PROFESSIONAL FINANCIAL MANAGEMENT, INC.
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July 26, 2013

Dear Client,

We hope this letter finds you enjoying the summer season and all it has to offer! Enclosed, please find your 2nd Quarter performance report.

With the first half of 2013 behind us, we are writing to discuss the expectations for your portfolio over the next several years and to discuss risk as explained by one of our favorite authors on financial subjects, Dr. William Bernstein. We conclude with a quick discussion on how these topics relate to the ongoing advisory of your portfolio specifically.

RETURN EXPECTATIONS GOING FORWARD

Last quarter, we discussed the use of market valuation information and its proper use as an indicator of future returns and not as means to "time" the market. We came across a couple of good articles in July's Wall Street Journal, both written by Joe Light who writes a column titled "Upside". His discussion expounds on the same points about market valuation made in our previous commentary. Both articles reference the Shiller P/E measure (as a refresher, the Shiller P/E is the cyclically adjusted price/earnings ratio developed by Professor Robert Shiller at Yale University) used to gauge market valuation and he addresses market valuation and how this data should be viewed by investors. He too, advises that the information serve not as a sell signal but a warning that "an above average Shiller P/E doesn't necessarily mean that stocks are going to drop over the next 10 years. It just means that returns are going to be lower than they normally are".

We are in somewhat uncharted waters regarding future investment returns, and investors hoping for the average long- term historical returns of 5% in bonds and 10% in stocks will definitely need to adjust their expectations. There has never been a previous time when bond interest rates were this low and stock valuations (expressed by the long-term price/earnings ratio) were this high at the same time. Truly, both stocks and bonds are overvalued, and your expectations for the future should be quite modest. Obtaining a real (after inflation) return of 3-4% over the next decade should be the upward limit of your expectations, and you may have to settle for less. Most investors, who make the usual mistakes, will get far less.

A DISCUSSION ABOUT RISK

A second article we saw in the Wall Street Journal, authored by Jason Zweig, addresses the issue of Risk. Zweig interviews Dr. William Bernstein, who defines what he terms are two major classifications of risk, "shallow risk" and "deep risk", and how investors often misinterpret the two, thereby acting contrary to their interests.

Shallow risk, or volatility, refers to the inevitable (and unpredictable) temporary decline in the value of an asset (or asset class) which almost assuredly will eventually bounce back to its original value or higher. However, the decline may be deep and/or prolonged, such as the market declines in 2000-02 and 2008-09. The fluctuations in the broad US stock market are an excellent example of shallow risk. Investors simply must accept shallow risk to have any hope of growth in their investments.

A deep risk (the only type you should worry about!) is the risk that an asset's value will permanently decline in inflation-adjusted terms (possibly to nothing!) and never return to even close its original value. Owning an individual stock or bond exposes the investor to deep risk. Inflation, over long time periods, is an often overlooked cause of deep risk. In today's interest rate environment, long term US government bonds expose the investor to significant deep risk. That's why we do not have our clients in that asset class at the present time.

Dr. Bernstein points out that owning stock mutual funds largely protects the investor against deep risk, but owning stock funds, even DFA passive funds, exposes the investor to a huge amount of shallow risk. Shallow risk shouldn't matter a bit if the investor "stay the course" during periods of stock market declines.

Unfortunately, investor behavior is an all-to-common cause of deep risk. A naïve investor who panics and sells out in a depressed market turns shallow risk into deep risk, seriously impacting their lifetime financial security.

WHAT THIS MEANS FOR YOUR PORTFOLIO

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In past letters we have outlined the guiding principles used in our approach to building and advising client portfolios. The two we highlight today are directly related to the topics covered above and vital to long-term portfolio security and investing success.

1. *Adhering to your plan*: As stated earlier, lower than normal forward looking returns for stocks and bonds are not indicators of a "sell /abandon strategy" course of action. Whether retired or still saving for retirement, you do have to invest your money somewhere. As bleak as these asset classes look, stocks and bonds historically still represent the best investment asset classes (real estate included) going forward should not be much different.

Sitting on the sidelines in cash, waiting for a better investment climate, is almost never advisable, as it assures the investor of a significant negative real return (that is, a certain loss of purchasing power, which is what really matters). With both asset classes looking overpriced at the moment, staying with your recommended allocation and not trying to weight to one extreme or the other chasing returns is the best and current course of action. In the end, your allocation will be the best determinant of your success.

For retirees, if you have done the proper planning (i.e. a retirement analysis), the consideration of varying market returns has been figured in to your ability to draw off your portfolio in good times and bad. Of course, planning doesn't insure against everything and sometimes tightening the belt in times of low or negative returns may be necessary. However, if you have not done this type of planning, it should be considered as it can provide a comfort level of what your portfolio will/will not be able to support over the course of your retirement.

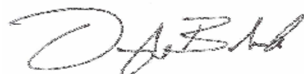
For those still saving for retirement, lower future returns may mean adjusting your savings rates. Savings combined with getting the best possible risk-adjusted long-term returns are the only sure way to secure long-term financial stability. With potential future returns in both stocks and bonds looking to be lower than the historical norm, the gap has to be made up through additional savings. Finding the ability to save additional money is not easy and as Mr. Light says in his article, "Hearing that you need to save more money is unsatisfying, but so is having a bad hand in poker. You don't get to choose your cards, only play the hand you're dealt."

2. *Taking the right level of risk*: Deep Risk affects those who are not invested, or if invested, not appropriately allocated and diversified. As a client, the concept of Deep Risk is mitigated through your investment plan and strategy. However, this leaves exposure to shallow risk. While shallow risk (market volatility) is inevitable, the more we know about your needs and goals, the better we can prepare you to handle it and guide you through it. Very few individuals are financially secure to the point that they can afford to have all their money invested in safe, principal protected vehicles (i.e., cash or CD's). The majority of individuals, whether retired or still saving for retirement, invest because they need their savings to attain the best possible rate of return to achieve stated goals and objectives, and not stand the risk of outliving their assets. Our objective, as always, is to attempt to provide you the best return reasonably available over the actual period invested, within your specified level of risk, helping you attain your goals and to minimize the risk of outliving your resources.

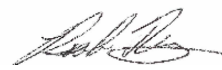
Rest assured we know and appreciate the difference between these two types of risk, and are very aware of the potential impact lower future returns can have on your portfolio. Maintaining strategy is just as important in good times as it is in bad. While we certainly appreciate your concerns about the markets and welcome the opportunity to discuss those concerns with you, we will invariably encourage you to remain fully invested and to stay the course, no matter what the investment climate. If we have helped you plan correctly, you will have the ability to ride out varying market climates. Almost all of you have wisely heeded that advice, and benefitted immensely. Often, simply doing nothing can be the wisest course of action (something we will discuss in subsequent communication!).

As always, thank-you for the opportunity to serve as your financial advisor.

Sincerely,



Doug Babcock, CFP®



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