

INVESTMENT UPDATE

Executive Summary

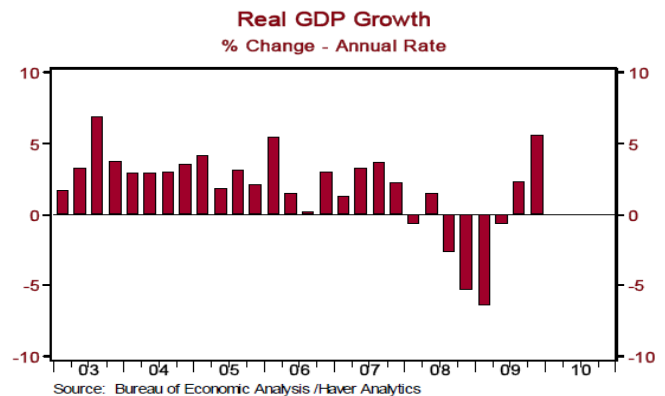
- Despite the strong stock market recovery, we still believe that equities remain undervalued and attractive for long-term investors.
- Stimulative monetary policy is expected to continue through much of 2010 and into 2011 and is more than offsetting the concerns about increased government spending and upcoming tax increases.
- Real GDP growth of +3% is expected through 2011.
- Corporate profits are growing rapidly and will eventually lead to higher employment and capital spending.
- Interest rates are headed higher. Stay relatively short.

Stock Market – Stay the Course

The stock market continued its recovery in the first quarter with its fourth consecutive positive quarterly return. For the quarter, the S&P 500 increased by +5.4%, while the Russell 2000 and EAFE indices rose by +8.8% and +0.1%, respectively. In a little over a year, the stock market, as measured by the S&P 500, has produced an incredible +75% gain from the March 9th intraday low of 666. Despite this strong recovery, we still believe the stock market remains undervalued and attractive for long-term investors. The fundamentals that could move stocks higher include a very stimulative monetary policy, a solid economic recovery, low interest rates, a strong credit market, better-than-expected earnings growth, a relatively low valuation, near record level of cash sitting on the sidelines and high short interest. Offsetting some of these positive factors are the increased size of government spending relative to the size of the private sector, the large Federal budget deficit, and the impending tax increases to pay for the increased government spending and reduce the budget deficit. At this point, we believe the positive factors outweigh the concerns and anticipate the S&P 500 approaching 1,450 over the next 12-18 months.

The Federal Reserve has been extremely stimulative in its monetary policy for the last two years (see Chart 1). Monetary stimulus has a very powerful impact on the economy, but only after a lag of approximately 12-18 months. Right on cue, the economy bottomed in June 2009 (roughly 18 months after the Fed became very aggressive with its monetary policy) and has picked up strength and sustainability in each of the last three quarters (see Chart 2). With the Fed expected to leave interest rates at or near these extremely stimulative levels for most of 2010, the economy and stock market will have a significant tailwind in 2010 and 2011. If monetary policy was the only factor to consider, we would be forecasting +6-8% growth for both 2010 and 2011. However, the combination of the relatively weak banking system, the restrictive impact of upcoming tax increases, the increasing government involvement in the private sector, and the extremely conservative mindset of businesses will partially offset the stimulative monetary policy leading us to forecast only +3% real GDP growth in 2010 and 2011.

CHART 2: Stimulative Monetary Policy Starting to Take Hold.



Despite the improvement in the economy over the last nine months, corporations have been slow to expand their businesses and hire new employees due to the concerns over economic growth, increased tax burdens, and uncertainty regarding health care legislation. We believe this is about to change as businesses are becoming more confident in the economy, the uncertainty around the health care legislation has been reduced, and corporate profits have rebounded. After declining by -39% in 2008, corporate profitability stabilized in the first half of 2009 and has been growing rapidly ever since. Corporate profits, as measured by the S&P 500, are expected to increase by +37% in 2010 and by +16% in 2011 (see Chart 3). Due to the strong growth in corporate earnings, the S&P 500 still appears relatively undervalued at 14.2x our 2010 earnings per share (EPS) estimate and only 12.3x our 2011 estimate.

CHART 1: The Economy and Stock Market Will Have a Tailwind in 2010 and 2011 From the Highly Stimulative Monetary Policy.



CHART 3: Corporate Profit Growth is Driving the Stock Market Higher.

S&P 500					
Year	EPS	Change	S&P	Change	PE Ratio
2007	\$90.00	+2.8%	1468	+3.5%	16.3x
2008	\$54.90	-39.0%	927	-36.9%	16.9x
2009	\$60.00	+9.3%	1115	+20.3%	18.6x
2010E	\$82.00	+36.7%	1169	+4.8%	14.2x
2011E	\$95.00	+15.9%	1169	+0.0%	12.3x

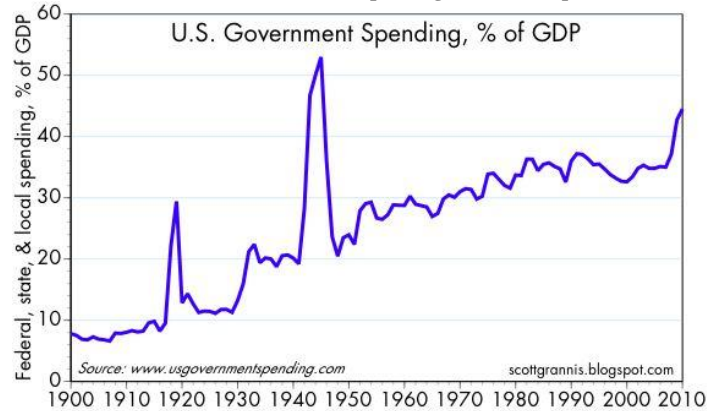
This strong profit growth is propelling the stock market higher and is setting the stage for self-sustaining economic growth in the future. The virtuous cycle of economic growth in which increasing demand drives higher corporate revenues and profits leading to an improvement in employment and capital spending which results in higher end demand has not yet kicked in due to the lack of employment growth and a subpar recovery in business spending. The strong rebound in corporate profits is starting to give businesses the confidence and the wherewithal to take additional risks, expand their operations, and increase employment. We believe there will be more evidence of the economy transitioning from a recovery into a self-sustaining expansion in the second quarter with positive employment growth and a pickup in business spending. This will be quite positive for the stock market as it will enhance corporate earnings and the price investors will be willing to pay for those earnings (the PE ratio).

So far, the stock market recovery has been primarily based on the ending of recession and the strong rebound in corporate profits. Investor psychology has remained quite pessimistic as evidenced by the high level of cash holdings (over \$3 trillion in money market funds and over \$10 trillion in money market, checking accounts, savings accounts and short term CDs), the net redemptions out of domestic stock mutual funds in 2009, the near record level of short interest (3.5% of shares outstanding are short versus a typical 1.5% level throughout the 90s), and relatively low PE ratios. It appears that investor psychology is beginning to improve as domestic stock fund flows have turned modestly positive in the first quarter, money market fund balances are beginning to shrink, short interest has fallen modestly, and PE ratios are expanding after declining for most of the last ten years. If investor psychology continues to improve, it will prove quite profitable for investors. For instance, assuming a more normal 15x PE ratio, the S&P 500 has upside of +20-25% over the next 12-18 months.

Typically with the economy improving, corporate profit rising rapidly, and low interest rates, one would expect the PE ratio on the stock market to be much higher than the current 12-14x. The reason PE ratios and investor confidence remain subdued is that many investors remain skeptical of the economic recovery. They are concerned that the large budget deficit, the anti-capitalistic policies of Congress, and the increased size of government spending relative to the size of the private sector

(see Chart 4) will lead to higher taxes and lower economic growth as the public sector “crowds-out” private spending. We agree that the increased taxes and bigger government will be a drag on economic growth and the stock market recovery. However, we believe that the strong monetary stimulus and recovery in corporate profits will outweigh these headwinds, resulting in modest growth and a strong move in the stock market over the next 12-18 months. In addition, it appears that the private sector is finally standing up and demanding fiscal responsibility at the local, state, and national levels. In time, this should lead to a more fiscally responsible government and a lower budget deficit.

CHART 4: The Rise in Government Spending Needs to Stop!



Bond Market – Stay Relatively Short

Interest rates were mostly unchanged in the quarter with the yield on the 10-year U.S. Treasury Note remaining at 3.83% and the 1-year U.S. Treasury Note yield decreasing modestly from 0.44% to 0.38% in the quarter. The Salomon Broad Investment Grade Bond Index produced a total return of +1.5% in the first quarter. Interest rates remain at very low levels due to the Fed’s guidance that it will maintain extremely low interest rates for an extended period. Nonetheless, with the economy recovering, inflation close to 2.2% and monetary and fiscal policies still extremely stimulative, we believe the 10-year U.S. Treasury yield is headed toward 5.0% and the Fed will have to start raising rates sooner than expected. As a result, we continue to recommend a shorter-than-average duration for bond portfolios.

Although a rise in interest rates could lead to a temporary correction in stock prices, we believe higher interest rates are a positive sign that the economic recovery is transitioning into a self-sustaining expansion. We would use any weakness as a buying opportunity and recommend maintaining our stock allocation towards the upper half of one’s targeted range.

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, Wisconsin 54952-8012