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MANAGEMENT, INC.
945 Technology Blvd., Suite #102, Bozeman, MT 59718

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Dear Client,

Hello! Enclosed, please find your Second quarter performance report and keep an eye out for your invoice as it has been sent under separate cover. As you are aware, we continue to deal with the same issues and will most likely continue to do so for a time to come. While not the most encouraging economic times, it is important to keep focused on investment strategy. So, as we enter July, we are writing to provide perspective on what happened in the first half of 2012 and to share our thoughts on how we are positioning portfolios for the period ahead. To help do that, we've tapped into the knowledge of three longstanding Wall Street veterans, one who made his career in stocks, the other in bonds, and the third Warren Buffett's teacher at Columbia (referred to in many of our previous communications). Before we get into their views, here's an overview of what's happened so far this year.

Market performance for first half of 2012

The first half of 2012 was a tale of two quarters. The first quarter represented the strongest start for the U.S. stock market since 1998, and with Japan turning in its best first quarter gains in 24 years. This was largely driven by a reduction of fears about Europe, as well as stronger economic data in the U.S.

The second quarter gave many of those gains back. Markets were driven by escalating concern about the European currency union and slowing global growth, accompanied by discouraging data on employment and a renewed focus on the capitalization of both European and American Banks. Slowing economic activity in China and India also put downward pressure on the prices of oil and other commodities, as well as stocks in general – markets declined 7% in the month of May amidst all these events. However, markets showed a 4% gain in June amidst signs of a "stabilizing" European situation. Below is a summary of global market performance for the current quarter first half of 2012, all in dollars (of note, the global "flight to safety" over the past year has led to a stronger dollar, depressing returns outside the U.S. when denominated in the dollar).

	US	International	Fixed Income
4/01/2012 to 6/30/2012	(3.19%)	(7.13%)	2.06%
1/01/2012 to 6/30/2012	9.18%	2.96%	2.37%

Sources: Wilshire, MSCI, Barclay's Capital - US Dollars

The dilemma for investors: Dangerous stocks, unattractive bond yields

On the surface, investors today face a range of unattractive choices. While stocks appear fairly valued by most measures, the second quarter saw volatility well above historical norms. Holding stocks has always been risky if your timeframe is short and geopolitical uncertainty and market swings make owning stocks feel especially dangerous today.

There is considerable debate about whether stocks are expensive, cheap or fairly valued. Some observers express doubts about the sustainability of today's record corporate profit margins and the enduring impact of debt problems and slow growth around the world. US stocks also show up on the pricey side using models such as the valuation approach advocated by Yale's Robert Shiller, comparing stock prices to average earnings over the past 10 years, adjusted for inflation.

On the other side, a fair number of reputable analysts view stocks as historically cheap, pointing to attractive ratios of stock prices to book values and measures like multiples of earnings and cash flows. Indeed, using Robert Shiller's multiple of average 10-year earnings, Europe is inexpensive by historical standards. Our view: For long term investors, stocks globally today provide fair value.

Fee Only Investment Management and Financial Planning
Robert M. Frey, MS, CFP®. CLU, bfrey@profinancialmgmt.com Douglas M. Babcock, CFP®, dbabcock@profinancialmgmt.com
PROFESSIONAL FINANCIAL MANAGEMENT • 945 Technology Blvd, Ste. 102 • Bozeman, MT 59718 • www.profinancialmgmt.com
Voice: 406.587.1604 • Fax: 406.586.8333

Bonds pose different risks. We're seeing historically low interest rates, as central banks around the world keep interest rates down to stoke economic growth. Given current inflation, in normal times we would expect to see interest rates about two percent higher than today – but of course these aren't normal times. Of course, holding cash to eliminate risk from stocks and bonds guarantees depreciation of purchasing power – and for many investors, cash gives them no chance of achieving the returns they need to achieve their long-term goals.

Clearly, every client and every portfolio is different. That said, even given short-term uncertainty in stocks, we are recommending that clients move to the upper end of the equity allocation in their investment policy. That decision is supported by perspectives from two respected investment veterans with long experience on Wall Street, Dan Fuss and Bob Farrell.

Dan Fuss: Replace market risk with company risk

Dan Fuss is vice chairman of Boston-based Loomis, Sayles & Co; with over 50 years of fixed-income experience, he is one of the most highly regarded bond managers of all time. Still actively running money in his mid-70s, the bond fund he manages has over $20 billion in assets and over the past 20 years has been a top performer in its category.

In an April interview with *Investment News*, Fuss made an unusual recommendation for a bond manager – to sell bonds and buy stocks. The reason relates to the risk of rising interest rates. "We're in the foothills of a gradual rise in interest rates," he said "Once they start to rise, you're probably looking at a 20- or 30-year secular trend of rising interest rates."

He went on to say that when the unemployment rate falls to between 6% and 7%, it's likely that Ben Bernanke and the Federal Reserve Board will alter the policy that has been keeping the interest rate on the 10-year Treasury bill artificially low. "Once that happens, you need to get out of the market risk that's in fixed-income and into the company-specific risk you can find in stocks," Fuss said.

Bob Farrell: Market rules to remember

In the 1950s, Bob Farrell attended the same Masters program at Columbia as Warren Buffett, studying under Benjamin Graham, considered the father of value investing. In 1957 Farrell joined Merrill Lynch as an analyst and stepped down as Merrill's chief investment strategist in 1992, although he continued to provide his perspectives through articles and media interviews.

In 1992, Farrell penned 10 rules on investing. Two of those 10 are particularly pertinent today and give us encouragement about stock returns for the mid- and long-term period ahead – these are:

Rule 1: Markets return to the mean over time

"Returning to the mean" is another way of saying that over time performance on stocks will revert to historical averages. The long term annual return in the US stock market going back to 1926 is 9.8% before inflation and 6.6% after inflation, what's called the real return. Whenever you have an extended period in which returns exceed the long-term average, chances are a period of underperformance will follow. And the opposite applies as well; a long period of underperformance will be followed by a period of above average returns.

The 1990s saw average real returns of 14.9% annually, the best decade on record. Then reversion to the mean kicked in and the following 10 years saw an average annual loss after inflation of 3.4%. Add the two decades together and you get a real return that's 1% below the long-term average. In essence (as we've discussed with you before), it's taken the last decade to rectify the valuation excesses of the previous 10 years – but with that behind us, history (and Bob Farrell's rule on reversion) suggest that long term real returns going forward should be closer to the 6.5% average.

Rule 5: The public buys the most at the top and least at the bottom

Since the financial crisis, total assets in U.S. fixed-income funds have more than doubled to over $2 trillion, up from $1 trillion at the start of 2008. At the same time, we've seen record outflows from US equity funds. To me, this is further indication that, provided you have a timeframe of five plus years and can tolerate the kind of volatility we've seen of late, investing in a broadly diversified stock portfolio is likely to serve you well.

What this means for your portfolio

Below are some guiding principles we adhere to in our approach to building and managing client portfolios, and though we have covered these at various times with you, want to highlight them again for reference. They are:

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1. For retired clients, we believe in maintaining a base of both cash and bonds to cover at least six years of withdrawals. While this may differ based on each individual client, the point of this structure is to have a buffer which reduces the risk of having to sell equities at depressed levels; this also lessens the stress and anxiety for you as the client (and us as advisor!). There is always the question of how much cash should be kept on hand and our view of this has changed recently based on a recent study discussed in the Journal of Financial Planning that exposes the perils of holding too much cash in a retirement portfolio – this will be a future topic of discussion.

2. The second principle is closely tied to #1 and relates to the role of bonds in the portfolio. While in "normal times" we do feel that bonds can help add return to the portfolio if structured properly, our main concern now in an uncertain economic environment with historically low interest rates, is protection of principal over chasing yield - we consider risk equally important to return in our portfolio management. That said, we have resorted to a shortened the maturity on our bond allocations over the couple of years, and though this has reduced returns over this time frame, it has significantly lowered the interest rate risk if (when!) prevailing bond yields rise. Bonds play vital roles as both a cash source and a "dampener" to volatility in our portfolios so making tactical "adjustments" to this asset class is key to both short and long term investment success.

3. Third, regardless of what happens to markets in the short term, we should adhere to the agreed to investment parameters, barring a significant change in circumstances. Some of you may recall our advice in early 2009, as we faced what appeared to be an end-of-the-world scenario and some stocks hit lows they hadn't seen in 20 years. At that time, we urged clients to maintain the course regarding their equity exposure. Given strong stock performance in the first quarter, we've received questions from some clients about increasing equity weight above the maximum boundary in portfolios. As well, in light of concerns about the Euro zone crisis, we've also had questions about selling stocks.

   While we will always discuss this on a case-by-case basis, we advise against deviating from the range we established over the last couple of years. Given stock valuations and the risk in bonds, for some clients we have recently increased equity weights to the upper end of their range. Of course market reversals from current levels are always possible; however, taking a long-term view, at current levels there is a strong case for stocks over bonds.

4. When building equity portfolios, we've always advocated strong diversification outside the U.S., and while as of late this has hurt performance, we need to remember how this benefitted your portfolio through most of the 2000s – remember, keep a long term perspective. Going forward, we have no idea whether the U.S. dollar and market will do better or worse than global markets, but we do know that the US represents less than half of investing opportunities around the world and one need's to stay geographically diversified as a result.

Should you have questions on anything covered in this note, or on any other issue, please feel free to give us a call. As always, thank you for the opportunity to serve as your financial advisor.

Sincerely,

Doug Babcock   Bob Frey

Fee Only Investment Management and Financial Planning
Robert M. Frey, MS, CFP®. CLU, bfrey@profinancialmgmt.com   Douglas M. Babcock, CFP®, dbabcock@profinancialmgmt.com
PROFESSIONAL FINANCIAL MANAGEMENT • 945 Technology Blvd, Ste. 102 • Bozeman, MT 59718 • www.profinancialmgmt.com
Voice: 406.587.1604 • Fax: 406.586.8333