PROFESSIONAL FINANCIAL MANAGEMENT, INC.

QUARTERLY NEWSLETTER

2018 Fourth Quarter

Dear Client,

We hope you are well and that your year got off to a good start! Please let us know if you have any questions regarding your 4th quarter and 2018 Annual reports – our commentary below will hopefully shed some light on what we experienced this past year! Tax information (TD Ameritrade 1099's and 1099R's, as well as our gain/loss reports) is out and hopefully you have received our communication with you on this front. All correction cycles have yet to be completed but we will keep you posted on any information forthcoming. Please take the time 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). Also, if you are not receiving account statements directly (either in print or electronically) from TD Ameritrade or other custodians, notify us immediately.

Before we get started, we want to give recognition to Brandon Smith in our office. Brandon completed the course requirements needed to sit for the CFP Board exam, and subsequently sat and passed the board exam this past November!   As you know, Brandon has been with us since 2014 as an Associate Advisor assisting clients in both investment and financial planning matters. Please don't hesitate to ask for Brandon's assistance if you need assistance in either of these areas – we have 100% confidence in him and are fortunate to have him as part of our team!

The 2018 market year is now clearly in our rear-view mirror, with financial markets around the world off to their best start in years and quickly erasing the pain of the late year…. wait, not so fast! While the pain of late year downside volatility may be waning, the reality that this is normal and will continue to be present is real. Volatile markets are here to stay and it is important as long-term investors that we be able to look back and learn, so we can better prepared as we go forward.   This said, questions have come to light both from the financial media and investors about the merits of long-standing investment strategy concepts, namely the benefits of diversification and further, the emphasis on value and small cap stocks in your portfolio. Along

with a refresher of these concepts, we will address these concerns and the re-enforce how these they the best opportunity for long-term investing success. First, a quick summary of what transpired in the market in 2018.

2018 – MARKETS IN REVIEW

The “all knowing” market gurus had 2018 pegged to be a relatively “benign” year with expectations of single digit equity gains on continued positive economic data. A common thread of headlines and data points served as fuel for markets, the most notable being global economic reports, corporate earnings, record low US unemployment, Brexit implementation, US trade wars with China and other countries, and a flattening of the US Treasury yield curve. The global economy did grow in 2018, with the economies of 44 of 45 countries tracked by the Organization for Economic Cooperation and Development expanding (Dimensional Funds, OECD Real GDP Forecast 2019).

However, markets became markets, and investors were quickly reminded how inherent volatility is to equity investing, with markets around the world retreating sharply in late January / early February. This was followed by a choppy climb through late September that started down and ended with a somewhat tumultuous late December slide. Though the S&P finished down -4.4% for the year, it ended with a 6.5% rally from its low in the remaining trading days after Christmas. International developed market equities (as measured by the MSCI All Country World Index), though besting US markets in the fourth quarter, finished down -9.4% for the year (information courtesy of Dimensional Fund Advisors). In all, what appeared to investors as unprecedented volatility in 2018 was just a return to the historical norm (25-year average of 32 days where the S&P 500 dropped by more than 1% - courtesy Russell Investments), underscoring the danger of investor complacency.

Specifically relating to portfolio strategy, factor performance was limited at best. Value stocks bested growth stocks in emerging markets, but underperformed 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) although negative for the year, bested US Equity market returns. In terms of total returns, short-term corporate bonds increased 1.57% for the year, while intermediate term bonds declined .23% (*information courtesy of Dimensional Fund Advisors).*

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**
Q4’18	-14.30%	-12.78%	-7.47%	???%	1.64%	1.89%
2018	-5.24%	-14.09%	-14.58%	???%	.01%	3.17%

Source: Russell, MSCI, Wilshire, Barclays and Citigroup

YOUR INVESTMENT STRATEGY WORKS

First, let's re-cap the term diversification. The term was coined by Nobel prize winner Harry Markowitz in 1952 when he demonstrated its ability to enhance portfolio returns at the benefit of minimizing risk or volatility. We discussed this concept in our letter a few years back when we experienced market conditions similar to this past year. When a portfolio is diversified, it holds several types of investment classes or classifications in both stocks and bonds. In stocks, this means exposure to US, International and emerging markets with further splits between large and small stock, as well as value and growth stocks. In bonds, this can mean US and international exposure, with consideration to credit quality and length of maturity.

There is no doubt about the importance and benefits of diversification to academics in the investment world, and individual investors should have the same belief. Diversification is considered the only "free lunch" in the investment world. Although, we need to acknowledge that as free things go, it may not be served every day, and it may not always be very appetizing – that doesn't mean it is not a good thing! Thus, in investing, being diversified will not get you the best return in any one given year, but it won't give you worst either. Having a properly diversified means some assets will lag while others move ahead. Emotionally this is difficult, as we don't like owning laggards or losers and we wish we owned more of what was up and less of what was down. Over the long-term, however, diversification has proven effective and allowed patient and disciplined investors to achieve market returns with much less volatility than being concentrated in any one asset class. However, conviction, patience and discipline are a must!

The benefits of remaining globally diversified: This leads to concerns of recent US market dominance over globally diversified portfolios. Since 2008, non-US equities have arguably provided little help to diversified portfolios. A 100% US equity portfolio bested a combination 60% US Stocks/40% non-US stocks portfolio by 2.7% annually, doing so with less volatility. However, the danger with most investors is that their memories are too short! The previous ten years, from 2000 to 2009 (termed the "Lost Decade" by US investors) painted a totally different picture. The opportunity cost with failing to diversify globally was painful. While the S&P 500 recorded its worst ever 10-year cumulative total return of –9.1%, the MSCI World ex USA Index returned 17.5%, and the MSCI Emerging Markets Index returned 154.3%. More so, from 1970 through 2007, a globally diversified 60% US/40% Non-US portfolio outperformed a 100% US equity portfolio 11.3% to 11.1%, doing so with 2.7% less volatility – diversification works, even if we go through periods of time (sometime extended periods) where it may be less effective. Remember, even ten years can be considered a short period for a long-term investor. Choosing where to be in any given year is difficult at best as evidenced in the following chart:

Equity Returns of Developed Markets

Annual Return (%)

1999	2000	2001	2002	2003	2004	2005	2006	2007	2008	2009	2010	2011	2012	2013	2014	2015	2016	2017	2018
Finland 152.6	Switz. 5.9	NZ 8.4	NZ 24.2	Sweden 64.5	Austria 71.5	Canada 28.3	Spain 49.4	Finland 48.7	Japan -29.2	Norway 87.1	Sweden 33.8	Ireland 13.7	Belgium 39.6	Finland 46.0	US 12.7	Denmark 23.4	Canada 24.6	Austria 58.3	Finland -3.4
Singapore 99.4	Canada 5.3	Australia 1.7	Austria 16.5	Germany 63.8	Norway 53.3	Japan 25.5	Portugal 47.4	HK 41.2	Switz. -30.5	Australia 76.4	Denmark 30.7	NZ 5.5	Denmark 31.3	Ireland 41.2	NZ 7.3	Ireland 16.5	NZ 18.4	HK 36.2	NZ -4.0
Sweden 79.7	Denmark 3.4	Ireland -2.8	Australia -1.3	Spain 58.5	Belgium 43.5	Austria 24.6	Ireland 46.8	Germany 35.2	US -37.6	Singapore 74.0	HK 23.2	US 1.4	Singapore 31.0	US 31.8	Denmark 6.2	Belgium 12.1	Norway 13.3	Singapore 35.6	US -5.0
Japan 61.5	Norway -0.9	Austria -5.6	Norway -7.3	Austria 57.0	Ireland 43.1	Denmark 24.5	Singapore 46.7	Norway 31.4	Spain -40.6	Sweden 64.2	Singapore 22.1	UK -2.6	Germany 30.9	Germany 31.4	HK 5.1	Japan 9.6	Australia 11.4	Denmark 34.7	HK -7.8
HK 59.5	Italy -1.3	Belgium -10.9	Italy -7.3	NZ 55.4	Sweden 36.3	Norway 24.3	Norway 45.1	Canada 29.6	France -43.3	HK 60.2	Canada 20.5	Switz. -6.8	NZ 29.3	Spain 31.3	Belgium 4.1	Austria 3.5	Austria 11.3	Nether. 32.2	Norway -8.6
Canada 53.7	Nether. -4.1	Spain -11.4	Japan -10.3	Canada 54.6	NZ 35.2	Finland 16.7	Sweden 43.4	Singapore 28.4	Canada -45.5	Belgium 57.5	Japan 15.4	Norway -10.0	HK 28.3	Nether. 31.3	Singapore 3.0	Italy 2.3	US 10.9	France 28.7	Switz. -9.1
Norway 31.7	France -4.3	Norway -12.2	Switz. -10.3	Australia 49.5	Italy 32.5	Switz. 16.3	Denmark 38.8	Australia 28.3	Germany -45.9	Canada 56.2	US 14.8	Belgium -10.6	Austria 25.9	Belgium 27.6	Ireland 2.3	Finland 2.0	France 4.9	Italy 28.4	Singapore -9.4
France 29.3	Australia -10.0	US -12.4	Singapore -11.0	Denmark 49.3	Denmark 30.8	Australia 16.0	Belgium 36.7	Denmark 25.6	Singapore -47.4	NZ 50.4	Australia 14.5	Australia -11.0	Australia 22.1	Japan 27.2	Canada 1.5	Nether. 1.3	Nether. 4.8	Norway 28.3	Portugal -11.1
US 21.9	Portugal -10.3	UK -14.0	Canada -13.2	Norway 48.1	Australia 30.3	Singapore 14.4	Austria 36.5	Portugal 24.0	Denmark -47.6	Spain 43.5	Switz. 11.8	Nether. -12.1	Sweden 22.0	Switz. 26.6	Switz. -0.1	Portugal 0.9	Portugal 3.6	Germany 27.7	Australia -12.0
Germany 20.0	UK -11.5	Denmark -14.8	Portugal -13.8	Ireland 43.8	Spain 28.9	Nether. 13.9	Germany 36.0	Spain 24.0	Nether. -48.2	UK 43.3	Norway 10.9	Spain -12.3	France 21.3	France 26.3	Finland -0.7	US 0.7	Germany 2.8	Spain 27.0	France -12.8
Australia 17.6	Austria -12.0	HK -18.6	Belgium -15.0	Portugal 43.0	HK 25.0	Sweden 10.3	France 34.5	Nether. 20.6	UK -48.3	Austria 43.2	Finland 10.3	Canada -12.7	Nether. 20.6	Denmark 25.2	Australia -3.4	Switz. 0.4	Japan 2.4	Japan 24.0	Japan -12.9
NZ 12.9	Ireland -12.7	Canada -20.4	UK -15.2	France 40.2	Portugal 24.7	Germany 9.9	Italy 32.5	France 13.2	Sweden -49.9	Nether. 42.3	Austria 9.9	Japan -14.3	Switz. 20.4	Sweden 24.5	Nether. -3.5	France -0.1	HK 2.3	Portugal 23.8	Nether. -13.1
UK 12.5	US -12.8	Switz. -21.4	Spain -15.3	HK 38.1	Singapore 22.3	France 9.9	Nether. 31.4	NZ 8.9	Italy -50.0	Portugal 40.4	UK 8.8	Sweden -16.0	Norway 18.7	UK 20.7	Japan -4.0	HK -0.5	Singapore 1.4	Switz. 22.5	Sweden -13.7
Denmark 12.1	Finland -14.2	Portugal -22.0	Denmark -16.0	Italy 37.8	Canada 22.2	Belgium 9.0	Australia 30.9	UK 8.4	Australia -50.7	Denmark 36.6	Germany 8.4	Denmark -16.0	US 15.3	Italy 20.4	Spain -4.7	Germany -1.9	Sweden 0.6	Finland 22.5	UK -14.2
Nether. 6.9	HK -14.7	Nether. -22.1	HK -17.8	Singapore 37.6	UK 19.6	HK 8.4	UK 30.6	Italy 6.1	HK -51.2	France 31.8	NZ 8.3	HK -16.0	UK 15.3	Austria 13.4	UK -5.4	Sweden -5.0	UK -0.1	UK 22.3	Denmark -15.4
Spain 4.8	Germany -15.6	France -22.4	Nether. -20.8	Japan 35.9	France 18.5	UK 7.4	HK 30.4	US 5.4	Portugal -52.2	Italy 26.6	Nether. 1.7	France -16.9	Finland 14.6	NZ 11.3	Sweden -7.5	NZ -6.3	Spain -1.0	US 21.2	Spain -16.2
Italy -0.3	Spain -15.9	Germany -22.4	France -21.2	Belgium 35.3	Germany 16.2	US 5.1	Finland 29.9	Switz. 5.3	NZ -53.8	US 26.3	Belgium -0.4	Singapore -17.9	Italy 12.5	HK 11.1	Italy -9.5	UK -7.6	Finland -4.7	Sweden 20.6	Canada -17.2
Switz. -7.0	Belgium -16.8	Singapore -23.4	US -23.1	Switz. 34.1	Japan 15.9	Spain 4.4	Switz. 27.4	Austria 2.2	Finland -55.2	Switz. 25.3	France -4.1	Germany -18.1	Canada 9.1	Portugal 11.0	France -9.9	Australia -10.0	Switz. -4.9	Australia 19.9	Italy -17.8
Portugal -8.9	Sweden -21.3	Italy -26.6	Ireland -26.2	UK 32.1	Switz. 15.0	Italy 1.9	Canada 17.8	Sweden 0.6	Norway -64.2	Germany 25.2	Portugal -11.3	Portugal -23.1	Japan 8.2	Norway 9.4	Germany -10.4	Norway -15.0	Ireland -7.1	Belgium 18.6	Germany -22.2
Austria -9.1	Singapore -27.7	Sweden -27.2	Finland -30.3	US 28.4	Nether. 12.2	NZ 1.7	NZ 16.6	Belgium -2.7	Belgium -66.5	Ireland 12.3	Italy -15.0	Italy -23.2	Ireland 5.7	Canada 5.6	Norway -22.0	Spain -15.6	Belgium -7.6	Ireland 18.1	Ireland -25.3
Ireland -12.6	Japan -28.2	Japan -29.4	Sweden -30.5	Nether. 28.1	US 10.1	Portugal -1.9	US 14.7	Japan -4.2	Austria -68.4	Finland 11.1	Ireland -18.1	Finland -31.9	Portugal 3.5	Australia 4.2	Austria -29.8	Singapore -17.7	Italy -10.5	Canada 16.1	Belgium -26.9
Belgium -14.3	NZ -33.5	Finland -38.2	Germany -33.2	Finland 19.4	Finland 6.1	Ireland -2.3	Japan 6.2	Ireland -20.1	Ireland -71.9	Japan 6.3	Spain -22.0	Austria -36.4	Spain 3.0	Singapore 1.7	Portugal -38.2	Canada -24.2	Denmark -15.8	NZ 11.7	Austria -27.4

In US dollars.

Source: MSCI country indices (net dividends) for each country listed. Does not include Israel, which MSCI classified as an emerging market prior to May 2010. MSCI data © MSCI 2019, all rights reserved.

Past performance is no guarantee of future results. Indices are not available for direct investment; therefore, their performance does not reflect the expenses associated with the management of an actual portfolio.

"Factoring" in the long-term benefits: Our entire message to you last quarter centered on the long-term return benefits gained from "evidenced based" investing, or tilting portfolios to value, small cap and profitable stocks (i.e. factor investing). I will spare you the details, but remember, trying "time" their benefits is like trying to time the market…impossible. They can go through extended periods where they don't materialize, and we are reminded of this as value stocks underperformed again this year (now an eleven-year deficit to growth – not here though that value stocks have had positive returns, just not those provided by growth). However, just as time is important in realizing the benefits of portfolio diversification, it is equally important to garnering the return benefits afforded by value, small-cap and high profitability stocks. Yes, value stocks are at a deficit to growth stocks over the last eleven years, but when looking back over longer periods you can see how favoring value stocks works. From 1929 through the end of 2017 value stocks have produced a better than 3.5% premium to growth stocks – weighting to value stocks works but time plays an important role in realizing the benefits.

The importance of diversification here should also be emphasized (again, explained in our previous letter but relevant!). The mix of value, small-cap and profitability stocks within and across major asset classes reminds us of the importance integrating premiums in your strategy. These premiums are not correlated and thus, positive premiums in one or two factors can offset negative premiums in others, helping contribute to overall

portfolio returns. A good example of this diversification can be seen in the complementary behavior of size (small vs. large) and relative price (value vs. growth) in 2018 emerging market returns. While small cap stocks underperformed, diversified portfolios were buoyed by outperformance among value stocks. This integration increases the reliability of outperformance while mitigating the impact of an individual asset group's underperformance. **We emphasize here that despite recent years' headwinds, the size, value, and profitability premiums remain persistent over the long term and around the globe. It is well documented that stocks with higher expected return potential, such as small cap and value stocks, do not realize outperformance every year. Maintaining discipline to these parts of the market is the key to effectively pursuing the long-term returns associated with size, value, and profitability.**

WHAT THIS MEANS FOR YOUR PORTFOLIO

Negative returns at this point should not be surprising to investors – we are long in an economic expansion and thus long in a bull market (although portfolios have recovered nicely through the first two months of this year). What probably did surprise investors was their returns compared to what most perceive as "the market" or the S&P 500. Being conscious that "the market" is really **all** components of a diversified portfolio and not about any one asset class (like the S&P 500 that measure purely large cap US stocks), is an important concept to grasp! Equally as important is the understanding of how being "diversified", as explained at the outset, can provide us with long-term benefits despite periods where it doesn't appear as though it is even working.

It can certainly be tempting to chase returns when individual asset classes (i.e. US Stocks) or segments of the market (I.e. growth stocks) outperform in a given year. This temptation is exacerbated when key elements of investment strategy are not clearly recognizable for extended periods of time. Investing cycles can be long, like our current bull market. However, if you are not there when the cycle turns (which eventually it will – all markets cycle!) benefit will be lost. When a part of your strategy appears not to be working, extend the time horizon 5 – 10 years, or more. Years of experience coupled with sound research have shown that it is not the hottest asset class or segment of the market in a given time frame that works – it is conviction in a sound, well researched investment philosophy through thick and thin that prevails. With this approach, you won't win every battle, but you will win the war! Too few investors today care to look beyond a year or two - we are happy to be among those that do. Having a long-term horizon takes the pressure off having to figure out what to do in shorter periods and shifts the focus to what actually works over the long run.

We appreciate your confidence and look forward to discussing your situation in the coming weeks and months.

Sincerely,

Doug Babcock, CFP®

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