



NORTHSTAR

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PLANNING INC

JULY 2007

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2007 Mid Year Investment Letter

We hope you are enjoying the beautiful summer weather we've had so far. We just noticed that once again we've escaped the pesky black flies and no-see'ems that the New England spring usually brings and so far, the mosquitoes are manageable!

First, some great news! Northstar has been named Top Dog by one of the premier publications in the investment world, Bloomberg's Wealth Manager magazine. Every year they compile a list of the top 500 wealth management firms in the US and this year, based on our 2006 results, Northstar Financial Planning was honored to be included. We really have you to thank for trusting us to help you with your financial life planning and wealth management over the years.

Market Commentary

Despite continued weakness in the domestic residential real estate market and ongoing woes in the sub-prime lending space, the second quarter of 2007 produced very fine results for our clients' portfolios. Let's look at how the broad markets did for the first six months of 2007:

| Market Indices | 2004 | 2005 | 2006 | 6 Mo.-2007 |
|----------------|-------|-------|-------|------------|
| S & P 500 | 10.9% | 4.9% | 15.8% | 7.0% |
| Russell 2000 | 18.9% | 4.6% | 18.4% | 6.5% |
| MSCI EAFE | 18.6% | 15.7% | 23.5% | 9.1% |
| Wilshire REIT | 32.1% | 14.0% | 36.1% | (6.0%) |

Most of our client portfolios are already enjoying year-to-date results which we'd find quite respectable for the whole year. This is a continuation of the superior portfolio results we've been able to achieve for clients generally since the market began its broad recovery more than four years ago. A large part of this recent good news is the strong recovery following the three year collapse of equity prices in 2000, 2001, and 2002. From that "catching up" perspective, it's probably *not* too

¹ This is the US Smaller Cap index

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

³ This is the US Real Estate index



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much of a good thing and reflects solid real economic performance around the world. Still, it's at an absolute *pace* that almost certainly cannot be sustained over the long-term.

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

| 2006 | Northstar Model Portfolio Return | 2007-1 st Half |
|-------|--|---------------------------|
| 16.7% | Aggressive (90% equities/10% bonds) | 6.2% |
| 15.3% | Capital Growth (80% equities/20% bonds) | 5.6% |
| 14.0% | Balanced Plus (70% equities/30% bonds) | 5.0% |
| 12.6% | Balanced (60% equities/40% bonds) | 4.5% |
| 11.6% | Conservative Balanced (50% equities/50% bonds) | 3.9% |
| 9.8% | Capital Preservation (40%/60% bonds) | 3.3% |

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

- o Hedge Funds-why we don't use them.
- o Sub-prime mortgages-are they really a problem?
- o Northstar's philosophy about the role of bonds in your portfolio.

Why We Don't Use Hedge Funds

It always amazes us how much personal income hedge fund managers can make for risking other people's money. The paychecks often run into the hundreds of millions of dollars, and there have been a few cases where the total compensation received by a hedge fund manager exceeded a billion dollars!

Are these "rock-star" managers really worth it? Have their returns really been that good? As it turned out, there were more than a few surprises once you look beyond the hype.

First off, there are a lot more hedge funds than most people realize. There are more than 8,500 hedge funds, all using increasingly complex strategies to squeeze out high returns by managing risk. The total amount under hedge fund management (AUM) was in excess of a trillion dollars – and much of that was from pension plans and other long-term institutional tax-exempt investors.

The growing interest in hedge funds by pension plans and other tax-exempt organizations is ascribed to dissatisfaction with the current lower level of equity and bond returns as well as increased correlation among traditional asset classes. In plain English, this means that institutional investors are seeking higher portfolio returns by including hedge funds in the mix and hoping to diversify away the higher risks through asset allocation.



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Here's the bottom line, though. A recent Ibbotson study calculated the average hedge fund return for 1995 through April 2006. The analysis showed annualized total returns of 11.0%. By comparison, the total return of the S & P 500 index fund for the same period of time was 11.6%.

Surprise! The average hedge fund generated returns about the same as the S & P 500 index! It is also important to remember that hedge funds tend to do best when the stock market is struggling and that 1995-1999 was the best five-year period in U. S. stock market history. We also stress that some hedge funds obviously did much better than average. The trouble comes in figuring out which ones will be above average before the fact. It is also nearly impossible for individual investors to gain access to the really successful hedge funds, which are reserved only for institutional investors and are usually closed anyway.

Essentially the study showed that any extra return earned by the average hedge fund was almost entirely offset by the higher fees that these funds charge. A common hedge fund fee structure is 2% of assets under management plus 20% of gains in excess of a market benchmark. Thus after paying the huge management fees, investors probably are just about as well off in an index fund. Instead of paying some superstar manager the "2% + 20%" fee, many index funds, e.g. the DFA US Large Company fund we use at Northstar, have fees of less than 1/10th of those charged by hedge funds—and there is no "20% bonus" haircut!

The Sub-Prime Mortgage Loan Mess!

Most of us who are over 40 remember how you applied for a mortgage not too long ago. In addition to having enough cash to make a minimum 10-15% down-payment, you had to have a clean credit history, hold a job providing you with a good steady income, and have a "good record" with the bank. It was all done on a face to face basis and everything was checked out. The local banker was an integral part of the community. The bank gave you the mortgage loan and you made your payments directly to the bank.

Well, that's all changed now!

For the past decade or so, major Wall Street investment banks have been taking advantage of the sea of cash sloshing around the globe and throwing so much money at mortgage brokers and lenders that the traditional "rules" for lending on mortgages have been bent and in some cases, broken.

- | | |
|--------------------------|----------------------------------|
| ✓ Credit problems? | no worries, take the money! |
| ✓ No down payment? | no problem, take the money! |
| ✓ Shaky job, low income? | "fuggegabouit!", take the money! |



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The trouble comes when a lot of high-risk mortgages are gathered up by an investment bank and then “securitized “. That means individual mortgage loans are packaged up together, sliced and diced into separate little investment packages by credit risk, by maturity, by loan quality or by interest rate and then sold to individual investors. But those underlying shaky “sub-prime” mortgage borrowers still have a high risk of defaulting on their loans and when that happens, all those fancy hedges and derivatives sometimes crash and burn as well. “Sub-prime” is often just another word for poor credit and high risk.

The Wall Street Journal put it very well in a recent editorial:

“The \$3.2 billion hedge-fund meltdown at Bear Stearns is an example of a “perfect storm” of modern financial slight of hand, combining sub prime mortgages gone bad, hedge funds taking on water, and opaque derivatives. It has already led to questions about whether all of these need better (read: “more”) regulation. What they really need is what they're so far getting; a good old fashioned “Adam Smith” cleaning out of the stables.

Financial bets gone wrong are not a crime. In fact, they are essential. Financial innovation has been a great boon to the American economy, but innovation entails risk, and risk means the potential for failure. The key point is that, when financial players step out too far on the risk curve in order to earn larger rewards, they must also be allowed to suffer the requisite market penalties for reckless driving.

Take the case of the Bear Stearns hedge funds, which focused on sub prime debt securities. The fund manager, Ralph Cioffi, was a hero to his boss and his investors as he developed new mortgage instruments that returned 20% a year. But he got in over his head when he had bet on derivative hedges that didn't protect his exposure to the sub prime market in the way that he imagined. The losses led to margin calls from creditors, and eventually to Bear's offer of a \$3.2 billion bailout lifeline to one of the two ailing hedge funds.

You'd think a hedge fund would know how to hedge. But many of today's debt instruments and derivatives are new enough that they haven't been tested in a downturn. The index against which the Bear Stearns funds were trying to hedge has only been in existence for 18 months, so no one knew how it would behave when the sub prime market swooned. It's bad if you're one of their investors, but it's a long way from market failure!

We may not have heard the worst in the sub prime space, and almost certainly not in high-yield credit markets either. As failures unfold, we're willing to bet that some investment banks will be found to have overcharged for innovative products of limited value, even if they seemed like a good idea at the time. People will have



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invested their money in places they shouldn't have and "lost everything." Shakeouts are never pretty, but they're necessary because mistakes do get made in a free-market financial system, and if the mistakes are not paid for by those who made them, the whole system suffers.

It may be that underwriting standards on adjustable-rate mortgages need another look, but a lot of this is happening anyway. Rule # 1 is still that banks that lend other people's money expect to be paid back, in full and on time.

When it comes to securitizing and reselling those loans, buyers who've been burned may also demand more in the way of disclosure and guarantees that the securities are what they purport to be, and that's also all to the good. Until things went south in the sub prime market, even sophisticated investors didn't necessarily know what information was important for them to have. They're now learning from their mistakes.¹

The Role of Bonds in Your Portfolio

Why should your portfolio include an allocation to fixed income (bonds)? Many people mistakenly look at bonds and bond funds as being poor investments, "boring" or just dead-weight. However, in the same way a deep keel keeps a wind-battered sailboat from tossing and heeling as it beats to windward, we think a well-designed bond component can serve a similar critical purpose for your investments – stability!

In 1958, James Tobin's research proposed that the main purpose of fixed income was to temper the risk of equities. His "Separation Theorem" shifted focus from security selection to portfolio structure, and earned him the Nobel Prize in Economics in 1981.

We share Tobin's view that the role of fixed income is to reduce the "wiggles", technically known as volatility (aka, "standard deviation") when combined judiciously with equities in a balanced portfolio. In order to do this, successful fixed income strategies must also:

- o Reduce maturity risk by holding shorter-term instruments of varying durations.
- o Reduce default risk by holding high-quality obligations.

¹ Wall Street Journal, June 27, 2007 Editorial Page



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- o Reduce currency risk through hedging foreign bonds back to the US dollar.
- o Manage yield curve gradient changes using a variable maturity trading strategy.

Thus we select fixed income investments to serve a higher purpose in the overall portfolio design and that is to minimize investors' exposure to un-rewarded risk.

Research by DFA's fixed income group has also demonstrated to our satisfaction that holding bonds or bond funds with a maturity (*the time until a bond will return its capital investment*) greater than five years does not make economic sense for most investors. The risk/reward profile of various bond maturities over the 42 year period from 1964 through 2006 demonstrates this.

| Maturity | One Month US T-Bills | Six Month US T-Bills | One Year US Notes | Five Year US Notes | 30 Year US Bonds |
|-----------------------------------|----------------------|----------------------|-------------------|--------------------|------------------|
| Annualized Compound Returns (%) | 5.81% | 6.55% | 6.73% | 7.34% | 7.66% |
| Annualized Standard Deviation (%) | 1.33% | 1.73% | 2.35% | 6.23% | <u>10.93%</u> |

As you can see, at maturities greater than five years the volatility (standard deviation) of bond returns exceeded the expected return. Therefore an investor is unlikely to be rewarded with sufficient return for accepting this greater risk. It is only by investing in the equity markets where higher volatilities have the potential to generate higher returns. This leads to our dictum - "**Use equities for growth; use bonds for stability.**" That's why we don't use long-term bonds or higher-risk bonds like GNMA or junk bond funds.

Please call if you have any questions or comments. Thank you again for allowing us to continue to be of service to you as your financial life planner and wealth managers.

Best regards,

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