

INVESTMENT UPDATE

Executive Summary

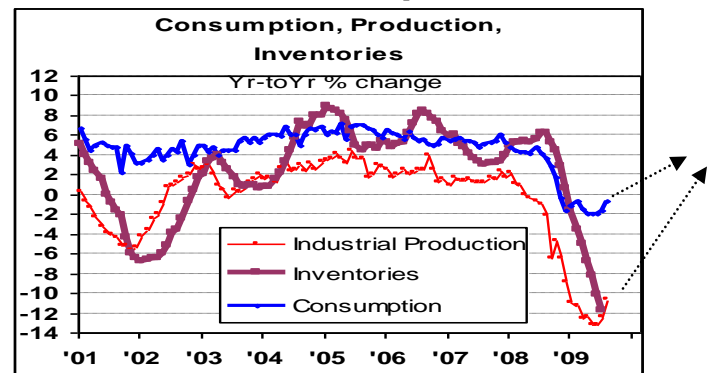
- The recession and credit crisis have ended.
- Real GDP growth of +3% is expected through 2010.
- Stimulative monetary policy expected to continue through much of next year. Fed will likely keep interest rates too low for too long.
- Potential for beneficial political gridlock is increasing. This should help restrain overly aggressive fiscal policies.
- Impressive recovery in the corporate credit markets during the past 6 months. Keep fixed income duration relatively short.
- Stock market outlook remains positive as corporate earnings snap back and investor confidence improves.

Economy – Recession is Over

The economic recovery continues to gain strength and momentum as the U.S. economy has once again proven its resiliency. We believe it is important to understand that the recession was caused by a credit crisis and not by weak economic fundamentals. The credit crisis and ensuing financial panic from the failure of Lehman Brothers and various other financial institutions scared businesses and consumers into reducing spending, increasing liquidity, and paying off debt. The result was a drop in end-demand and a large reduction in business spending, employment, and inventories. With the credit crisis ending, thanks to an incredible reversal in access to the credit markets in the last six months, a giant headwind has dissipated, allowing the highly stimulative monetary and fiscal policies to finally take hold.

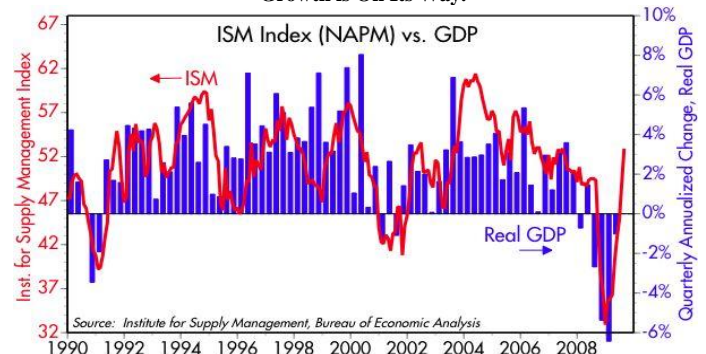
As with most economic recoveries, the initial signs of growth are most evident in the manufacturing sector. This is because the manufacturing sector, fearing the worst, tends to cut production and employment too much during a recession. Once consumption stabilizes, manufacturers find themselves low on inventory and needing to quickly increase production to meet demand. This was the case in the last recession as corporations aggressively reduced costs and cut production to below end-demand levels, resulting in the largest three month decline in inventories in the last 40 years. With consumption not falling as much as feared, and actually increasing during the recent months, businesses are starting to increase production to meet demand and stop the inventory depletion (see Chart 1).

Chart 1: Industrial Production Needs to Increase Significantly Just to Meet Current Consumption.



Corporations will initially be reluctant to bring back employees, keeping the unemployment rate high, but allowing corporate profitability to quickly and significantly improve. This will give them the financial wherewithal and incentive to increase employment, which will increase end-demand and restart the cycle of growth. Evidence supporting the strong rebound in manufacturing sales includes the strong rebound in auto sales (even excluding the cash for clunkers incentives), the +10% annualized rate of growth in industrial production in the last two months, and the rebound in durable goods orders over the last three months. The strong rebound in the ISM manufacturing index (a reliable leading indicator of manufacturing activity and economic growth) in the last four months is indicating, if historical patterns persist, +3.5% economic growth in the quarters ahead (see Chart 2).

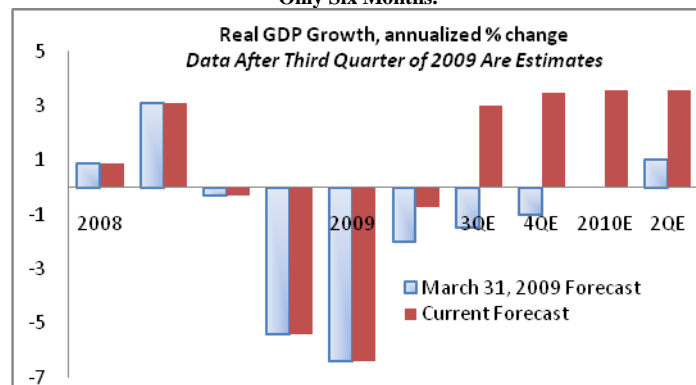
Chart 2: The Rebound in the ISM Index Indicates Stronger Economic Growth is On Its Way.



In addition to the start of a rebound in manufacturing, retail sales and exports have also shown signs of improvement. In the last three months, retail sales and exports have increased at an annualized rate of +14.3% and +22.0%, respectively, increasing our confidence that the economic recovery is gaining strength. Add in the improvement in housing and strong growth in

government spending and you have a recipe for a typical cyclical economic recovery. As a result, we are increasing our real GDP growth expectations for the third and fourth quarter from +0.5% and +1.5% to +3.0% and +3.5%, respectively. Only six months ago, the consensus economic forecast was for negative growth in both the third and fourth quarters (see Chart 3). Longer term, the economy still faces several challenges including huge federal deficits, the possibility of higher income taxes, increasing size of the government, and increased regulation. Nonetheless, economic growth through 2010 should continue at a respectable rate of at least +3% based on the strength of the extremely stimulative monetary and fiscal policies of the past year.

CHART 3: Economic Growth Expectations Have Improved Significantly In Only Six Months.



Federal Reserve Policy – Stimulative Through 2010

The Federal Reserve's aggressive actions to reduce the Fed Funds rate to 0-0.25% over the last year is finally starting to take hold with the economy bottoming in June and gaining strength ever since. Since Fed actions usually impact the economy with a 12-18 month lag, most of the Fed's aggressive actions are just now starting to have a positive impact on the economy. The Fed is not expected to begin raising rates until the first half of 2010 as Fed Chairman Ben Bernanke has repeatedly stated that the Fed is going to error on the side of growth in the near term. As a result, it appears that the Fed will remain in a stimulative mode for most of 2010 even as they are increasing interest rates, which means the economy should have a significant stimulative monetary policy tailwind for the next two years.

The downside of an overly stimulative monetary policy is that it may eventually result in higher inflation. Higher inflation is not a foregone conclusion as the Fed may be able to withdraw the excess money from the financial system before it causes too much damage. The fact that the Fed tends to be reactive, not proactive, to changes in economic activity, leads us to the conclusion that the Fed will most likely error on the side of too much stimulus.

Fiscal Policy – Excessive Spending

Generally, the best policy coming from Washington is no policy, as both parties have proven their inability to control spending,

waste, fraud, and abuse of taxpayer money. The potential return to gridlock during the last few months has been a significant positive for the markets and the economy. We are cautiously optimistic that next year's Congressional elections will further solidify gridlock with the Republicans poised to gain seats in both the House and the Senate. The U.S. economy is the largest and strongest economy in the world because of the relatively minimal government interference in the U.S. economy. The return to gridlock should help minimize further government intrusion and hopefully restrain new government spending programs.

Bond Market – Stay Short

The yield on the 10-year U.S. Treasury Note at the end of the third quarter was 3.30%, down from 3.52% at the end of second quarter and up from 2.25% at the start of the year. The Salomon Broad Investment Grade Bond Index produced a total return of +3.6% in the third quarter and +5.0% in the first nine months of 2009 as corporate bond spreads narrowed significantly. The bond market has made an amazing recovery from one of the worst credit markets in 80 years into one of the strongest credit markets with plenty of credit available at relatively low interest rates. Within the last six months, the bond market has transitioned from an extreme headwind to a healthy tailwind for economic growth. With the economy recovering and monetary and fiscal policy still extremely stimulative, 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 - Undervalued

The total return of S&P 500 was +15.6% in the quarter as investors started to look beyond the recession and towards economic recovery. Both international and small stocks outperformed the S&P 500 in the quarter with the EAFE return at +19.5% and the Russell 2000 return at +19.3% as it is typical for riskier assets to outperform in the initial stages of a recovery. For the first nine months of the year, the S&P 500 is up +19.3%, while the Russell 2000 is up +22.4% and the EAFE is up +29.0%. We anticipate additional increases in the stock market in the next six to nine months as corporate earnings (as measured by the S&P 500) rebound significantly from \$60 per share in 2009 to \$75 in 2010 and \$95 in 2011 due to the significant operating leverage from all of the cost cutting undertaken this year. In the last 20 years, the stock market has increased the most when the Fed is increasing rates (as we expect in 2010), not decreasing rates, which goes against conventional wisdom. Pessimism is still very high with a lot of cash on the sidelines, a near record level of short interest, and a general disbelief in the recovery. Stock valuations remain very attractive selling at only 13.8x and 10.9x our 2010 and 2011 S&P 500 earnings estimates.

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