NORTHSTAR
FINANCIAL PLANNING INC

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603.216.9226

2008 Mid Year Investment Letter

This is our mid-year Northstar investment review letter and it is proving to be both hard and easy to write. "Hard" because we are now officially in Bear Market territory, with the Dow Jones down 20% from the high reached nine months ago in October, 2007. The US economy is groaning under the twin shocks of the financial sector credit fiasco and resulting freezing of global liquidity and the doubling of crude oil prices over the past year. We'll talk more about oil, the economy and the stock market a bit later in this report.

"Easy" because, as we said in January, *"Our rational conscious mind has to work very hard to overcome emotions and help us return to rational thinking" and that continues to be our advice to all who may find themselves overly worried about the drumbeat of "bad news".* During tough times like this, we each have a job to do. Our job as your advisor is to hold your financial strategy on course towards your goals. Your "job" is to hold your focus on your dreams and goals.

We'll also talk more about some of the fascinating research now being done in "neuroeconomics" - a new field of study describing how the evolution of the human brain makes us ill-suited to come to rational economic decisions- even though we think we do!

Stock Market Commentary

Let's look at how the broad markets did for the first half of 2008 and how that compares to the three previous years:

Market Indices	2005	2006	2007	1st Half-2008
S & P 500	4.9%	15.8%	4.9%	**(12.2%)**
Russell 2000 [1]	4.6%	18.4%	(1.6%)	**(9.4%)**
MSCI EAFE [2]	15.7%	23.5%	11.2%	**(12.7%)**
Wilshire REIT [3]	14.0%	36.1%	(17.6%)	**(3.4%)**
AIG Commodities	21.4%	2.1%	16.2%	**26.0%**
S & P Energy	31.4%	24.2%	34.4%	**6.4%**
Bond Aggregate	2.4%	4.3%	7.0%	**1.2%**

[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

The total returns for the Northstar Model Portfolios for the first half of 2008 were:

2007	**Northstar Model Portfolio Return**	**2008**
6.40%	Aggressive *(90% equities/10% bonds)*	**(8.6%)**
6.46%	Capital Growth *(80% equities/20% bonds)*	**(7.5%)**
6.52%	Balanced Plus *(70% equities/30% bonds)*	**(6.4%)**
6.59%	Balanced *(60% equities/40% bonds)*	**(5.3%)**
6.65%	Conservative Balanced *(50% equities/50% bonds)*	**(4.2%)**
6.72%	Capital Preservation *(40%/60% bonds)*	**(3.2%)**

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

- Are we returning to the 1970's – is "stagflation" back?
- Oil, the economy and the stock market.
- Why do investors make poor decisions most of the time?

Are we heading back to the future?
Nowadays, a lot of comparisons are being made by the media to life in the 1970's. This is because the U.S. economy feels like it is once again stuck in the throes of stagflation. Back then, for about 10 years the US stock market basically went sideways (or down) and there seemed nowhere for the average investor to hide. Remember- bell-bottomed slacks, long hair, VW vans, Jimmy Carter's "killer rabbits", waiting lines at the gasoline pumps, price freezes, "Watergate and all that stuff", Vietnam war peace rallies - now those were interesting times! But something new- we invented the term "*stagflation*"- was really the root cause for much of the world's economic woes.

The combination of little or no growth (stagnation) and rapidly rising consumer and producer prices (inflation), the term stagflation was first coined by Iain Macleod, the British Chancellor of the Exchequer, in a speech to the House of Commons in 1965. He said, *"We now have the worst of both worlds -- not just inflation on one side or stagnation on the other, but both of them together ... sort of a stagflation situation."*

At first glance, it does appear to be déjà vu all over again.

The US economy has barely grown over the past six months (the last two quarters each reported at an anemic 0.6%), leading to reduced new job creation rates and a jump in the jobless rate. Meanwhile, consumer prices are up nearly 4% over the past twelve months with energy, food and health care -- the big costs in most households -- rising several times faster.

Not surprisingly, inflation psychology has begun to heat up. Some observers expect consumer prices to rise as much as 5% to 6% next year, which would be the most since the bad old days we just talked about! However, it is always good to remember that the "observers" and "experts" have been wrong in their high-inflation warnings before. Fed Chairman Greenspan spent years worrying about future high inflation and somehow it always stayed much lower than the he and the other "experts" forecast.

But are people doing anything about high-inflation fears, such as buying in advance or demanding higher wages? The answer seems to be no. There are some who argue that wages are still rising at a modest pace and that the lack of a wage-price spiral suggests that wages will eventually overwhelm inflation and cause prices to rise slowly, if at all.

Others, however, regard all this more ominously. You may remember that back when the 1973-74 oil shock forced price inflation into double-digits (10% or more), it was common for employers to give their workers pay hikes equaling or exceeding the rate of inflation. Alas, this doesn't seem to be the case these days, so the pressure on wages earners continues and eventually could dampen the purchasing power that keeps the economy humming along.

Oil, the economy and the stock market

In 1998, a barrel of crude oil cost about $10. Today that same barrel will cost around $140 in the world market. What is going on? "Who is to blame", to ask the politician's favorite question? A recent research report issued by the Vanguard Group's Joseph H. Davis, Ph.D. and Roger Aliaga-Diaz, Ph.D. sheds some much needed light on these issues. Their work suggests that price increases beyond around $85/bbl are not due to supply interruptions (e.g., the '70's Middle East oil cut-off), global demand fundamentals (high increases in China) or the weakened US dollar and are instead largely attributable to *precautionary demand* and/or *speculation.* What's the difference?

Precautionary demand reflects a genuine desire to hedge against future oil supply concerns arising either from geopolitical concerns (Middle East unrest & civil strife) or rising fears about running out of oil. This is sometimes known as the "peak oil" theory and is based on the work of Hubbert in the 1950's that predicts an imminent and permanent decline in oil supply that will drive cataclysmic civil unrest and dramatic and permanent increases in the price of all energy that will totally disrupt the world's economy and degrade our standard of living. Others (including Northstar) discount this theory as overlooking the economic imperative that has always been humankind's response to crisis. The economic response to higher oil prices is even-now being reflected in the allocation of greater capital & human resources and technology, directed to finding and producing more oil. A study by the Energy Information Agency predicts rising production through 2065, with long-term process leveling off around $85/bbl in constant dollars when some breathing space between supply and demand is created by falling demand (people switching from Hummer SUVs to small cars) and/or increased oil supplies as new production facilities come on-line.

High speculative demand, on the other hand, is a temporary factor and should reverse itself eventually as the market re-adjusts to eliminate arbitrage & inordinately high speculative profits. There has been a huge increase in investment in oil as an asset class with the resultant effect being that long-term positions being held rather than traded. Hedgers and speculators add liquidity to a market and are a necessary ingredient in the efficient operation of the market. However, when investor interest in commodities and oil as an asset class wanes, the US dollar strengthens and/or the "crisis de jour" attention being paid by the media to peak oil fears wanes, then speculative boom with its attendant $50-60/bbl premium will fade away as well.

How does oil process affect the stock market? Statistical analysis going back nearly 40 years seems to show that the global equity market varies inversely to oil price increases. This analysis indicates that a doubling of oil process could be expected to be associated with a 20-22% decline in the stock market. That is almost exactly what has happened over the past nine months- oil has gone from $70 per barrel to $140 and the market has dropped just over 20% in value.

So what can we do in the short-term? First –just plain common sense says that each of us has to become more efficient in our gasoline usage! The US uses just over 21 million barrels of oil per day and nearly 70% of that is used in the transportation sector; for cars, trains, ships, planes and boats. Increasing our gas mileage is a must. In Europe the average car mileage is 44 mpg, nearly double that of the US!

Secondly, the Federal Reserve should lower short-term rates as an immediate response to the next oil-price shock. Opening up offshore drilling and /or releasing some oil from the Strategic Reserve would also show the speculators that we are serious about popping the oil price bubble.

Neuroeconomics and the Investor

We just finished a fascinating article by Jason Zweig in the latest Journal of Indexes describing his research into the arcane science of neuroeconomics[4].

4 Jason Zweig; *Your Money & Your Brain; How the New Science of Neuroeconomics Can Help Make You Rich*., Simon & Shuster

Simply put, this is all about emotion and the role our emotions play in the investment process. We think of ourselves as rational beings, especially when it comes to something as important and "serious" as money. But in reality, our emotions dominate our ability to evaluate and are being generated in parts of the old brain that are all about not being rational - and most of the time we aren't even aware of what's going on!

Neuroeconomics postulates that while the *Homo sapiens* brain has changed over the past 200,000 years, most of the core functions that were necessary for survival came about in the millions of years before modern man arose. The skills necessary for solving pre-historic problems like recognizing simple patterns or recognizing shapes are obvious (*Is that coiled snake in the tree ahead of me or just a vine?*) but others, like the skill in extrapolation that were necessary for getting food, shelter and survival are not serving us so well today in making investment decisions. Our ancestor's pre-historic brains learned to make the most of small amounts of data- and to extrapolate what they thought it meant into immediate action. We learned to perceive patterns everywhere, to take fragmentary information and leap to a conclusion, to over-rely on the short-run in planning for our long-term safety.

How this plays out in today's investing world? Consider the lucky stock market analyst or TV talking head who gets a few key predictions right. They are immediately proclaimed as a genius and show up on CNBC with "The Word" on our financial future. However, as Berkeley economist Matthew Rabin points out, while a couple of lucky predictions can seem to make one a forecasting genius, this is only because people have no practical way to look at the analyst's entire forecasting record. In the absence of a full sample, a small streak of random luck can be mistakenly perceived to be part of a longer pattern of reliable foresight, not a small piece of a longer dismal record of misses.

The basic reality of our pre-historic brain at work in today's investing world looks like this:

- **We leap to conclusions.** Seeing several in a row of almost anything- rising or falling stock prices, high or low mutual fund returns – will make you expect more of the same thing in the future.
- **We are unconscious.** Even when we think we are fully engaged in a sophisticated analysis of an investment choice, the pattern-seeking Cro-Magnon part of our brain may well guide us to a deeper, more instinctive action, like fight or flight.
- **We are automatic.** Whenever we are confronted with anything random, we will search for patterns within what you see. Even if there are none, we will

usually see something. It is how our brains are built- and how a burnt piece of toast can sell on EBay for $28,000 because people "see" a picture of Elvis on it!

- **It is uncontrollable.** While we can't turn this kind of deep-brain processing off and on (*watch out*! *It looks like a saber-toothed tiger is lurking in those shadows just ahead)*, we can learn to recognize it when it happens.

How does all this relate to you right now as an investor? Well, after the last nine months of falling stock prices, scary glimpses of a future energy crisis, constant drum-beats of our collapsing economy and maybe a sense of increasing class and generational strife, it is normal to start to see a pattern of chaos and doom that cries out "*Do something! Get me out of here*!

Here's where we come in as your investment advisor and financial life planner. It's our job that when things start to hurt and the future looks scary to remind you that it is a mistake to abandon your long-term investment strategy in response to short-term events. Stay the course and talk to us!

Best Personal Regards,

Robin Young, CFP®, RLP®
Alexa Darbe, CFP®
Sam Hull, CFP®, RLP®