PROFESSIONAL FINANCIAL MANAGEMENT, INC.
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Dear Client,

We hope this letter finds you doing well and enjoying all the great things this fall season offers.

Portfolio diversification has been a common theme in our communication to you this year – a fortuitous and timely subject matter considering the volatile market conditions experienced this past quarter. Following our review of market activity we will expand on this topic by providing a "refresher" on how your portfolio is constructed to provide diversification and a better understanding of what you own and why you own it.

Third Quarter 2015 in Review

This past quarter was a volatile one with US markets moving into correction territory for the first time in four years and global markets as a whole seeing their worst quarterly performance since 2011. On review of all world asset classes, (in terms of US dollars), US markets outperformed International developed and emerging markets on the whole, with US REITS having the best performance and outperforming all equity markets. The Value premium failed to show up in US, International Developed and Emerging markets. The small cap premium was realized in both the International Developed and Emerging markets but not in the US. Further magnifying poor international and emerging market returns was a strong US dollar, which again, appreciated against most currencies. On the Fixed income front, shorter term yields remained relatively unchanged while mid and longer term yields fell. A summary of third quarter and YTD markets returns is as follows:

The negative equity markets have put portfolio returns in negative territory for the year. However, staying diversified and remaining patient has helped investors fare better than individual markets (for more information on diversified portfolios, see page 13 of the Quarterly Market Review posted on our website, www.profinancialmgmt.com). A summary of third quarter and YTD markets returns is as follows:

	US Stock Mkt.	International Dev. Mkts	Emerging Mkts	Global Real Est.	US Bond Mkt.	Global Bond–ex US
Q3 '15	-2.25%	-10.57%	-17.90%	-.54%	+1.23%	+2.01%

Source: Russell, MSCI, Barclays and Citigroup

A Refresher on Portfolio Construction and Strategy

There is both an art and science to building broadly diversified portfolios specifically tailored to an investor's personal situation. A top-down hierarchy best describes our portfolio construction process, where the client's goals and objectives drive the development of the broad allocation and further diversification to sub-asset classes. We adhere to an evidenced-based investment philosophy that seeks to leverage areas of the market that can improve long-term portfolio returns. Below is an explanation of the five stages we go through in the development process:

1.) Defining investment goals and constraints: This is best termed the discovery stage and is focused on gaining an understanding of client investment goals. Whether a client is in the accumulation phase, transition to retirement phase, or the retirement withdrawal phase, our review considers both a client's tolerance to accept short-term volatility (including tracking error to the broad market indices) along with a client's financial "capacity" to absorb volatility. While for many, this information is best uncovered in the financial planning process, it is also gathered through discussions and meetings prior to moving on to the allocation stage.

2.) Establishment of a broad strategic asset allocation to Equity vs. Fixed Income: The initial stock / bond allocation can be responsible for better than 80% of a portfolio's future return so it is one of the most important decisions in the portfolio construction process. Knowledge of a client's personal situation helps us to establish a base or macro allocation that can

range anywhere from 0 to 100% in stocks. While there is no black and white process to determine what this allocation should be, our years of experience combined with research help provide an appropriate allocation for an investor's particular situation. This general allocation is "fine-tuned" in the next stage of the process.

3.) Sub-asset class allocation: The heart of the diversification process begins here – this is where the relative weights to the various sub-asset classes are determined. For equities, this includes market capitalization (large vs. small), style (growth vs. value), and geographic (domestic vs. international and developed country vs. emerging market). For Bonds it includes term exposure (short vs. intermediate vs. long), credit exposure (high, medium, low), and geographic (domestic vs. international). It is important to point out here that there are many asset combinations that can work to achieve a stated objective, and the perfectly "optimal" asset combination for one's situation can only be determined in hindsight. That said, we emphasize reasonable over optimal in the allocation process.

While the steps in the process of stock and bond diversification are similar, the bond decision, though not less important, is less complex. For purposes of our client portfolios, bonds serve two primary purposes: 1.) to dampen volatility; and 2.) provide liquidity or cash in the event stocks are down. In general, this means shorter-terms and high credit quality, with some exposure to international and emerging markets. However, the term and credit exposures are subject to adjustment based on a client's objectives. The stock diversification decision has a few additional considerations. While stocks are the major driver of returns in a portfolio, they also present the largest element of risk, and our allocation process here is as follows:

Determine Opportunity Set: The opportunity set is all possible portfolios that can be constructed from a given set of assets. As financial theory would suggest, a global cap weighted portfolio represents the best starting point for an investor seeking optimal diversification. The best representation of this is the MSCI All-Country World All Cap Index which represents approximately 99% of the global marketplace as it tracks over 14,000 large-, mid-, and small-cap stock in developed and emerging market companies on a cap-weighted basis. From here we begin the portfolio development process with the ability to rationalize any decision to deviate from this set as needed.

A consideration here that affects weightings to domestic and international securities is "home bias", or the known tendency of investors to overweight exposure to their home country in relation to its actual weight in the global market index (i.e., at the end of 2014, the US accounted for 52% of the world market cap, but most Americans carry a much heavier weight to US stocks in their portfolios). While there are many reasons for this, the most prominent for US investors has to do with currency risk – everything eventually is converted back into the US dollar so this may be warranted to protect domestic consumption. For this reason, our equity allocation is 70% domestic, 20% international developed, and 10% emerging markets.

Consideration of / exposure to the drivers of Expected Returns**:** Here is where the science of investing comes into play. We adhere to an Evidenced based investing philosophy which is the result of decades of research identifying various premiums in the market that are possible sources of higher expected returns. This research (much of which was pioneered by Nobel Prize recipient Eugene Fama and Kenneth French) has concluded that there are four factors or drivers of expected returns that provide valid justification for movement away from the global market baseline (discussed above) – these are:

- Asset Class: Stocks outperform bonds over time
- Size: Small-cap stocks tend to outperform large-cap stocks over time
- Relative Price: Value stocks (low Price/Book) tend to outperform growth stocks (high price/book) over time
- Profitability: Stocks of companies that are highly profitable tend to outperform stocks of less profitable companies

The premiums relating to these factors have been positive across most time periods. We say most because there are periods (sometimes long periods) where they have not been present, and further, it is not possible to predict their occurrence.

While structuring portfolios with increased exposure to these factors can result in higher returns, it needs to be understood that higher returns equate to higher risk. This does not necessarily mean higher risk than the overall market, just different risk, such us "under-performance" risk or tracking error to the broader market indices when the premiums are not present.

Clients should understand that, by design, their portfolios will no longer track a market-cap weighted benchmark (such as the MSCI All-Country World Index mentioned earlier) and to expect unpredictable short to medium term periods of under-performance to get the benefit of higher long-term returns over portfolios with no exposure to these factors (i.e. the broad market). This is an important concept to grasp because of what is termed “TV Risk”, where there is tendency is for clients to typically compare short-term returns to whatever index is being discussed on the news or in the media.

4.) Determining Final Allocation: Information from all stages of development is used to reach an appropriate and reasonable allocation decision for a client’s given situation. Final weightings to the various domestic and international sub-asset classes for both equities and fixed income are determined based on client objectives, with a reasonable t ilt to the drivers of expected returns applied to the equity component of the portfolio. A client Investment Policy statement containing a full break-out of the final allocation, along with client objective and other pertinent portfolio information is developed for both advisor and client guidance going forward.

5.) Allocation Implementation: Art and experience combine when actually applying the allocation to a client’s investment assets. We begin by selecting the best investment vehicles we believe will achieve the desired result, with consideration here given to both objective and cost. For our client portfolios, the primary fund vehicles are the DFA (for their factor implementation) and Vanguard Funds.

Next, we turn to the process of applying the allocation to the client’s various account types. Allocating each account separately can be duplicative and costly. Our process considers all client accounts as a single portfolio and applies it as an overlay to all household accounts (taxable accounts, IRA’s, Roth IRA’s, 401k’s, etc.), meaning the client portfolio is the sum total of all investable assets. The primary advantage of this is that the tax characteristics of each account type can be leveraged, where tax inefficient investments (those that have annual distributions that are taxable at ordinary income rates, such as bonds or REITS) can be held in tax-deferred accounts, while more tax efficient investments (such large Capitalization stock index funds) can be held in taxable accounts.

We are always cognizant of a client tax picture and though we will not let the “tax tail wag the dog”, we always consider the tax implications of any investment decision relating to both original allocation and ongoing advisory.

What all this means to you and your portfolio

Too many investors focus on the things they can’t control, such as the markets and economy in general, instead of focusing on what can be controlled. Understanding how you are invested and having a well thought out plan that: 1.) is developed with consideration of overall financial objectives; 2.) utilizes core investment fundamentals in combination with market leading research; and 3.) emphasizes balance, diversification, and discipline, provides the best strategy for long-term success. Remember though, this plan is fluid and not static (“set-it and forget it”). Re-balancing the portfolio to stay in line with the strategy and potential adjustments to the overall allocation as you move through life will be needed to keep your plan on track – we will be here to continually monitor your situation and keep you focused so that you can achieve your long-term objectives.

As always, thank-you for the opportunity to serve as your Financial Advisor – we look forward to talking with you soon.

Sincerely,

Doug Babcock, CFP®

Bob Frey, MS, CFP®