QUARTERLY NEWSLETTER

2018 Third Quarter

Dear Client,

It's hard to believe that we are three quarters through 2018 and nearing the end of the year! Third quarter reports were mailed last Friday so it should be in your hands shortly - please let us know if this is not the case. As always, please remember to compare the information on your report to your account statements received from TD Ameritrade or other custodians, and promptly contact the office should you find material discrepancies (note that there might be slight discrepancies due to the timing of the credit of dividends or transactions at quarter end). Let us know as well if you are not receiving account statements directly (either in print or electronically) from TD Ameritrade or other custodians.

Much happened over the past quarter, but the economic landscape remains largely the same. While overall market returns appear to be strong, certain areas of the market are struggling. The financial press has brought to light the growing disparity in returns of value stocks (those that by certain financial metrics are underpriced relative to the market) to growth stocks (stocks that by certain metrics appear to have substantial prospects for growth). Despite respectable relative returns from value, net underperformance reaches back to 2008, making this the third longest period in history that this has occurred and only the sixth time in modern market history (going back to 1926). While accurate, there is a great deal to understand here before getting too concerned, and we will delve into this topic, its implications and the longer-term outlook where your portfolio is concerned. First, however, is a brief review of how markets fared this past quarter.

THIRD QUARTER 2018 RE-CAP

The US economy posted 4.2% real GDP growth in the third quarter despite continued trade war fears and the Fed's resolve for continued interest rate hikes. Both issues could create headwinds in the fourth quarter and in 2019, but for the time being, the labor market, manufacturing and service industries continue to look healthy with encouraging consumer confidence and spending reports. The US equity markets reflected this strength as the Russell 3000 (measures the broad US market) returned 7.12%, dominating global returns and outperforming both International Developed and Emerging markets which posted 1.31% and -1.09% respectively.

Fee Only Investment Advisory and Financial Planning
Douglas M. Babcock, CFP®, dbabcock@profinancialmgmt.com Brandon M. Smith, bsmith@profinancialmgmt.com
PROFESSIONAL FINANCIAL MANAGEMENT • 945 Technology Blvd, Ste. 102 • Bozeman, MT 59718 • www.profinancialmgmt.com
Voice: 406.587.1604 • Fax: 406.586.8333

Specifically relating to portfolio strategy, factor performance was mixed. Value premiums were positive in emerging markets but negative in both US and international developed markets. Small cap stocks underperformed large caps in the US, international developed and emerging markets. US Real Estate (REITS) remains positive for the year although they trailed the US equity market in performance. Interest rates continued to rise on both the short-end (Fed control) and long-end of the curve. While both short-term and intermediate-term corporates gained .71% and .80% respectively, short-term corporate returns remain positive for the year while intermediate-term corporates remain in the red (*information courtesy of Dimensional Fund Advisors and Russell Investments).*

More detailed information and additional commentary on the markets can be viewed by going to our web-site and selecting the "News" tab. Below is a summary of broad market index performance for the quarter based on the asset class exposure in your portfolio:

	US Stock Mkt.	**International Dev. Mkts.**	**Emerging Mkts.**	**US Real Est.**	**US Bond Mkt.**	**Global Bond– ex US**
Q3'18	7.12	1.31	-1.09	0.72	0.02	-0.17

Source: Russell, MSCI, Wilshire, Barclays and Citigroup

WHAT WINNE THE POOH CAN TEACH US ABOUT SUCCESSFUL LONG-TERM INVESTING

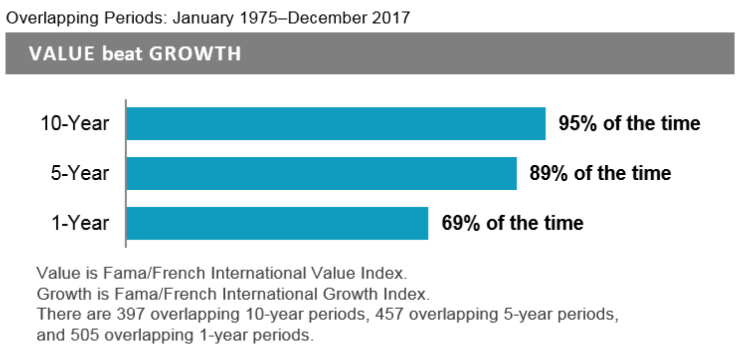
A month or so ago my daughter picked out "Winnie the Pooh and the Honey Tree", by A.A. Milne, for her bed-time story. For those who don't know the story, Pooh finds a tree with buzzing bees, equates this to a stash of honey, and spends the rest of the story devising a plan to access his most beloved staple. Not far into the book, Pooh makes his first attempt to reach his prize by climbing the tree and near the top, acknowledges the difficulty and as Milne writes, complains about it through a simple song:

> *"It's a very funny thought that, if Bears were Bees, they'd build their nests at the bottom of trees."*
> *"And that being so (if the Bees were Bears), We shouldn't have to climb all these stairs."*

Milne was known to provide messages to readers through his characters and their plights (although it may have taken until adulthood to understand them!) and now I know why my late mother was such a fan. While reading this story to my daughter, the wise old bear Winnie the Pooh made a couple of things clear to me: Life's successes and rewards require (among other things) dedication, perseverance, and patience, making them worth the effort. Furthermore, if achievement of a goal or objective were easy, everyone would follow the same path, eliminating the benefits or advantages to be gained. While sage advice in general, its value to long-term investors is priceless.

Investing for the long haul in today's environment is difficult at best. Investors are continually bombarded with mis-information which can create impatience. This impatience can lead to poor decisions and/or the abandonment of one's strategy in pursuit of overnight success – after all, we live in a day of instant information, instant results…instant everything. Sometimes, perspective and sound advice are needed when expectations don't meet with reality. Specifically, let's look at the underperformance of value to growth as discussed earlier. Yes, despite periods of success, value stock returns have been dominated by growth stock returns over the trailing ten-year time period. However, the financial media might have you believe that the advantages of investing in value stocks has "disappeared" or that new forces are in play and that "this time is different". While we can't dismiss any of these allegations, we can step back and refer to history as our guide.

What we know from the research (Eugene Fama and Kenneth French – discussed further below) is that growth stocks do beat value stocks and sometimes for extended time periods, it happens and is what we are experiencing now. However, we also know from the research that value stocks have historically outperformed growth stocks most of time dating back to 1926. The chart referenced below shows the percentage of times value has bested growth over rolling ten, five, and one-year time windows. You can see that as time progresses, the probability increases, and that value bested growth 84% of the time over all 10-year rolling periods. This outperformance has resulted in an annualized "premium" or excess return of 3.54% (through 2017).



Financial markets cycle and eventually "the worm turns" - value stocks should have their day again. But as we pointed out earlier, patience and focus are paramount and jumping ship to chase returns could be detrimental. Take the period from 1995 – 2000. Tech stocks were booming giving growth stocks a substantial return edge over value. If you had value as part of your strategic long-term approach, you may certainly have been disenchanted. However, that party ended abruptly and painfully in 2000. Those who showed resolve and hung in were rewarded handsomely – value stocks recovered a five-year deficit to growth stocks in just 16 months! The reversal happened quickly and was impossible to time – another reason to believe in your strategy.

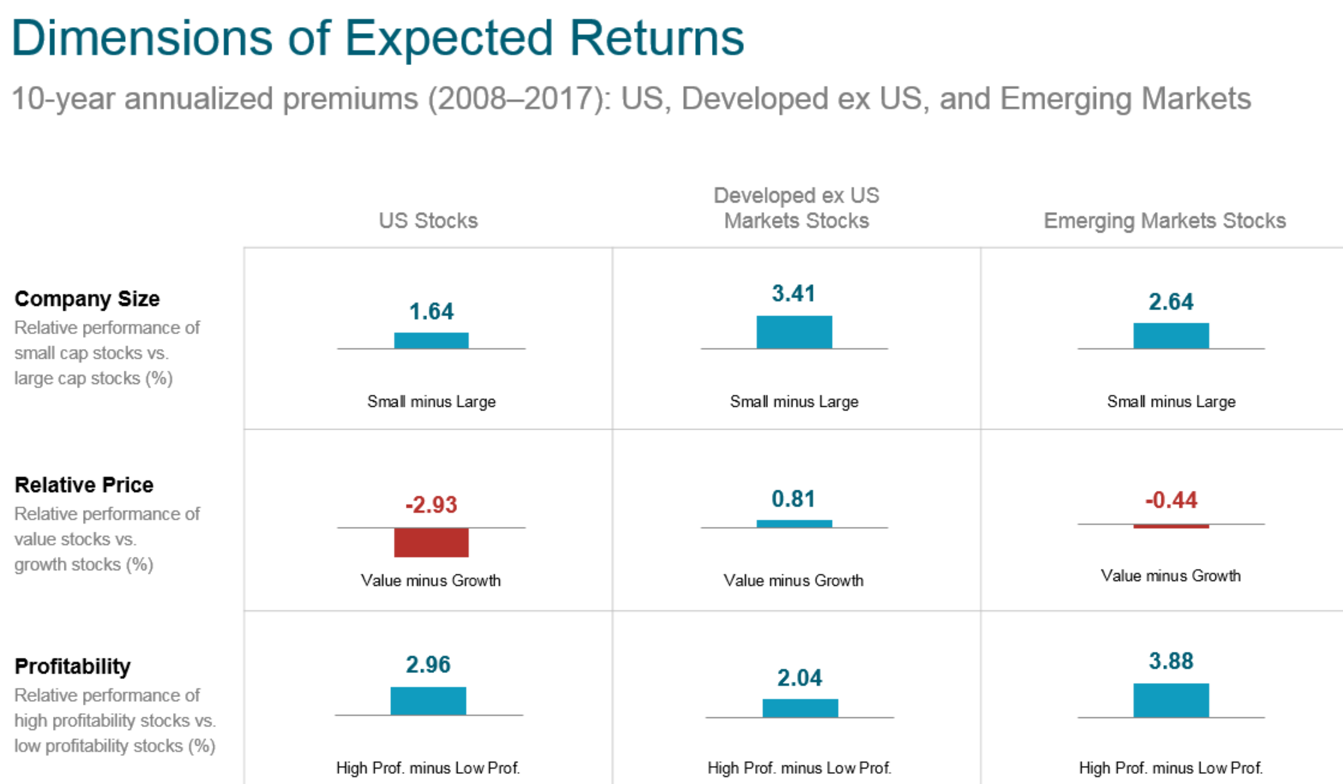
Other "factors" at work - To this point the only discussion here has been on the near-term performance of value to growth…and only in the US market. There are key components at play in your portfolio strategy to mitigate such occurrences in addition to providing excess return over time. In addition to US Value, International and emerging market value exposure, along with small cap and relative profitability (to be discussed) stock exposure across major equity asset classes, provide valuable return diversification benefits. The research substantiating the use of these "factors" as they are termed by academics, was primarily compiled by two of the brightest investment minds of our day, Eugene Fama (2013 Nobel prize winner in Economics) and Kenneth French (Professor of Finance, Tuck School of Business, Dartmouth College).

To summarize, their research determined that in addition to the long-term benefit of stocks over bonds (market premium), value and small cap stocks (value over growth as discussed above and small cap stocks over large) provided similar long-term benefits or premiums. In 2012, extensive research added a fourth component, relative profitability (complex but the quick explanation is that there are companies that are consistently more profitable than others and that over time, these companies tend to perform better than the broad market). The model, now termed the four-factor model, can explain approximately 95% of the variability of returns in the equity marketplace.

Unfortunately, these factors are not alone in the research world. Larry Swedroe, prominent investment academic and co-author of "Your Complete Guide to Factor-Based Investing", points out that financial innovation has ginned up over 600 factors since Fama and French's 1992 ground breaking research. The good news as Mr. Swedroe puts it, is that Fama and French's early work on value and small cap along with the newer research on profitability explain nearly all the variation of returns between diversified equity portfolios (mentioned above). Also, these factors are among the very few that are not considered "data mined" or manipulated. Each factor holds up against the following stringent academic criteria and are considered:

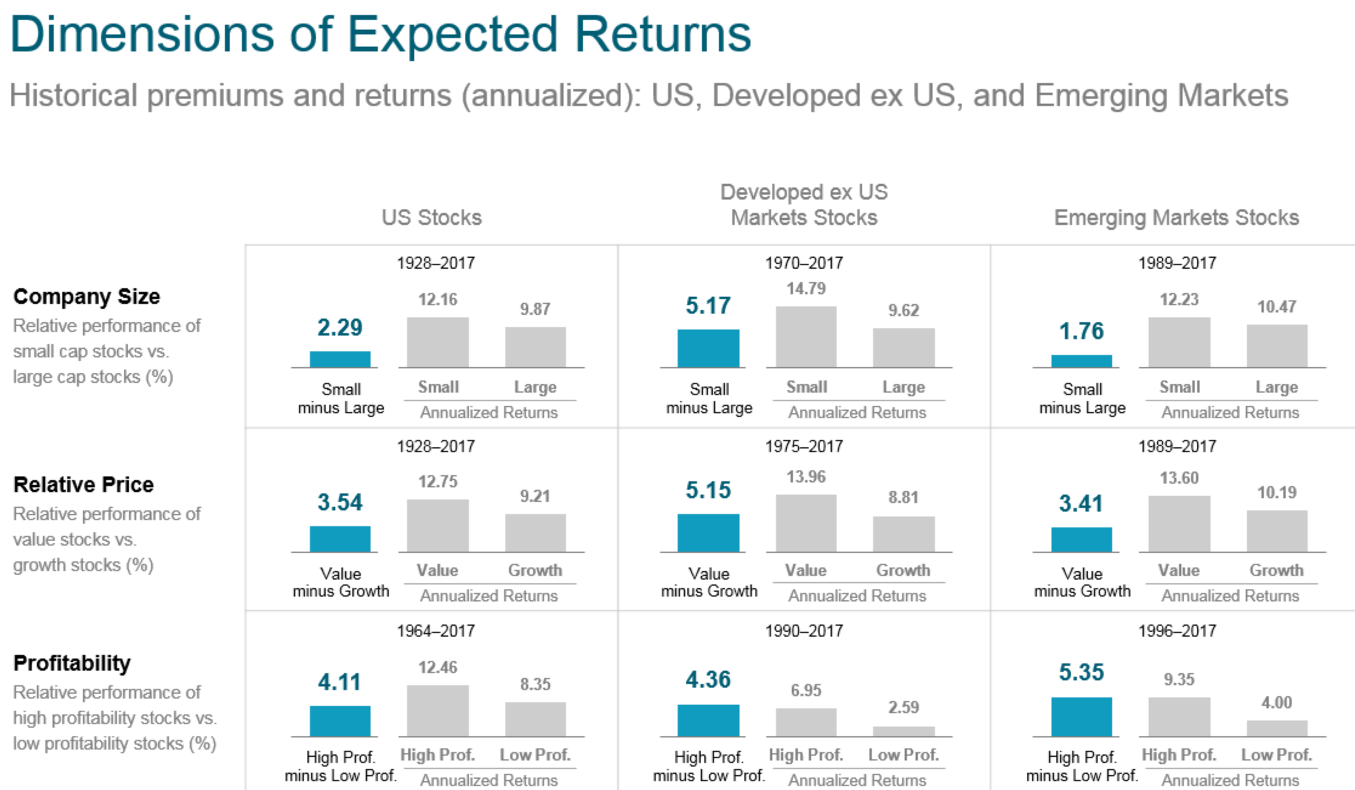
- Persistent: Hold up over very long time periods - value and small cap research goes back more than 100 years;
- Pervasive: Occurs across multiple asset classes, market sectors, and markets (domestic, international and emerging markets);
- Robust: Must hold up to various definitions of an asset class - i.e. value stocks can be defined by book -to-market, price to earnings, etc. – must work no matter what measure used;
- Investable: Have to be able to capture the benefit;
- Intuitive: Logical explanations for premium due to risk or behavioral based explanations.

While the evidence of factor premiums is compelling, their benefits are by no means guaranteed. Like trying to time the market, trying to time factor performance (i.e. value over growth or small cap over large cap) is equally impossible. Just as stocks don't outperform bonds every year, factor premiums don't materialize every year. In fact, history shows they can go through extended periods of underperformance, just like we are experiencing with US Value stocks now. On a one-off basis, they could be risky. However, the correlations of these factors to one another are very low, meaning they don't move in concert with and are not dependent on one another. Thus, when combined, they provide valuable diversification benefits for a portfolio, as when one factor is not performing, the others have the potential to pick up the slack. The chart below illustrates this benefit detailing the performance of all factors over the previous 10-year period (the most recent period of US Value underperformance):



Information provided by Dimensional Fund Advisors LP.
All figures represent 10-year annualized compound returns (%) in US dollars. US size premium: Dimensional US Small Cap Index minus S&P 500 Index. US relative price premium: Fama/French US Value Research Index minus Fama/French US Growth Research Index. US profitability premium: Dimensional US High Profitability Index minus Dimensional US Low Profitability Index. Dev. ex US size premium: Dimensional Intl. Small Cap Index minus MSCI World ex USA Index (gross div.). Dev. ex US relative price premium: Fama/French International Value index minus Fama/French International Growth Index. Dev. ex US profitability premium: Dimensional International High Profitability Index minus Dimensional International Low Profitability Index. Emerging Markets size premium: Dimensional Emerging Markets Small Cap Index minus MSCI Emerging Markets Index (gross div.). Emerging Markets relative price premium: Fama/French Emerging Markets Value Index minus Fama/French Emerging Markets Growth Index. Emerging Markets profitability premium: Dimensional Emerging Markets High Profitability Index minus Dimensional Emerging Markets Low Profitability Index. Profitability is measured as operating income before depreciation and amortization minus interest expense scaled by book. Dimensional indices use CRSP, Compustat and Bloomberg data. Fama/French indices provided by Ken French. S&P data copyright 2018 S&P Dow Jones Indices LLC, a division of S&P Global. All rights reserved. MSCI data © MSCI 2018, all rights reserved. Indices are not available for direct investment. Their performance does not reflect the expenses associated with the management of an actual portfolio. Past performance is not a guarantee of future results. Index returns are not representative of actual portfolios and do not reflect costs and fees associated with an actual investment. Actual returns may be lower. See "Index Descriptions" for descriptions of Dimensional and Fama/French index data. Eugene Fama and Ken French are members of the Board of Directors of the general partner of, and provide consulting services to, Dimensional Fund Advisors LP.

The last point here is to understand that your entire strategy is not “immersed” in these factors, meaning assets are only “tilted” to them, allowing for a potential premium over the broad market long-term while not deviating substantially (plus or minus) in any given period. This said, the long-term benefit provided by these factors is illustrated in the following chart:



Information provided by Dimensional Fund Advisors LP.
In US dollars. US size premium: Dimensional US Small Cap Index minus S&P 500 Index. US relative price premium: Fama/French US Value Research Index minus Fama/French US Growth Research Index. US profitability premium: Dimensional US High Profitability Index minus Dimensional US Low Profitability Index. Dev. ex US size premium: Dimensional Intl. Small Cap Index minus MSCI World ex USA Index (gross div.). Dev. ex US relative price premium: Fama/French International Value Index minus Fama/French International Growth Index. Dev. ex US profitability premium: Dimensional International High Profitability Index minus Dimensional International Low Profitability Index. Emerging Markets size premium: Dimensional Emerging Markets Small Cap Index minus MSCI Emerging Markets Index (gross div.). Emerging Markets relative price premium: Fama/French Emerging Markets Value Index minus Fama/French Emerging Markets Growth Index. Emerging Markets profitability premium: Dimensional Emerging Markets High Profitability Index minus Dimensional Emerging Markets Low Profitability Index. Profitability is measured as operating income before depreciation and amortization minus interest expense scaled by book. S&P data copyright 2018 S&P Dow Jones Indices LLC, a division of S&P Global. All rights reserved. MSCI data © MSCI 2018, all rights reserved.
Indices are not available for direct investment. Their performance does not reflect the expenses associated with the management of an actual portfolio. Past performance is not a guarantee of future results. Index returns are not representative of actual portfolios and do not reflect costs and fees associated with an actual investment. Actual returns may be lower. See “Index Descriptions” for descriptions of Dimensional and Fama/French index data. Eugene Fama and Ken French are members of the Board of Directors of the general partner of, and provide consulting services to, Dimensional Fund Advisors LP.

What this means for your portfolio - Like Winnie the Pooh’s quest for honey, investors have a quest to achieve the best long-term returns possible for their portfolios. However, this quest is not easy, requiring time, patience, and diligence, and as stated earlier, there will be periods when expectations don’t meet reality.   We know that in investing, nothing works all the time. Therefore, we stress that investing is a process of weighing the probabilities and implementing what works most of the time will allow us to be successful over the long haul.   No one can outguess the market – we know this. Formulating a strategy that harnesses the best data and market research available to provide the highest probability of success is the best one can do.

We do believe your strategy will provide a long-term premium over the broad market. However, outperforming means underperforming from time to time…such is the nature of investing. Assuming the right allocation and planning, however, your strategy with its diversified factor elements should keep you in the game and on track with your goals.   One of the most successful value investors of all time, Warren Buffet, was quoted as saying, "Successful Investing takes time, discipline and patience…." Heed Buffett's and Winnie the Pooh's advice because if it were easy to beat the market, everyone would be doing it.

Thank-you for your continued confidence and the privilege to serve as your Financial Advisor.

Sincerely,

Doug Babcock, CFP®