

INVESTMENT UPDATE

Executive Summary

- Continued economic growth, improving corporate earnings, the likelihood of political gridlock, and an easing of double dip recession fears drove stocks higher in the third quarter.
- Real GDP growth of +2-3% is expected over the next 12 months.
- Stock market valuation remains attractive.
- Current ultra-low interest rates should eventually move higher as economic growth continues and the fear mentality eases. Continue to stay relatively short with fixed income investments.

Stock Market - Moderate Economic Growth, Strong Corporate Earnings, and an Easing of Fear Should Continue to Drive Stock Prices Higher

The stock market rebounded during the third quarter with the S&P 500 and Russell 2000 Index of small to midsized companies both up +11.3%, and the Morgan Stanley EAFE Index of international stocks up +16.6%. This occurred despite the continued flow of investor money into bonds and out of stock mutual funds. During the third quarter, investors added \$87 billion to bond mutual funds, while pulling \$43 billion out of stock funds. According to Bloomberg, U.S. investors have shunned stocks for the longest stretch in 23 years, with investors placing more money in bond funds than stock funds for 31 consecutive months. This pervasive pessimism has held down stock valuations, even as corporate profits have risen dramatically over the past several quarters.

The stock market started off the third quarter on a positive note with the S&P rising +7%, as companies began reporting better than expected earnings for the second quarter, only to give it back in August (S&P 500 -4.5%) owing to fears of a double dip recession. Abatement of those fears allowed for a dramatic recovery of +8.9% in September. We believe that an eventual reversal in money flows, continued economic expansion, strong corporate earnings growth, and political gridlock will drive the stock market higher through the end of this year and into 2011.

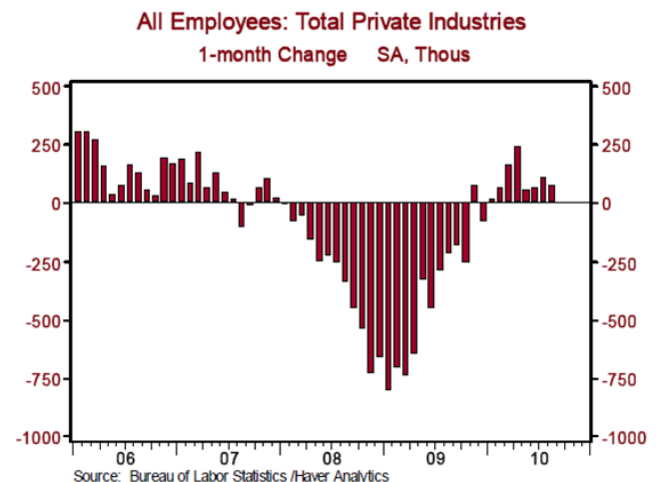
Strong Corporate Fundamentals

Despite the modest economic recovery, companies continue to participate in a V-shaped recovery in earnings that began in earnest in the first quarter of 2009. Operating earnings for the S&P 500 were up +34% in the second quarter of 2010 compared to 2009 and are expected to be up +26% in the third quarter. One area where investors have been looking for improvement has been revenue growth, which up until the second quarter, has

been unimpressive. Corporate revenue began to show positive comparisons in the second quarter, and when combined with the continued expansion in profit margins is resulting in solid earnings growth. Companies are also generating record free cash flow and have the highest cash on their balance sheets in over 50 years. This gives corporations the flexibility and wherewithal to pay down debt, enhance dividends, repurchase their shares, make acquisitions, and eventually increase capital spending and hiring.

Continued Economic Growth

Contrary to what is portrayed by the media, the economy continues to grow. Although second quarter GDP growth was lower than expected at +1.7%, economic growth has been positive in each of the past four quarters, averaging +3%, and the pace of recovery has actually been stronger than those following the last two recessions. While the overall unemployment rate remains high at an elevated 9.6%, it is important to keep in mind that as corporate profits continue to grow and profit per worker expands, human resources will become stretched and companies will need to hire to remain competitive and to keep up with increased demand. Through September, non-seasonally adjusted weekly jobless claims have continued their downward trend to levels not seen since the collapse of Lehman Brothers in 2008, while the change in employment has moved from reductions of the workforce to additions (see graph below). As this trend continues and accelerates, we will eventually see the unemployment rate improve. This should trigger an increase in confidence and continued economic growth of +2-3% through 2011.



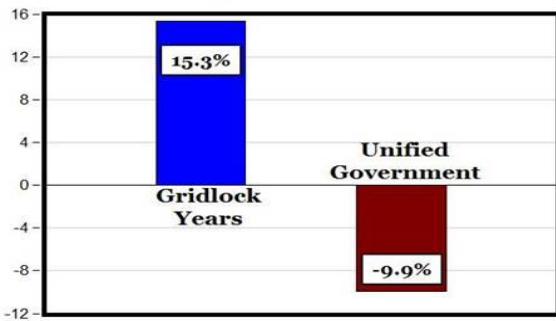
Accommodative Monetary Policy

The Fed has been very accommodative in the continuation of its ultra low interest rate policy and has indicated that it intends to maintain this for an extended period. However, as the economy continues to grow, the Fed will eventually need to move away from this easy money policy and allow interest rates to rise. The longer it takes to start this transition, the more potentially disruptive it could be when it does occur.

Political Gridlock

There has been a considerable shift in the political winds for both of the major political parties as the year has progressed and voter dissatisfaction has become more palpable. Partisan battles have been endemic to our political process since the foundation of this country. What is unique about current times is that this dissatisfaction applies equally to both parties. The negative sentiment has become more pervasive in tandem with the witnessing of the fiscal problems experienced by countries in the European Union, and the corrective measures that are taking place in response to the actions of bond vigilantes. History has shown an inverse relationship between government spending and GDP growth, to the contrary of what many in Washington believe as evidenced by the sharp increases in discretionary government spending over the last several decades. As we move into the November elections, voter dissatisfaction sets the stage for a shift away from government largesse and recklessness, and towards more fiscally responsible policies resulting in stronger fundamentals and more consistent economic growth in the future. Although both parties appear to be shifting in that direction, expected election results will likely lead to political gridlock. Regardless of political affiliation, as an investor, gridlock has historically been very positive for the stock market (see graph below).

**Real Returns for the S&P500
Gridlock Years vs. Unified Gov't.
1973 to 2010**



Attractive Valuations

We believe the stock market remains exceptionally attractive, and are maintaining equity ratios toward the high end of one's equity range. The forward P/E ratio on the Standard & Poor's

500 Index is 12x the 2011 earnings estimate, significantly lower than the long run average in the mid-teens. An additional sign of attractive valuations is the recent increase witnessed in mergers and acquisitions activity. According to Thompson Reuters, U.S. deal making activity reached \$575 billion so far this year, up +13.7% from the first 9 months of 2009. The combination of ultra low interest rates, sound balance sheets, healed credit markets, and attractive valuations contributed to this trend. This activity also reflects confidence in continued economic growth, and historically coincides with improving equity markets. In addition to positive fundamental factors, investors and businesses are holding record amounts of cash earning very low returns. The recession, and the temporarily reduced ability of individuals and businesses to access the credit markets during the financial crises, coupled with a political climate of uncertainty regarding regulation and taxation, has caused an increase in household and business preferences for liquidity, resulting in higher savings and cash holdings. We believe that the election could bring some clarity to tax policy and regulation, which may be the catalyst needed to spur both businesses and investors to deploy cash reserves through stock buybacks, mergers and acquisitions, and investments into equity securities.

Bond Market – Continue to Stay Relatively Short

Bond investors continue to benefit from the massive push towards risk aversion witnessed over the past several years. Fear driven investor flows continued into bonds, particularly U.S. Treasury securities, during the third quarter. The yield on the 10- year Treasury has fallen from 3.8% at the beginning of the year to 2.5% at the end of September. The Salomon Broad Investment Grade Index produced a total return of +2.4% during the third quarter and +7.8% for the first nine months of this year. A number of things have converged to drive bond prices higher and yields lower. The existing flows, coupled with the ever increasing prospect of quantitative easing by the Fed, and the purchasing of mortgage securities by Fannie Mae and Freddie Mac, have put further downward pressure on interest rates. While it is highly unlikely that the Fed will move rates higher during the next 3-6 months, the prospect of investors re-evaluating the large disparity between valuations on stocks versus bonds could push one of the driving factors behind the bond market's success (investor flows) in the other direction, resulting in higher interest rates. Also, as economic growth continues and inflationary pressures build, Fed policy will need to be adjusted and interest rates will rise. In other words, today's low bond yields do not appear to compensate for the increasing interest rate risk of longer term bonds. We continue to advocate for shorter-than-average durations in bond 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