PROFESSIONAL FINANCIAL MANAGEMENT, INC.
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Dear Client,

Greetings from the PFM staff! We are enjoying fabulous fall weather and hope you are enjoying the same. Enclosed, please find your 4th Quarter and 2013 Annual performance reports.

In this letter, we will talk about mean reversion as it relates to the markets and a separate discussion on small cap stock performance and what this means to your portfolio. Before we get to these subjects, here is a summary of what happened in the market over the past quarter.

On a broad measure, here is how the major asset classes of your portfolio fared over the past three months:

Q3 2014 in Review

	US Stocks	International Dev. Markets	Emerging Markets	US REIT	Fixed Income
3rd Qtr 2014	-.02%	-5.88%	-3.5%	-3.07%	.94%

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

In the US, equity markets recorded a slightly negative return (as measured by the Wilshire 5000 Index). Breaking things down by asset class, large cap stocks significantly outperformed small cap stocks (discussed further below) and value underperformed growth across all size ranges, with the exception of micro cap indices. International Developed equity markets saw a similar trend with large caps outperforming small caps and value underperforming growth across all size segments. Emerging markets experienced somewhat opposite results from US and International developed markets with small cap stocks outperforming large cap and large value stocks outperforming growth stocks. However, value underperformed in small cap stocks. REIT's (both domestically and internationally) were negative for the quarter after posting strong results in the 2nd quarter. Last, but not least, fixed income had mixed results. Long and intermediate bonds declined on the quarter while short-term bond rates saw a slight increase.

Now, as you are undoubtedly aware, volatility has returned to the markets over the past few weeks (from around quarter end up until now). As of this writing it is down 2% from its peak, recovering significantly from the lows of a few weeks ago, and may yet change by the time you receive this. However, as we have relayed in our discussion with you, the relatively smooth, upward ride over the past two years is not typical, and this recent volatility is more of a "normal" state – that's the price an investor pays for receiving good returns from stocks. You should realize that your portfolio's stock returns over the past five years have been outstanding. Statistically, there was less than a 15% chance of your achieving those results. Therefore, you should be thankful for your good fortune.

Reversion to the Mean (or "What goes up must come down, and vice versa)

What this means, as pertains to today's somewhat overvalued stock market, is that periods of outstanding returns are normally followed by periods of mediocre (possibly negative) returns (and, conversely, bear markets are normally followed by bull markets, such as we have experienced over the past six years). In your case, that means you should temper your return expectations over the next decade. We would be (pleasantly!) surprised if stock returns were more than 5-6% annually, on average, over the next several years. Additionally, rest assured that you will see future temporary and unanticipated declines, some severe, in the value of the stock portion of your portfolio. Remember, if you can ride out those declines without selling stocks, you have lost nothing.

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However, that doesn't mean that you can anticipate these declines, profiting from nimbly jumping in and out of the stock market. Probably the most striking example of this is an investor, in 1996 ,hearing Alan Greenspan's famous "irrational exuberance" speech (where he stated unequivocally that the stock market was significantly overvalued), sold out of stocks, waiting for the "right" time to get back into the market. The stock market never returned to that supposedly overvalued 1996 level, and that investor is still waiting! Every single reputable study has demonstrated that market timing, moving from stocks to cash and back again based on the investor's perception of the stock market, simply doesn't work, and those that try it do so at their own peril.

This doesn't mean that you should simply "set it and forget it" and never adjust the portfolio. Rebalancing approximately back to your original allocation (which we do periodically), is a form of "selling high and buying low," and benefits you as an investor, both from a risk and return standpoint. Also, some asset classes are plainly overvalued. An example is bonds today. With the Fed holding interest rates at an artificially low level, the future returns on bonds are bound to be rather dismal. Therefore, we are keeping the bond portion of our clients' portfolios at the low end of the range, and using mainly short term bonds which have the least risk if – when – interest rates rise. However, you do need some bonds, in the event you have to withdraw cash from the portfolio during a stock market decline.

Also, international stocks have not recovered nearly as well as US stocks. Therefore, when rebalancing or investing new money, we are (slightly) overweighting international stocks versus U.S. stocks.

Small Cap Pullback and What It Means

Small capitalization stocks "led the charge" on the stock market rebound after the 2008-09 bear market. However, that period of superior performance seems to have come to an end, and small capitalization stocks are seriously underperforming the broad stock market over the past twelve months. What does this mean to you? The U.S. stock portion of your portfolio, which is approximately 1/3 in small cap stocks, will undoubtedly underperform the U.S. stock market benchmark over short trailing periods (one and possibly three years), which may mean the entire portfolio will underperform the total benchmark over those periods. Should you worry about it? No. Asset classes move in unpredictable cycles, small cap stocks are expected to underperform over short periods, and the DFA funds (holding the smallest of the small capitalization stocks) are often the worst performers. However, over longer periods, the beneficial effect of holding very small capitalization stocks is usually quite evident. Said another way, the periods of outperformance have a greater impact than the periods of underperformance. Again, since these cycles are totally unpredictable, the investor simply has to "stay the course" long term, to reap the benefits of the small capitalization premium.

As always, thank-you for the opportunity to serve as your Advisor and we look forward to serving you in the coming months.

Sincerely,

Doug Babcock, CFP®

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