PROFESSIONAL
FINANCIAL
MANAGEMENT, INC.
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October 16, 2013

Dear Client,

Fall (or "pre-winter" as we know it here) has come to the mountains of Montana and we hope you are enjoying this great time of year, no matter how long or short the season, wherever you are. Enclosed, please find your 3rd Quarter performance report.

Our focus in this quarterly letter will look at the investor lessons learned from the "Great Recession" of 2008 and, despite the issues we continually are confronted with, how maintaining a consistent approach is so important to long-term success. First, however, is a quick look at how markets performed this past quarter.

Resilience of the market remains the story as of the writing of this letter. Despite continued challenges in Europe and Emerging Markets, the possibility of rising interest rates, and renewed conflict in Washington, the economy continues to chug along and markets continue their to steady march upward. The below table summarizes Third quarter 2013 returns:

	US Stock Mkt.	International Dev. Mkts	Emerging Mkts	US Bond Mkt.	Global Bond Mkt – ex US
Third Qtr. 2013	+6.35	+11.31%	+5.77%	+.57%	+1.01%

Source: Russell, MSCI, Barclays and Citigroup

TIME HONORED TRUTHS – LESSONS FROM THE 2008 MARKET CRASH

It's hard to believe that five years have passed since that dreaded day in September of 2008 when the collapse of Lehman Brothers sparked the beginning of a market free fall that shook the confidence of markets and investors worldwide. The last five years have proven a tough road with a slow and sluggish recovery that arguably still has a way to go. In spite of adversity, however, the portfolios of disciplined investors have recovered, moving beyond their pre-recession levels. So what has been learned from this experience?

The lessons are simple and reflective of philosophies that, time and time again, prove relevant. As much as we'd rather forget, the last five years have proven that proper investment planning and staying "the course", as hard as it was to do, was (and always will be) the best course of action. As much as the pundits and financial product marketer's push the notion that the investment world has changed, it really hasn't. The following are a few basic "time honored" investment principles we feel this crisis has strongly re-enforced and are worthy of acknowledgment no matter what market conditions investors face going forward. These are:

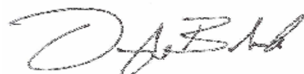
A buy and hold core investment strategy still works. Investors who thought they could time the market by selling out of their stock positions as the market fell and eventually putting it back in over the next few years, were wrong. Most that did go back in, were either way late, or, felt bonds were the best route…and here's what happened: the bull market that started in March 2009 returned 174% (dividends re-invested), vs. 25% for bonds. Investors who stayed the course with their strategy captured this gain are now whole (and then some), while most investors lost out, letting their emotions get the best of them. A great example of staying the course was demonstrated by one of the nation's largest pension funds, CalPERS (California Public Employees' Retirement System). An article in Bloomberg Businessweek this past January highlighted the fact the pension giant had recovered 97% of its pre-recession high through this time (and probably well beyond this by now) by sticking to its equity allocation. In other words, as the article says, "it followed the advice wealth manager's give individual investors". The lesson: Sticking with your strategy and staying the course will work long-term, and if the brightest investment minds at a large institutional investment entity like CalPERS believe in it, so should the average investor.

Asset Allocation and Diversification work. Many believed that these principles failed them in the market downturn as all stock categories fell in concert. However, Asset allocation (the division of a portfolio between asset categories such as stocks, bonds, etc.) did work – the bond portion of most investor portfolios, held its value. Diversification (spreading out money within an asset category, such as stocks, to own many different companies in different industry sectors, geographies, investment styles -growth vs. value, and market capitalizations - large vs. small companies) did work eventually. One must understand though, that diversification is a tool meant to reduce the risk of owning one, or a small basket of securities in just one of the aforementioned areas. As such, while eliminating several types of risk, it can't eliminate overall market risk (Systematic risk) – this is why it did not work during the initial market downturn in late 2008 and early 2009. However, the benefits of diversification became relevant as the US market, despite the woes of the economy, began to recover. In 2012, when the European debt crisis took center stage and everyone wanted to flee European stocks, European stocks beat the world, returning over 20%. The lesson: staying disciplined and letting these principles work is key to capturing return in all areas of the market, allowing for long-term investment success. Although these two principles initially appeared to be useless, they eventually worked to benefit investors…….in spades.

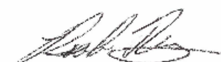
Your retirement portfolio is a long-term endeavor – plan accordingly. Improper investment planning left many investors in peril, forcing them to sell stocks for cash needs at a very inopportune time. It is important to understand your investment time horizon and your need for cash – cash flow planning at any age is essential. Among the key elements to the investment allocation decision (Risk Tolerance and Risk capacity aside) is the need for cash from a portfolio. As discussed in previous communication, we advocate the use of a "bucket" strategy. Bucket #1 one should consist of money to be used in one or two years and is relegated to cash (checking, savings or money market account). Bucket #2 should consist of funds slated for use in years 3-6 and are relegated to a sound bond strategy. Bucket #3 is your long-term money, primarily your growth and long-term inflationary hedge money for retirement needs, and is relegated to a sound stock strategy. The percentage allocation to these "buckets" depends on age and needs. However, do realize that regardless of age and spending needs, the money allocated to buckets #1 and #2 shield cash from the whims of stock market volatility creating the confidence that cash will be available without the potential need to sell assets at a loss (note, bonds also have risk so an understanding of how to allocate amongst bond investment choices is critical). This strategy was employed for clients taking cash withdraws from their portfolios over the last five years and it was a key to their success over this time frame. The lesson: proper planning can mitigate market volatility concerns.

We recognize that there are very few instances during an investor's lifetime that allow them to just to sit back and smell the roses. Something is always happening and some new crisis is always looming on the horizon - knowing what can and can't be controlled is vital to long-term investment success. Unfortunately, it took a crisis of this magnitude for many investors to learn. Fortunately, our clients had this knowledge implemented into their investment strategy ahead of time, and proper planning and sound guidance helped to weather this storm and be prepared for those that lie ahead. Should you have any questions about the content of this letter or any other issues, please feel free to call or email.

Sincerely,



Doug Babcock, CFP®



Bob Frey, MS, CFP®