

Dear Clients & Friends:

October 15, 2011

Stephen Rhea

Alex Thompson

Lance Hollingsworth

John Laughlin

Sarah Haizlip

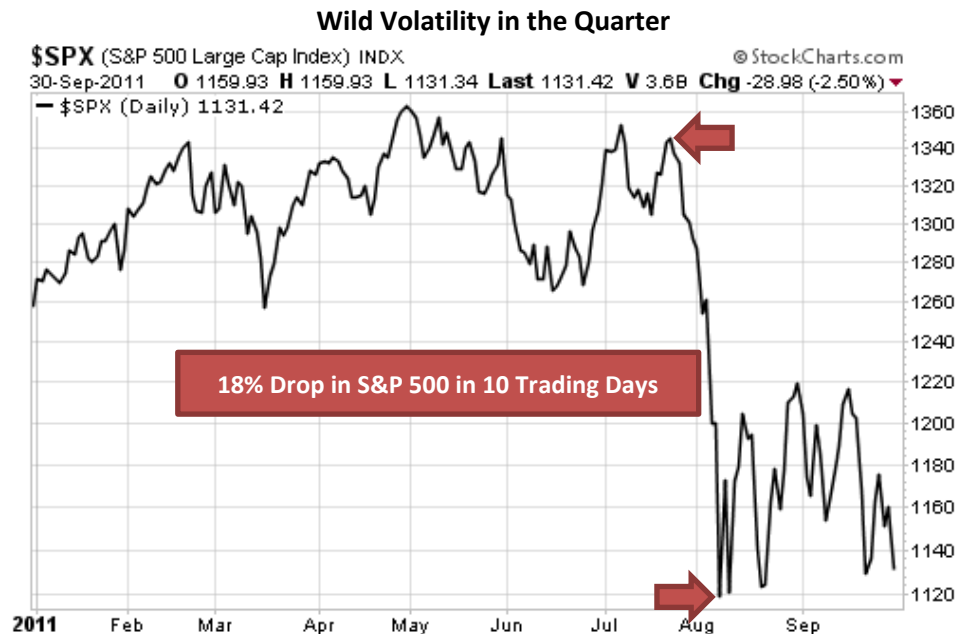
Amery Staub

While the quarter started out fairly quietly, events throughout the quarter contributed to significant declines in the global equity markets and dragged the major indexes into negative territory for the year to date. These events also led us to make a dramatic shift in Summit's market expectations. Depending on individual client situations, we raised cash and reduced equities in many portfolios. This letter is longer than most, but we want to take time to explain.

<u>Major Market Indexes</u>	<u>3Q</u>	<u>YTD</u>
Dow Jones Industrial Average	-11.5%	-4.0%
S&P 500 Index	-14.0%	-8.8%
MSCI EAFE Foreign Equity	-19.0%	-15.1%
MSCI World Index	-17.7%	-14.1%
Barclay's Aggregate Bond Index	3.8%	6.6%

Our concerns at the end of the second quarter were focused on the U.S. fiscal policy and debt ceiling debate along with the ongoing European debt crisis. During July, we saw progress stall on both fronts and the "temporary" supply disruption caused by the Japanese earthquake turn into a global economic slowdown. The news of a slowdown rapidly intensified the debt debates and created massive volatility in the equity markets. Additionally, the U.S. sovereign debt rating was downgraded from our historically high AAA status.

Confidence in both the willingness and ability of political leaders to solve problems was shaken, both in the U.S. by the behavior of the President and Congress and in Europe by politicians who seem to always be behind the curve. On both continents, politicians preferred to focus on saving their political lives rather than decisively saving their economies.



During the quarter, as a result of the news, the S&P 500 became unpredictable. We saw a waterfall 19% decline, followed by a 10% rally, followed by a 7% decline, followed by a 10% rally, followed by an 8% decline, followed by a 7% rally and then the 8% decline to end the quarter. October has added another 5% decline and now a 10% rally. The markets have become rumor driven, reacting exuberantly or despondently at political news trickling out of Europe, no matter how minor or inconsequential.

The wild volatility caused our internal models to signal that we should switch to playing defense and go into capital preservation mode. Our views were heavily influenced by two factors: 1) the possibility of a European debt meltdown leading to a freeze up in the banking system and producing a 2008-like decline and 2) a global economic slowdown that left equities vulnerable to much lower stock prices.

It is in this context that Summit repositioned many client portfolios by reducing equity exposure throughout the quarter. However, the markets moved down so rapidly in the beginning and the swings were so great during the interim that it was extremely difficult to time our actions perfectly. Many of these moves were geared towards volatility management both in the present and in the difficult environment we see continuing over the intermediate term.

With the possible consequences from a disorderly Greek default so dire, the upside for stocks seemingly limited by the sudden economic deterioration and continued policy uncertainty, reducing risk by significantly decreasing equity exposure appeared to be our best course of action. Next we will discuss in greater detail some of the concerns that we outlined.

### **Continued Volatility and Instability**

Investors are fleeing risk in response to a highly unstable economic and financial environment. Investor confidence today is as damaged as in 2008-2009. As traditional, longer term oriented investors withdraw from the markets, they leave a vacuum. This vacuum has been filled with technical traders with much shorter time frames and different objectives. High Frequency Trading programs, for instance, are estimated to be in excess of 70% of daily trading volume. As long as these kinds of investors are dominating, we expect higher levels of volatility.

### **Growing Sovereign Debt Contagion**

Markets have been vulnerable to the perpetual crisis environment in Europe, which is now in the acute phase. It is our major concern that no one wants to admit the real problems in Europe. Politicians want to do the minimum to “kick the can” down the road and postpone as much pain as possible. This is what the U.S. did in 2008, and it is our fear that a similar result could occur here.

As discussed in previous letters, the structural flaw of the European Union is the present arrangement of a monetary union without a fiscal union. EU nations all share the same credit card, but have no individual credit card limits. Additionally, since there is a shared currency, the traditional mechanisms used to keep less efficient countries competitive in the global economy (currency devaluation) are no longer available. This has resulted in the peripheral countries racking up huge amounts of debt (relative to their individual

GDPs) in order to maintain their current standard of living. Mind you that these countries have also been wasteful as they have binged on the cheap access to debt.

Now, they have put the entire Union at risk. We believe insolvent peripheral countries will either default and potentially exit the EU (going back to their former currencies), or there must be fiscal union where the debt will be monetized by the European Central bank. Defaulting and exiting the Euro is perceived as terribly disruptive and expensive, and a move toward fiscal union means countries have to give up many of their sovereign powers. The latter means that another elected European body would have control over individual country budgets, not a preferable option.

The search has been to find a middle ground solution. Much of the recent drama in Europe has been centered on the European Financial Stability Fund (EFSF). This is the 440 billion Euro package agreed to in July that was initially to be used to bail out Greece. This Fund has morphed in purpose from helping Greece, to buying sovereign debt, to recapitalizing banks, to being leveraged 10:1 and doing all the above.

Unfortunately, the existing size and scope of the EFSF are already being seen as inadequate. However, there has been such difficulty in getting current EU members to sign off on this deal that doing a secondary EFSF seems extremely unlikely. Much energy has been spent instead on finding the most effective way to use the limited resources that would not require another vote of European parliaments.

Fear is gripping the financial sector where banks may soon have to take big losses on bonds they own from governments with shaky finances, like Greece. That uncertainty is stifling lending -- both between banks and to the wider economy -- threatening to kill off a halting recovery in the 17-nation Eurozone and much of the rest of the world.

A recent example of our concerns would be the Belgian bank, Dexia. Dexia is the first victim of the new squeeze in European credit markets. The bailout/nationalization was triggered by other banks' increasing reluctance to lend to it due to its exposure to highly indebted Eurozone states like Greece and Italy and to struggling municipalities in the United States. Dexia received \$122 billion in guarantees from France and Belgium to secure borrowing for the next 10 years. To put this in perspective, Dexia's total credit risk exposure amounts to some \$700 billion according to Reuters, more than twice the size of the individual GDPs of Greece, Austria, and Sweden, and about double the individual GDPs of Belgium and Poland. Europe cannot afford to absorb many more liabilities like this.

No one knows exactly how events in Europe will play out. It seems futile to try to guess the shape and timing of the outcome. To actually fix the problems would require a tremendous amount of pain, and politicians have been reluctant to implement. Meanwhile, global markets gyrate based upon the latest rumor.

### **Continued Political Partisanship**

Governments and central banks are being forced to intervene in the markets like we have never seen before. Yet, policy makers, both here and in Europe, seem unable to do anything to inspire confidence from their constituents. We believe the failure of our leaders to address and confront our fiscal imbalances and to promote pro-growth policies

has been damaging. In our opinion, their actions, and inactions, have been destructive to confidence. As is often the case with politics, it appears problems must escalate to crisis to bring resolution. This has negative implications for markets near-term.

In the coming months, the American public will be subject to Congressional debate over the President’s recent jobs bill, the recommendations coming out of the “super committee,” the expiration of the “Payroll Tax Holiday,” the expiration of the Bush Tax Cuts, and of course, the 2012 Presidential election. Each of these events has the potential to cause distinct periods of stress and uncertainty for the markets.

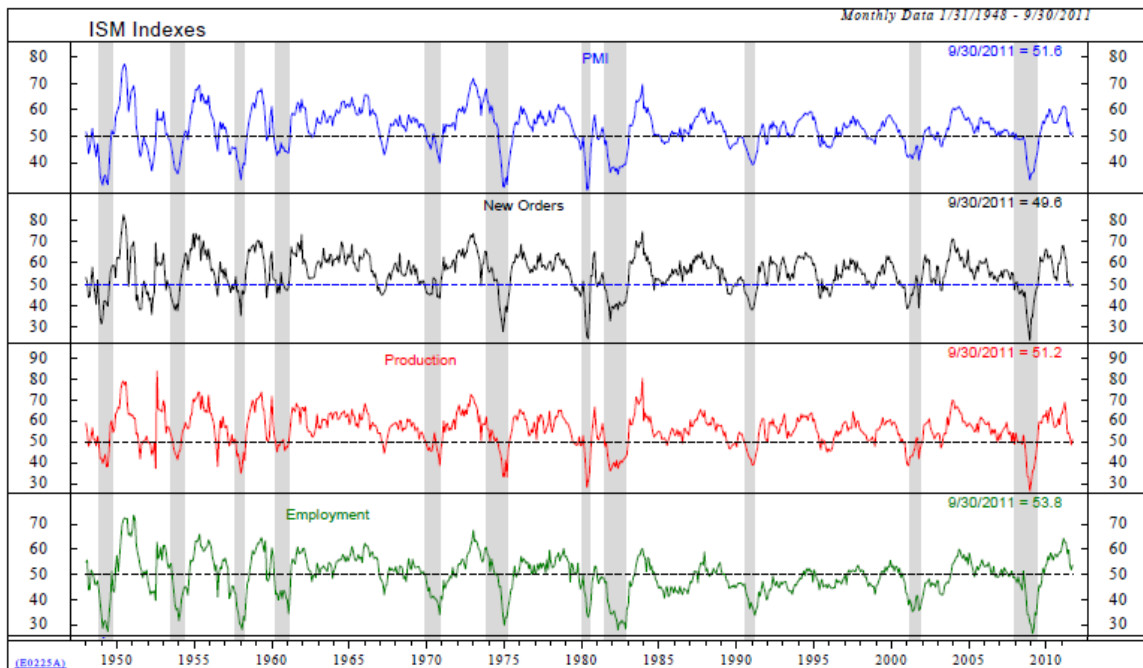
Because there is no clear policy direction for Europe or the U.S., investment decisions have become overwhelmingly dependent upon predicting the actions of politicians and bureaucrats. We want more confidence to put capital at risk and this requires a more clear view of the future.

**Current Economic Environment**

In the United States a massive credit bubble has left the economy with a huge debt overhang, draining demand, and record unemployment and low wages.

As mentioned, we had perceived the economic slowdown arising from the Japanese earthquake as temporary. However, a good deal of economic data released in the third quarter has given us reason to believe the slowdown may be lingering. First, revisions to GDP released during the quarter showed the first quarter grew at only 0.4% and at 1.3% in the second. Both were significantly below levels in 2010.

Many other economic indicators turned negative during the quarter. Below are various readings from the Institute of Supply Management. These are monthly measures of business activity. Generally, a reading above 50 suggests growing activity and below 50 suggests contraction in activity. It appears all elements have rolled over in the last three months. Although not at contraction levels, they are reasons for concern.

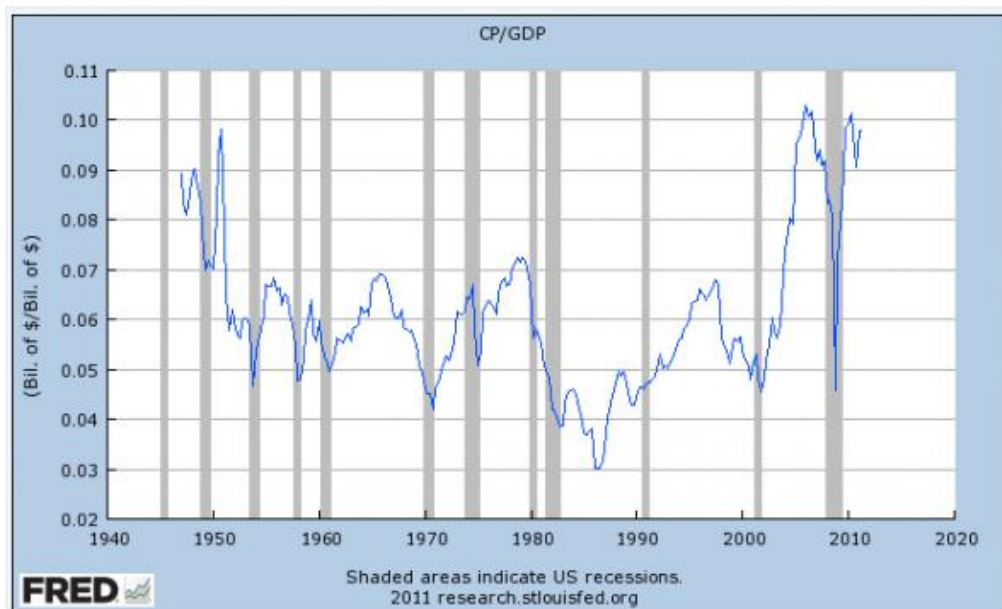


Although some economists believe the U.S. can avoid a recession, the Economic Cycle Research Institute, an authority in terms of forecasting economic cycles, recently stated:

“This is a done deal. We are going into recession. We’ve been very objective about getting to this point. A broad range – this is not based on one indicator – this is based on dozens of indicators for the United States – there is a contagion among those forward looking indicators that we only see at times of a business cycle recession. These leading indicators have a certain pattern that they present in front of a recession, and that is what we are seeing now.”

News trickling in so far in October has shown the deterioration moderating somewhat. We’ve been surprised on the upside by indicators such as retail sales and industrial production, but disappointed in consumer confidence and inflation. These are just additions to the murky outlook.

Another concern we have is the chart below:



Corporate profits as a percent of Gross Domestic Product are approaching record levels again. When this is coupled with corporate profit margins at record levels and wages as a percent of GDP at a record low, we think corporate earnings are vulnerable to contraction. As costs rise and margins get squeezed, earnings estimates will likely come down and stock prices come under pressure.

We are in the midst of a cycle where there is continual consumer and corporate deleveraging. Everyone is focused on improving his own balance sheet; this means reducing debt and increasing savings. The global buzzword is “austerity.” We must put home and abroad) equals less spending. Less spending equals less growth and a slower economy.

These examples, and many more, have caused us to become much more concerned about the short term expectations for returns in the equity markets. This has led to our pull back in equity exposure and concentration on capital preservation. That being said, in the short run, the markets will do what the markets will do. The reactions to rumors may lead to “sugar highs” in the market that we believe will not last. However, we are diligently analyzing the data and making the best capital allocation decisions we can. Should the information change, the problems appear to be fixed, or our initial analysis proves wrong, we will rethink the situation and make new allocation decisions.

In the immediate future this may have us holding larger amounts of cash than we would otherwise hold. In the intermediate term, it may have us utilizing investments outside the traditional stock and bond markets. In the event our concerns come to fruition, we hope to take advantage of the market disruptions and establish long term positions and under more favorable conditions.

If you have any questions, concerns, or if your situation has changed, please call, email, or come by.

Thank you for your continued trust in us.

*Summit Asset Management LLC*