PROFESSIONAL
FINANCIAL
MANAGEMENT, INC.
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July 20, 2016

Dear Client,

We hope you are having a great summer and that this letter finds you well.

As a reminder, please compare the information reported in the enclosed quarterly report to the account statements you receive directly from the custodian (note that there might be slight discrepancies due to the timing of the credit of dividends or transactions at quarter end). Promptly report any material discrepancy between the data found in the enclosed quarterly report and the account statements you receive directly from the custodian. Also, if you are not receiving account statements directly (either in print or electronically) from the custodian please notify us immediately!

A major part of our job is helping you understand how and why you are invested the way you are, and in turn, how the design and structure of your investment portfolio (i.e. strategy) provides you a high probability for long-term investment success. Our 3rd quarter 2015 letter went into depth about our approach to portfolio construction, and our ongoing objective is to continually educate you about investing whenever (and however) we can! This letter will further discuss your investment strategy and how the drivers of expected excess returns (Value, small company, and high profitability stocks – key strategy components) have and continue to impact portfolio performance. First though, here is a quick review of how the various asset classes in your portfolio performed over this past quarter.

Second Quarter 2016 in Review

Despite perceived economic headwinds and fall-out from the U.K. vote to leave the European Union, both domestic and International markets showed resilience and continued to move up.

In terms of US dollars, the US outperformed both International developed and emerging markets. US REITS have continued their dominance, recording the highest returns and outperforming the broad equity market for the quarter. The Value premium was positive in the US for the quarter but negative in both International Developed and emerging markets. Small cap stocks outperformed large caps in the US but slightly underperformed in both International developed and emerging markets. A summary of QTD and YTD performance is as follows (more detailed information can be found on the website):

	US Stock Mkt.	International Dev. Mkts	Emerging Mkts	US Real Est.	US Bond Mkt.	Global Bond–ex US
Q2 '16	+2.63%	-1.05%	+.66%	+5.60%	+2.21%	+3.11%
YTD '16	+3.62%	-2.98%	+6.41%	+11.09%	+5.31%	+7.40%

Source: Russell, MSCI, Wilshire, Barclays and Citigroup

"Dimensions" of Expected Returns – performance of Value and Small Cap premiums

A major component of your equity investment strategy is the intentional "tilting" or "weighting" of your portfolio toward a higher percentage of both Value (low book-to-market stocks – cheap or inexpensive) and small company stocks. This is part of our "evidenced based" investment philosophy supported by research from Nobel Prize winner Eugene Fama. For this reason, value and small cap performance is specifically mentioned in our market

review (above) for the purpose of explaining what is happening in your portfolio. While value and small cap premiums have been present through the first six months of this year, one or the other (or both in some years) have not materialized in several of the past eight years, causing the most recent rolling five and ten year returns in the US stock portion of your portfolio to trail the broad market index. As such, it is probably time to reflect on how markets and investment strategies work (and, sometimes, don't work) in your favor.

First, despite what the "talking heads" on CNBC say, an investor can only hope to get what the broad financial markets deliver, less investment fees and taxes, and no one can predict where stocks are going in the near future. With the exception of the last couple of weeks, the US stock market, after a significant recovery from the depths of the 2008-2009 financial recovery, has been in a "holding pattern" since the beginning of 2015. These occasional periods of flat or negative returns are the price an investor pays for superior long term growth. Stocks don't go continually up with no risk, year after year. If they did, they wouldn't deliver significant long term growth. Such is the nature of risk and return - it can be no other way.

Second, no investor (or advisor) can predict in advance when these periods of disappointing returns will occur, so attempting to "time" the market by getting out of stocks (or a stock strategy) before a downturn is a fool's errand, dooming the investor to poor results.

*Sound stock investment strategies, such as our strategy of tilting the stock portion of your portfolio towards value and small capitalization stocks usually (but not always) delivers investment returns over the broad stock markets. Growth stocks usually (but again, not always) lag the broad stock market. However, no strategy works all the time - if it did, the superior long term results over the broad market would not be achievable. Both U.S. value and small capitalization stocks have trailed the broad U.S. stock market over the past five and ten year periods and again, this is the price an investor pays for usual long term success. However, looking back further, value and small capitalization stocks, and the U.S. stock portion of our clients' portfolios, have significantly outperformed the broad U.S. stock market over the past 15 years.

How bad can it get? We went back and analyzed the historical performance of the U.S. stock market, and value and small capitalization stocks against the broad US stock markets over varying periods. Here are the facts:

1. The stock market can underperform for a long time. The, real (after inflation) returns in U.S. stocks looking forward from any year between 1965-1973 and 1999-2001 were flat or negative for most periods up to 14 years. [However, from 1965-73, a period of high inflation, U.S. Treasury bills and bonds did no better – there was simply "no place to hide" in this period of high inflation]. Fortunately, these periods of prolonged underperformance are rare.
2. Similarly, value and/or small cap stocks can trail the market for a long time, and these periods of underperformance often appear in clusters. For instance, small cap stocks trailed the U.S. broad market for ten years for every ten year period from 1979-1990, and large cap value stocks trailed the broad market by a wide margin for ten years for every period from 1988-1990. Again, these periods of prolonged underperformance are rare.
3. The short term (1 year) results are all over the map for both the overall U.S. stock market and the value and small capitalization stock premiums over the market. On average, the U.S. market had a negative annual return 20% of the time over the past 50 years, and value and small capitalization stocks outperformed the broad market in any single year only slightly more often than 50% of the time over the same period.
4. The (usual) superior stock market performance, and superior value and small cap performance over the broad stock market comes largely from a few short periods (sometimes as short as a month!) of unexpectedly large returns, typically immediately after a period of underperformance. After the dismal long period of flat to negative returns in the U.S. market ending in 1981, the U.S. stock market went on a tear, returning over 20% annually for three of the next four years. After significantly lagging the broad market for 5 straight years from 1995-99, large capitalization value stocks significantly outperformed the broad market from 2000-2002, totally making up (and more) for the previously disappointing five year

losing period. The many disillusioned Investors who bailed out of the U.S. stock market in 1981 or abandoned value stocks in 1999 entirely missed the subsequent stellar returns.

5. Very occasionally (like the period beginning 1988-1990 and the ten year period ending now) both small capitalization stocks and value stocks both underperformed over the same period. That is the reason our performance is lagging the broad stock market over the past ten years.

The “takeaway lessons” from all of this are:

1. No one can predict where markets are going in the future. We can only look at history to guide us.
2. The longer the period, the higher the likelihood that the stock market will outperform other asset classes and that value and small capitalization stocks will outperform the broad stock market.
3. In both the overall stock market and any stock strategy, periods of underperformance over certain (fortunately rare) long periods are to be expected. You should be prepared for this.
4. Since outperformance over most long periods comes from a relatively few short periods of outstanding returns, and those periods cannot be predicted, the worst thing an investor can do is abandon a strategy that usually works in the midst of disappointing results.

In summary, we advise you to “stay the course” through these and any future difficult times, as your investments are well diversified. For those of you who are retired (or nearing retirement) and are drawing money off your portfolios, we do have your portfolios in a defensive posture, providing the liquidity (through stable bond investments) to make withdrawals over several years without having to sell depressed stocks in the event of a prolonged market downturn.

Your expectations should be quite realistic. As always, we will attempt to get you the best return reasonably possible from the world’s financial markets at a prudent level of risk, but even that return in the next few decades will probably be modest. The U.S. stock market, in the opinion of most investment professionals, is still overvalued, and bonds are paying almost nothing, adjusted for inflation. Be prepared for overall returns in the low to mid-single digits (far lower than the historical averages) over the next decade….the road may be rocky, with many short periods of disappointing returns. That’s the best you can do, and you should be prepared for it and plan accordingly (including, for those still working, probably saving more).

We are confident that somewhat better times will eventually return, but we don’t know when (and are smart enough to admit it!). Certainly, if you want to discuss these matters in more depth, do not hesitate to contact us.

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®