



Investing in Challenging Times

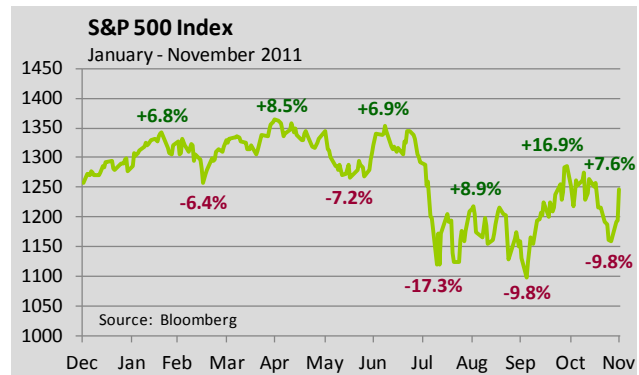
December 1, 2011

Summary

The past few months have been marked with significant economic, political, and market uncertainty. Policy paralysis in the U.S. continued as the “super committee” failed to make any meaningful progress on deficit reduction. Capital markets in Europe have forced euro zone members to consider serious changes in the fundamental construction of the European Union. As the spotlight shifted from problems in one country to the next, the market responded with a series of declines and recoveries as each problem was resolved or delayed. Unfortunately, few were resolved and most were delayed, causing capital markets to signal that continued delays will no longer be tolerated.

Even in the face of continued deleveraging, economic indicators have been positive and a double-dip recession has been avoided... for now. Additionally, in an environment where there is no clarity on policy, recent advancements in economic data have had little sustainable impact on consumer confidence or market performance.

Despite all of the market volatility and negative media headlines, as of November 30, the S&P 500 is down less than 1% this year. As discussed in our August commentary, the market has continued to move quite quickly in both directions. Since our equity reduction in May of this year, we have maintained a neutral equity position and are pleased to have mitigated some of the volatility. We recently made modifications to client portfolios; generally, equity levels were unchanged, although the mix of underlying assets, including non-equity investments, were changed to reduce correlation between investments.



European Instability

The tone of discussion in Europe has changed dramatically in recent months. The summer period was focused primarily on problems of specific countries (mostly Greece), but the stability and sustainability of the broader euro zone has been brought into question in recent months. Sovereign debt concerns over the prior 18 months focused on smaller countries, such as Greece and Ireland, but the risk associated with debt from larger countries such as Italy, Spain, and even France has increased substantially. Evidenced by the yield on Italian debt, which rose from 5.2% in September to over 7.5% in November, concerns over sovereign debt and foreign bank stability increased dramatically. In November, even bastion Germany had trouble finding buyers for a recent debt offering.

The European debt situation is complex, encompassing difficult to navigate issues on both political and financial fronts, but it is likely that the resolution comes from one of two general outcomes. If the euro zone countries agree to some sort of binding fiscal measures and tighter economic unity, the current crisis should be averted. As French President Nicolas Sarkozy stated recently, “There cannot be a single currency without economic convergence... or the euro zone will collapse.” If the euro zone cannot agree to stronger economic integration, it is unlikely that the membership of the European Union would remain the same, and financial tensions would increase dramatically.

This issue is important for financial markets, not only because European banks are significant global lenders (particularly to emerging markets), but also because of confidence in global markets. The lack of



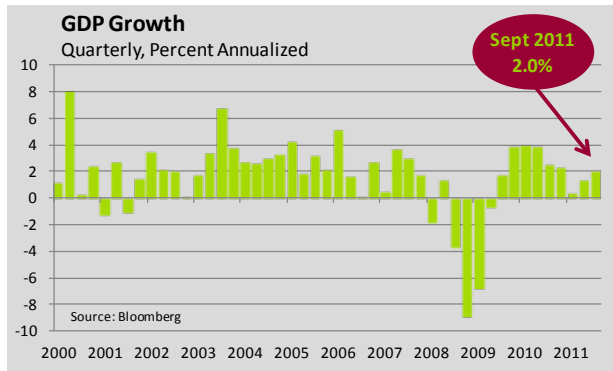
confidence has caused credit markets to tighten significantly, reviving memories of the 2008 financial crisis.

This week saw the coordinated action of 6 central banks to address a potential liquidity crisis in Europe. In addition, statements of unity from various euro zone members have relieved some pressure, at least temporarily, from capital markets.

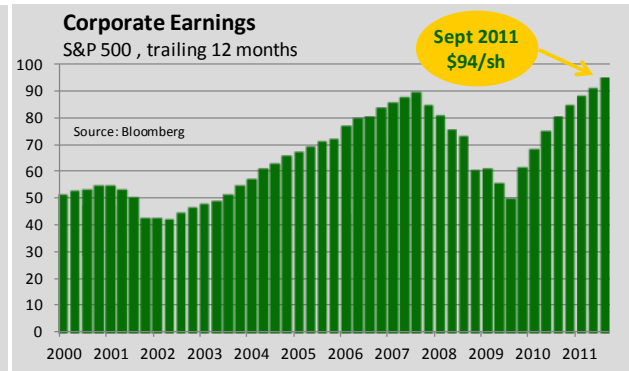
General Economic Conditions

Despite the recent focus on European problems, data on the health of the U.S. economy is improving but still somewhat mixed.

The economy is growing...

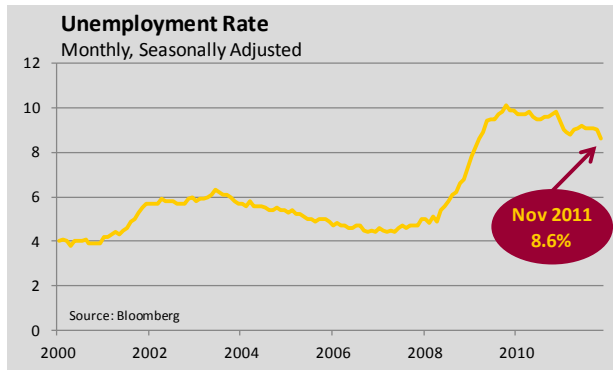


and companies are generating profits...

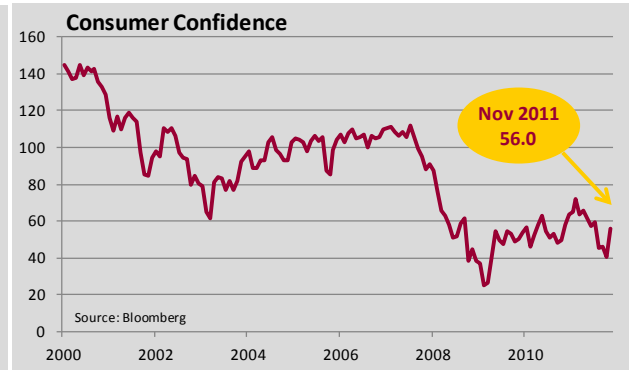


Gross domestic product (GDP) growth slowed early in the year but continues to be substantially positive. Although still weaker than the typical post-recession recovery, GDP has remained positive despite a very challenging environment. Corporate earnings continue to be strong; however, there is risk to future growth due to a pending recession in Europe. With U.S. corporate profits at historic highs, much of those earnings are due to cost reductions and lean operating environments, not large revenue growth.

but unemployment remains stubbornly high...



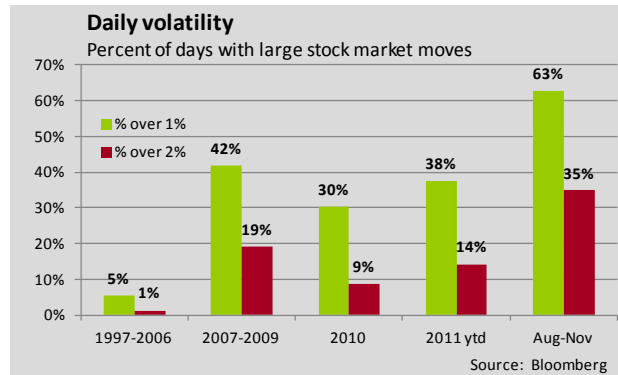
and consumer confidence is quite low...



The unemployment rate has been stuck near 9% for most of the year. Although economic growth of 2-3% is near the long-run GDP growth average, it is not sufficient to add net new jobs and significantly slower than normal post-recession periods. Total new payroll employment has averaged approximately 100,000 new jobs per month this year; however, the number of new jobs required to make a significant dent in unemployment is 2-3 times that number. The numerous items discussed previously have continued to batter consumer confidence. Although the debt ceiling was perceived as a major issue in August, it seems a distant memory after the "super committee", forced leadership changes in Europe, and dramatic increases in borrowing rates for certain European nations.



...so market volatility remains high.

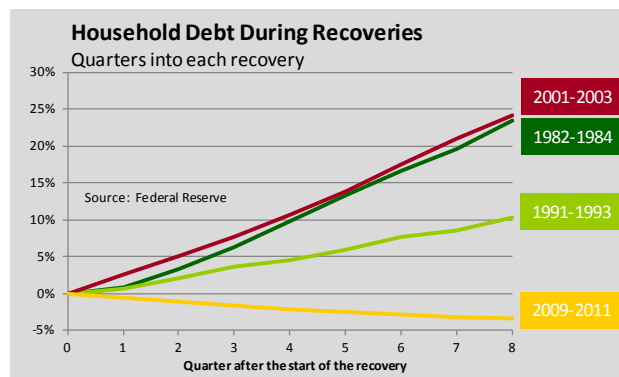


Driven by the crisis du jour, the stock market has continued to be somewhat unpredictable in recent months. When viewed in a historical context, this volatility is quite high. During the decade prior to the 2008 crisis, volatility was quite low as only 1 in 100 days realized an increase or decrease of over 2%. Since August, over one-third of the days have realized moves of over 2% on a market close basis (the intra-day volatility has obviously been even higher). In fact, one day in August the S&P 500 moved over 7% in a single day.

Deleveraging is contributing to slow economic growth

One topic that we have discussed frequently in past commentaries is the process of deleveraging, or the reduction of debt, that is occurring on a broad scale. Debt has two sides: on one hand, it allows increased investment and helps generate economic growth; on the other hand, debt can be burdensome when it grows too large or becomes too expensive. One way the current economic recovery is different from prior periods is the continued reduction in debt obligations, which seems to be having a dampening effect on economic growth. Summarizing this problem, Jon Hilsenrath wrote in the Wall Street Journal,

“Total household debt – through payment or default – fell by \$1.1 trillion from mid-2008 through the first half of 2011, according to the Federal Reserve Bank of New York. ‘Households appear to have made some progress in deleveraging, but many still face elevated debt burdens and reduced access to credit,’ Janet Yellen, the Federal Reserve’s second-ranking official said... Deleveraging should help the U.S. economy in the long-run, putting households on sounder footing... But there are short-term dangers. During the Great Depression, economist John Maynard Keynes warned of a so-called paradox of thrift: When everyone turns frugal, everyone suffers. Synchronized thrift slows the economy, according to Keynes, which hobbles income growth and makes people even stingier in a pernicious cycle. Some experts worry that is happening now.”



The percentage change in the level of household debt during this economic recovery is significantly lower than those of past recoveries (see above chart). That could explain, in part, why the U.S. economy only expanded at a 2.5% annual rate after the 2009 recession, far slower than the average growth of 4.3%



during the first two years of the last four recoveries.

Federal Reserve Chairman Ben Bernanke addressed the slow recovery in the annual economic symposium in Jackson Hole in late August. Some relevant excerpts:

“The financial crisis and the subsequent slow recovery have caused some to question whether the United States, notwithstanding its long-term record of vigorous economic growth, might not now be facing a prolonged period of stagnation, regardless of its public policy choices...

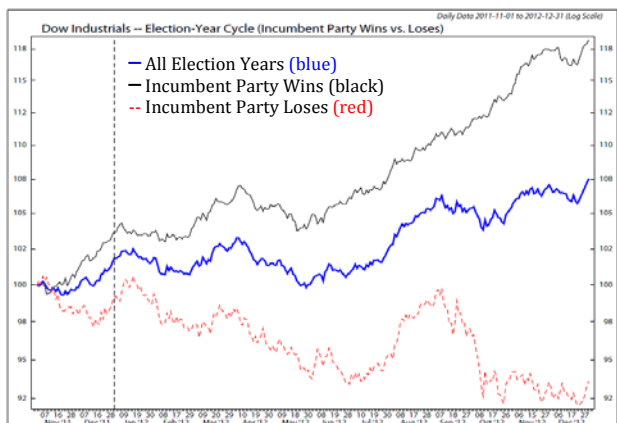
Why has the recovery from the crisis been so slow and erratic? Historically, recessions have typically sowed the seeds of their own recoveries as reduced spending on investment, housing, and consumer durables generates pent-up demand. As the business cycle bottoms out and confidence returns, this pent-up demand, often augmented by the effects of stimulative monetary and fiscal policies, is met through increased production and hiring. Increased production in turn boosts business revenues and household incomes and provides further impetus to business and household spending. Improving income prospects and balance sheets also make households and businesses more creditworthy, and financial institutions become more willing to lend. Normally, these developments create a virtuous circle of rising incomes and profits, more supportive financial and credit conditions, and lower uncertainty, allowing the process of recovery to develop momentum...

These restorative forces are at work today, and they will continue to promote recovery over time. Unfortunately, the recession, besides being extraordinarily severe as well as global in scope, was also unusual in being associated with both a very deep slump in the housing market and a historic financial crisis. These two features of the downturn, individually and in combination, have acted to slow the natural recovery process.”

Presidential election year

In the presidential election cycle, the election year is historically one of the strongest in the four-year cycle. When combined with seasonal tendencies, election cycle influences would generate positive expectations for December and early 2012. This year, however, our concerns over European bank liquidity, policy paralysis in the U.S., and a soft economy have overshadowed the history of election year returns.

There has been some variation in election year market returns, with the market tending to perform worse when the incumbent party loses the election. A study by Ned Davis Research (NDR) shows the relationship between election results and market returns (see chart), noting “rather than a direct relationship, a plausible explanation is that the election losses and market losses are often consequences of worsening economic conditions.” Since World War II, no president has been re-elected with unemployment over 7.2%. While it is too early to forecast the election next November, economic uncertainty has an important impact on both presidential politics and the stock market. NDR summarized the outlook for next year succinctly, “Whether 2012 turns out to be a good year for the market, and whether Obama returns to the White House in 2013, will have a lot to do with whether the economy can continue to avert recession.”



Summary of recent actions

Given the current environment, this week we took action in client accounts to reposition portfolios. We continue to maintain a “neutral” equity position (halfway between maximum and minimum equity levels), which we initiated in May. Although the modestly positive economic data might lead one to optimistic



stock market expectations, the situation in Europe could change quickly to a negative extreme. We continue to believe that the stock market has room for healthy gains, but a liquidity crisis in Europe could cause a significant market reaction. Many actions have been taken in the euro zone to address the mounting concerns over debt restructuring, but a more concrete plan is necessary to alleviate many existing financial stresses. The current direction seems to be favorable, but we need the situation to become clearer before taking further action. Getting 17 euro member countries to agree on specific details will be difficult and are likely to produce highly volatile markets. We remain poised to act, either more defensively or aggressively, depending how the situation unfolds.

Our recent action includes a few changes to portfolio allocations. To reduce risk from potential problems in the euro zone, we reduced allocations to developed international investments. We continue to remain balanced between growth and value investments. Although value investments are typically considered more defensive than growth, value driven mutual funds also typically include financial stocks which have been extremely volatile and could be hurt significantly should the European financial situation worsen. In our non-equity allocations, we have increased allocations to investments that are not correlated with global equities. In addition, although we remain worried about rising interest rates in the future, we have added intermediate-term bond investments that should benefit if concerns over European liquidity increase.

Specific actions regarding recent actions depend on client objectives, investment options available, and other factors.

Final Thoughts

While instability remains high in the euro zone, our investment positioning remains at neutral. We are hopeful that Europe will be able to move to a more fiscally oriented union or will find another way to tighten their complicated partnership, but we are concerned about the speed in which specific actions are agreed upon. The recent coordinated action by six central banks to increase bank liquidity is positive but limited; summarized aptly by Bank of Japan Governor Masaaki Shirakawa, "The European debt problems can't be solved by liquidity alone... The step is meant to buy time for European countries to proceed with their fiscal and economic reform." Policy makers in the U.S. and Europe continue to "kick the can down the road," and until we are more confident in a positive outcome in Europe, we will continue to maintain a reduced allocation to equity investments.

If you have questions on the investment environment or your portfolio, please call us at 734-769-7727.

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