INVESTMENT COMMENTARY

1st Quarter 2013

Bragg Building
1031 South Caldwell Street, Charlotte

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"It's been that way since the git go . . . Lord it's always been that way."
Texas country music songwriter, Billy Joe Shaver

TAYLOR SWIFT AND MARKET HIGHS

Pop country star Taylor Swift has a new hit single called "**We Are Never *Ever* Getting Back Together**." Swift is a storyteller, and this song chronicles an emotional saga of breaking up and then getting back together with her boyfriend. If you have a nine-year-old daughter you've likely heard it a thousand times. If not, give it a listen on YouTube, preferably at high volume . . . you'll find it's a bumping, thumping, catchy tune. I admit I'm a huge Taylor Swift fan, much to my daughter Frances's delight. Whenever the whole family is together in the car, she says, "Daddy, put on some Taylor!" and I happily oblige, cranking it up until the whole car is rocking to the beat. Even the boys (ages 12, 11 and 5), who are "too cool" to like Taylor Swift, sing at the top of their lungs. Here are some selected lines of "We Are Never *Ever* Getting Back Together":

I remember when we broke up the first time, When you said you needed space, what? Then you come around again and say, "Baby, I miss you and I swear I'm gonna change, trust me." Remember how that lasted for a day? I say, "I hate you," we break up, you call me, I love you. (Frances says, "Click to listen.")

I know, I know, she's no Bob Dylan, but she's human, and she's singing about the age-old conflict between our heart and our mind. She knows the relationship isn't going to work, but her emotions take over and she takes him back. Been there? Me too.

By now you've figured out that I'm writing about irrational behavior. A lot of it has been on display lately with investors. As you hum your new

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SHRUGGING OFF BAD NEWS

The S&P 500 and the Dow Jones Industrial Average both closed at record highs on the last day of the first quarter. Small cap stocks as measured by the Russell 2000 Index also finished the quarter in record territory, while foreign indices, including developed markets (MSCI EAFE Index) and emerging markets (M*Star EM Category) remain more than 15% below their highs of 2007. The aforementioned indices are all price-only measurements. The returns shown in the charts below are total returns (including dividends). As you can see in the lower chart, since the low of March 2009, the S&P 500 has notched a total investment gain of 153%! Especially in the last three

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Chart lines reflect index price change only while returns and annotations reflect total return (including dividends). Compiled by JP Morgan and used with permission. Source: Russell Investment Group, Standard & Poor's, FactSet, J.P. Morgan Asset Management

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Market Index Returns for Periods ending March 31, 2013					
Index	1st Qtr 2013	One Year	Three Years	Five Years	Ten Years
S&P 500 (US Large Cap)	10.6%	13.9%	12.7%	5.8%	8.5%
S&P 400 US (US Mid Cap)	13.5	17.8	15.1	9.8	12.4
Russell 2000 (US Small Cap)	12.4	16.3	13.4	8.2	11.5
MSCI EAFE (Foreign Equity)	5.2	11.3	5.0	-0.9	9.7
Barclays Aggregate Bond	-0.1	3.8	5.5	5.5	5.0
Barclays Muni Bond	0.3	5.3	6.2	6.1	5.0

Three, Five and Ten-Year Returns are annualized

months, it seems that investors have shrugged off negative headlines that would have really spooked the market over the past four years. Those include renewed flare-ups in the European financial system—this time centered on tiny Cyprus, continued softness in China's economy, tensions in North Korea and Iran, the stubbornly slow recovery of the US economy, slowing corporate earnings growth and of course the unsolved issue of federal and municipal debt in the US.

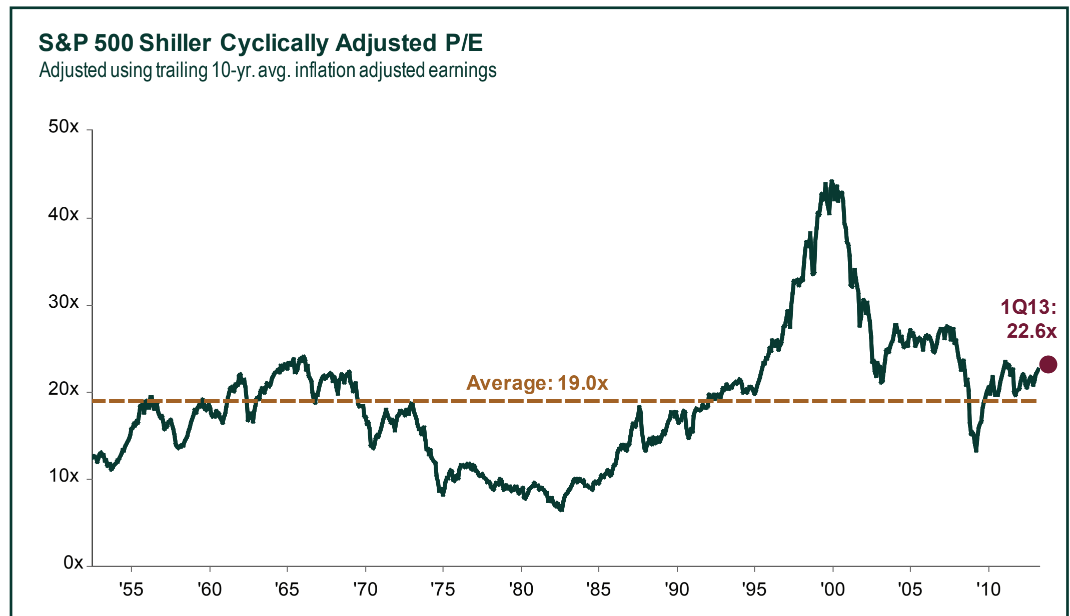
So how does one explain the continued strength of the US market? We think there are three primary drivers. One is that there is simply not a good alternative to owning stocks. The actions of the Fed have driven fixed income yields down to historic lows. A ten-year treasury bond yields 1.85% today. The Fed's goal is to stimulate the economy by keeping money "cheap," prompting borrowing and investment in riskier assets like stocks, real estate and capital equipment. The hope is that rising prices will instill confidence and confidence will lead to more investment and the economy will grow. Part of the plan is working . . . prices have risen dramatically. We are still waiting for the economic growth. With luck it is coming.

Second, US stocks have fared well because investing is a relative game. The US economy, weak as it is, is performing better than much of the rest of the world. In particular, housing continues to show strength. Much of Europe is in recession and the emerging economies, including China, Brazil and India, have cooled considerably.

And finally, we think stocks are doing well because investors are human. The passage of time heals wounds and we forget how bad things were when things were bad. Investors who have been on the sidelines are coming back into the market. At the end of the day, we humans are risk takers. And thank goodness for this human characteristic; without it we likely would have never emerged from the cave after our first fight with the mighty mastodon. Instead, we emerged from the cave and we tried again and look where we are today.

Of course, our propensity to take risk can get us into trouble from time to time. Our progress has been anything but a straight line upward and maybe we humans are overdoing it a bit here lately with our forgetfulness.

Take a look at the table above and you will see that in contrast to stocks, bonds were flat in the first quarter. As we have discussed before, we think the future performance of bonds will not match past performance and while bonds are an important part of most portfolios, it makes sense to have realistic expectations of this asset class. The chart on the back page of this letter underscores this point quite well.



*Cyclically adjusted P/E uses as reported earnings throughout. *Latest reflects data as of 3/31/2013. Compiled by JP Morgan and used with permission. Source: Standard & Poor's, FactSet, Robert Schiller Data, JP Morgan Asset Management. Data are as of 3/31/2013.*

"At this juncture, however, the impact on the broader economy and financial markets of the problems in the subprime market seems likely to be contained. In particular, mortgages to prime borrowers and fixed-rate mortgages to all classes of borrowers continue to perform well, with low rates of delinquency."

Fed Chairman, Ben Bernanke on March 28, 2007

INVESTING IN A FULLY-VALUED WORLD

One of our favorite equity valuation models was developed by Robert Shiller and it is shown at the bottom of the preceding page. In contrast to many of the forward-looking models in use today that show the market to be cheap relative to historical norms, the more conservative Shiller model makes adjustments to account for the cyclicality and mean-reverting nature of profits and profit margins. As you can see, the model shows that stocks are fully valued to slightly overvalued.

So how do we proceed when models show that bonds are fully valued, stocks are fully valued and cash yields are zero? First, we think it is important to recognize that while models are helpful, they usually fail to help us make consistently good portfolio decisions. Had we gotten out of bonds in 2003 when many models suggested that the bond bull market was over, we would have missed a great decade for this asset class. And the Shiller model first signaled that stocks were overvalued in May of 2009, just months after the low. Instead of looking for buy/sell indicators, we think it makes sense to own a portfolio that first provides the liquidity (bonds/cash) you need for your stage of life and second provides the long-term exposure to riskier assets (stocks and real estate) that will provide growth. And finally we suggest regular rebalancing of the portfolio. This is what we are doing today after the great run in equities.

KEEPING PERSPECTIVE

So the market has soared over the last four years and the gains feel good. But look back a little further and you are reminded that the last four years aren't the whole story. The chart below goes back to 1997 and clearly illustrates the roller coaster of the last sixteen years. Up 100%, down 50%, up 100%, down 50% and so on. At Bragg, we call it the Coronary Chart and frankly whenever we study it, we experience a range of emotions including: 1) Frustration. It has been a difficult decade and a half for investors and for advisors. 2) Humility. We can't see the future. No one predicted this roller coaster and it is important to recognize that the future is unknown. The Ben Bernanke quote at the top of this page does a good job illustrating that even the "smartest guy in the room" can't see the future. 3) Gratitude. Despite this experience, we and our employers (you) are in very good shape. 4) Determination. If we work hard, save/invest a lot, live within our means, build appropriate, diversified portfolios and keep our emotions in check we can prosper. We hope this perspective is useful to you as we move forward. Please let us know if you would like to discuss your planning and investing.

Compiled by JP Morgan and used with permission. Source: Standard & Poor's, First Call, Compustat, FactSet, JP Morgan.
Dividend yield is calculated as the annualized dividend rate divided by price, as provided by Compustat. Forward Price to Earnings Ration 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.

Taylor Swift and Market Highs *(Continued from page 1)*

favorite Taylor Swift song, consider that in January, investors poured a record $77 billion into stock funds, blowing away the previous monthly record of $55 billion set in February of 2000 (Trim Tabs Investment Research). Recall that February of 2000 was the peak of the tech bubble, a time when all the news was good. A month later the market started a thirty-month decline of almost fifty percent.

Now, I'm not suggesting that the market is getting ready to decline; it's anyone's guess what stocks will do in the short term. I'm pointing out that once again, investors are behaving badly. Glance back at the bottom chart on page 1 of this report which shows the level of the S&P 500 since the market peak of 2007. Stocks purchased at *any point* over the last four years offered a better value than stocks purchased today. And yet, since the low of 2009, investors were *net redeemers* of stock fund shares; more than $300 billion was pulled from stock funds since March of 2009. And now that the market has reached a new high, many investors are piling in with enthusiasm.

A recent *Wall Street Journal* article titled "Mom and Pop Run with the Bulls" described the phenomenon of many Americans "getting more comfortable" with the market and returning to stocks as they "feel like the danger has passed." In particular, the article profiled a couple who abandoned stocks in 2008 after watching their portfolio decline by 50%. They sat on the sidelines until finally getting back into the market last month. Now, I usually love the *Wall Street Journal* but this article totally failed to make the obvious point that these investors had made *disastrous* decisions. Maybe a more appropriate title for the article would have been "How to Ruin Your Financial Life."

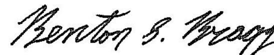
The money that came out of stock funds over the last four years went into bonds and bond funds. In 2012 alone, investors put more than $300 billion into bond funds, one of the largest annual inflows in history. Bond returns over the last 30 years have been above average, enhanced by the powerful tailwind from falling interest rates (recall that bond values rise when interest rates fall). Take a look at the chart to the right which shows the trajectory of bond yields (or interest rates) from 1958 through 2012. The chart makes it very clear that any period in the last 30 years offered better prices/yields for the bond buyer than the prices/yields available in 2012, and yet 2012 was a huge year for bond purchases. Bond yields today are at historic lows (prices have never been higher); a ten-year Treasury bond yields 1.8% down from 15.8% in 1981. I am not suggesting that bonds are getting ready to get clobbered. As with stocks, it's anyone's guess what bonds will do in the short term and bonds are an important part of most portfolios. I *am* suggesting that many investors are guilty of chasing what has been hot, what Warren Buffett calls "rear-view mirror investing." This usually leads to disappointment, as returns of the future often look different from returns of the past.

Rear-view mirror investing is nothing new; history is littered with stories of boom, bust, greed, fear and the incredibly irrational decisions investors make. As country music song writer Billy Joe Shaver wrote, "It's been that way since the git go . . . Lord it's always been that way." I write about this today because the market has just hit a new high; stocks surged more than 10% in the first three months of the year. Surging prices and plunging prices seem to fuel emotions more than gradual price changes do. Now is a good time to be rational and disciplined.

Sorry for the overdose on country music! Between the 23-year-old Taylor Swift and the 73-year-old Billy Joe Shaver, my hope is that you've picked up something you can use in the days ahead.

Thank you for trusting Bragg to help you with your financial planning and investing.

Sincerely,



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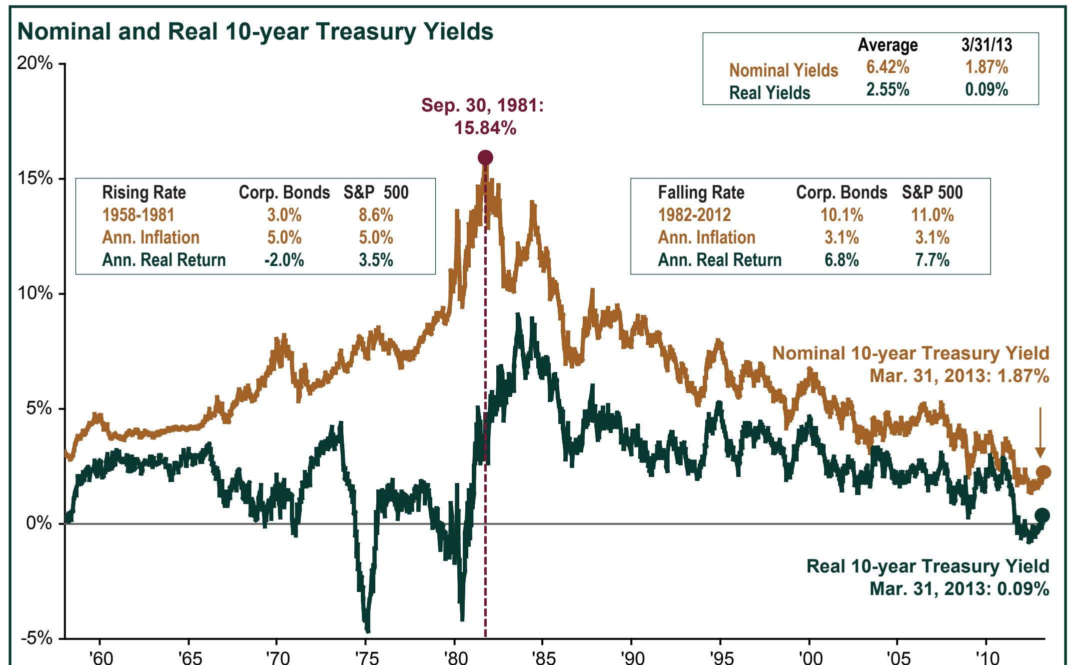

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