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

January 15, 2014

Dear Client,

Happy New Year! We hope this letter finds you well and your year off to a great start. Enclosed, please find your 4th Quarter and 2013 Annual performance reports. Please note that all tax information (if it applies to your account) will be sent in a separate mailing.

Financial "rules of thumb" are used extensively in our investment / money management decision making processes. Despite all the research, tools and processes available to us today, these "principles" are what people seem to gravitate to, right or wrong. While good for general guidance, taking them at face value without regard to specific circumstances could lead to less than satisfactory outcomes. In this letter we look at a few of the most widely used of these in an effort to dispel the myths these "principles" portray. First, however, here is a review of what happened in the markets this past year.

**2013 MARKET REVIEW**

The financial markets encountered strong headwinds but little turbulence on the way to a record-setting year. 2013 has been described as a "year about nothing." In reality, a lot happened—but nothing could challenge the market's profitable run. Investors shrugged off news of a sluggish US recovery, recessions in China and Japan, threats of a US government shutdown, lingering euro zone debt problems, climbing interest rates, worsening turmoil in the Middle East, and stock market glitches.

The US and most developed market indexes experienced double-digit gains for the year. Overall, US stocks were up for the fifth year in a row while daily volatility fell to its lowest level in seven years. The Dow Jones Industrial Average posted a gain of 26.50%, its largest advance in 18 years. The S&P 500 Index had its best year since 1997, returning 32.39%. In the non-US developed markets, the MSCI-EAFE Index returned 22.78%, and all developed country markets in the MSCI indexes had positive returns. Emerging markets were the exception to the worldwide equity advance, as returns in many emerging countries turned negative, with the MSCI Emerging Markets Index returning -2.60% for the year.

During 2013, the yield on the 10-year Treasury note climbed from 1.76% to 3.01%—its largest increase since 2009. Rising interest rates left US fixed income indexes with either flat or negative returns, with longer-term and higher-quality bonds declining the most. TIPS performance was notably poor. Returns in the international bond markets were mixed, and emerging market bond index returns were negative.

While another very strong year for equity market returns, we continually urge clients to put this information in proper context. We've had five very good years – quite a run. While markets may continue to move up from here, a setback is equally likely. What goes up (and up, and up!), must eventually come back down or revert back to its mean. No one knows what will happen and the financial guru's are out in full force with all their crystal ball predictions. Just remember that your portfolio allocation is in place for a reason and whether markets are up, down, or sideways, your strategy will help you achieve long-term investment success.

**MYTHS OF PERSONAL FINANCE**

**Using your age to determine you stock/bond allocation**: The premise states that one should subtract their age from 100 to determine their stock allocation. This is an investment planning tool that has been around for a few decades, and began as a "quick and dirty" for advisors to allocate clients without providing specific justification. The stock/bond split for an investor is a more complex equation dependent of many factors such


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

as life expectancy, retirement age, portfolio size, goals, and other income sources at retirement (i.e. Social Security) to name a few. While this rule works well for younger investors who have jobs and time to let markets work, it could potentially hamstring an investor approaching or in retirement, depending on their situation. For example, a recently retired investor who needs to bridge the gap between when they retire and when they draw social security, may need to be initially more conservative with the investment of their portfolio to ensure they have the resources to cover themselves if they hit a rough patch in the market. However, once they begin to collect benefits and are able to cut back on the amounts needed from the portfolio, they may be able to increase their equity exposure. The take away: one's allocation to stocks and bonds is very dependent on their personal situation and using general assumptions could lead to unexpected consequences.

**Assuming use of a 4% portfolio withdrawal rate in retirement**: The problem with this assumption is that it is way too simplistic and there are many factors to consider when discussing sustainable portfolio withdrawals. Since William Bengen pioneered research on this with his groundbreaking work back in the mid 90's, more extensive research has come about requiring retirees to give this process much more consideration than they have in the past. Bengen's research originally states that an investor can withdraw approximately 4% (called the "safe withdrawal rate") of the value of an IRA the first year, adjust that withdrawal annually for inflation, and have a 90% chance of not running out of money over a thirty year period. There are several problems with this assumption. First, no one actually withdraws money from their portfolio in that fashion. Since retiree's spending varies from year to year, and other entitlements such as Social Security payments or pensions may begin at different times during retirement, almost all retirees withdraw varying portfolio amounts each year. The "4% rule" was determined using stock returns from 1926 until the mid-90's, and most reputable authorities feel that future stock returns will be lower (discussed later). The research did not consider investment fees, which can significantly lower the portfolio's return. Most importantly, the "safe withdrawal rate" depends heavily on the stock and bond market valuations at the beginning of the withdrawal period. With today's stock and bond markets significantly overvalued, it would be very risky to base a retirement withdrawal strategy on this rule – applying a "one size fits all" strategy like this could prove disastrous in the long-run.

**The stock market will provide a long-term average of 10%:** First and foremost, forget about achieving the superb historical US long term stock return of 6% over inflation. That return included reinvesting all dividends, and most of that record was achieved in the days that stocks paid 5% dividends (they pay less than 2% today). Additionally, there is absolutely no guarantee of any definite level of return in stocks, and today's US stock market is probably moderately overvalued (meaning returns over the next decade may be quite modest). However, despite this frustrating lack of assurance, stocks have invariably been the best investment, long term, over almost all historical holding periods. The investor must simply have a disciplined, coherent strategy and accept whatever results occur over the actual time period invested. Our prediction (and the consensus of most other reputable authorities) is that a broad basket of US stocks will probably return 3-4% over inflation over the next several decades, with value and small capitalization stocks usually (but not always) doing moderately better. That is also the consensus of most other reputable authorities.

There are many more of these "financial rule of thumb" principles out there and we can't highlight them all. However, like the one's mentioned, they are not "one size fits all" strategies and caution needs to be exercised when applying them your personal situation. If you'd like a more detailed approach to your planning, it wouldn't hurt to give us a call to discuss your situation.

Thank-you for allowing us to serve as your Advisor and we look forward to helping you accomplish your goals in the coming year.

Sincerely,

Doug Babcock, CFP®

Bob Frey, MS, CFP®