



NORTHSTAR

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PLANNING INC

JANUARY 2008

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2007 Full Year Investment Letter

This is the 14th annual Northstar year end investment letter to our clients. After looking over a few of our past letters, we are reminded again of the difficulty we all have in turbulent times in keeping the long view forefront in our decision making process. The amygdala - the "old brain" that is home to powerful unconscious emotions - want to drive us into a "flight or fight" response when things go bad. We are hard-wired to feel that doing something is better than doing nothing when we feel threatened by our world. Our rational conscious mind has to work very hard to overcome emotions and help us return to rational thinking. The disciplined investment approach that we follow at Northstar is our checks and balance as we make decisions in your portfolio. Our job as your advisor is to help you focus on your long-term dreams and goals and resist the normal impulse to let short-term emotions drive long term planning.

Market Commentary

The weakness in the domestic residential real estate market and disaster in the sub-prime lending fiasco finally brought general malaise to the US and to some extent, the global markets as well, and overturned the fine results earned in the first half of the year. The third and fourth quarters of 2007 were tumultuous to say the least! Let's look at how the broad markets did for 2007 and how that compares to the two previous years:

Market Indices	2005	2006	2007
S & P 500	4.9%	15.8%	4.9%
Russell 2000 ¹	4.6%	18.4%	(1.6%)
MSCI EAFE ²	15.7%	23.5%	11.2%
Wilshire REIT ³	14.0%	36.1%	(17.6%)
AIG Commodities	21.4%	2.1%	16.2%
S & P Energy	31.4%	24.2%	34.4%

¹ This is the US Smaller Cap index

² This is the broad International index covering Europe, Australia and Far East markets

³ The US Real Estate, AIG Commodity and S & P Energy indices represent Northstar's Diversifier Asset Class



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Most of our client portfolios earned results which, while lower than we'd hoped six months ago and lower than in previous years, are still well within the realm of expected returns. It seems to us as if the markets are nervously holding their breath, waiting to see if 2008 brings merely a slowdown in the US economy or if we dip into a mild recession. We're betting on the former outcome and believe the mortgage loan mess will be worked out on the balance sheets of the Big Name lending institutions that played that risky game. It's also a pretty good bet that Congress is too busy playing election year politics in 2008 to craft legislation slyly intended to push the cost of \$400 billion or so of losses on those failed high risk bets made by lenders & Wall Street securities re-packagers off on to you and me-the taxpayers.

The total returns for the Northstar Model Portfolios in 2007 were:

2006	Northstar Model Portfolio Return	2007
16.7%	Aggressive (90% equities/10% bonds)	6.40%
15.3%	Capital Growth (80% equities/20% bonds)	6.46%
14.0%	Balanced Plus (70% equities/30% bonds)	6.52%
12.6%	Balanced (60% equities/40% bonds)	6.59%
11.6%	Conservative Balanced (50% equities/50% bonds)	6.65%
9.8%	Capital Preservation (40%/60% bonds)	6.72%

We'd also like to take this opportunity to talk about three investment topics:

- o Our brave (*but dimly seen*) economic outlook for 2008.
- o A review of the markets in 2007
- o Northstar's philosophy about oil and the energy future

A Look into the Future

What's 2008 likely to bring as far as the economy is concerned? Just about everyone expects a slowdown in GDP growth and continued weakness in job growth. We think we might be pleasantly surprised, however, and things may not turn out to be as bad as forecast.

Reaching again for our peerless crystal ball, we boldly offer some predictions for 2008:

1. GDP growth will slow down, but the U. S. economy will still out-perform those of Europe and Japan.
2. Gasoline prices will rise a little –not as much in 2008 as they did in 2007 – but don't expect any big drop either.



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3. New job growth will continue at about 100,000 to 150,000 per month range – that's about 1,500,000 new jobs being created every year.
4. The cost of money (interest rates) will slip slightly to keep the money supply moving nicely, but the Fed will remain ever-alert for any smoke signals of inflation and shy away from dropping rates dramatically.
5. The stock markets will likely have another exciting year with lots of volatility and total returns ending up below the 10% long-term average.

The presidential election campaigns will dominate the media and influence a lot about how we feel about things. The economy is fragile and uncertain in the minds of most people right now and things could dip close to the "recession" the market fears so much. Don't expect too much action from Congress or the lame-duck Bush administration on the economic front.

Market Review

2007 could have been worse. The markets actually held up pretty well, considering all the stuff the world threw at us last year but it sure was a bumpy second half, wasn't it? The Dow ended up 7.24% for the year, the S & P 500 was up 4.90%, and the NASDAQ Composite up 10.73% as well, but they all slipped at year end and started the New Year on a down note. The markets seem to accept slower economic growth in the fourth quarter, and weaker corporate earnings as well. We're a couple of weeks away from final earnings reports, but we could see some positive surprises, which would bring some good cheer to us all.

Housing, which was the major economic story of the year, continued its relentless decline. We're also likely to see more multi-billion dollar write-down's from Citigroup and other financial services firms, but we think this is a good thing, as it will wring out the mess and clear the "*never should have bought it in the first place*" junk that is clogging up the system.

Home mortgage rates ended 2007 about where they were at the beginning. However, just looking at beginning and end of year numbers really wouldn't tell the sad story of mortgages and housing for 2007. People used to make jokes about using their home equity as an ATM card and we all knew in our hearts that thinking was wrong. Every generation seems to have to relearn the lesson: "*Never bet assets you need for the long term to try to meet short term cash flow needs.*"



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Treasury interest rates were lower at the long end of the yield curve, but higher for 90-day T-bills. Even so, short-term Treasuries are yielding about two percentage points less than at the beginning of 2007. That's good news for adjustable-rate borrowers, but bad news for investors in CDs and money-market funds. We are moving bond fund maturities out to five years or so, after several years on the short end since we think this trend will continue throughout this year. The continued weakness of the financial sector may increase pressure on the Fed to lower interest rates during the year as they try to jump-start the flagging economy.

The U. S. dollar plummeted against the Euro and will end the year down about twelve percent against European currency. A weaker dollar helps U. S. manufacturers and stimulates our exports but makes imported goods more expensive to us.

From an investment point of view, the weakening dollar argues for investing more in global and international mutual funds. Foreign stocks have outperformed domestic investments for five of the last six years. That pattern seems likely to continue and we continue to recommend around 35% of your total equity portfolio be in Developed and Emerging market holdings.

In addition, although we continue to be dedicated Value investors, we also recognize that growth equities may play an important cyclical role in building portfolio value and accordingly, are adding a Growth component to our model portfolio. Depending on your circumstances, we may be shifting a small percentage (generally less than 5%) of your US equity holding to a broad-based Growth index fund.

The End of Cheap Oil

Adding to the long list of "big worries" we are burdened by these days is the fear that the world is about to run out of oil. Oil literally fuels the world's economy and we all intuitively know that the amount of oil hidden away in Planet Earth is finite. What will happen when it starts to run really low or worst case, when it's all gone? Is that "someday" in our lifetime? We join with Adam Smith and say no. The invisible hand of market forces and economics will change the way things work as surely as happened in the 1700's when the fear was that we were running out of trees for burning or in the 1800's when whales being hunted to extinction for lamp oil. New technologies will arise and non-economic use of oil will cut demand to long-term sustainable levels. How do we know this? Because we have unbridled faith in the ingenuity and resourcefulness of the human race and see the future bright instead of dimming hope and playing "Chicken Little".



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Experts who are predicting the worst about “Peak Oil” and running out of energy are missing the crucial role that Economics 101 plays in determining the price of energy. As in Newton’s Second Law of physics, every action has an equal but opposite reaction. The tripling of oil prices since the summer of 2003 has unleashed forces that within the next two or three years may well bring oil prices back down to below \$70 a barrel or lower. We figure there’s about \$20/barrel worth of “fear” built into the current price and \$10 worth of speculation.

Also consider that since 2001, the dollar price of oil has run almost in perfect parallel with the increase in the price of gold and other commodities. Gold is up 240% and oil is up 267% over that time. The original concession agreements for Aramco (the Arabian American Oil Co), IPC (Iraq Petroleum Company) and KOC (Kuwait Oil Co) called for royalty payments to be made in gold; it wasn’t until the ‘50’s that the switch was made to dollars as the global currency of exchange for oil. So, if you want to blame someone for the high price today of your fuel oil and gasoline, we must really blame ourselves for allowing our Government to erode the exchange value of the dollar in world trade. Even if the dollar had just kept parity with the euro since 2001, we would have been better off. Oil in euro terms is priced at around \$57 per barrel. The US Government has been pumping out dollars into world market and that has led directly to \$100 oil.

The key to understanding where prices are headed is distinguishing between the short term and the long run. In the world of oil exploration and production, the supply of crude is more or less fixed for five years. Drilling for oil is a time-consuming, costly and unpredictable process. Even after a major new oil/gas reservoir is discovered, putting in the complex production facilities takes years. Current production capacities reflect drilling successes and investment decisions made in the late 1990s or earlier.

Today, OPEC has the ability to produce about 35 million barrels of crude a day; the rest of the world can produce perhaps 50 million barrels a day. As recently as 2003, this seemed like plenty. Since then, though, global demand has grown rapidly, and a series of catastrophes—some natural (hurricanes Rita and Katrina), some man-made (war in Iraq and unrest in Nigeria and Venezuela)—have curtailed production by about 2 million barrels per day, causing supply to temporarily dip below demand. In September, the global demand for crude reached 85.9 million barrels a day, whereas global supply was just 85.1 million barrels a day, according to I.E.A. figures. Like sharks smelling blood in the water, the speculators entered the market and start trading, betting on volatility.

When shortages emerge in any market, prices spike. If the imbalance is expected to continue, speculators move in and drive prices even higher. Oil is no exception. In the fall, as crude inventories declined and the war of words between the U.S.



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and Iran grew louder, trading (*not production!*) volume shot up. Prices rose and volatility increased.

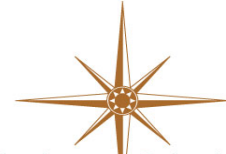
With oil prices at inflation-adjusted highs, energy companies and governments are investing heavily in facilities that generate crude and crude substitutes. Far more important is the longer-term changes that are starting to become “hard-wired” in US consumer’s minds. People are starting to economize, and over time, these changes in behavior will shift the balance of power in the marketplace away from suppliers and speculators.

Many two-car families are now seeing monthly gas bills reach over \$400 to \$500 a month and believe me, that changes your thinking! When enough people make their next car a small fuel-efficient Civic or Chevy and dump their gas-guzzling SUV, pump prices will drop. It happened in the ‘70’s and it will happen again now.

In the US and Canada, hundreds of mothballed, low-producing “stripper” wells have been brought back into production. At \$25 per barrel it didn’t make economic sense to run these wells; with sustained prices over \$50, it does. Overseas, many African, South American and Asian governments are setting up development deals with the Chinese oil companies. In Alberta, Suncor and other companies are building massive mining and in-situ recovery operations to develop the massive Canadian tar sand deposits, which can be converted into synthetic oil or refined directly into petroleum at a cost of roughly \$30 a barrel. Some experts believe the sands contain more oil than the deserts of Saudi Arabia. The same is true of the Venezuelan heavy oil deposits; high oil prices support sustained investment in technology that will yield huge new sources of oil for the world.

Not very long ago, energy companies were slashing their exploration and drilling budgets, refusing to finance any project unless it could generate crude for less than \$20 a barrel. But the industry has raised its assumptions about long-term crude prices and thus beefed up capital spending. Over the next few years, Exxon Mobil plans to begin pumping oil or gas from no fewer than 20 new discovery oil fields!

High prices mean the oil companies are also returning to areas that weren’t economically viable when oil was cheap, including the Arctic Ocean and the deep waters of the Gulf of Mexico. The industry’s efforts aren’t confined to searching for new reserves. It is also investing heavily in new technology to start up enhanced recovery programs that will increase the amount of oil that can be recovered from existing reservoirs. Many people don’t understand that when oil was cheap, over 60% of the oil was left in the ground since it was uneconomic to recover it with existing technology.



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What is really happening is that the era of cheap oil is coming to an end. Outside of Saudi Arabia, Iraq, Russia and Eastern Asia, it is no longer possible to recover large quantities of crude for a dollar or two a barrel. When Sam was working with Mobil Oil's Aramco activities back in the '70's, it actually cost about a dime to get a barrel of oil (*that's 42 gallons*) out of the ground in Saudi Arabia. Now it costs about \$20 for most reservoirs.

However, over time as energy supplies expand and replacement technologies emerge or the demand for oil starts to ease, it won't be very long before economic fundamentals reassert themselves. Of course, the oil market is hardly a textbook case of open competition: The OPEC cartel controls 40 percent of the supply, and Middle Eastern "real politics" are an ever-present factor, as is speculation. The recent surge toward \$100 a barrel was a dramatic demonstration of how monetary policies, fear and speculation can cause prices to become detached from real costs.

We believe that your portfolio should continue to hold oil and gas exploration, refining, transportation, supply and service companies in the Energy sector as a major component of your Diversifier asset class. At a current price/earning ratio of 12, this sector still has significant upside potential. You have been well rewarded from this strategy over the past five years or so and we believe the benefit will continue.

Sincerely,

Robin A. Young, CFP[®], RLP[®]
Alexa Darbe, CFP
Sam Hull, CFP[®], RLP[®]