

## INVESTMENT UPDATE

### Executive Summary

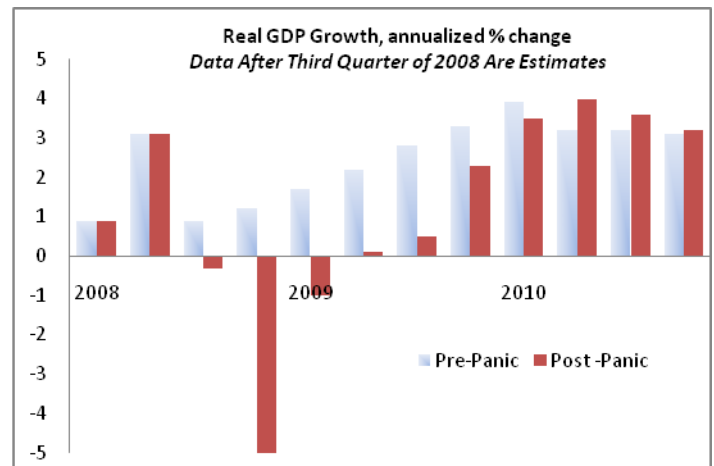
- The brutal bear market in equities (-52%) has been a function of the collapse in confidence in the financial markets as a result of the Lehman bankruptcy. The turmoil in the financial markets has spread into the economy resulting in a severe economic recession.
- The aggressive actions by the Federal Reserve and central banks around the world will eventually re-ignite global growth. The economic recovery should start in the second half of 2009.
- We are cautiously optimistic that the worst is behind us and the opportunity to rebuild wealth is forthcoming. Stock valuations are at historic lows and there is a record amount of cash ready to be invested. U.S. Treasury interest rates are at extremely low levels.
- Investors should start to become somewhat more aggressive by reducing cash positions, rebalancing equity ratios back up, and adding more corporate bonds to fixed income portfolios.

The last year was an extremely painful period for investors. The bankruptcy of Lehman Brothers was the key event that damaged investor confidence and pushed the economy into a severe recession. The Lehman bankruptcy was a huge blow to the financial system that sent shockwaves around the world. The first aftershock happened two days after the Lehman bankruptcy when the oldest and one of the largest money market fund providers, known as the Reserve Funds, announced that three of its money market funds had lost money. Suddenly, even the perceived safest of investments, money market funds, were too toxic to own. That started the worldwide panic as investors fled money market funds, corporate bonds, stocks, real estate, and commodities in order to buy the only perceived "safe" investment, U.S. Treasuries. The initial drop in the bond and stock markets resulted in additional panic selling and forced liquidations of hedge funds which further pressured the stock market downward in a vicious cycle.

Making matters worse, the loss of confidence in the financial markets and the lack of adequate access to credit spilled over into the real economy. The banking industry, already under duress due to falling home prices and increased mortgage delinquencies, became even more cautious after the Lehman bankruptcy and hesitated to loan to each other, let alone to customers. With access to credit drying up, confidence in the financial markets lost, and significant losses in net worth, both

consumers and businesses quickly cut back on spending and hoarded cash. As a result, instead of expecting modest economic growth in the second half of 2008 with faster growth throughout 2009, the economy quickly and decisively started to contract at the end of the 3<sup>rd</sup> quarter. The contraction has continued into the 4<sup>th</sup> quarter of 2008 and a recovery is not expected until the second half of 2009 (See Chart 1).

Chart 1: Everything Changed After the Lehman Bankruptcy



Even though the economy is currently working through one of the deepest recessions since the Great Depression, we are cautiously optimistic that the worst is behind us and the opportunity to rebuild wealth is forthcoming. Most of the market decline in the last three months was attributable to the loss of confidence in the global financial system and the perceived inability of the world's governments to get the financial markets flowing again. These declines were not based on fundamental analysis, but on a "sell first, think later" selling panic. In the last few weeks, there are signs that confidence in the financial markets is returning, albeit gradually, and that the panic selling has ended. We point to the decline in investment grade bond yields (see Chart 2 on the next page) and the increase in stock prices. While there is still a long way before the markets return to normal, the stabilization of the financial markets is an encouraging first step in the healing process.

Addressing the collateral damage to the global economy is the second step in the healing process. The response from the Federal Reserve, foreign central banks, the U.S. government and governments around the world has been unprecedented in its size and scope and will have a significant positive impact on economic growth in time.

The Federal Reserve has aggressively lowered the Federal Funds rate to an extremely stimulative range of 0.0%-0.25%. Unlike earlier in the year when lower Federal Funds rates were associated with rising commodity prices and mortgage rates (which offset much of the stimulative benefit of the Fed's initial reductions in Federal Funds rates), commodity prices and mortgage rates are now falling. The lower commodity prices act like a huge tax cut for businesses and consumers through lower gasoline prices or raw material costs. With mortgage rates dropping to record low levels, another mortgage refinancing boom is currently underway, freeing up additional cash flow for consumers. In addition to the Fed adding a record level of monetary stimulus, the Treasury has pumped billions into the banking industry to help stimulate lending. President-elect Obama is working on a \$750 billion stimulus plan and has assembled a sound economic team to help navigate the economy through these difficult times. The central banks in India, China, Australia, England and Europe have all lowered interest rates significantly. In time, the extremely stimulative monetary policy, aggressive fiscal spending, mortgage refinancing boom, and lower commodity prices will re-ignite economic growth and bring life back to the financial markets. It is not a matter of "if", but "when" this will happen. We believe that the recovery will start in the second half of 2009.

Corporate Bond index was down -4.7%. As investor confidence is restored in 2009, this performance differential will reverse as we expect the spreads on corporate bonds versus Treasuries to narrow dramatically.

The stock market finished the year down -38.5% for the third largest annual decline in history. Only the -47.1% drop in 1931 and the -38.6% decline in 1937 were larger. From the top of the market in October 2007 to the bottom in November 2008, the S&P 500 fell -51.9%, the second largest drop since the -83.4% decline from Sept 1929 to June 1932. International stock markets were worse last year with a -43.4% decline in the EAFE index, partly due to the recent strength in the U.S. dollar.

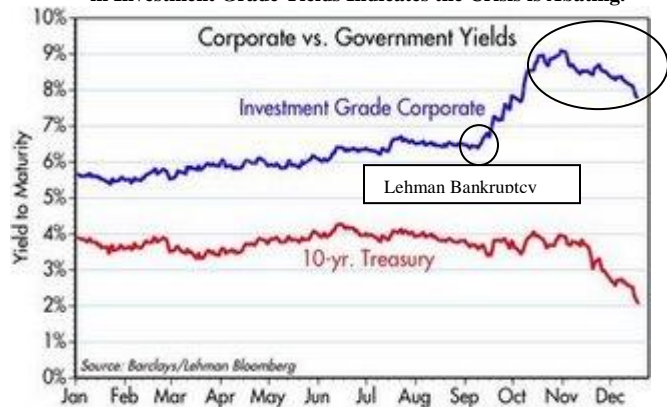
The stock market appears to be currently discounting a significant recession, further credit market dislocations, and a lackluster economic recovery. Stock market valuations are back to lows not seen in decades and yet it seems as no one wants to own stocks. In addition, investors have indiscriminately sold stocks, regardless of fundamentals factors. Over 50% of the S&P 500 was selling at less than 10 times estimated earnings. The last time this happened was in the 1970s when interest rates were significantly higher. Just as the market peaks are generally associated with irrational exuberance, bottoms are reached when there is an equally irrational pessimism.

A good indicator of irrational pessimism is the huge increase in cash and money market holdings. At the bottom in November, the amount in interest bearing savings account and money market investments had grown to \$8.5 trillion, more than the value of the entire U.S. stock market as measured by the Wilshire 5000. Even after the market has rebounded off of the bottom, interest bearing savings accounts and money markets currently represent approximately 75% of the value of the stock market, more than any time in the last thirty years prior to the last three months. Another sign of excess pessimism is that the 3.0% dividend yield on the S&P 500 exceeds the yield on the 10-year Treasury Bond (2.2%) for the first time in 50 years. With money market yields nearing zero, inflation at 1%, core inflation at 2%, investment grade corporate bonds yielding around 4-7% and a 3% dividend yield on the S&P 500, there will be pressure and incentive for investors to look for higher yielding investments such as corporate bonds and stocks.

Our philosophy of investing in high quality companies at attractive prices will help us weather this storm. The recovery will take some time and there will be numerous detours along the way. Nonetheless, we believe the healing process is underway and the stock market will be considerably higher in the years ahead. Therefore, we are suggesting a moderately more aggressive investment strategy that involves reducing cash positions, rebalancing equity ratios back up, and adding more corporate bonds to fixed income portfolios.

*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*

**Chart 2: Treasury Yields Fall to Record Low Levels & the Recent Decline in Investment Grade Yields Indicates the Crisis is Abating.**



Treasury Bills, Notes and Bonds benefited from the panic selling of corporate bonds and stocks driving interest rates to record low levels. At the end of the year the one month Treasury Bill was yielding 0.01% with the three month Treasury Bill yielding only 0.35%. Longer term Treasury rates also fell considerably with the 5, 10 and 30 year Treasury bonds yielding only 1.5%, 2.2% and 2.7%, respectively. (See Chart 2 above for yield information on the 10 year Treasury Bond.) With inflation running at 1% and core inflation still at 2%, Treasury yields are extremely stimulative to economic growth but appear to be at unsustainably low levels. Corporate bond yields did not follow Treasury yields lower as panic selling and recessionary fears drove corporate bond rates higher (see Chart 2). For the year, the Salomon Broad Bond Index (which is 70% Treasuries) increased by +7.0% while the Intermediate Investment Grade