

INVESTMENT UPDATE

Executive Summary

A combination of +3% economic growth, low inflation and interest rates, favorable election results, and the return of corporate profit growth reminded investors that all is not wrong in the world and contributed to a +8.4% increase in the S&P 500 for the quarter. The rally was temporarily put on hold in the last weeks of the year as trepidation over the escalating Iraqi conflict partially offset these positive fundamentals. The market still does not seem to be discounting the strength and resiliency of the economy that has withstood an incredible combination of negative developments including terrorism, war, accounting scandals, and disappointing earnings which have battered investor, business and consumer confidence. For the economy to have grown an estimated +3% in 2002 despite these impediments is remarkable. Assuming the Iraqi conflict is resolved without a major setback, the economy should strengthen throughout 2003, leading to higher corporate profits and positive equity returns. Eventually, as investors begin to focus on improving fundamentals, the market psychology and valuations will improve. Patience and continued commitment to equity investing will once again prove to be rewarding. The bond market is a different story as a stronger economy and a weaker dollar is likely to push interest rates higher in 2003. The extremely low yields are not enough to compensate for this risk, indicating a shorter-than-average duration for our bond portfolios.

Economy

Economic growth resumed in 2002 but not as robustly as anticipated or as compared to the average of the previous six recoveries (See Chart 1, Figure 1A). This should result in a longer and more sustainable recovery in both economic growth and corporate profits. Economic growth should accelerate next year to +3-4% from the +3% year-over-year growth in 2002. It should be remembered that the rate of economic growth coming out of the 1990-91 recession was even slower than this recovery (with similar concerns being raised) but it then set the stage for an unprecedented 10 consecutive years of economic expansion and a rising stock market (See Chart 1, Figure 1B).

The combination of rapid money supply growth by the Federal Reserve, increased government spending, additional tax cuts, and the weaker dollar should provide more than enough

stimulus to offset any short term economic weakness caused by the Iraqi conflict, higher oil prices or any unanticipated shocks to the economy.

CHART 1: Current Recovery Versus Typical Recovery from Recession

Figure 1A. Compared To Past Expansions, The Current Advance In GDP Is Below Average...

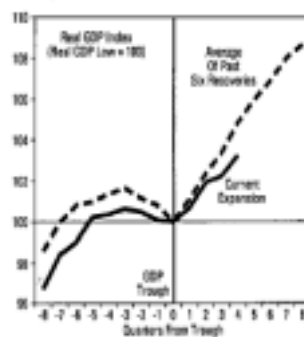
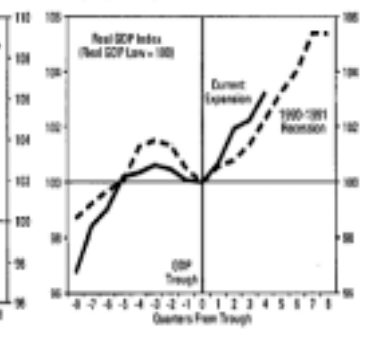


Figure 1B. ...But Compared To The Single Prior Cycle, The Current One Has Been Slightly Stronger



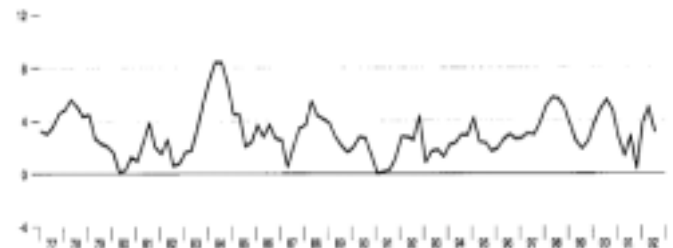
Note: Latest data are for third quarter 2002.
Source: U.S. Department of Commerce.

Strong consumer spending throughout the recession minimized the economic decline but is also reducing the subsequent recovery, as there is little pent-up demand to drive above-average growth. Regardless, consumer spending should continue at a reasonable pace due to strong real disposable income growth (see Chart 2), lower mortgage rates allowing consumers to reduce their monthly mortgage payments, and the aging of the baby boomlet which represents 100 million people 26 years or younger who are just starting to enter the workforce and buy homes, cars, etc.

CHART 2: Increased Personal Income Supports Higher Spending

Real Disposable Personal Income

Percent change from year ago, quarterly data



There has been a sizable increase in consumer indebtedness over the last decade, but when taken in context of an increase in home values, the significant decrease in interest rates, the growth in home ownership versus renting, and the increase in

real disposable incomes, the level of debt and debt service ratios are not overly worrisome at this point.

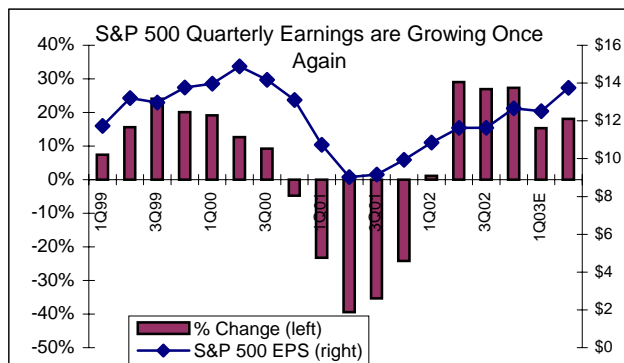
Capital spending should begin to strengthen in 2003, as many believe it is at or near maintenance levels. Longer term, the benefits of investing in new equipment and technology to increase productivity, competitiveness, and corporate profitability are too great for capital spending not to recover. In a global economy, the only way U.S. companies can compete with cheap foreign labor is to increase productivity through the use of better equipment and technology.

Equity Market

Just as many pundits were advising clients to abandon stocks, the S&P 500 rebounded with a +8.4% quarterly return. The S&P 500 was up as much as +15% during the quarter, but anxieties over the escalating Iraqi conflict temporarily halted the recovery. During the quarter the total return for the large capitalization S&P 500 Index outperformed the returns from smaller capitalization stocks (Russell 2000 Index: +5.8%) and foreign equities (EAFE Index: +2.7%). Despite the recovery in the fourth quarter, the markets were down considerably for the full year with the S&P 500 Index return at -22.1%, Russell 2000 Index at -21.6%, and EAFE Index at -17.7%.

When all is said and done, corporate profit growth is the key factor that drives stock prices in the long run. While the economic recession was relatively short-lived and mild, corporate profitability went through a severe profit recession in 2000 and 2001 (See Chart 3). This helps explain the magnitude of the decline in the market in 2000 and 2001. However, corporate profit growth resumed in the first quarter of 2002 and increased by approximately 30% for the year. With a +20% increase in corporate profits expected in 2003, profits (as measured by the S&P 500 on a quarterly basis) should exceed 2Q00 peak earnings by the end of 4Q03.

CHART 3: Corporate Profit Growth Has Returned



With a decline in the S&P 500 of -40% from its peak and earnings expected to exceed record levels within the year, it appears as if a significant opportunity exists and that patient

investors will be rewarded. The case for owning stocks strengthens considerably by also considering that individual investors as a group (the best contrary indicator) are selling stocks to buy bonds and money market instruments, P/E ratios are very reasonable at 16 times 2003 EPS estimates, interest rates are at extremely low levels, and dividend yields on stocks are higher than money market rates.

The inevitable military effort to remove Saddam Hussein from power in Iraq carries with it many of the same uncertainties that were faced 12 years ago during the last Gulf war, i.e. human and financial costs, escalation, weapons of mass destruction, oil prices, etc. Although the uncertainties and related market pressures will likely remain until the battle commences, we anticipate that the effort will be abbreviated, contained, and successful. The silver linings in this cloud will hopefully involve a reduction in the threat of terrorism, increased oil supplies and lower energy prices, and a catalyst to renew investor confidence and improve economic growth.

Bond Market

The yield on the 10-year U.S. Treasury Bond increased from 3.59% at the end of the third quarter to 3.82% at the end of the year. Although interest rates increased in the quarter, our fixed income benchmark, the Salomon Broad Investment Grade Bond Index, produced a total return of +1.6% for the fourth quarter as corporate spreads narrowed versus U.S. Treasury securities. The index increased by +10.1% for the year as bonds served as a safe haven from the volatile equity market, and the threat of war, while also benefiting from muted inflation (+2.38% CPI during the past 12 months) and a sluggish economic recovery. We continue to recommend a shorter-than-average duration for bond portfolios in anticipation of a rise in both short and longer-term interest rates by the middle of 2003.

Management Meetings

During the last six months of 2002, in addition to having teleconferences with various corporate executives, members of our investment team have traveled to San Francisco, Atlanta, Minneapolis, Washington DC, and Los Angeles to meet with management from Merck, International Multifoods, Bemis, Patterson Dental, Best Buy, ADC Telecom, JDS Uniphase, Sun Microsystems, Xilinx, AES, Amcore Financial, Power One, Public Storage, Mentor Corp, Human Genome Sciences, Xcel Energy, US Bancorp, McKesson, Genentech, Intel, National Semiconductor, Solectron, Equifax, Home Depot, Coca Cola, and United Parcel Services. Please contact us if you have inquiries about any of these meetings.

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.

