

Cautiously Optimistic

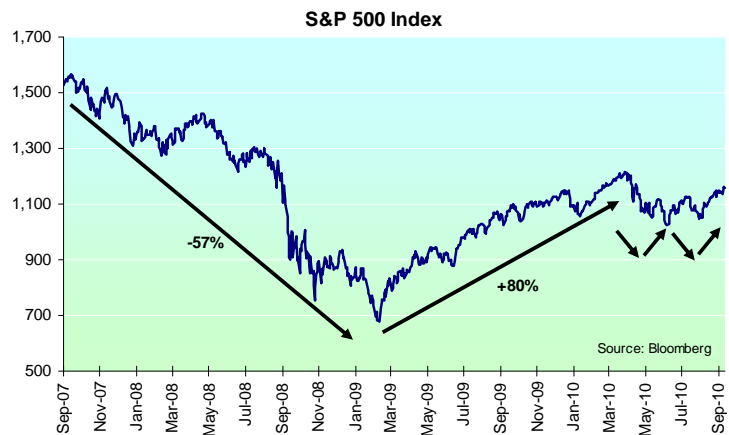
October 2010

SUMMARY

We recently made our Seasonal changes in client portfolios to reflect our expectations for the future. Those expectations are positive but modest in proportion. Although the stock market recovery over the past 18 months was quite strong, the economic results have been somewhat uninspiring, and that trend is expected to continue. General economic indicators such as unemployment and GDP growth should continue to improve but more slowly than most had hoped for. Recent positive returns in the stock market seem to reflect corporate profitability rather than economic growth. Most businesses are profitable due to cost reductions, but top-line growth in revenue may be more difficult to achieve.

We believe the Federal Reserve will continue to pull out all of the stops to prevent a double-dip recession and deflationary environment. Many consider these actions to be “pushing on a string,” but in some ways today’s environment is healthier than it was a few years ago. The process of unwinding excess leverage and risk-taking is ongoing; household debts are falling and most banks have cash to lend. The environment that caused the financial turmoil of 2008 is mostly gone; we are left with financial circumstances that are weak but much more stable than the recent past.

On October 7, we moved money out of defensive positions back into clients’ maximum equity positions. The portfolio positioning over the past six months was positive due to our avoidance of the downward movement in the stock market as well as the positive performance of our defensive investments. The S&P 500 index fell by 2.8% between our reduction in equities on April 28 and October 7. More important than the point to point loss prevention was the avoidance of a 16% correction in the stock market that occurred in May and June. We were happy to have client investments on the sidelines during this unstable period as well as the rest of the volatile summer.

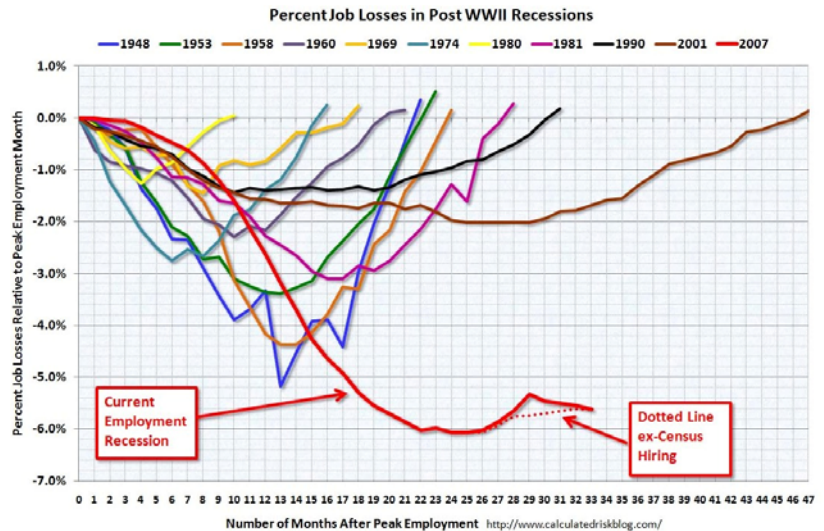


Looking forward, we are cautiously optimistic on prospects for the stock market, mainly due to the seasonality trends around the presidential election cycle. The average pre-presidential election year (e.g. 2011) has returned 18%, although our expectations are more modest. We believe most of the risk of a double-dip recession has passed, and even if returns are half the historical average, it will be a positive six to nine months. Our caution relates to the underlying modest economic growth throughout the world. In general, stocks look attractively priced when compared to bonds, CDs, and money markets. We expect the stock market to rise between now and the end of the year, but the significant uncertainty surrounding congressional elections and tax legislation will be a key factor in that outcome. Given the exceptionally strong stock market performance in September, it is feasible that a small pullback in the market will occur in the next few months; however, we expect that pullback to be shallow and believe it is important to be fully-invested at this time.

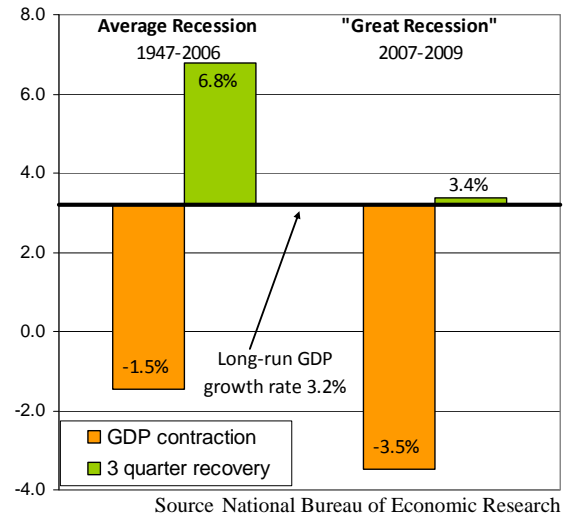
GENERAL ECONOMIC CONDITIONS

The stock market recovery over the past 18 months has been excellent, but general economic conditions have not kept pace with the stock market recovery. Looking forward, we expect that the economy will continue with a slow-paced, modest recovery. Several key components are below:

UNEMPLOYMENT will likely remain stubbornly high but decline slowly over time. The current jobless rate has equaled or exceeded 9.5% for 14 months, surpassing the 13-month period from mid-1982 to mid-1983 as the longest period since records began in 1948. When compared to past recessions (see right), job growth is recovering more slowly. The key will be private sector job creation moving forward.



ECONOMIC GROWTH will likely be slower but positive. Recessionary periods are typically symmetrical (more of a “U” shape), in that a brief economic decline is followed by several quarters of strong Gross Domestic Product (GDP) growth. Using NBER data on recessions since 1947, the typical recession was followed by strong economic growth. Analyzing the ten recessions from 1947 to 2006 (see right), the three quarters following the end of a recession averaged GDP growth of 6.8% (annualized), while the long-run average GDP growth rate is 3.2%. The most recent recession (December 2007 to June 2009) was the longest U.S. recession since 1940 and was followed by GDP growth of 3.4%, half of a typical “recovery period.” This lackluster recovery is likely to continue.



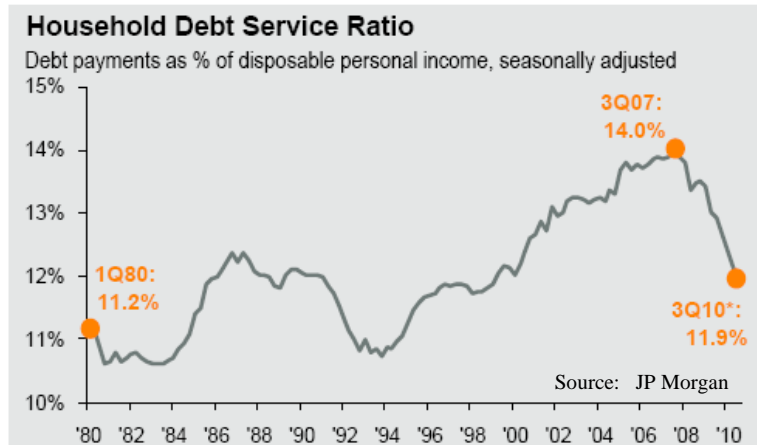
QUANTITATIVE EASING (QE) will likely continue to reduce the risk of a double-dip recession. It is unlikely that the Federal Reserve (Fed) will increase rates until the second quarter of 2011, and, depending on the economic recovery, rates may not increase at all in 2011. Since short-term interest rates cannot go much lower, the Fed is utilizing non-traditional methods to stimulate the economy often called quantitative easing. In this process, the Fed buys various financial assets from banks which increases bank reserves. With increased reserves, banks may have an easier time lending money, which should help stimulate the economy.

Deflation is an important risk looking forward, but the Fed will use QE to prevent any movement in that direction. In an August speech, Fed Chairman Ben Bernanke stated, "The Federal Open Market Committee will strongly resist deviations from price stability in the downward direction." Not only is the Fed focused on avoiding deflation, but it is likely the Fed will err on the side of mild inflation before reducing focus on deflation and economic stimulation. The Fed will likely continue with QE and low rates until growth hits 3 to 4% in a given quarter.

The De-Leveraging Problem

Although the Great Recession technically ended in June 2009, the process of deleveraging will continue for some time. Leverage is double-edged sword; using debt or derivatives can magnify gains but it can also amplify losses as well. Individuals are paying down their debt, refinancing, or walking away from debt they cannot afford; this can be seen in the household debt service ratio (see below), which illustrates the housecleaning done by many individuals and families. At the same time, balance sheets of businesses and financial institutions are becoming healthier as many companies have significantly increased cash positions.

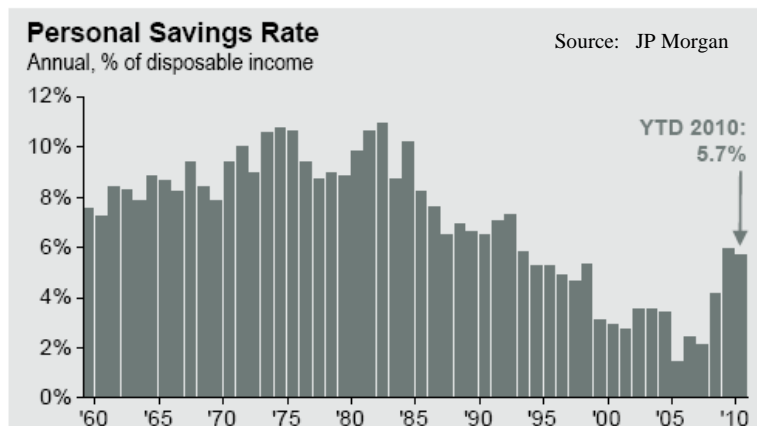
The balancing of contradictory long-run objectives and short-term needs is a challenge. There is an inherent conflict between needing to reduce leverage on a sustained basis and, at the same time, encourage spending, investment and borrowing to restart the economy and generate jobs. This dilemma can be seen in a few areas:



LENDING: Clearly, tighter lending standards are needed (compared to the mid-2000's) to ensure that borrowers are not encouraged to take loans that they cannot afford. However, in the short run, banks should not stop lending altogether. Banks provide much-needed capital that is crucial for economic growth. Without enough bank lending, the economy cannot get back on track, and currently not enough lending is taking place.

REAL ESTATE: Less speculation in residential real estate will be healthy. Borrowing money to finance the purchase of a home with the intent to “flip it” is a sign of excess, and homes are not liquid or tradable commodities. However, without enough buyers of real estate, even current (reduced) real estate values may not be supported. And, although commercial real estate vacancy rates have reached their highest level in 16 years, many of the higher-grade properties seem to have stabilized.

SAVINGS: The long-term trend of declining savings rates in the U.S. has reversed. Personal savings, which steadily declined over the past two decades, has improved to almost 6% (see right), a much more sustainable level. Over time, it is important for this trend to continue, but consumer spending is a significant portion of GDP. The dilemma is that increases in employment are heavily dependent on increases in consumer spending.



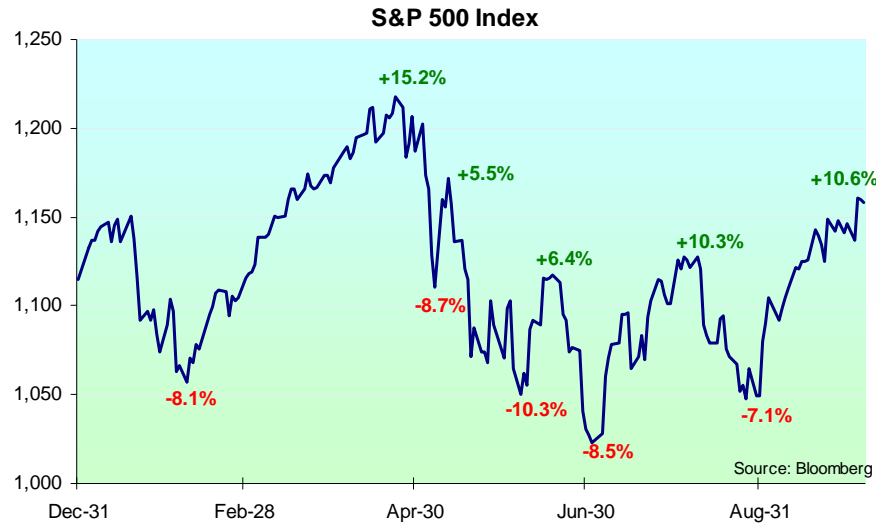
Individuals, banks, and corporations will continue the deleveraging process, but the excesses of prior years cannot be completely reversed in just one or two years. In fact, too swift a movement in that direction could stall the much-needed economic recovery.

STOCK MARKET OBSERVATIONS

Continued Volatility

As expected, volatility in the stock market has continued with a few differences from the past. The significant daily volatility from 2008-2009 has been replaced with a trendless intermediate market which has had numerous short-term movements resembling a see-saw. So far this year, the S&P 500 has realized ten different significant swings, eight of which occurred since April.

After a remarkable period of stability from February to April, the stock market recovery broke down in May. The threat of a double-dip recession as well as concerns over sovereign debt problems generated a market correction of ~16%. Those concerns continued throughout the summer and are reflective of the historically poor stock market returns in the weak season which runs from April to October.



Recent Actions & Expectations

This past spring, on April 28 (just three business days after the high for the year), we moved clients to their minimum equity position by taking money out of the stock market and putting the proceeds into bonds, money markets and other non-equity alternatives. We were happy to avoid the significant volatility of the summer months driven by fears of a double-dip recession, sovereign debt risk, and deflation. On October 7, we moved clients back to their maximum equity position. During that period (April 28 to October 7), the S&P 500 index fell by 2.8%. A reasonable proxy for bond investments is the Barclays Aggregate Bond Index which returned 6.5% over that same period. It is difficult to generalize, but, over the six months, floating-rate, high-yield, and total return bond funds earned 2% to 10%, and to the extent client accounts were invested in such funds, they benefited from these returns (most but not all clients were in these types of bond investments). Not only was the move positive to portfolios, but we feel good about missing the “flash crash” in May and correction (16% peak to trough) that occurred in May and June.

Despite our uninspiring economic expectations, we are cautiously optimistic about stock market prospects for the near term. There are several components for those expectations: the positive influences of the presidential election cycle, the relative valuations of stocks versus bonds, and other technical and valuation indicators. There are always risks to future expectations, the most significant of which are likely tax legislation, deflation and an external event resulting in international instability. These and other factors can cause changes in the stock market and losses in client accounts.

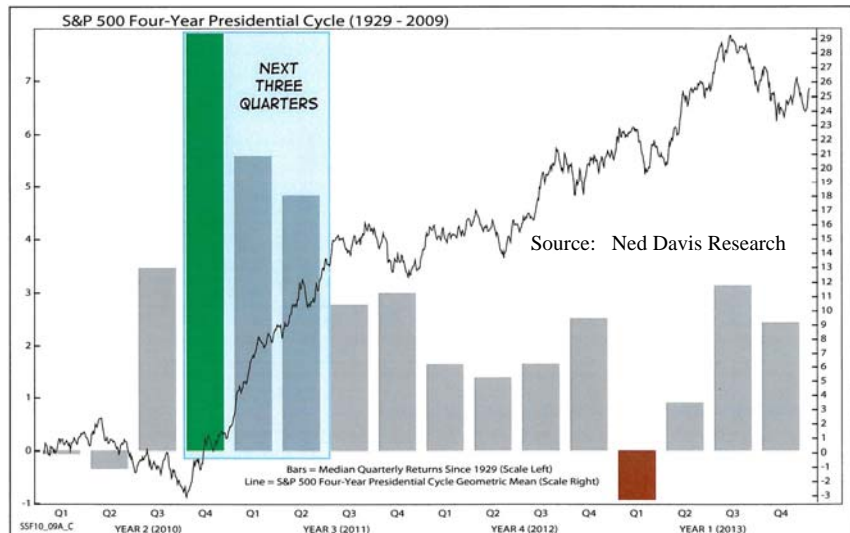
The discussion above and elsewhere in the commentary reflects the changes in investments made for most but not all of our managed accounts at the time(s) shown above. The Seasonal Strategy used by RIS cannot in and of itself be used to determine which securities to buy and sell, the amount to buy and sell, or when to buy and sell them for an individual account because client objectives differ. During this period, some clients lost money and others gained. Factors such as specific securities price movements, timing of investments, the amounts invested and withdrawn, cyclical and market trends, client growth or conservative objectives, economic conditions, interest rates and other factors all influence performance materially. For these reasons, the chart and commentary should not be considered the performance results of RIS or any RIS account. Losses can occur by using any investment strategy, including RIS's Seasonal Strategy.

Presidential Election Cycle

The four-year presidential election cycle has had an interesting influence on stock market returns. We have written extensively about this tendency in the past, which is mostly driven by the uncertainty around elections and the short-term economic impact of discretionary spending and fiscal actions within the election cycle.

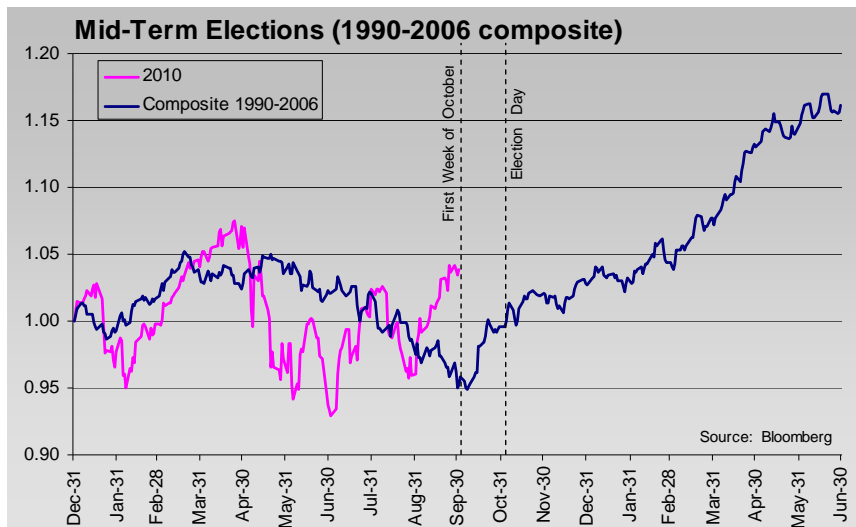
There are two positive statistics that come out of the presidential election cycle studies. The first shows that the pre-presidential election year (e.g. 2011) has historically been the year with the lowest risk of stock market loss and highest historical returns.

Since 1950, the stock market has returned an average of 18% in pre-presidential election years and has not experienced negative returns. The second indicates that the three quarters starting at the end of the mid-term election year are the three best quarters of the 16 in the cycle. Thus, we are at the beginning of the strongest nine months in the four-year cycle. See data to right provided by Ned Davis Research.



Sy Harding has studied this cycle extensively, stating, “The driving force is the desire for each new Administration to be re-elected when the next election rolls around in four years... Therefore, it has been common since at least 1918 for the incumbent administration to do whatever it takes in the last two years of each presidential term to make sure a prosperous economy and stock market are in place when the next election arrives. Such pump-priming traditionally includes increased government-spending, cuts in interest rates and taxes, even tax rebates.”

Additionally, when looking at mid-term election years from 1990-2006, there is a strong tendency for the stock market to bottom in the first week of October. Returns are positive leading up to the election,



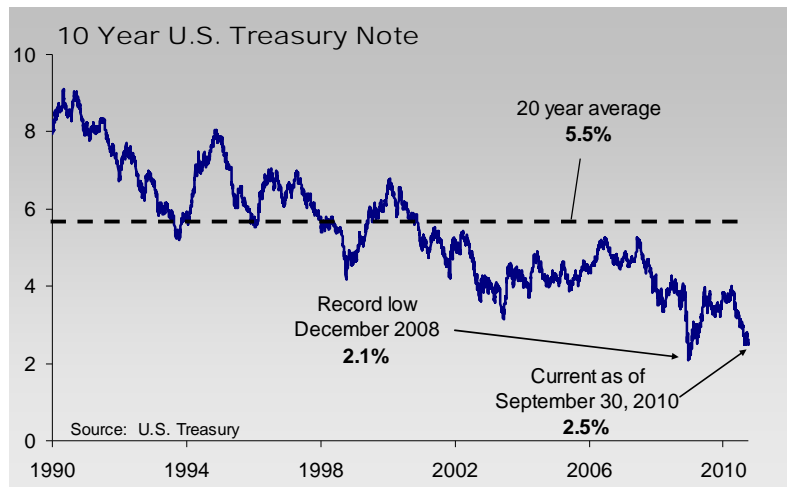
and after 6 months the stock market was positive in all 5 cases. Although 2011 should be positive when viewed in light of the presidential election cycle, we expect that the uncertainty in terms of Congress, taxes, and the economy will moderate the very strong history of pre-presidential election years, thus not assuring any market trend.

RETIREMENT INCOME SOLUTIONS, INC.

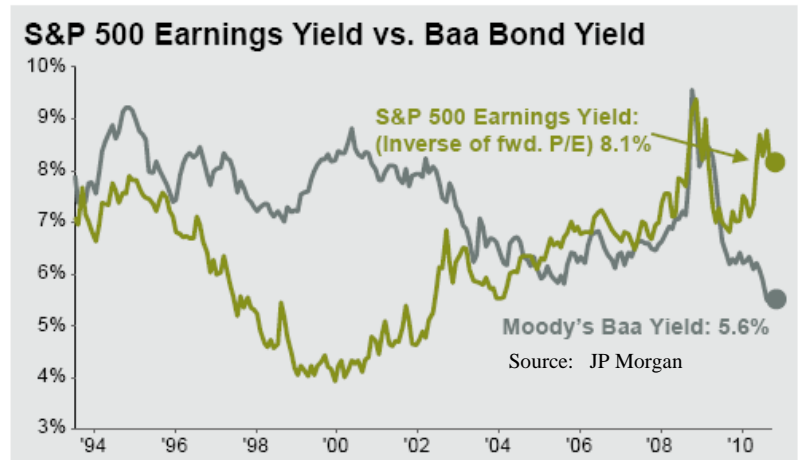
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Relative Value: Stocks & Bonds

One factor that may be a positive influence on the stock market is the relative value of bonds. As interest rates fall, the value (potential earning power) of certain bonds relative to other investments declines, and implicit in the Fed low interest rate and quantitative easing policies is the encouragement of investors to take more risk. For example, in order to achieve the “safety” of a 10-year government bond, an investor would have to be interested in receiving 2.5% per year over that 10-year holding period. Three years ago, an investor would have been rewarded with 4.5% on the same Treasury bond and ten years ago 6.5%. Important to note is the current yield on the 10-year Treasury is near historic lows.



It is interesting to compare the earnings yield on stocks in the S&P 500 to that of investment grade corporate bonds (Baa bonds). The chart to the right illustrates the difference in earnings (i.e. value) between stocks and bonds over time. In 2000, stocks were quite expensive when the S&P earnings yield was 4% while investment grade corporate bonds yielded over 8%. Today, bonds look more expensive; corporate bonds are yielding 5.6% while the S&P 500 earnings yield is over 8%. Making the same comparison to the 10-year Treasury bond yield of 2.5% is even more significant (but also note there are important risk differences between the two).



Despite the low yields, investors continue piling money into bond funds (\$216 million this year versus a net outflow for stocks). As long as bond yields remain at this low level, investors are being encouraged to look elsewhere for yield – to earn a higher return, investors must take on more credit risk, maturity risk, or allocate funds into the stock market or alternative investments. These factors should provide positive undertones for the stock market in the future, at least until rates begin to rise.

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Risks & Uncertainty

The stock market does not like uncertainty, and there are numerous political questions that are still open: the majority in Congress, healthcare, expiration of the Bush tax cuts, estate tax legislation, as well as the general political landscape. All of these issues should become clearer in the next few months; regardless of the outcome, clarity will likely be a positive factor for the market.

There are a few significant risks which we consider unlikely but could have a significant impact on stock market returns:

EXPIRATION OF THE BUSH TAX CUTS: Potential gridlock in Congress after the mid-term election could derail any serious proposal or compromise on tax legislation. Regardless of the need for some longer-term tax reform, if the entirety of the Bush tax cuts is allowed to expire without replacement in 2011, the negative impact on consumer spending would be significant and likely result in negative economic and stock market activity.

A study performed by Ned Davis indicates that tax increases could dampen stock market expectations in the near term, “... since a change in the tax rate would almost certainly be to the upside... in years when taxes have been increased, the DJIA has gained a median of 6.1%, less than the 8% annual norm and less than a third of the 19.5% gain in years when the rate has been cut.”

A substantial risk to the stock market in the next year is a full expiration of the Bush tax cuts. Despite the need to address the increasing level of government debt, a significant increase of (or return of higher) taxes on the lower and middle income brackets could have a significant impact on consumer spending, and thus put added pressure on businesses and employment.

DEFLATION: Deflation is generally described as a decrease in the general price level of goods and services. Typically, a deflationary environment is one in which consumer demand is low causing businesses to cut prices on the goods and services they provide. Initially this is not a problem, but on a sustained basis, deflation can be problematic due to the resulting need for businesses to cut wages. This can result in higher unemployment as well as make it more difficult for workers to spend and/or pay off debt. Additionally, consumers begin to delay spending while waiting for further price cuts. It is noteworthy that inflation is typically a term with a negative connotation; this is the first time in our lifetimes that we have heard advocates for the benefits of inflation, compared to the greater risks of deflation.

EXTERNAL EVENT: There is always risk of an international conflict, worries over sovereign debt default risk, chaos caused by currency negotiations, etc.

MORTGAGE RATES ARE ATTRACTIVE

Interest rates are down significantly, and even if you refinanced your mortgage two years ago, it may be advantageous to consider it again. Conforming loan (those under \$417,000) rates are more than 1% lower than a year ago (see right). The following are recent sample rates, but please remember that rates are fluctuating and subject to your personal circumstances.

Period	Points	Rate
15 year	None	~ 3.625 to 3.875%
30 year	None	~ 4.250 to 4.375%

If you would like a referral to a mortgage banker, we would be happy to supply you with a few options. This has been a busy period for mortgage bankers, but it is worth the time to investigate options.

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FINAL THOUGHTS

There will be many challenges over the next decade. In the near term, we expect to encounter a period of positive but lower stock market returns and economic growth; a double-dip recession and another bear market are not likely to occur over the next 6-12 months. Over the longer term, there are numerous themes that will continue to be focus areas for the world and our investment philosophy:

- Higher inflation
- Higher interest rates
- Ongoing recovery of the housing market
- Improvement of the U.S. economy (but at a slower growth mode)
- Increasing role of emerging market economies
- Increased debt burden of developed (versus emerging) nations and the resulting impact on spending & programs

Please call if you want to discuss this commentary, your portfolio, and any other questions or concerns that you might have. We are available at 734-769-7727.

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Important Notes on Indices: The S&P 500 is an index of 500 stocks representing major U.S. industry sectors. Small Cap is represented by Russell 2000 Index, which is an index of the 2000 smallest companies in the Russell 3000 Index of 3000 broad-based U.S. companies. Mid Cap is represented by S&P MidCap 400 Index, which tracks medium-sized U.S. firms, which is broadly defined as a company with a market capitalization ranging from about \$2 billion to \$10 billion. Large Growth is represented by the Russell 1000 Growth Index, which measures the performance of the large-cap growth segment of the U.S. equity universe; it includes those Russell 1000 companies with higher price-to-book ratios and higher forecasted growth rates. Large Value is represented by the Russell 1000 Value Index, which measures the performance of the large-cap value segment of the U.S. equity universe; it includes those Russell 1000 companies with lower price-to-book ratios and lower forecasted growth rates. Barclays Aggregate Bond Index includes most U.S. traded investment grade bonds, including Treasury securities, government agency bonds, mortgage-backed bonds, corporate bonds, and a small amount of foreign bonds traded in U.S. Investment Grade Corporate is represented by the iBoxx Investment Grade Corporate Index, which is a rules-based index consisting of up to 100 highly liquid, investment grade, U.S. dollar-denominated corporate bonds that seeks to maximize liquidity while maintaining representation of the broader corporate bond market. Treasury Bonds is represented by Barclays Capital U.S. 7-10 Year Treasury Bond Index, which is an index of U.S. Treasury securities that have a remaining maturity of 7 to 10 years. High Yield Bonds is represented by the iBoxx \$ Liquid High Yield Index, which is designed to provide a broad representation of the U.S. dollar-denominated high yield liquid corporate bond market. Indices are unmanaged, and one cannot invest directly in any index.

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