

INVESTMENT UPDATE

Executive Summary

- The economy has stabilized as the aggressive actions by the Federal Reserve, U.S. Treasury and central banks around the world along with the natural healing powers of a capitalistic economy have taken hold.
- Stocks rebounded sharply as the economy began to stabilize. We anticipate another significant increase in the stock market when more concrete signs of economic growth, not just stabilization, return later in the year or early in 2010. Stock valuations remain very attractive and there is a record amount of cash available for potential investment.
- U.S. Treasury interest rates increased from extremely low levels. Despite the increase, U.S. Treasury rates remain relatively low and unattractive for long term investors.
- Investors should continue to reduce cash positions, gradually increase equity ratios, and add more corporate bonds to fixed income portfolios.

Economy

Although the economy still faces a number of challenges as corporate and consumer confidence remain very fragile, unemployment is at extremely high levels, and many states have significant budget issues, it appears that the aggressive moves by the Federal Reserve and the Treasury to stabilize credit markets and boost economic growth are starting to take hold. The economy exhibited signs of stabilization and even a few initial signs of growth in the second quarter. After -5.5% economic growth in the first quarter, we expected only a modest -1% decline in the second quarter followed by +1-2% growth in the third quarter and +2-3% growth in the fourth quarter.

Some of the key reasons for our optimism that the economy has stabilized and the cycle of growth is re-starting include:

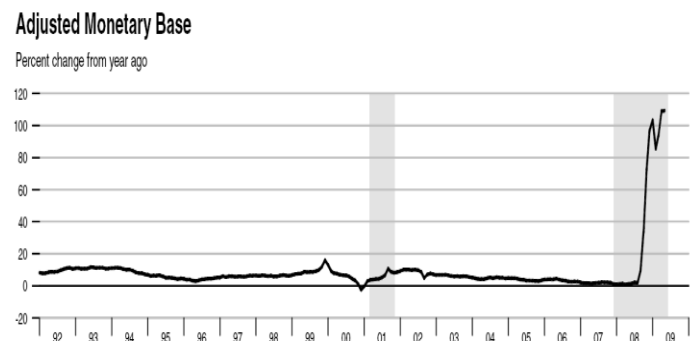
- The stabilization in the economy has coincided with a dramatic recovery in the stock market, despite the bankruptcies of GM and Chrysler, as fears of financial Armageddon have proved unfounded.
- The corporate credit markets appear to be working properly again. That is a great sign that the economic recovery is sustainable because the freezing up of credit was instrumental in causing the stock market panic and the sharp slowdown in economic activity.
- Retail sales have been very resilient with year to date sales up at an annualized rate of +2.6% through May.
- Real disposable after-tax income was up +1.6% in May, +1.3% in April and +8.7% in the last six months annualized.

- The savings rate has increased to 6.9% from 0% a year ago, the highest rate since 1995 and above the 30-year average savings rate of 5.4%. The higher savings rate will generate more than \$750 billion annually that will be available for debt reduction, increased savings and investments. The fact that consumers have been able to improve their savings rate so quickly bodes well for a strong economic recovery once they regain greater confidence in the economy and their own financial situations.
- New and existing home sales are showing signs of bottoming.
- The banking and insurance industries have been able to take advantage of the improvement in the bond and stock markets by raising much needed capital through debt and stock offerings. The additional capital significantly reduces the threat of a financial meltdown.
- Weekly unemployment claims peaked in January and have been trending lower ever since.
- Durable goods orders are starting to improve with both May and April orders up +1.8%.
- The natural adjustment process of the economy is well underway as corporations have reduced costs aggressively. They have also cut production to below end-demand levels resulting in the largest three month decline in inventories in the last 40 years. As the economy turns up, corporations' profitability will quickly improve, giving them the financial wherewithal to increase production and employment, restarting the cycle of growth.

Federal Reserve Policy

The Federal Reserve continues to be extremely aggressive in its attempt to revive economic growth. To put this in perspective, the Federal Reserve has doubled the size of the monetary base in the last six months (see Chart 1). In the short term, the excessive stimulus is helping end the recession and will, most likely, drive above-average economic growth in 2010.

Chart 1: The Excessive Stimulative Policy of the Fed Will Re-Ignite Economic Growth and Inflationary Pressures.



Longer term, we are concerned that the Fed is being too aggressive in its efforts to stimulate the economy, which will eventually be reflected in higher inflation sometime in 2011-2013. Higher inflation is not a foregone conclusion as the Fed may be able to withdraw this excess money from the financial system after it has helped restart economic growth and before it causes too much damage. Our concern lies in the fact that the Fed tends to be reactive, not proactive, to changes in economic activity, meaning the Fed will most likely error on the side of too much stimulus.

Fiscal Policy

The Obama Administration's anti-capitalistic policies of higher taxes, bigger government, and constant attacking of the business community continue to frustrate and scare investors. We believe the stock market would be considerably higher in anticipation of a typical economic recovery if the Obama administration would become more investor friendly. President Obama's first budget proposal represents the largest increase in government spending since WWII and the largest budget deficit in the history of the United States (see Charts 2 & 3). Making matters worse, the anticipated \$1.3 trillion budget deficit is before the true costs of Obama's healthcare reform proposals (estimated at over \$1 trillion over the next five years) are factored in.

Chart 2: Significant Increase in Proposed Spending a Concern.

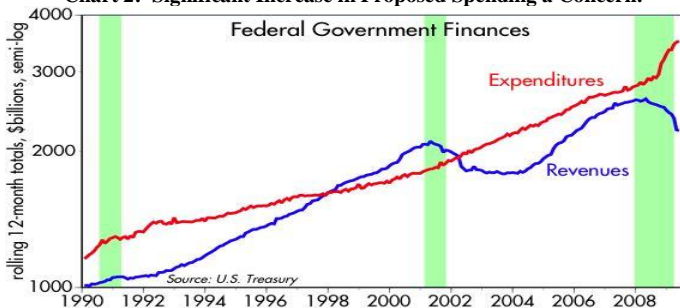


Chart 3: Excessive Government Deficits a Huge Concern for Investors.



Much of the increased spending was intended to help stimulate the economy. However, the vast majority of the stimulus money and the incremental budget spending will not have an impact on the economy until 2010, long after the economy could have used the stimulus. Investors are deeply concerned by the prospect of massive increases in the size of government and its attendant rise in tax burdens and interest rates, both of which represent a

significant drag on economic growth. We attribute some of the increased savings rate (and subsequent lower economic growth) as a proactive response by consumers to scale back on spending in anticipation of higher taxes. Fortunately, it appears that Congress is finally starting to put the brakes on many of President Obama's most radical ideas.

Bond Market

The yield on the 10-year U.S. Treasury Note at the end of the first quarter was 3.52%, up from 2.69% at the end of first quarter and 2.25% at the start of the year. Shorter term interest rates remain at extremely low levels with the 1, 3, and 5 year Treasury Notes yielding 0.47%, 1.61%, and 2.53%, respectively. Despite the sharp rise in Treasury rates, the Salomon Broad Investment Grade Bond Index produced a total return of +1.2% in the first quarter and +1.4% in the first half of 2008 as corporate bond spreads narrowed significantly. The increase in U.S. Treasury rates is a positive signal confirming that the credit crisis is ending and that the economy is recovering. Further evidence that the bond market is improving is that corporate bond spreads have narrowed and new bond issuance has improved significantly. Nonetheless, with core inflation hovering around +2.0% during a recession and given the extremely stimulative monetary and fiscal policies, we believe U.S. Treasury rates are headed higher. As a result, we continue to recommend a shorter-than-average duration for bond portfolios.

Stock Market

Investors responded very positively to the signs of stabilization and improvement in the economy. The S&P 500 increased by +15.9% in the quarter, the first quarterly increase in 1.5 years and the largest quarterly increase since the fourth quarter of 1998. Both international and small stocks outperformed the S&P 500 in the quarter with the EAFE return at +25.4% and the Russell 2000 return at +20.7%. For the first six months of the year, the S&P 500 is up +3.2%, while the Russell 2000 is up +2.6% and the EAFE is up +8.0%. We anticipate additional increases in the stock market in the second half of the year when more concrete signs of economic growth, not just stabilization, become evident. Pessimism is still very high given the concerns over excessive spending by the government, potentially inflationary policies by the Fed and general disbelief in the recovery. Stock valuations reflect this high level of pessimism and remain very attractive. There is a significant amount of pent up purchasing power with more cash in interest bearing savings accounts and money market investments than the total value of the U.S. stock market. Therefore, we continue to suggest a moderately more aggressive investment strategy that involves reducing cash positions, gradually increasing equity ratios, and adding 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