NORTH STAR ASSET MANAGEMENT, INC.

October 2015

INVESTMENT UPDATE

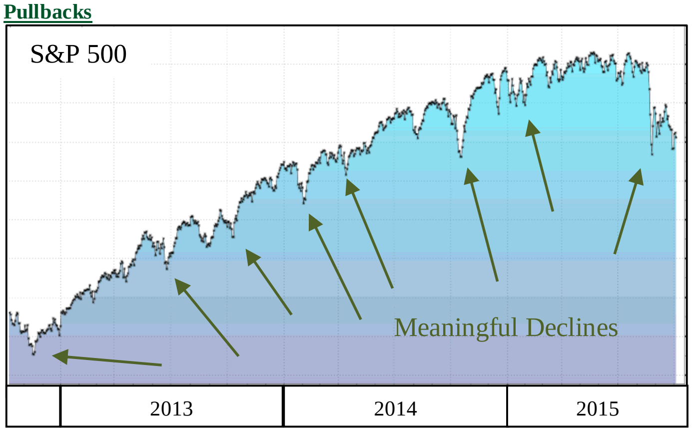
Executive Summary

- It was a difficult quarter for investors as the market experienced its 20th decline of greater than 4% since the start of the bull market in March 2009. We do not anticipate that this is the start of a bear market for stocks since the factors that typically trigger a recession do not appear to be an immediate cause for concern.
- Partially owing to the markets correction, the Fed once again delayed the start of normalizing interest rates, despite rapidly declining unemployment and core inflation close to its target level.
- As a result of the recent correction in the stock market, P/E valuations have gone from the high end of the normal range at 17.2x, to the low end, now at 15.1x. With an expectation of a return to more normal corporate earnings growth in 2016 as the headwinds of lower oil prices and the strong dollar are annualized, we believe stocks appear reasonably valued and recommend clients rebalance their equity portfolios up towards the mid-point of an investor's targeted range.

Market Falls on Fear, not Fundamentals

After a solid start to the year with the S&P 500 up more than 4% through July, the market fell significantly in August with the S&P 500 down over 10% in 6 consecutive business days and 12.5% overall (see Graph 1). This pullback marked the 20th decline of greater than 4% since the recession ended in 2009 and the first 10% correction since the 10.9% decline almost 3.5 years ago. Although these pullbacks are very painful, they are a normal occurrence in the stock market as there has been 3.5 mini-corrections of more than 4% each year since 2009 and a 10% correction on average every 1.5 years since the 1950s.

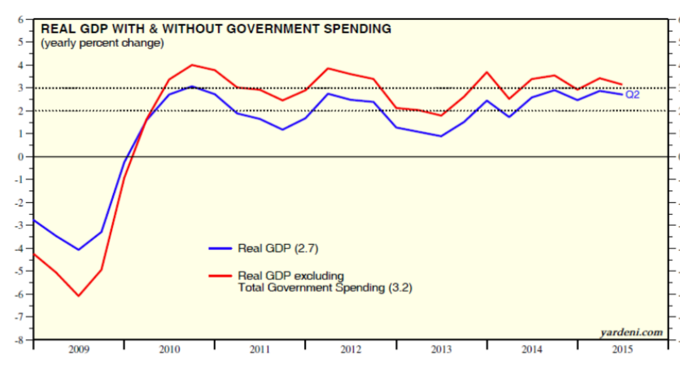
Graph 1. Stock Market Continues to Trend Higher Despite Numerous Pullbacks



As with the previous 19 declines of greater than 4%, we once again believe that this is not the start of a longer secular bear market in stocks since bear markets are almost always caused by a recession. Currently, none of the factors that typically trigger a recession, such as tight monetary policy, tax hikes, trade protectionism, excess debt or oil price shocks, look to be a cause for immediate concern, giving us confidence that the U.S. economy can continue to grow.

In fact, the U.S. economy appears reasonably healthy. Unemployment has declined to 5.1% and is still falling, private sector job creation has been very healthy for a number of years, new home sales are up 21% in the past year, household net worth is at an all-time high, and household financial obligations are at 30 year lows. Meanwhile, corporate balance sheets continue to carry high levels of cash, profit margins are high, cash flow generation is at record levels, and capacity utilization is running near long-term averages indicating that corporations have the need and the ability to increase investment spending. The private sector (GDP excluding government spending) has actually been growing at a relatively healthy rate at or above 3% for most of the past 5 years (see Graph 2).

Graph 2. Government Spending a Drag on U.S. GDP Growth



If government spending had been adding to reported GDP growth instead of subtracting from it, economic growth would have been closer to a more normal 3.5-4.0%. It appears that this headwind has the potential to subside as the last five years of gridlock has resulted in the federal deficit declining to a more sustainable level at 2% of GDP, providing the government with the capacity to increase spending moderately. All of these factors should allow U.S. economic growth to remain reasonably healthy over the near term and should provide support for stocks as well. As with last year's Ebola scare induced market sell off and the numerous European Debt Crisis corrections prior to that, this correction too shall pass and markets should once again reach new highs driven by the continued perseverance of the U.S. economy.

Yet Another Delay from the Fed

In September, despite six years of economic growth, unemployment falling from 6.1% to 5.1% in the past 12 months, signs of accelerating wage growth, and core inflation running close to the Fed's long-term target level, the Fed continued its dovish stance and delayed the start of the normalization of interest rates, pointing to weaker labor force participation levels, continued low inflation, and global macroeconomic concerns as their excuse to wait. This delay added to an already volatile environment with stocks resuming their declines in the days after the decision, as the Fed undercut investor confidence in both itself and the U.S. economy and prolonged uncertainty with regard to U.S. monetary policy.

Even if the Fed starts raising rates before the end of the year, monetary policy will remain highly accommodative and will continue to apply upward pressure on inflation and support continued improvement in labor markets for the next several years. Therefore, we continue to believe that the Fed should raise interest rates soon as higher rates now mean the Fed will be able to raise interest rates more gradually and potentially avoid the need for highly restrictive rates in the future, thus prolonging the current economic expansion. At this point, we believe the stock market will welcome the Fed beginning to raise rates as the market is starting to worry about the potential negative ramifications of maintaining these extremely low interest rates for too long.

Due to the Fed's decision to delay the normalization of interest rates, the yield on 10 year U.S. Treasury Notes declined by 32 basis points during the quarter and by 13 basis points so far this year to 2.04%. Given our expectation that the Fed will begin raising short-term interest rates by the end of the year, and that this will put upward pressure on bond yields across all maturities, we continue to believe that it is prudent to maintain a more defensive bond portfolio with relatively short durations until this normalization is complete.

Stock Market Declines Leave Valuation Attractive

During the third quarter, the S&P 500 produced a total return of -6.4%, resulting in a loss of -5.3% so far this year. Small capitalization stocks (Russell 2000), foreign stocks (EAFE) and emerging market stocks (MSCI EM) all lagged the S&P 500 significantly in the third quarter, generating losses of -11.9%, -10.2%, and -17.8%, respectively. Year to date returns for foreign stocks have matched the returns of the S&P 500 at -5.3%, while small caps and emerging market returns have lagged at -7.7% and -15.3%, respectively.

With the recent pullback in stock prices, stock valuations have declined from 17.2x forward earnings in July, to 15.1x today. With valuations now at the lower end of the normal range, stocks appear reasonably valued. Additionally, with the headwinds (lower oil prices and a strengthening dollar) that pressured corporate profit growth in 2015 now subsiding, we anticipate a return to more typical total returns for stock investors of around 10% based on earnings growth of +7-8%, a steady P/E valuation multiple, and a 2% dividend yield. Therefore, we recommend rebalancing equity allocations back up towards the mid-point of an investor's targeted range to take advantage of these lower valuations.

China Concerns Appear Transitory

One of the major reasons blamed for triggering the correction has been weakness in China, primarily relating to the Chinese stock market (which is down -4.2% year to date after being up over 60% earlier in the year) as well as a slowdown in the region's economy. The Chinese economy is in the process of transitioning from an infrastructure and export based economy into a consumer driven economy. This transition, while necessary for the country's long-term economic health, can be uneven as growth from new consumer led sectors may not be fast enough to offset the decline from the infrastructure led sectors early in the transition, resulting in a modest slowdown in economic growth for a short period of time. Additionally, over the past ten years, China's economy has grown at an average pace of 10.1% per year, resulting in its GDP, at $10.3 trillion, now being more than 2.5x as large as it was 10 years ago. Given its larger size, it is only natural for the pace of economic growth to slow. However, at the current 6% rate of growth, China is adding more to GDP each year than it was 10 years ago when it was growing faster than 10% per year. Therefore, with only around 5% of U.S. exports going to China and with growth expected to continue at a reasonable pace, we believe the impact on the U.S. economy will be minimal and the modest slowdown in China will be transitory.

Lastly, this transition away from an infrastructure based economy is having a negative impact on commodity prices, particularly heavy metals, as China has reduced its spending on buildings and infrastructure, reducing demand for these commodities. This pressure on commodity prices is particularly difficult for a number of emerging market countries whose economies are highly reliant on commodity exports. The volatility in commodities is just another reason why we believe our philosophy of investing in high quality, consistent growth companies, which tends to result in limited exposure to commodity related investments, should enable client portfolios to continue to enjoy strong returns over the long-term.