

INVESTMENT UPDATE

Executive Summary

- It appears increasingly likely that the Federal Reserve has orchestrated a soft landing for the economy.
- We expect economic growth to slow to a more normal level of +3%-3.5% for the second half of this year and for 2007.
- Strong growth in corporate profits this year is evidence of a healthy economy and will eventually lead to higher stock prices.
- With commodity prices falling, a relatively stable dollar, and economic growth moderating, inflationary pressures appear to be abating. Core inflation should start to decline in 2007 to approximately +2.5%.
- The long-term bond market appears overvalued with the yield on the 10-year Treasury Note falling to 4.63% at the end of the third quarter. We recommend maintaining bond durations shorter than the benchmark duration of 5.1 years.

Federal Reserve

Despite a tenuous start for new Federal Reserve Chairman Ben Bernanke, it appears that the Federal Reserve is successfully engineering a soft landing for the economy. The Fed has been gradually removing the excess liquidity from the economy by increasing the Federal Funds rate 17 times since July 2004 from 1% to 5.25%. The Fed has finally found the right level of interest rates and liquidity as commodity prices are falling, economic growth is moderating to a more normal level, the dollar has stabilized, and the stock market is moving higher.

We believe Bernanke has been successful where many of his predecessors failed because he has more aggressively responded to forward-looking indicators, such as gold, commodities, and the inflation expectations. While it is still too early to get overly enthused about Bernanke's leadership, investors' confidence in the Fed has increased significantly. In time, this increased confidence will translate into higher stock prices through a lower risk premium.

Economy

Although there are signs of a slowdown, the economy remains healthy. In fact, the economy grew by +3.5% during the twelve months ending June 30th and at an even faster +4.2% annualized rate in the first half of 2006. Economic growth in the second half of 2006 appears to be slowing to a more normal +3.0%-3.5% growth rate. This is not surprising as the economy was overdue for a moderation in growth after expanding at an above-average rate for the past 3.5 years. In addition, the 17 interest rate increases and the removal of excess liquidity by the Fed over the last several years combined with over 100 interest rate

increases in the past year by Central Banks outside the U.S. is having the intended effect of bringing economic growth back to a more sustainable and non-inflationary level.

Our confidence in the underlying strength of the economy is based on the strong growth in corporate profits. Corporate income as measured by the S&P 500 has increased by +13% this year and over +50% since 2004 (see Chart 1). Corporate profits are the heartbeat of the economy. Government tax receipts, capital spending, consumer wages, and personal income are all dependent on businesses providing the jobs and profits that generate the payroll taxes, income taxes, dividends, and interest payments. Over time, the economy will flourish or flounder depending on the direction of corporate profits.

Chart 1: Strong Growth in Corporate Profits Illustrates the Underlying Strength of the U.S. Economy.



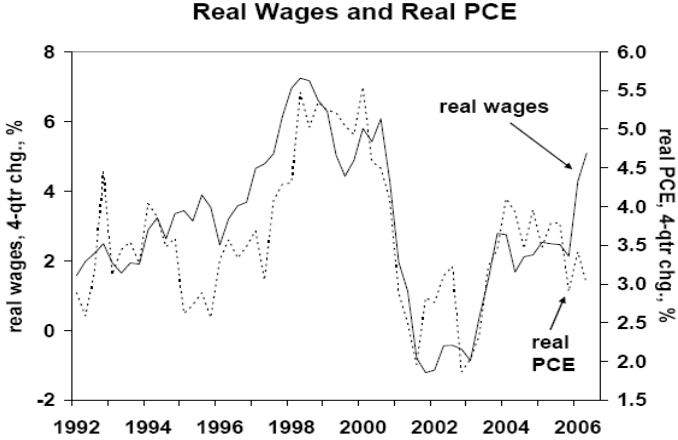
* 52-week forward consensus expected S&P 500 operating earnings per share. Time-weighted average of current and next year's consensus earnings estimates. Monthly through April 1994; weekly thereafter.

Currently, the corporate sector is in excellent financial health with strong balance sheets and rising profits (see Chart 1) providing the support for continued strong economic growth. The strong growth in corporate profits is being reinvested for future growth and showing up in healthy growth in corporate spending (+7.1%), commercial construction (+8.0%), employment growth in excess of 2 million net new jobs per year, wages and salaries (+7.7%), personal income (+9.4%) and tax receipts (+11.7%). U.S. companies are increasingly competitive on a worldwide basis, as exports have grown faster than imports over the last 1.5 years.

Despite concerns over a housing slowdown, consumer spending should continue to grow at a healthy level. The reason for our optimism is that most consumers base spending on their income and not the value of their home. The evidence of this is illustrated by the close relationship between the growth in real wages and real personal consumption expenditures over the last 14 years (see Chart 2). With real wages currently increasing at

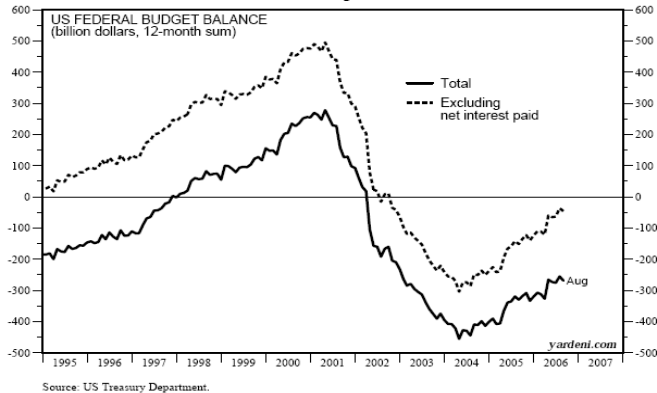
the fastest rate in the last five years combined with lower energy costs and a record level of consumer net worth, we are confident consumer spending will continue to grow despite the slowdown in home construction and a modest decline in home prices.

Chart 2: Strong Growth in Real Wages Indicates Consumer Spending Should Continue.



The continued strength in corporate and personal incomes has led to rapid growth in tax receipts in the last few years. Given the rapid growth in tax receipts and the decline in the budget deficit to under \$300 billion (see Chart 3), Congress is unlikely to rein in its liberal spending habits. This gives us confidence that government spending should continue to add to GDP growth. At some point, the government will need to watch spending more closely. However, at the present time the strong growth in tax receipts is more than offsetting excessive government spending.

Chart 3: Budget Deficit Declining Rapidly Due to Strong Growth in Tax Receipts.



Inflation

Inflationary fears have subsided as the markets have regained confidence that the Fed will not let inflation get out of control. We are now seeing signs of success with oil and commodity prices declining and the value of the dollar stabilizing. Other factors such as the return of Asian import price deflation, rapid increase in productivity that is offsetting much of the increase in labor costs, and the multiple interest rate increases by Central

Banks in the past year have also reduced inflationary pressures. The overall rate of inflation as measured by the consumer price index (CPI) peaked in September 2005 at +4.7% and is currently at +3.8% and heading lower. Core inflation, which excludes the volatile food and energy components, has been trending modestly higher at +2.8%, up from +2.2% in 2005 and 2004. We expect the core inflation rate to rise modestly in the fourth quarter to +2.9% before declining back towards the 10-year average of +2.3% in 2007.

Bond Market

The yield on the 10-year U.S. Treasury Note at the end of the third quarter was 4.63%, down from 5.14% at the end of the second quarter and up from 4.39% at the start of the year. Our fixed income benchmark, the Salomon Broad Investment Grade Bond Index, produced a total return of +3.9% in the third quarter and +3.0% for the first nine months of the 2006. With long-term interest rates below the Fed Funds rate, bond investors are anticipating a significant economic slowdown or a recession. We disagree with their assessment and continue to recommend a shorter-than-average duration for bond portfolios in anticipation of an increase in the 10-year U.S. Treasury Note yield to 5.25% by year end based on 2.50%-2.75% expected core inflation and a 2.50%-2.75% real return.

Stock Market

The large capitalization S&P 500 Index finished with a +5.7% return in the third quarter after being down as much as -3.0% during the period. Through the first nine months of the year, the total return of the S&P 500 was +8.5%. The third quarter returns on the smaller capitalization stocks (Russell 2000) and foreign equities (EAFE) were +0.4% and +3.9%, respectively. This was the first quarter that the S&P 500 had outperformed the Russell 2000 and the EAFE since the second quarter of 2004. We expect this trend to continue throughout the next six to 12 months. During the first nine months of the year, the Russell 2000 and EAFE indices advanced by +8.7% and +14.5%, respectively.

The stock market rebounded in the quarter as investors reacted positively to the Fed decision to maintain interest rates at 5.25%, signs that the inflation scare was receding, continued strong earnings growth, and the end of the Israeli and Hezbollah conflict. As long as there is not a major escalation in terrorist activity, stocks are poised to continue moving higher, driven by increasing confidence that the Fed has managed an economic soft landing, continued growth in corporate profits, and lower oil prices. At 15.7x 2006 expected earnings per share and 14.1x 2007 earnings, the stock market valuation is very attractive, especially considering the current level of interest rates.

In accordance with SEC Rule 204-3(b), our Form ADV Part II is available upon request. Please call or write to Susan C. Beaver, North Star Asset Management, Inc., P.O. Box 8012, Menasha, WI 54952-8012