![North Star Asset Management, Inc.]

April 2017

INVESTMENT UPDATE

Executive Summary

- Stocks are off to a solid start on improving fundamentals and expectations for new pro-business government policies.
- As a result of the stock market's recent strength, valuations have risen to an above average 17.5x multiple to forward earnings.
- After raising the Fed funds rate in March, the Fed remains poised for two additional rate increases in 2017, and will consider beginning to reduce the size of its $4.5 trillion balance sheet.
- While a small number of mega capitalization stocks contributed disproportionately to stock market returns in the first quarter, we believe diversification remains prudent, and that investing in high-quality, consistent growth companies at a reasonable price will provide for strong returns over the long term.

Strengthening Fundamentals Driving Stocks Higher

Stock market returns started out the year on a positive note driven by strong economic fundamentals, a return of corporate profit growth, and expectations for the implementation of pro-business policies by the new Presidential Administration. Much has been made about these policies in the financial media and how they are responsible for the strong performance in the stock market since the election. While these pro-business policies of lower corporate and individual tax rates, less costly regulation, and a potential repatriation tax holiday for stranded overseas cash, once implemented, should provide for stronger economic fundamentals and corporate profit growth, we believe that the bigger driver of the stock market strength since the election has actually been the already improving underlying fundamentals.

For example, after two years of weak manufacturing production in the U.S., manufacturing started to accelerate towards the end of 2016 and has continued to improve early in 2017. New orders for manufactured goods have also been constructive recently, positioning manufacturing production growth to remain strong in the near term. In addition to the strength in manufacturing growth, consumers are gaining confidence, as demonstrated by growth in retail sales exceeding the rate of growth in incomes for the first time in one and a half years (see Graph 1).

Graph 1. Retail Sales Growth Improving

* Aggregate weekly hours times average hourly earnings of total private industries times 52.
Source: US Department of Labor, Bureau of Labor Statistics and US Department of Commerce, Bureau of the Census.

Additionally, while stock prices reached record highs during the first quarter, corporate profits are also approaching record levels as they recover from seven straight quarterly declines that took place through the first half of 2016. Despite the declines to start the year, corporate profits ended 2016 growing +4.3%, including a very strong +22.3% year-over-year growth rate in the fourth quarter as energy sector profits benefitted from a recovery in oil prices. Corporate profits should reach record levels in 2017, aided by the continued benefit of higher oil prices and nominal GDP growth in the range of +4-5%.

While we believe these expectations for new record high corporate profits justify much of the recent strength in the stock market since the election, it appears that investors are likely pricing in some pro-business policy changes being implemented as well with equity valuations rising to 17.5x forward earnings (up from around 16.0x prior to the election and above the historical average of around 15-16x). While successfully passing President Trump's proposed corporate tax rate reduction alone could immediately increase corporate profits enough to drive valuations back in-line with historical averages, we believe this is easier said than done, as demonstrated by the inability of the Republican controlled House of Representatives to repeal and replace

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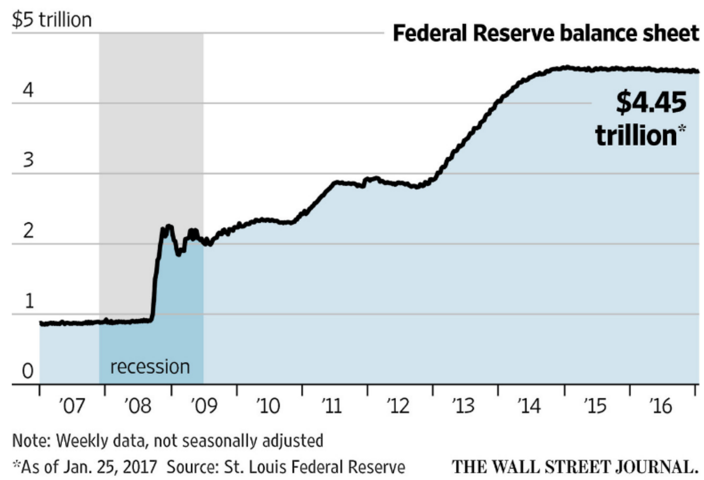
the Affordable Care Act. What we believe has investors more excited is the scaling back of costly and restrictive government regulations. This can largely be done without the need for congressional approval and should free employers to expand their businesses and create new jobs, spurring faster economic growth. As these policy changes are debated, we will likely continue to see periods of increased volatility in the stock market, but with strong underlying fundamentals, we remain optimistic on stocks for long-term investors.

Fed Funds Rate Heading Higher

In March, the Federal Reserve raised interest rates for the second time in three months to a range of 0.75-1.0%, signaling confidence in the economy. The Fed continues to project a total of three rate hikes during 2017, though faster economic growth could result in a higher number of rate hikes during the year. We continue to believe that the Fed funds rate should be much higher, as the real Fed funds rate currently remains negative when you consider core inflation running at 2.2%. Eventually savers will demand a positive real rate of return on their short-term investments. With the Fed's preferred measure of inflation (Personal Consumption Expenditures Price Index) now at 2.1%, above its 2.0% target rate, unemployment at 4.5%, manufacturing improving, and the quits rate matching its highest level since 2007 (a positive since most people don't quit their job unless they are confident they will be able to find another one quickly), we feel the Fed should continue raising rates to avoid getting behind the curve on inflation. However, in addition to raising interest rates, the Fed needs to start unwinding its balance sheet.

Since 2008, the Fed increased the size of its balance sheet from just under $1 trillion to nearly $4.5 trillion (see Graph 2) through three rounds of quantitative easing in an effort to stimulate economic growth. Much of the $3.5 trillion increase has ended up as excess reserves on bank balance sheets and never actually made its way into the economy. Prior to the recession, banks held essentially no excess reserves, while today these amount to nearly $2.4 trillion. While banks are paid by the Fed to maintain these excess reserves, with interest rates rising, they are able to earn more on these reserves by lending them out than what they are receiving from the Fed. Should banks increase their lending to take advantage of the higher rates of return available to them, this will increase the supply of money in the economy and apply upward pressure on inflation. If the Fed doesn't act soon to at least begin shrinking the size of its balance sheet, and thus the excess reserves of the banks, they may end up behind the curve on inflation and be forced to unwind its balance sheet and raise interest rates faster than they would otherwise like. While a gradual pace of rate increases would be well tolerated by the economy, a need to rapidly raise rates to stave off inflation would likely result in a shock to the economy and cause the pace of growth to slow. Fortunately, the Fed recently expressed a willingness to start reducing the size of its balance sheet after making its final two rate hikes planned for the year. A rising Fed funds rate, along with the unwinding of the Fed's balance sheet would likely apply upward pressure on bond yields, therefore we continue to recommend defensive bond portfolios with below average durations.

Graph 2. Federal Reserve Balance Sheet Remains Large



Mega Capitalization Stocks Driving Market Returns

A small number of mega capitalization stocks continue to disproportionately contribute to the returns of the market capitalization weighted S&P 500 Index so far this year. During the first quarter, the S&P 500 generated a total return of +6.1%, driven in part by three stocks (Apple, Amazon, and Facebook), representing 7% of the S&P 500 Index, that each generated returns of greater than +18%. The Equal Weighted S&P 500 Index, which neutralizes the weighting of the 500 holdings in the index, generated a return of +5.4%. Small capitalization stocks (Russell 2000 Index), generated more modest returns at +2.5%, while foreign stocks (MSCI EAFE Index), after trailing their large cap domestic peers for much of the past decade, outperformed the S&P 500 with a total return of +7.3% in the quarter. While diversification can negatively impact relative performance at times, we continue to believe it is prudent, and that our philosophy of investing in high quality, consistent growth companies at a reasonable price will help our clients generate strong returns over the long term.

In accordance with SEC Rule 204-3(b), our Form ADV is available upon request. Please call or write to Susan C. Beaver, North Star Asset Management, Inc., 59 Racine St., Suite A, Menasha, WI 54952.