



MEMO FROM THE NORTHERN CAPITAL MANAGEMENT, INC. INVESTMENT COMMITTEE
January 17, 2008

It is the opinion of Northern Capital Management, Inc.’s Investment Committee the economy has slipped into recession. This will prove to be a particularly difficult time for investors who experienced the last downturn.

Our response to the onset of recession in year 2000 was to rely on the normalcy of the economic cycle. That is to say, watch the Fed raise interest rates to cool the economy, watch the economy cool, watch the Fed lower interest rates to reinvigorate the economy and experience stock market recovery.

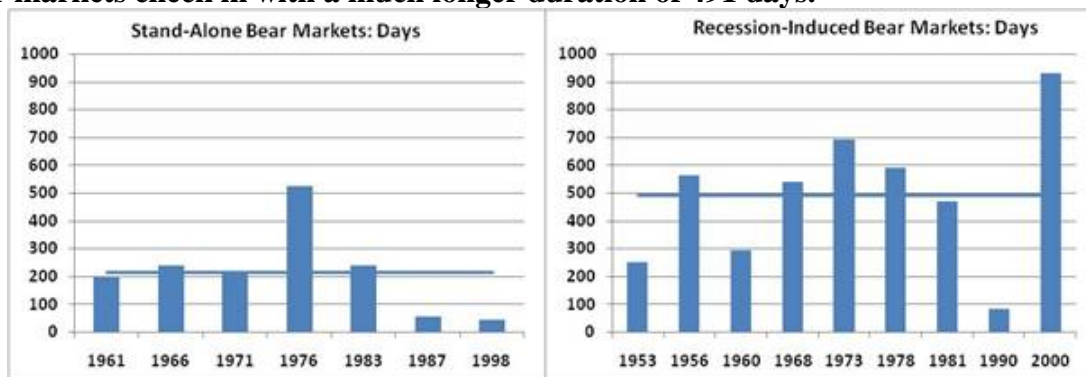
Midway through 2001 we felt we were in good company predicting recovery. In August of 2001 Ben Bernanke, then chair of the economics department at Princeton, was asked by the university’s newspaper whether he believed the economy was heading for a recession. He said that outside of the technology industry, the economy was reasonably healthy and that tax cuts and the recent interest rate cuts by the Federal Reserve Board would be enough to give the economy a boost. “I think there’s a good chance we’ll dodge the bullet this time,” he said.

The NBER – with the help of Mr. Bernanke, who at that time was a member of the group’s Business Cycle Dating Committee – would eventually declare that the 2001 recession began 6 months earlier in March. The economy would trough in November of that year. But then again, who could have anticipated September 11?

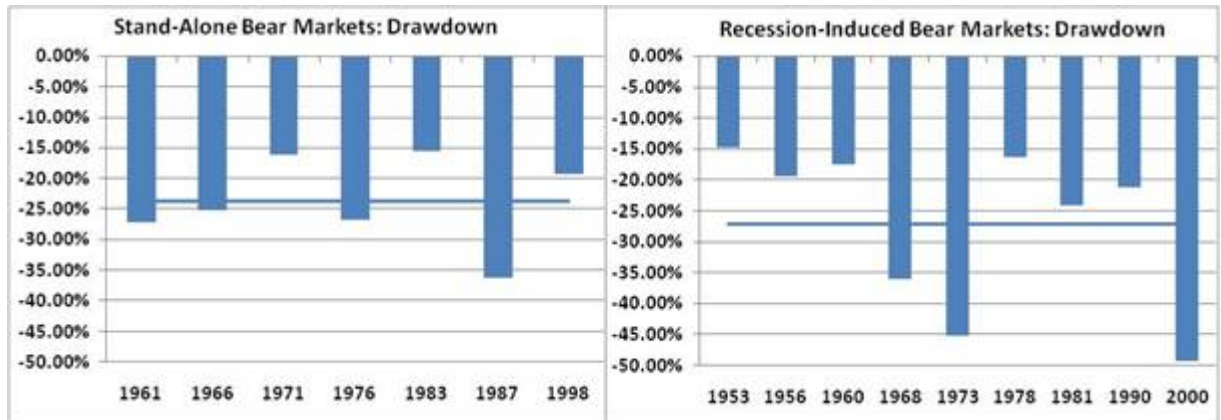
With market conditions weakening further in 2002 Northern Capital Management, Inc. took more radical proactive steps to buffer portfolios from the significant market declines. While our clients did not suffer nearly as much as investors with high technology exposure, these trades did little to allow them to fully participate in the recovery of 2003. Our early decision to rely on the norms of the economic cycle versus taking pre-emptive defensive steps led to losses we could have done a better job of avoiding.

That experience forced Northern Capital Management, Inc. to seriously reconsider our approach to managing money through periods of economic weakness.

There are essentially two types of bear markets...those which coincide with recessions and those which are normal and necessary spasms that bring stock valuations back to more reasonable levels. The average bear market *not coincident* with a recession has had an average duration of 215 days. **Alternatively, recession-induced bear markets check in with a much longer duration of 491 days.**

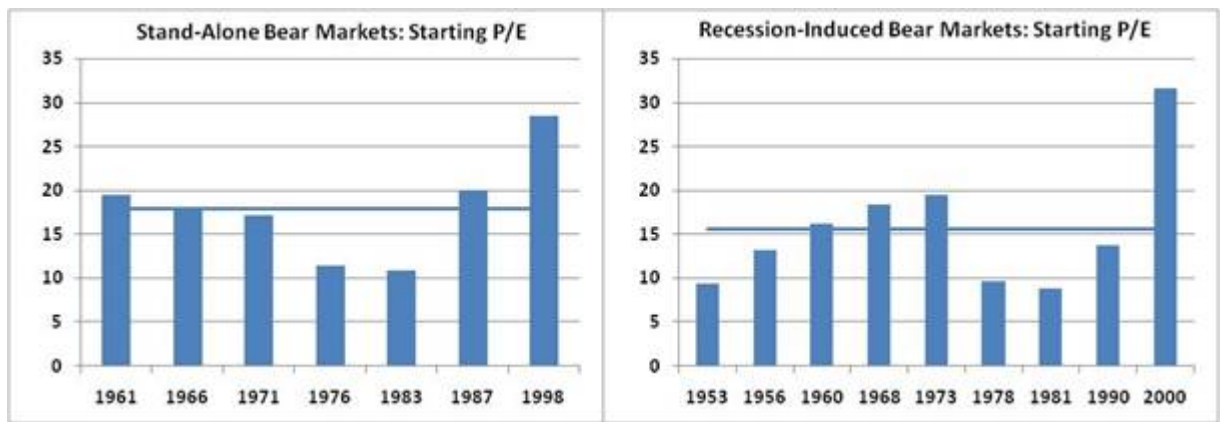


The next set of charts shows the decline in the S&P 500 from peak to trough during each bear market. Notably, stand-alone bear market losses tend to be fairly consistent in terms of their magnitude. Alternatively, bear markets that coincide with recessions have a high degree of variability in terms of their severity.



One argument aired during recent Investment Committee meetings has been the relatively reasonable valuations of stocks presently. In other words, if one compares the profitability of companies relative to their stock prices, stocks do not appear “expensive” or over-inflated.

Unfortunately, as evidenced by the graphs below, the price/earnings statistic provides us little guidance as to the anticipated magnitude of any given downturn.



To put the charts above into perspective, assuming projected earnings for 2008 hold, stocks presently trade around 13.8 times earnings.

While recessions are difficult to forecast it appears our present economy has few tailwinds, with the exception of a huffing and puffing Fed and the strong prospect for some type of governmental stimulus package.

The most recent economic statistics that suggest recession include:

- Weakening consumer spending;
- Freight shippers such as Federal Express reporting slowing volumes and fewer “full loads”;
- Rising consumer debt levels (to a record);
- Rising unemployment as a result of poor job creation (unemployment has now risen a third of a percentage point. Only once since World War II (1951) has this not resulted in recession);
- Manufacturing has fallen into a state of contraction (albeit mild);
- Housing remains weak;

- Other leading indicators are showing signs of weakness.

The Committee has already taken some actions late last year and early this year to “get ahead” of the deteriorating fundamentals. To date these include:

- Eliminating bond funds containing any sub-prime exposure;
- Eliminating low quality bond funds from portfolios;
- Investing in high credit quality bond funds designed to appreciate as the Fed lowers rates;
- Investing in “world allocation” funds that have the ability to invest in commodities and/or “short” the market (a bet on a decline);
- Eliminating the most vulnerable type of stock funds from portfolios (value, blend and growth small company stocks)
- Reductions in “value” categories dominated by financial companies (such as Countrywide and Citigroup);
- Investing in recession resistant healthcare.

The next moves may prove more bold if deemed necessary and could include the following:

- Elimination of convertible bond funds from portfolios (tend to underperform in deep recessions);
- The first ever use of a class of funds referred to as “inverse”. Inverse funds key off of some basket of stocks or an index and move in the opposite direction. Appealing categories at present include real estate and small company stock inverse funds.

While all of the aforementioned moves may not prevent losses entirely in 2008, they should help to blunt them while still allowing for participation in the inevitable recovery.

At present we continue to maintain significant holdings outside of the US. One has to wonder what impact globalization will have on overseas economies and markets. On the one hand, it could be argued when the United States sneezes, the global cold could be much worse than in times past due to tighter economic reliance.

However, notably the economies of several emerging markets are far *less* reliant on foreign trade to extend their expansions. Instead growth is being fueled by domestic demand. Good examples are the Chinese and Indian economies, which are both expected to growth in the high single digits in 2008. Of the 11.5% growth the Chinese economy experienced in 2008, 2.5% was attributable to trade with the United States.

We will closely monitor the performance of our foreign holdings in this downturn and seek out opportunities.

Timing the market is a dicey game and not one that is consistently successful. Hence, the challenge for the Committee is to provide just the right amount of protection at the right times. Such trading activity has been characterized as part art, part science and part chaos. We describe it as nerve-racking.

If we are in recession and the duration of the resulting bear market equals the average, stock performance will not improve until 2009.

We did put a good year in the books for 2007, but take little pleasure as we are keenly aware of the difficult decisions which lie in the months ahead. ***If clients prefer a less-measured and more aggressive defensive response we must know now.***

The Investment Committee now meets nearly daily to evaluate strategies in place, discuss market and economic events and to attempt to identify favorable investment opportunities. Despite all of our efforts, we anticipate this to be a very difficult year.

Remember, while the 2000-2002 debacle seemed as though it would never end...it did.

Investment Committee
Northern Capital Management, Inc.