PROFESSIONAL FINANCIAL

Consultative Wealth Management

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2014 Year in Review

Paul Byron Hill, CFP®
President | Top Wealth Manager
Professional Financial Strategies, Inc.
Powder Mill Office Park
1159 Pittsford-Victor Road, Suite 120
P. O. Box 999
Pittsford, NY 14534
(585) 218-9080
www.linkedin.com/in/paulbyronhill/
www.professionalfinancial.com

Planning Perspectives
2014 Year in Review: Economy & Markets

Paul Byron Hill, MBA MSFS MFP
Certified Financial Planner™ ©2015

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Key takeaways:

- Markets fluctuate constantly. Investors should view daily events from a long-term planning perspective. Achieving market rates of return in 2014 required patience and discipline that eluded many investors.
- US stocks substantially out-performed non-US international stocks in 2014, driven primarily by a 12.5 percent increase in the US dollar during 2014 relative to other currencies.
- Contrary to expectations of most economists and commentators who predicted continuing economic recovery, interest rates did not rise in 2014, but resumed a decline, boosting bond total returns worldwide.
- A strong US dollar in 2014 negatively impacted returns of most non-US asset class allocations.

Despite increasingly turbulent markets during the course of 2014, as the US economy improved, the US equity and fixed income markets outperformed most markets around the world. This performance came with higher market volatility in the US, a rallying dollar, slowing economies in Europe and Asia, and rising geopolitical tensions, including conflicts in Ukraine and the Middle East.

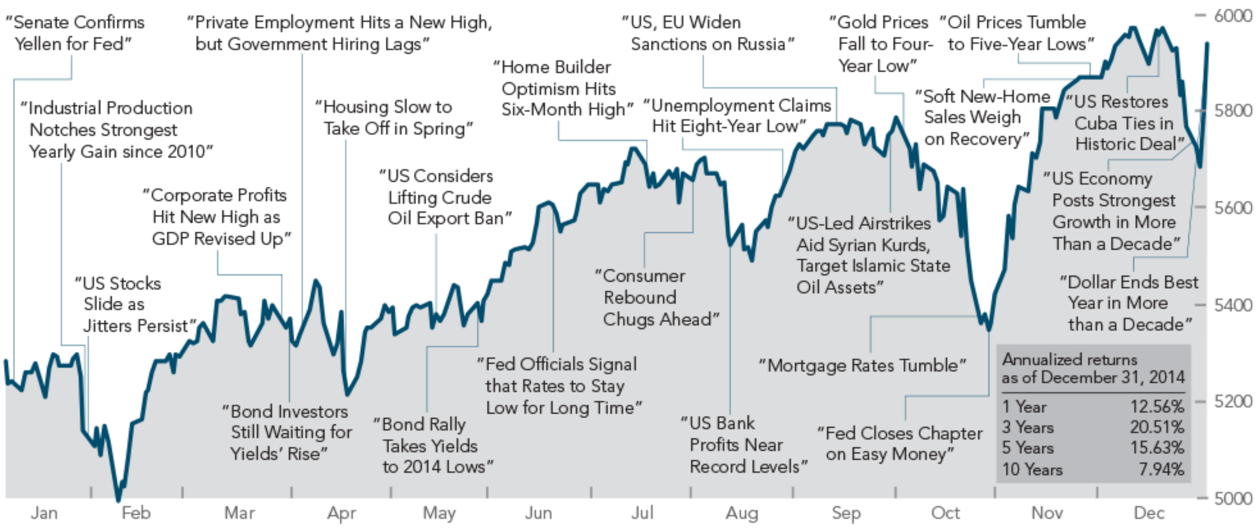
The Dow Jones Industrial Average rose for the sixth straight year, posting a 7.5% gain (price-only return). The S&P 500 Index rose 13.7% (including reinvested dividends), marking the third straight year in which the benchmark has returned more than 10%. The Dow closed at a record high on 38 calendar days, while the S&P 500 had 53 record closes. The non-US markets followed a much different track: All major indices outside the US logged negative performance for 2014 (in USD). The MSCI EAFE Index had a minus 4.9% return and the MSCI Emerging Markets Index a minus 2.2% return (net dividends, in USD). The dollar's strong performance relative to major regional currencies contributed significantly to the lower returns for US investors. The WSJ Dollar Index showed a rise of 12.5%, most of it occurring during the last quarter of 2014 as oil prices plunged nearly 50%.

Government bond yields fell across major markets, including in the US, where many expected higher rates in response to improving economic growth domestically and eventual higher interest rates due to the end of quantitative easing by the Federal Reserve.

The yield on the 10-year Treasury note declined to 2.2% by year-end, down from 3.0% in 2013, with lower prices boosting its return to over 4.0% for the year. The Barclays US Government Bond Index returned 4.9%. World government bonds had slightly positive returns: The Citigroup World Government Bond 1–5 Year Index (hedged) returned 1.9%.response to improving economic growth and an eventual rate increase due to the end of quantitative easing by the Federal Reserve. The yield on the 10-year Treasury note declined to 2.17% by year-end, down from 3.03% in 2013, with lower prices boosting its return to over 4.0% for the year. The

US Stock Market Performance

Russell 3000 Index with selected headlines from 2014



Source: Russell Investment Group.

These headlines are not offered to explain market returns. Instead, they serve as a reminder that investors should view daily events from a long-term perspective and avoid making investment decisions based solely on the news. Past performance is not a guarantee of future results. In US dollars. Index is not available for direct investment. Performance does not reflect the expenses associated with management of an actual portfolio.

Barclays US Government Bond Index returned 4.92%. World government bonds had slightly positive returns: The Citigroup World Government Bond 1–5 Year Index (hedged) returned 1.90%.

The chart above highlights some of the year's prominent headlines within the context of broad US market performance, measured by the well-known Russell 3000 Index. These headlines do not explain market returns. Instead, they are associated with events occurring at the time, and investors should remind themselves to view daily events from a long-term perspective and to avoid making investment decisions based on news events.

The chart on the next page offers a snapshot of non-US stock market performance (both developed and emerging markets), as measured by the MSCI All Country World ex USA Index. Again, the headlines do not explain the market's direction but provide poignant examples of events testng investor discipline during the year. Markets reflect the vast, complex network of information, expectations, and human behavior. These forces collectively drive prices to fair value—not the news headlines many associate with market turning points.

Economic Backdrop

Accelerating US Recovery

The US economy showed signs of weakening in early 2014, with Q1 GDP growth reported at an annualized minus 2.9%. In Q2, GDP rebounded strongly at a 4.6% annual growth rate (seasonally adjusted)—the highest since 2003. Growth in Q3 was even stronger at 5%, capping its best six-month stretch since 2003 and reaching the highest annualized growth rate in 11 years. If the Fed's Q4 estimates hold, 2014 GDP growth will have been in the 2.4% range.

A host of indicators pointed to improving conditions during the year, including:

- **Employment**— The US economy added nearly 3 million jobs, the best employment growth in 15 years. Claims for jobless benefits ran lower than at any point since 2000. By year-end, the US had recovered all jobs lost in the past recession, and joblessness was at a six-year low. Despite the lowest labor force participation rate since the 1970s, the economy entered 2015 with record level of employment, partly aided by unemployment benefit cuts in 2013 that lead to an estimated 1 million workers re-entering the work force.

Non-US Stock Market Performance

MSCI All Country World Index ex USA (net div.) with selected headlines from 2014

Source: MSCI.

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- **Manufacturing**—Economic activity in the manufacturing sector improved throughout most of 2014. The Institute for Supply Management (ISM) reported that its Purchasing Managers Index (PMI) stood at 59.0 in October, 58.7 in November, and 55.5 in December. (A reading above 50% indicates general expansion.) For the year, the PMI averaged 55.8, its highest level since the first year following the recession in 2007–09.

- **Consumer spending**—An improving labor market and lower energy prices translated into higher income and purchases among American workers. Real personal consumption expenditures increased at a seasonally adjusted 3.2% rate in Q3, compared to 2.5% in Q2. US equity market gains over the past three years have added $7 trillion to household wealth, which many believe has helped fuel consumer spending rather than post-crisis government spending.

- **Company earnings**—The Department of Commerce reported a 2.8% rise in US corporate profits in Q2, followed by a 5.1% increase in Q3, marking 12 straight quarters of year-over-year growth. According to GDP data, Q2 after-tax profits hit a record high. However, after adjustments for depreciation and inventory changes, profit margins—particularly among smaller companies—appeared to be declining due to rising labor costs and capital expenditures.

Declining Oil Prices

Oil prices fell by almost half during 2014, a victim of excess supply due to fracking for drilling, which caused domestic production to soar to its highest level since 1986—and to weakening demand from the economic slowdown in Europe and Asia. In the US, oil prices plummeted to just over $53 per barrel by year end from $107 per barrel in June. For the year, Brent crude was down 48%. The price decline most affected the economies and currencies of oil-exporting countries, especially Russia.

Soaring Dollar

In 2014, the US dollar rose against every developed nation's currency. Overall, the dollar gained an astonishing 12.5% against a basket of widely traded currencies, measured by the *Wall Street Journal* dollar index. This was the best yearly gain since 2005 and second-best on record. The rise was attributed to relatively stronger US economic data compared to other developed nations, falling global oil prices, expectations of higher interest rates,

and monetary easing policies of Japanese and European central banks.

Weak Inflation

Despite rising to an 18-month high in May and June (2.1% each), average US inflation remained low throughout 2014. Year-over-year inflation fell to 1.6%. Since rising inflation is normally viewed as a sign of an economic uptick, some believe that weak inflation influenced the Fed's decision to not raise interest rates. Across the world's largest economies, inflation eased for the seventh straight month in December, with the Organization for Economic Cooperation and Development (OECD) reporting average annual inflation for its 34 members at 1.5%.

2014 Investment Overview

Market Summary

The US equity markets—and particularly the large cap segment of the market—logged a strong year. The S&P 500 Index total return was 13.7%; the NASDAQ Composite Index gained 13.4%; and the Russell 2000, a popular benchmark for small company US stocks, returned 4.9%. US market volatility, measured by the Chicago Board Options Exchange Market Volatility Index (VIX), increased to its highest level in two years, with most activity occurring in Q3. Average volatility for the year was still the lowest since 2006.

Non-US developed stock markets experienced negative performance across almost all major indices (references in USD). The MSCI World ex USA Index, a benchmark for large cap stocks in developed markets outside the US, returned -4.3%. The small cap and value versions of the MSCI EAFE index returned minus 4.9% and minus 5.4%, respectively. Emerging markets proved no exception, with the MSCI Emerging Markets Index returning minus 2.2% and the value subindex returning minus 4.1%. The small cap subindex returned 1.0%.

Among the equity markets tracked by MSCI, more than half of the countries in the non-US developed markets index had negative total returns and the range of returns was broad. The top three return countries were Israel (22.8%), New Zealand (7.3%), and Denmark (6.2%).

Major World Indices
As of December 31, 2014

US Equity Returns (%)

Index	Three Months	One Year	Three Years*
Russell 3000	5.24	12.56	20.51
Russell 2500	6.77	7.07	19.97
Russell 2000	9.73	4.89	19.21
Russell 2000 Value	9.40	4.22	18.29
Russell 2000 Growth	10.06	5.60	20.14
Russell 1000	4.88	13.24	20.62
Russell 1000 Value	4.98	13.45	20.89
Russell 1000 Growth	4.78	13.05	20.26
S&P 500	4.93	13.69	20.41

Non-US Equity Returns (net div.) (%)

Index	Three Months	One Year	Three Years*
MSCI EAFE Small Cap	-2.27	-4.95	13.83
MSCI World ex USA Small Cap	-3.38	-5.35	11.77
MSCI EAFE	-3.57	-4.90	11.06
MSCI World ex USA	-3.69	-4.32	10.47
MSCI EAFE Value	-4.85	-5.39	11.04
MSCI World ex USA Value	-5.17	-5.41	10.46
MSCI EAFE Growth	-2.29	-4.43	11.03
MSCI World ex USA Growth	-2.22	-3.26	10.43
MSCI Emerging Markets	-4.50	-2.19	4.04
MSCI Emerging Markets Small Cap	-6.02	1.01	7.65
MSCI Emerging Markets Value	-6.44	-4.08	1.79

Fixed Income Returns (%)

	Three Months	One Year	Three Years*
BofA Merrill Lynch Three-Month US Treasury Bill	0.00	0.04	0.07
BofA Merrill Lynch 1-Year US Treasury Note	-0.07	0.18	0.23
Citigroup World Government Bond 1-3 Years (hedged)	0.22	0.96	1.03
Barclays US Government Bond	1.86	4.92	1.40
BofA Merrill Lynch 1-5 Year US Treasury and Agency	0.48	1.24	0.68
Citigroup World Government Bond 1-5 Years (hedged)	0.47	1.90	1.54
Barclays US TIPS	-0.03	3.64	0.44

Other Returns (%)

	Three Months	One Year	Three Years*
Dow Jones US Select REIT	15.09	32.00	16.10
S&P Global ex US REIT (net div.)	2.98	10.94	14.42
Bloomberg Commodity Total Return	-12.10	-17.01	-9.43

**Annualized.*
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In US dollars. Indices are not available for direct investment.
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Countries with the lowest returns were Portugal (-38.2%), Austria (-29.8%), and Norway (-22.0%).

In emerging markets, 13 of the 23 countries tracked by MSCI logged negative total returns and the dispersion of returns was broader. Egypt (29.3%), Indonesia (26.6%), and the Philippines (25.6%) were the top-performing countries in the index. The lowest returns in the index came from Russia (-46.3%), Greece (-40.0%), and Hungary (-27.4%).

Returns of major fixed income indices were positive due to falling yields and rising prices. One-year US Treasury notes returned 0.18%, US government bonds 4.9%, world government bonds (hedged) 1.9%, and US TIPS 3.6%.

Real estate securities had a banner year: The Dow Jones US Select REIT Index returned 32.0%, and the S&P Global ex US REIT Index returned 10.9%. Commodities were negative for the fourth year in a row, with the Bloomberg Commodity Total Return Index returning -17.0%. Brent crude oil and gasoline futures were the worst performers in the index, posting -48.3% and -48.5% returns, respectively. Natural gas fell 31.7%. Gold was down for the second year in a row, falling 1.5%; silver prices were down 19.5%.

Diverging Returns

While US equity returns were high relative to those of other regional markets, returns within various US market segments diverged. Based on the respective Russell 1000 and 2000 indices, US large cap stocks significantly outperformed small cap stocks, and within the value (relative price) dimension, large value stocks slightly outperformed large growth. Among small cap stocks, growth outperformed value.

In the non-US developed markets (based on the MSCI indices in USD), all segments suffered negative performance. Negative returns among large and small caps stocks were similar, while large growth stocks slightly outperformed large value stocks. In the emerging markets, small cap, which had a slightly positive return, outperformed large cap, and growth outperformed value, although both returns were negative.

Major World Indices Ranked by One-Year Performance (%)

As of December 31, 2014

Dow Jones US Select REIT	32.00
S&P 500	13.69
Russell 1000 Value	13.45
Russell 1000	13.24
Russell 1000 Growth	13.05
Russell 3000	12.56
S&P Global ex US REIT (net div.)	10.94
Russell 2500	7.07
Russell 2000 Growth	5.60
Barclays US Government Bond	4.92
Russell 2000	4.89
Russell 2000 Value	4.22
MSCI All Country World (net div.)	4.16
Barclays US TIPS	3.64
Citigroup World Government Bond 1-5 Years (hedged to USD)	1.90
BofA Merrill Lynch 1-5 Year US Treasury and Agency	1.24
MSCI Emerging Markets Small Cap (net div.)	1.01
Citigroup World Government Bond 1-3 Years (hedged to USD)	0.96
BofA Merrill Lynch 1-Year US Treasury Note	0.18
BofA Merrill Lynch Three-Month US Treasury Bill	0.04
MSCI Emerging Markets (net div.)	-2.19
MSCI World ex USA Growth (net div.)	-3.26
MSCI Emerging Markets Value (net div.)	-4.08
MSCI World ex USA (net div.)	-4.32
MSCI EAFE Growth (net div.)	-4.43
MSCI EAFE (net div.)	-4.90
MSCI EAFE Small Cap (net div.)	-4.95
MSCI World ex USA Small Cap (net div.)	-5.35
MSCI EAFE Value (net div.)	-5.39
MSCI World ex USA Value (net div.)	-5.41
Bloomberg Commodity Total Return	-17.01

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The mixed results of the size and value dimensions in 2014 were not historically unusual. Although small cap and value stocks have offered higher expected returns relative to their large cap and growth allocations, such returns do not occur each year. For example, since 1979, US small caps have outperformed large caps in 52% of calendar years. Results are similar for the relative price dimension: Since 1979, value has outperformed growth 55% of the time. Small cap value has outperformed large cap growth in 58% of the calendar years.

History also has produced multiyear periods in which small caps and value did not outperform large caps and growth. Noteworthy periods include 1984 to 1987 and 1994 to 1998, when small caps underperformed large caps, often by a wide margin each year. Since 1979, the value premium has also experienced extended periods of underperformance—and, in some cases, the differential exceeded 15% margin. The same is true of small value vs. large growth stocks. In the three-year period from 2009 to 2011, both value and small caps underperformed. *Yet, despite even extended negative-premium periods, small caps and value have outperformed over time, and when the premiums reversed, they often did so strongly and over multiple years.*

Currency Impact

The strength of the US dollar had a very strong negative impact on returns for US investors with holdings in unhedged non-US assets. (Generally, investors gain when their home currency falls relative to the local currency of the foreign asset they own, but lose when the opposite happens.)

For example, in 2014, the dollar's rise relative to the euro hurt the returns of US investors in European markets. The MSCI Europe Index (net dividends) returned a positive 6.84% in euros but a negative 6.18% in US dollars. The dollar outperformed a number of major local currencies. Other examples: The MSCI UK Index returned 0.50% in pounds but -5.39% in USD. The MSCI Japan Index returned 9.83% in yen and -3.72% in USD

Strategy for 2015 and Beyond

Markets worldwide have a history of rewarding investors for the capital they supply. Companies compete with each other for investment capital, and millions of investors compete to find the most attractive returns. This competition quickly drives prices to fair value, ensuring that no investor can expect greater returns without bearing greater risk.

Therefore, the asset allocation of our clients' investment policies are tilted toward dimensions of higher expected returns, using solutions that seek to add value through portfolio design and implementation. Clients are expected be strongly committed to the investing philosophy we employ: securities and asset classes regularly move out of favor, even for years at a time. *But our fundamental economic belief is that the cost of capital is the investors return.* It is no surprise to us that disappointing international stock allocations last year suddenly perform better than US stocks. The "invisible hand" of market equilibrium works itself out through a vast and complex network of information, expectations and human behavior around the world.

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Second Opinion Service
Exclusively for friends, family and colleagues of our valued clients

Paul Byron Hill, MBA MSFS MFP
Certified Financial Planner™ ©2014

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In these changing times, you probably know a friend, family member or colleague who may be in a complex situation, or who wonders whether they have the right financial advisor, or who needs help, but doesn't get it. That's not uncommon. Recent studies have shown that over 80 percent of affluent investors would value a second opinion.*

In order to help the people you care about achieve their financial goals, we have created our complimentary **Second Opinion Service**. We're pleased to offer your friends, family and colleagues the same expertise and guidance that you've come to expect as a valued client of Professional Financial.

Working with a team that redefines wealth management

Ask ten investors to define wealth management. Actually, ask ten "wealth managers" to do so. You'll almost definitely get ten different answers, and most will be heavily focused only on investing. As a client of Professional Financial, however, you benefit from a cutting-edge team that has a clear and comprehensive vision of wealth management.

Our consultative process

At Professional Financial we approach each new engagement with a time-tested, collaborative process. This allows us to have an open dialogue with you so we can learn about your values and goals. This enables us to work with you to tailor a plan that helps you meet those goals. As a valued client, you'll recognize each of the five steps below. As part of our **Second Opinion Service**, we can offer a portion of our consulting service, complimentary, to your friends, family and colleagues.

WEALTH MANAGEMENT CONSULTING PROCESS

Step 1	Step 2	Step 3	Step 4	Step 5
Discovery meeting	Investment planning meeting	Mutual commitment meeting	Organizational meeting	Regular process meetings

Professional Financial helps successful families meet complex financial challenges and make informed decisions about wealth for planning major concerns. Major wealth concerns include wealth enhancement, wealth transfer, wealth protection, and charitable giving. Professional Financial is an elite wealth management firm located in western New York. We accept only those clients for whom we can make a major impact: professionals, physicians, and retirees.

Founded over twenty years ago, Professional Financial is an independent registered investment advisor staffed with a team of experienced Certified Financial Planners.™ As trusted advisors, we have a fiduciary duty of loyalty to you. As fee-only advisors, we avoid typical conflicts of interest with commissions. Professional memberships include: Financial Planning Association, American Institute of CPAs, Institute of Chartered Management Accountants, and National Society of Accountants.

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What to expect from the Second Opinion Service

We will meet with your friends, family and colleagues for a discovery meeting and then invite them back for an investment planning meeting. Hopefully, we can confirm whether they are on track to meet their values and goals with their current financial providers. If needed, we'll suggest ways in which we can help, including recommending another CFP® advisor if we're not a good fit for your friends' or relatives' needs. Either way, they'll receive both a Total Client Profile and personalized analysis of their current financial situation—a value that may be in excess of $5,000.

SECOND OPINION SERVICE

Step 1 — Discovery meeting

Step 2 — Investment planning meeting

Consultative Wealth Management

Investment consulting
- Wealth preservation
- Portfolio structure
- Manager due diligence
- Risk evaluation
- Performance benchmarking
- Goal monitoring

Advanced planning
- Wealth enhancement, including cash flow, tax minimization, and liability management
- Wealth transfer
- Wealth protection
- Charitable giving

Relationship management
- Regularly scheduled calls, reviews and in-person meetings
- Team of experts, including legal, tax, insurance and financial specialists

Let us help you help those you care about. Contact us today.

Professional Financial Strategies, Inc.
Powder Mill Office Park
1159 Pittsford-Victor Road, Suite 120
Pittsford, NY 14534
(585) 218-9080
(585) 218-9352 (fax)
planning@ProfessionalFinancial.com

Paul Byron Hill, CFP®
President | Wealth Manager

Kam-Lin "Katherine" Hill, CFP®
Vice President | Wealth Advisor

CFP™ CERTIFIED FINANCIAL PLANNER

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*Source: Russ Alan Prince and David A. Geracioti, *Cultivating the Middle-Class Millionaire*, 2005.