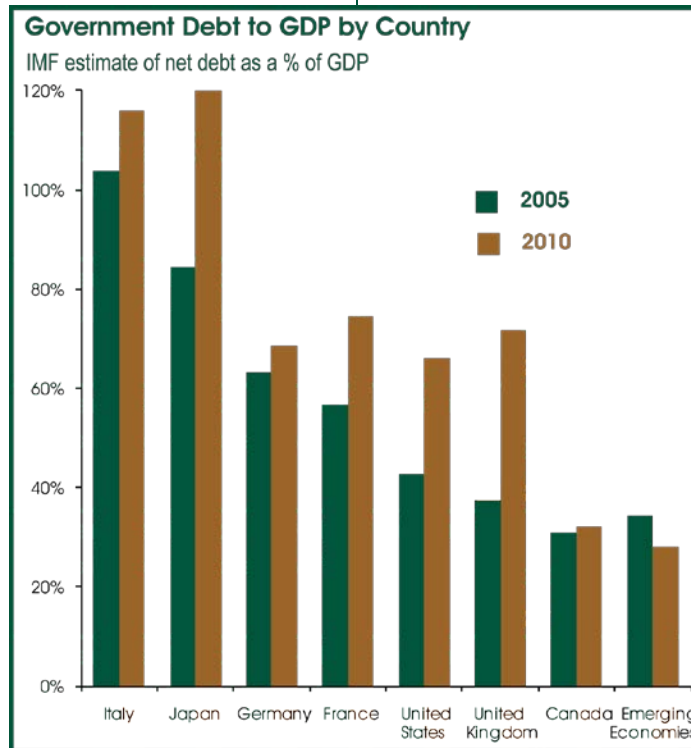
in the face of this renewed weakness in the economy. Spooking the market the most is the fear that we slide back into recession, the so-called “double-dip” recession. This would be a very difficult situation as the government, through fiscal and monetary policy, has already used most of its ammunition to get the economy back on track. Future generations of taxpayers are already on the hook for a massive increase in government debt and as we are learning from our friends across the pond in Europe, there is a limit to government spending.

You likely have followed the unfolding crisis in Greece. The European Union with assistance from the rest of the world has bailed out the Greek government. While Greece is small, its problems are indicative of what ails the global economy. The government debt to GDP chart below does a good job of summarizing the predicament in which the world economy finds itself. It shows total government debt as a percentage of Gross Domestic Product or total debt to economic output. First take note of the massive increase in the ratio over the last five years for developed countries (US, UK, Europe, Japan). Also note the disparity in the ratio between developed countries and emerging economies. As Greece has demonstrated, developed countries are “hitting the wall” with regard to borrowing. For another case study in massive debt, we can look to Japan. Japan’s debt to GDP ratio has been north of 100% for two decades and it has served as a major drag on economic growth. In real terms, Japan’s total economic output in 2009 was almost identical to its economic output twenty years ago in 1989. For comparison,



Charts compiled by JP Morgan. Source data from BLS.

section about bond yields). The economic and market events of 2008 and early 2009 were difficult for all of us. Stocks were down 57% and bonds offered very little in the way of protection. It was not a good experience and it is fresh on our minds. As the market has gotten a little choppy here lately,



Charts compiled by JP Morgan. Source data from IMF Fiscal Monitor.

US economic output has almost doubled in real terms over the same period.

Emerging economies like China and India are primarily export economies and are therefore largely dependent on developed economies for growth. We are tied together as never before. Hopefully the relatively strong balance sheets of the emerging economies will spark global growth in the years ahead.

**KEEPING THE DISCIPLINE**

While the environment for growth is somewhat challenging, we think the points made earlier about market valuations are important. We are hesitant to sell stocks at these prices, especially when we consider the alternatives (see earlier section about bond yields). The economic and market events of 2008 and early 2009 were difficult for all of us. Stocks were down 57% and bonds offered very little in the way of protection. It was not a good experience and it is fresh on our minds. As the market has gotten a little choppy here lately, we have sensed that many of you share a strong sentiment that can best be stated as follows: “I don’t want to go through that again.” Let me assure you first, that we hear you and second that we share the sentiment. It is on our minds and it influences our decisions as we construct and rebalance your portfolio. Recall that as we work on your portfolio, we consider not only your written investment plan, but also other things we know about you such as your age, your attitude toward risk and your station in life.

Even as we tweak portfolios in an effort to be mindful of downside risk, there are two things that we feel very strongly about. First, we work

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hard to avoid situations where market timing is involved. While it might seem appealing to “get out until things calm down and then get back in,” I don’t have to tell you that it never works that way. What if you got out in March of 2009?

The second thing we will always do is maintain discipline about diversification. Are we loading the portfolio with municipals bonds and dumping treasuries because of the yield differential? No, we own both. There are risks and opportunities in both. Are we loading up on BP and oil drillers now that their stocks are cheap following the Gulf oil spill? Loading up? No. Do we have energy exposure? Yes, and we might tweak it slightly but no big bets. Are we dumping US equities in favor of emerging markets equities because conventional

**“Even if you’re on the right track, you’ll get run over if you just sit there.” - Will Rogers**

wisdom holds that US global leadership is behind us and emerging economies are where the growth is? We’ve always been skeptical of conventional wisdom...remember when oil was at \$143 per barrel and “on its way to \$200?” Six months later it was at \$37 per barrel. We certainly have emerging markets exposure but we also have significant exposure to US equities. So we’ll continue to diversify.

The fact that we do not time the market and the fact that we remain diversified means your investment advisor will never be recognized on the cover of Barron’s for having the best 12 month investment return. Nor will your advisor be recognized by Barron’s for having lost all of your money. It is our hope that you will recognize Bragg as the firm whose disciplined approach helped you accumulate, grow, preserve and enjoy your financial resources. Please let us know if you would like to discuss your portfolio.



Phillips Bragg’s son Johnny sells sunflowers at the Davidson Farmer’s Market.

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So I grabbed a hoe. It was physical work and it was still hot as blazes. It had rained the day before and the soil was damp and really heavy to turn with the hoe. I hadn’t gone far before I felt I should ask him about the tiller again. I mean this was going to take a long time and it was crazy to do it by hand if there was a tiller right there in the barn. “Don’t you have a nice Troy-Bilt tiller in the barn?” I asked. More grumbling from him: “Last I checked it wasn’t running good and this kind of work is good for you.” Then he said, “You can tell a lot about a man by looking at his garden.” “Oh boy, here we go,” I thought to myself. He continued, “When I was a boy, when we’d go somewhere in the car, Daddy would slow down at every garden we passed to see how straight the rows were and whether the weeds were ahead of the produce. Daddy said a garden would tell you if a man was a family man with good work ethic or if he was man who always had one foot in the road. Benton, you need to get your kids out here to learn how to work. And they need to go to the farmer’s market with me to learn how to sell this corn.”

I already had two blisters despite my gloves. My back was stiff from the repetitive motion and sweat was pouring from under my hat and dripping down into the soil. After about 45 minutes, I was ready to put the hoe down. Of course I did not want Dad to know that. I stole a glance over at him every now and then to check his pace and be sure he wasn’t going faster than I was. I was holding my own but then he had done five rows before I got there. I watched him. He was working steadily with smooth, efficient strokes, using a forty-year-old, hand-sharpened hoe that had belonged to his mother. He never slowed down until he stopped at the end of the last row. He thanked me for helping him and said he was going to tie up some tomatoes. I headed off in the direction of the pond. It occurred to me then as it has before when I’ve worked with him: the man is very strong and he knows how to work very hard. He gets a lot done. Even at his age, he can go longer than I can and he can get more done than I can.

Do I need to work that hard? Do we need to work that hard? I think we do. And I think we can. I don’t think we need gardens as big as Frank Bragg’s garden, but we’ll need to work hard in the coming years. Our debt-burdened economy likely won’t grow at the pace we’ve grown accustomed to over the last three decades. This will require us to adjust our expectations. Our portfolios may give us less. We’ll need to save a little more and spend a little less. Fortunately, we can do these things and life can be good. Fix the tiller and life can be great!

As usual, we think it makes sense to be proactive with your financial planning. Be sure your plan for saving and for spending makes sense in today’s economy. As Will Rogers once said, “Even if you’re on the right track, you’ll get run over if you just sit there.” Thank you for choosing Bragg to help you with your financial planning and investing.

Sincerely,

*Benton S. Bragg*

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