

INVESTMENT UPDATE

Executive Summary

- i We remain cautiously optimistic that the economy will avoid recession during the remainder of this year and 2012.
- i Corporations should continue to show earnings and dividend growth even in a moderate economic growth environment, providing support for stock prices.
- i A more credible resolution to the European sovereign debt crisis may finally be starting to take shape.
- i The Federal Reserve is likely to keep interest rates artificially low for the foreseeable future. However, the relative richness of bond valuations coupled with higher inflation argues for keeping bond portfolio durations relatively short.
- i The disparity between earnings and stock prices continues to widen, driving stock P/E (price-to-earnings) ratios to the lowest level in more than 20 years. Dividend yields now exceed 10-year U.S. Treasury Note rates for only the second time in 50 years.

Stock Market Corrects on Recession Fears, Political Brinkmanship and the Continuing European Debt Crisis

The stock market dropped considerably in the third quarter as investors have once again overreacted. The S&P 500 Index (representing larger capitalization stocks) corrected by -16.0% from the peak in early July to the end of September while the Russell 2000 Index (smaller companies) and the MSCI EAFE Index (foreign equities) suffered even greater declines of -24.7% and -19.5%, respectively. The current list of fears and frustrations includes bipartisan political ineptitude, excessive spending and debt loads of various European governments, and a potential U.S. economic recession. While we acknowledge that significant risks exist, we are cautiously optimistic that the European debt issues will be adequately addressed and that the U.S. economy will avoid recession in the year ahead.

Crisis Phobic Investment Culture

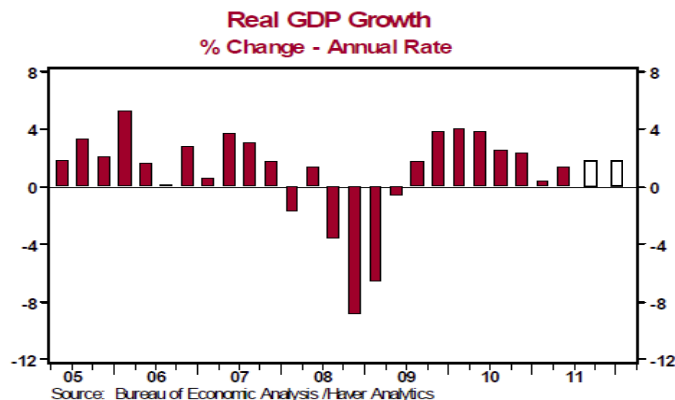
In the past decade, a number of large scale global events including the 9/11 terrorist attack, the bursting of the housing bubble, the credit/liquidity crisis of 2008, and the deep recession of 2008-2009, have left us with an investment culture that has been accurately described as "Crisis Phobic". Any inkling of real or potential threat tends to bring about an oversized reaction in the stock market that is detached from fundamentals. This

"sell first, think later" approach results in increased volatility which becomes self-fulfilling as an increasing number of investors stampede out of stocks at any hint of bad news. Eventually, as new economic data challenges the negative sentiment, the stock market recovers in an equally oversized fashion. As an example, once it became apparent that the economy was not going to fall back into recession after the correction in the summer of 2010, the stock market rebounded by +33% over the next 10 months. We continue to believe that future economic data will show that, while growth will likely be moderate, the economy will not contract and predictions of a double-dip recession will be incorrect just as they were in 2010.

Moderate Economic Growth Likely to Continue

While real GDP growth slowed to a pace of less than +1.0% in the first half of 2011, it is expected to rebound to +2.0% in the second half of the year (See Chart 1). Much of the first half slowdown was related to temporary factors such as supply disruptions resulting from the earthquake in Japan and weather related issues in the South. Growth in private payroll employment remains positive with 1.3 million net new jobs created since the beginning of the year. This has been partially offset by reductions in government payrolls. However, we view these government job cutbacks as a necessary and positive step towards greater fiscal discipline. Industrial production has increased by a +4.7% annual rate over the past three months while the ISM manufacturing index recently beat consensus expectations and increased to a three month high of 51.6% (figures greater than 50.0% suggest an expanding economy). The recent rebound in auto sales and higher durable goods orders also suggest real GDP growth of at least +2% for the third and fourth quarters of this year.

Chart 1: Economy Still Growing.



European Debt Woes

One of the main problems threatening the financial markets over the past year has been the European sovereign debt crisis. This issue has materialized as a number of European countries, most notably Greece and Portugal, have accumulated a huge amount of debt through excessive government spending and now can no longer meet their scheduled interest and debt payments without assistance. The situation is complicated by the fact that many European banks would likely be severely under-capitalized if Greece and other countries default on their bonds. For some investors, the situation is too reminiscent of the Lehman-induced financial panic experienced during the latter part of 2008 and leads to fears of another meltdown. While a final resolution has yet to surface, we believe that European leaders have learned from the last credit crisis and will ultimately pursue a solution that provides capital to the European banking system, a structured default for Greece, and protection for the other weak European nations along with very strong inducements for them to reduce spending and improve their global competitiveness.

Flight to Safety Pushes Bond Yields to Record Low Levels

With fear overriding fundamentals, panicked investors fled from equities to the relative safety of bonds, pushing bond prices up and driving the yield of the 10-year U.S. Treasury Note to a record low of 1.7% in mid-September (See Chart 2). This led to a total return of +4.0% and +6.7% for the Citigroup U.S. Broad Investment Grade Bond Index for the third quarter and first nine months of 2011, respectively.

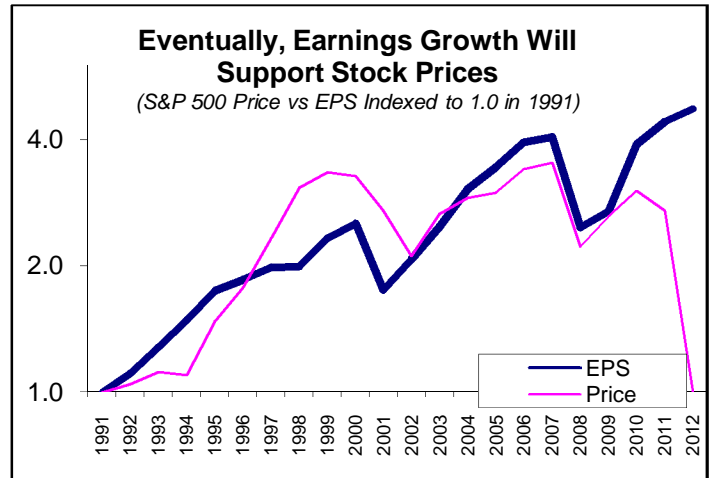


While the Fed has signaled that it intends to maintain its zero-interest rate policy for the foreseeable future, this extreme level of stimulus is already resulting in increased inflationary pressures. Over the last year, inflation has increased to 3.8% while core inflation (ex-food and energy) has moved to the upper limit of the Fed’s comfort level of 2.0%. With inflation running at nearly 4%, we believe interest rates will eventually need to rise despite the Fed’s pledge to keep the Fed Funds rate near 0%. Therefore, we continue to maintain relatively short bond durations to protect the principal of fixed income portfolios from an eventual interest rate rebound.

Wide Disparity in Stock Valuations Relative to Earnings and Interest Rates

For the third quarter, the S&P 500 dropped –13.9% while other major equity indices fared even worse as the Russell 2000 total return was –21.9% and that of the EAFE Index was -18.9%. Returns for the first nine months of 2011 also reflected the underperformance of smaller cap stocks and foreign equities relative to the S&P 500 Index as the Russell 2000 and the EAFE Index generated returns of -17.0% and -15.0%, respectively, compared to -8.7% for the S&P 500. However, this sharp correction in stock prices combined with continued earnings growth (See Chart 3) has created a significant divergence between equity prices and underlying earnings. In other words, stock valuations have gotten much more attractive with the S&P 500 Index selling at 11.6 times 2011 estimated earnings per share and only 10.8 times 2012 estimated earnings. This is the lowest P/E ratio in 20 years and appears to discount a recession that is unlikely to occur.

Chart 3: Recent Divergence Between Stock Prices and Earnings



The stock market should also garner downside support from the dividend yield on the S&P 500 which, as of 9/30/11, was 2.3% versus 1.8% for the yield on the 10-year U.S. Treasury Note. This positive yield advantage has occurred only one other time since 1962 which was during the stock market bottom in March 2009. This illustrates the wide disparity in the relative valuation of stocks versus bonds.

While there are many global challenges that must be overcome, corporations have proven to be very resilient. We continue to expect record corporate profits in 2011 and 2012, a credible resolution to the current European sovereign debt crisis and continued moderate U.S. economic growth through next year. Patient investors will ultimately be rewarded for rebalancing their portfolios to maintain their equity allocations during these periods of overreaction.

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