

Investing in a Uncertain Economy

January 2011

SUMMARY

For many investors, 2010 was a challenging but rewarding year as most investments realized healthy positive returns. As governments and central banks continue to try to stabilize markets at the expense of growing debt levels, many would describe recent actions as “kicking the can down the road.” Regardless, the stock market was up 15% in 2010, overcoming worries about a double-dip recession and concerns over sovereign debt.

Economic growth is technically positive, but unemployment, job creation, manufacturing, and business lending remain depressed. The risk of a double dip recession is all but past us, and government stimuli in the form of income tax cuts, payroll tax reduction, and extension of unemployment benefits continue to support markets in the near term. Positive market performance has also helped boost consumers’ confidence somewhat. Despite these factors, there is a noticeable uncertainty about the future, which means that it may not take much bad news for current trends and enthusiasm for the stock market to reverse.

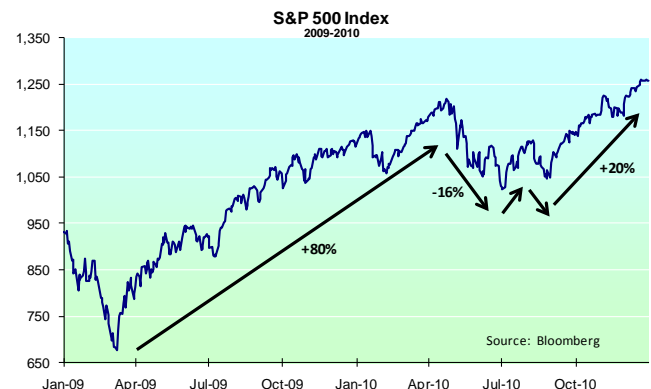
Interest rates finally moved up significantly in the fourth quarter, despite substantial efforts by the Federal Reserve to keep them down. This long-expected reversal may be the beginning of a broader trend and change in focus. We have discussed deleveraging in past writings, and Kopin Tap writes in Barron’s, “As debt shifts from the private sector to the government, so does the onus of deleveraging.” The year 2010 may mark the beginning of a shift from a time when government actions reduced risk to an environment when they become a source of risk.

The stock market followed our rough outline of expectations for 2010, with significant weakness in the summer months that included a 16% correction. Our investment allocations outside of traditional large company stock and conventional bond investments were all positive contributors to portfolio performance.

Looking forward, our outlook for the year is positive, but it comes with increased skepticism. One of the strongest undertones for the market in

2011 is the presidential election cycle which indicates we are in the midst of the best 3 quarters of the 16 in the cycle. Also positive is historical research on bear market recoveries, but there are many remaining obstacles that could easily destroy the modest confidence that the market currently reflects.

Although no crystal ball exists, we feel positive about the upcoming 3-6 months. However, it is uncertain how the economy will evolve, and as time passes, it is increasingly likely that a stock market correction will occur. In our view, the middle part of the year remains a period of elevated risk and is the one most likely to realize a correction. Whether that correction is minor or qualifies as a “bear market” (a 20% pullback) is unclear. While most prognosticators are very optimistic about the prospects for 2011, we are more cautious. We hope the prognosticators are right.

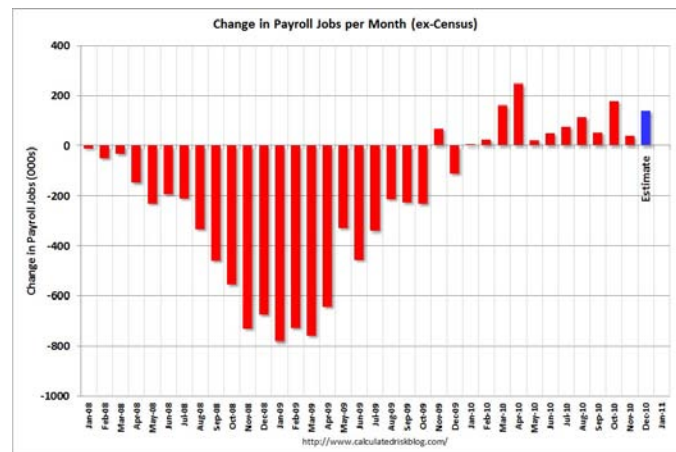


GENERAL ECONOMIC CONDITIONS

Current economic conditions are quite mixed. When viewed from a corporate profitability and recession perspective, the recovery is well intact. However, the uncertainty that exists is widespread and may act to slow recovery in important areas such as employment, residential real estate, consumer spending, etc.

UNCERTAINTY: Uncertainty, or lack of confidence, is currently demonstrated by banks, corporate managers, investors, and individuals that are reluctant to spend and invest. The concept of risk versus uncertainty is important, and it is evident that one key factor restraining economic activity is uncertainty. Risk is different from uncertainty, and the distinction between the two is significant. Frank Knight wrote in his book, *Risk, Uncertainty, and Profit*, “risk is present when future events occur with measurable probability... uncertainty is present when the likelihood of future events is indefinite or incalculable.” Until businesses and individuals are better able to determine the risk of action (spending, investing, etc.), economic recovery will continue to be slow as evidenced by weak employment, GDP growth, home prices, etc.

UNEMPLOYMENT: Although there is job growth, unemployment will remain stubbornly high for an extended period. Job growth does exist (see right), but it is not sufficient to offset the significant job losses from 2008-2009. Unemployment is a lagging indicator and will only recover more substantially after the broader economy grows at a faster rate.



COMPANY EARNINGS: It has been a good year for corporate profits, which has been positive for stocks. However, most of the increase in profits has been from reduced costs. More sales growth is needed before good company news makes a meaningful impact on unemployment and the general economy. According to Zachs Investment Research, “Full-year total earnings for the S&P 500 [are] expected to jump 42.9% in 2010, 15.1% further in 2011... Total revenues for the S&P 500 [are] expected to rise 4.03% in 2010, 5.38% in 2011.” However, in some ways, slow sales growth may be better than rapid growth due to inflation and interest rate concerns.

To see improvement in indicators such as unemployment, companies need to lessen their iron grip on cash. This requires less uncertainty on the part of corporate managers. According to Barron’s magazine, “Nonfinancial companies also are sitting on record cash stashes, which make up 7.4% of corporate assets, the highest figure in five decades. These aren’t earning much at the bank, and even after raising dividends to \$30 a share in 2011 from \$25 this year, and increasing expenditures by 10% to a projected \$540 billion next year, S&P 500 companies will still be left with \$480 billion in surplus free cash flow.” So, companies have the resources to spend and invest, but corporate managers do not yet have the confidence to take action.

RISK OF DOUBLE DIP RECESSION: In general, the risk of double dip recession is low. The current economic recovery has run 18 months, and when analyzing recessions since 1926 (using NBER data), the average recovery lasted 56 months. Of the 14 recessions during that period, only two were shorter than 24 months – 1981 and 1929. Typically, a recession will occur when the economy has overheated for an extended period and then collapses. It would be quite a stretch to describe recent economic

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activity as “overheating,” (look at employment, vehicle sales, new home starts, etc.) and it is hard to collapse when your starting point is relatively low.

IMPACT OF TAX CUT EXTENSION: The impact of the tax cut extension is positive in the short run. Analyst estimates vary, but the extension of the Bush tax cuts are expected to add 0.5% to 1.25% to GDP in 2011. Regardless of the amount, the uncertainty surrounding tax legislation has been eliminated... at least until 2012. The U.S. debt burden is still an outstanding issue, but that is unlikely to be problematic (or solved) in 2011.

INTEREST RATES & THE BOND MARKET

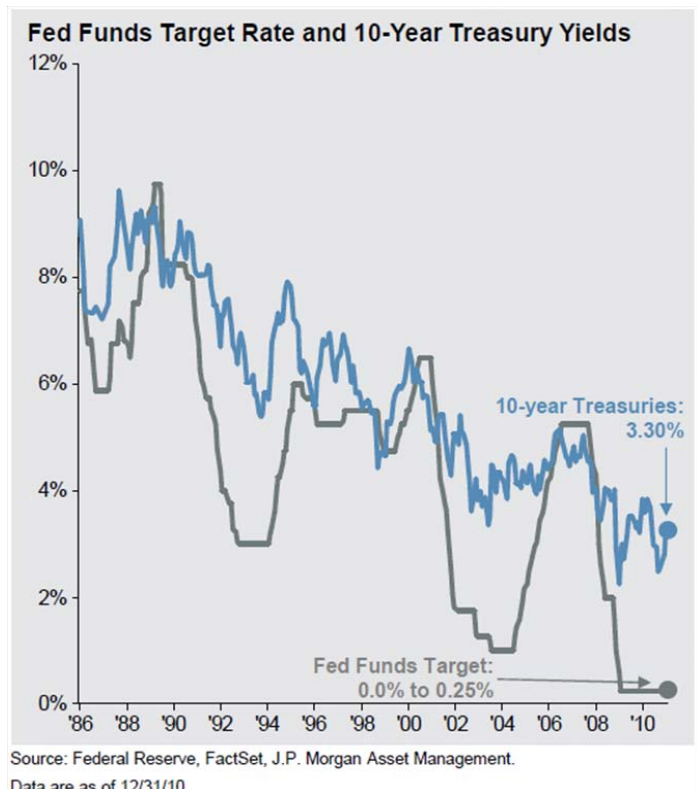
An important indicator to watch during 2011 is bond yields. Despite the Federal Reserve’s (Fed) second round of Quantitative Easing (QE2), interest rates have begun to rise. The Fed’s intent with QE2 (flooding financial markets with liquidity) was to keep interest rates low (and perhaps they are lower than they would have been without QE2), but recently market forces have pushed rates significantly upward. Since rates bottomed in October, the yield on the 10-year Treasury bond has risen by 1% (from 2.4% to 3.4%).

Despite the significant uptick in rates, when compared to history, rates are still 2-4% lower than average. Since 1962, the 10-Year Treasury bond yield averaged 6.8% and was higher than 4% over 89% of the time. Interest rates should continue to rise; however, the amount of increase may be limited. With the Fed keeping short-term rates at record lows (see below), it is difficult for intermediate term rates to rise too far. When the Fed begins to tighten monetary policy by raising the Fed Funds Target, it will be easier for intermediate-term rates to rise.

The 10-year Treasury is a good indicator to watch since it is a proxy for borrowing costs (mortgages, business lending, etc.). If the 10-year Treasury yield climbs too quickly, it could threaten the stability of the economy and thus stock market potential.

Inflation is a risk in the longer term, but may not be a significant issue in 2011. As long as there is excess supply of labor, abundant supply of real estate and households continue to reduce debt, inflationary pressures should remain low. There should be a modest increase in inflation expectations if the economy improves, but most consequences of large government deficits will not be realized in the short run.

While inflation (as measured by CPI) is not expected to flare up in 2011, there are components of the inflation equation that may, such as hard and soft commodities, food, healthcare, and higher education. CPI itself is unlikely to jump quickly since approximately 40% of CPI is based on housing costs, and most data indicates those costs (renting or buying) remain relatively low. Commodity prices, driven by emerging market demand, will also have an important psychological impact on inflation expectations.



MARKET OBSERVATIONS

The Year in Review

Most equity investments for 2010 ended on a positive note, but this was another year where the journey was more “interesting” than the destination. The year followed historical seasonal patterns with strength through April, followed by a weak and volatile summer, and closed with strong returns in the fall. Volatility remained but in a slightly different form. The prior year (2009) was marked with significant daily volatility but the general trend was clearly upward after the March low. Last year had significantly lower daily volatility, but included ten directional reversals of at least 5% (see right). In some ways, this made active management more challenging in 2010.

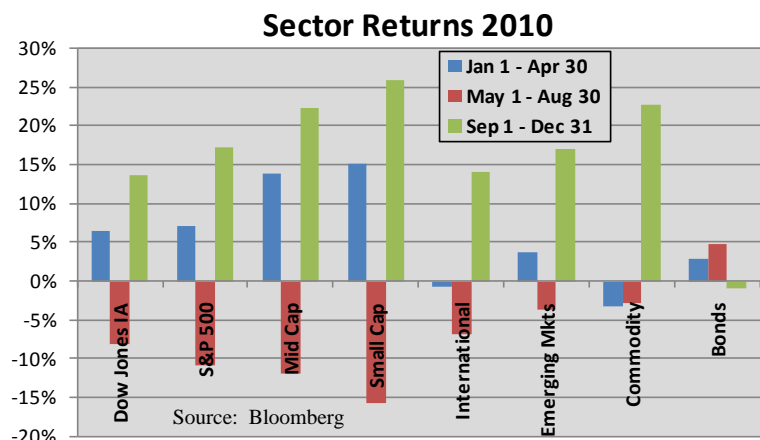
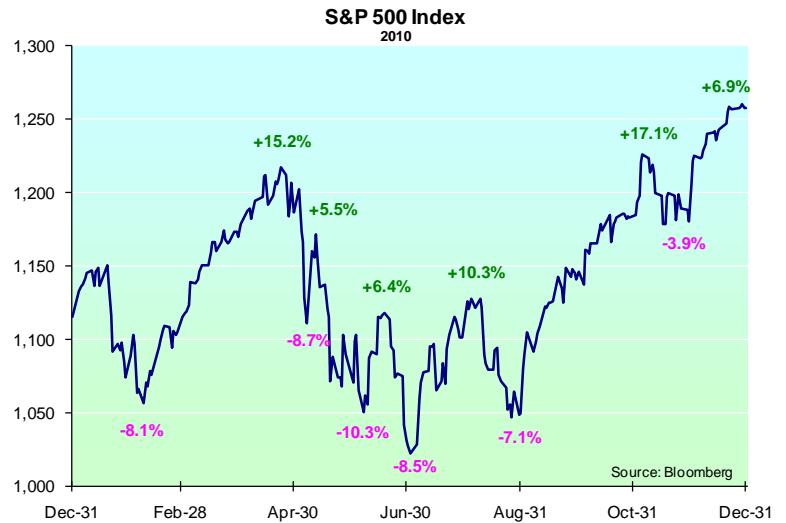
Looking at sector returns, small and mid-cap investments performed the best in 2010, each returning 27%. Emerging markets continue to outperform the S&P 500, although the pace of outperformance is lessening. Developed international investments had the lowest returns in the

equity space, mostly due to uncertainty in the euro zone. Also note the broad equity weakness in summer months. Bonds performed modestly well until the fall, when interest rates began to rise and some bonds lost money. For example, the Lehman Aggregate Bond Index lost 1% from September 1 to December 31. The iShares 7-10 Year US Treasury ETF lost 4.6% during the same period. This exemplifies the effect of rising interest rates on total returns, even for high-quality bonds.

Investment Actions*

This past spring, on April 28, 2010 (just three business days after the high for the year), we made our Seasonal defensive move and shifted clients to minimum equity positions by taking money out of the stock market and putting the proceeds into bonds and other non-equity alternatives. We were happy to avoid the significant volatility of the summer months, which were 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. 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.

* 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 charts 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.



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Bear Market Recoveries

When compared to history, the current market recovery seems to be on track. Although the recovery from the stock market bottom in March 2009 is significant, in terms of the “average recovery”, the current one is still modest. The average recovery time after a bear market is 68 months, and the shortest recovery was 26 months; the current run is only 22 months in duration. The average recovery in terms of percentage gain is 176%, more than double the current recovery of 86%. When compared to history, the recovery is young and modest.

One concerning point looking at recoveries is the small correlation between the size of the decline and the length of the recovery. For deeper bear market contractions of 35% or more, the average increase from the bottom is 100% over 55 months, less than the broader average, meaning the current trend may have less upside potential than average recoveries.

Market Peak	Market Low	Bear Market Return	Length of Decline	Bull Run	Length of Run	Yrs to Reach Old Peak
5/29/46	5/19/47	-28.6%	12	257.6%	122	3.1 yrs
7/15/57	10/22/57	-20.7%	3	86.4%	50	0.9 yrs
12/12/61	6/26/62	-28.0%	6	79.8%	44	1.2 yrs
2/9/66	10/7/66	-22.2%	8	48.0%	26	0.6 yrs
11/29/68	5/26/70	-36.1%	18	74.2%	31	1.8 yrs
1/5/73	10/3/74	-48.4%	21	125.6%	74	5.8 yrs
11/28/80	8/12/82	-27.1%	20	228.8%	60	0.2 yrs
8/25/87	12/4/87	-33.5%	3	582.1%	148	1.6 yrs
3/24/00	10/9/02	-49.1%	31	101.5%	60	4.6 yrs
10/9/07	3/9/09	-56.8%	17	85.8%*	22*	-
Average:		-35.0%	14 mo's	176.0%	68 mo's	2.2 yrs

Source: JP Morgan

Presidential Election Cycle

The four-year presidential election cycle has had an interesting influence on stock market returns. We have written extensively about this trend 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.

	Post-presidential election year	Mid-term year	Pre-presidential election year	Election year
Example year	2009	2010	2011	2012
Average Return	3.8%	6.7%	17.7%	4.6%
Frequency of loss	53%	38%	0%	27%

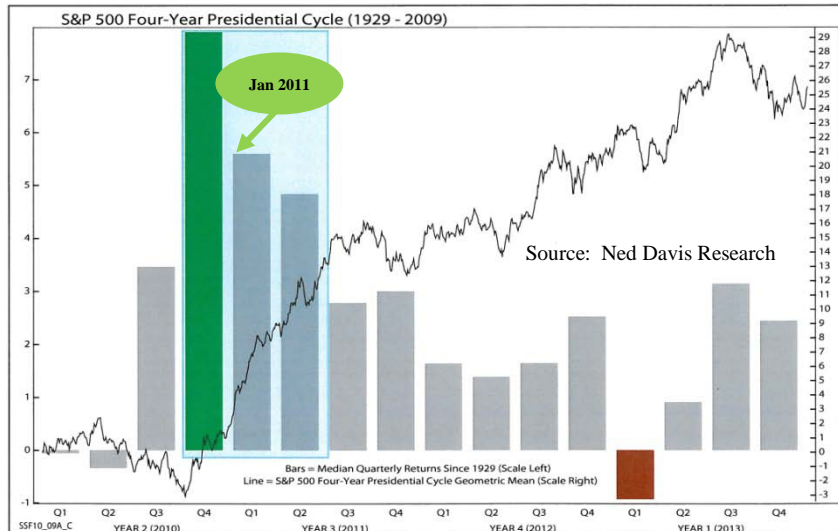
Source: Bloomberg

In light of the positive returns during the first two years of the presidential cycle (2009 & 2010), which have a much higher likelihood of loss, it might be expected that the third year would not be as positive. Historically, this is not the case, and a closer look at recent history demonstrates the trend is still intact. The first year in the cycle was 2009, and although it realized a calendar year gain, the year was quite volatile and encountered significant declines in the first quarter. In addition, according to a study conducted by the Street Smart Report, in all four cases since 1929 where the market was positive for the first two years of the presidential cycle, it was also positive in the third year. The data points are limited but encouraging.

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The third year in the cycle (2011) has traditionally been the strongest period of the four-year cycle. Since 1950, there have been no negative third (pre-presidential election) years. In fact, we are in the midst of the 3 historically strongest quarters in the 16 quarter cycle. See chart below.



When put into the context of the current environment, this third presidential year contains many of the positive stimuli that contribute to the presidential cycle theory. The 2010 actions include:

- Federal Reserve initiated QE2, the plan to purchase \$600M of US Treasury bonds;
- Extension of the Bush tax cuts;
- Reduction in the payroll tax; and
- Extension of unemployment benefits.

While the presidential cycle is a positive trend in the short term, an important indicator tracked by Ned Davis Research is clearly concerning for the second half of 2011 and early 2012. The S&P 500 Cycle Composite (see right) is a combination of the one-year, four-year (presidential) and ten-year market cycles. This indicator alone is not sufficient to alter portfolios, but it is a concept that we will be watching closely throughout the year.

In addition, another Ned Davis Research study on market pullbacks since 1926 shows that we are overdue for 5%, 10% and 20% corrections. The average number of days without a 5% correction is 32 days; we have been 93 days without one. The average number of days without 20% correction is 485 days; we have been 464 days.



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Risks & Uncertainty

Although there was a flurry of political activity in the second half of the year, many legislative items, particularly tax legislation, were addressed only on a short-term basis. With a new balance of power in Congress, it remains unclear whether the political parties can find common ground to address painful long-term issues.

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

EURO-ZONE FINANCIAL INSTABILITY: Although the European Union has taken steps to address the sovereign debt crisis in Europe, significant risk remains. Saumil Parikh, a managing director at PIMCO summarized the situation, “Truly fixing the sovereign debt crisis in Europe would require overcoming a great political divide between ‘core’ and ‘periphery.’ Germany is perhaps the only country in the eurozone with the financial ability to guarantee government bonds of troubled peripheral nations, but that is a politically unpopular option within Germany. On the flip side, the weakest peripheral nations need to make very difficult choices that essentially force them to surrender their future fiscal policy authority to Germany and other ‘core’ countries in Europe in exchange for liquidity assistance today.” This divide continues to be a significant risk looking forward.

INFLATION / DEFLATION / INTEREST RATES: When viewed broadly, the current environment seems to be a goldilocks scenario (neither deflation nor significant inflation) but a tenuous one at that. Conflicting inflationary trends are effectively offsetting one another. Wages, home prices, and deleveraging are clearly still in a deflationary mode; however, commodities, food, and health care appear to be positive inflationary factors. If interest rates rise too quickly in developed nations, either from inflation or concerns over increasing debt burdens, expectations for GDP growth and thus stock prices could be at risk.

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

Expectations for 2011

Nearly two years from the trough of the financial crisis, the economy and stock market have stabilized significantly. Fears of collapsing financial institutions are gone, and the focus has shifted to the speed of world economic growth. Many historical trends appear to be positive for 2011; however, both data and experience tell us that the course of the next year will not be that easy. Our expectations for the year are positive, but there are many factors that provide a cautionary note.

Obviously, the trend of the market has been quite positive when looking back at the whole year and particularly since the fall. The economy is improving slowly, and the risk of a double-dip recession seems to be low. The presidential election cycle is a very strong historical undertone, with very low chance of loss in a pre-presidential election year (2011). Most economists are forecasting improving economic growth. Based on history, the stock market recovery is young and modest. Perhaps most significantly, the Federal Reserve is likely to continue utilizing easy monetary policy to keep interest rates low, thereby making home (via mortgages) and business investment more affordable.

The more normal volatility in 2010 also suggests a future that would include a more normal “rally then correction” environment. The rally since September has occurred with barely a blemish, and a shallow correction is likely in the first two months of the year. In addition, expectations for this year are almost too steady and consistent. When looking at the Barron’s Outlook for 2011, the poll of market

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strategies looked suspiciously consistent. Nine of 10 market strategists expect the market to return between 7% and 17% in 2011; none expected a loss, and only one expected a flat market. This contentment was described aptly by the strategy group at Bank of America, “we think downside risks are augmented by a higher level of complacency built into the forecasts than may be warranted.”

In addition, the positive undertones must be tempered by awareness of the current environment. The stock market has rebounded significantly (86%) from the stock market bottom in March 2009, and it could take only a seemingly minor event to send the economy and markets downward in a significant fashion (note the panic generated by the Greek debt crisis in May and June). Many risks remain.

The current environment, in many ways, is more difficult to assess than the one from a year ago (when the market was still coming out of a deep bear market). Although we cannot predict what the market will do, our expectations for the year are positive, and there are likely to be major bumps in the road. For example, the rally since September has been almost without pause. The market may be due for a shallow correction very early in the year.

After a minor pullback in the first quarter, we expect the market to continue with strength through mid year. Depending on the breadth and momentum of the market during the first half of the year, it would not be surprising to see significant weakness again during the summer months (see Ned Davis Research cycle composite on page 6). Several indicators reveal that the market may be overdue for a correction; that risk will likely increase throughout the year, and that makes us more cautious than most strategists.

Fed actions and government stimulus can propel the economy in the near term. As the year progresses, many problems that have been pushed off will need to be addressed. When the world economy comes to terms with a multitude of items such as sovereign debt issues of PIIGS nations (Portugal, Ireland, Italy, Greece, and Spain), ongoing U.S. deficit spending, currency destabilization, inflation fears in emerging nations, etc., the recent period of relative stability may come to an end. In the near term, a bear market (defined as a 20% pullback in the stock market) is not likely; however, we are less optimistic about the prospects for the second half of the year as many of the current positive indicators may have run their course.

Sector Recommendations

In addition to equity allocation decisions, we think that asset class selection is an important component of portfolio construction. Following are some overweight recommendations for usage inside a diversified portfolio:

LARGE VERSUS SMALL: Generally, a late stage cyclical bull market is characterized by small caps outperforming large caps. As long as the market remains in an uptrend, this trend should continue and we would favor small cap stocks; however, heightened risk in the second half of the year may elicit a change in preference.

GROWTH VERSUS VALUE: We are currently neutral between the two styles. Growth stocks would typically demonstrate strength during this stage of a market cycle, but value stocks are still recovering from very depressed levels.

INTERNATIONAL: We continue to favor emerging markets equity and debt investments due to growth prospects and sovereign debt issues.

BONDS: As discussed throughout this commentary, we are worried about rising interest rates and thus recommend caution with any U.S. Treasury investments. Bonds with shorter maturities have lower sensitivity to interest rate changes. We believe that short-term and floating rate bonds are valuable tools to cushion portfolios against rising interest rates.

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FINAL THOUGHTS

Assessing and managing risk is quite a challenge, but it is also very important. Our investment approach is data-driven and integrated into our financial planning process. Please note that stock market corrections are part of investing, and pullbacks happen several times each year. While significant corrections are difficult to forecast, we believe there are times when investors should be more attentive and prepared. And knowing that we are not always right and that our strategies and judgments may result in gains or losses, we hope that the insights we share help provide insight into how the economy, world events, and government actions may impact investment results and your portfolio.

The past few years have been quite a journey, but we are glad that our actions have helped clients preserve and grow their investments. We look forward to helping you achieve your investment objectives and navigate an interesting 2011.

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. The Dow Jones Industrial Average is an index of 30 large U.S. company stocks. 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. Bonds are represented by the 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. Indices are unmanaged, and one cannot invest directly in any index.

For more complete information on mutual funds, please contact us to obtain a prospectus which includes all charges and expenses. Read it carefully before you invest. The principal value and investment returns will fluctuate so that an investor's shares, when redeemed, may be worth more or less than their original cost. Investments in foreign securities involves risks relating to political and economic developments abroad, foreign taxation, currency exchange rate fluctuations, as well as differences in accounting.