

SECOND QUARTER 2005

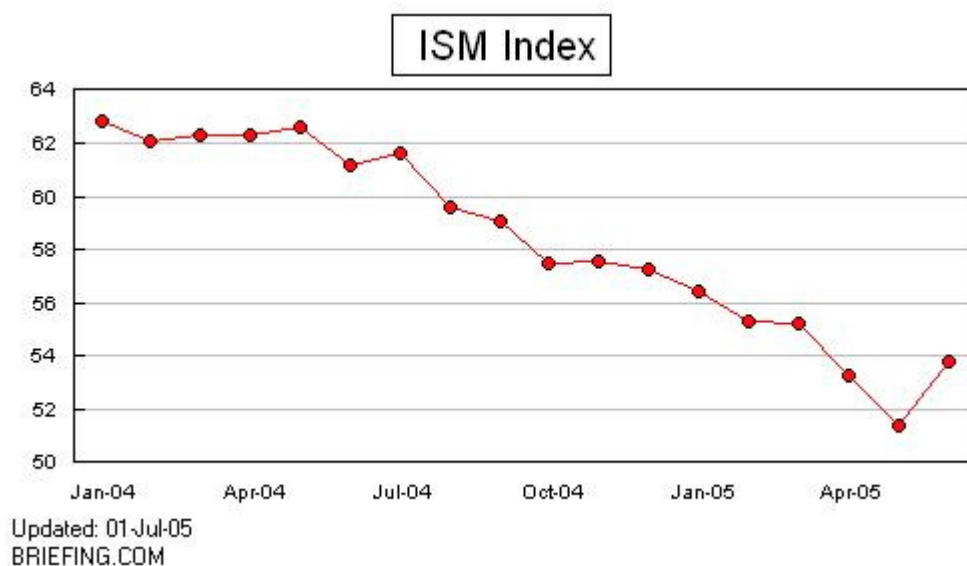
The stock markets have confounded pundits and investors alike during the first half of the year by staying in a very tight trading range. For the quarter just ended, the S&P 500 was up 1.37% including dividends, for a year-to-date return of -.81%. While there are many political crosscurrents at work in the world, economic fundamentals have not changed markedly since January. Indeed, inflation has not increased, earnings growth is strong, and the price/earnings ratio on the S&P 500 has moved to 16.8 on that growth. Markets rarely move in any one direction for very long, and the bull market that ostensibly began in late 2002 is entering its 32nd month. By historical standards, this one is getting a bit long in the tooth: the average bull market is expected to last 36 to 39 months. While this bit of information is not a major distraction, we will keep it in mind as we look ahead.

INTEREST RATES

The bond market enjoyed a respectable rally during the second quarter. The yield on the ten-year U.S. Treasury Note declined from 4.50% at the start of the period to the closing yield of 3.95%. This strength occurred in spite of several more rate increases by the Federal Reserve. In his testimony before the Joint Economic Committee, Alan Greenspan stated that the economy seems to be on reasonably firm footing, and underlying inflation remains contained. The current Goldilocks scenario of relatively strong economic growth, high consumer confidence, well contained inflation, and an improving manufacturing sector seems to have trumped everyone's expectation of rising long-term interest rates.



The improvement in the manufacturing sector, as evidenced by the monthly ISM survey, is worth expanding upon. The Institute of Supply Management publishes this diffusion index every month as a barometer on the manufacturing economy. As a diffusion index, any reading over 50 indicates an expanding economy; a reading under 50 a contracting economy. The index peaked in January of 2004 at 63.6 and has been declining since that time to the recent reading of 51.4 for May of this year. While still indicating an expanding economy, the index appeared to be heading for the land of contracting economies. As the chart below reveals, the index reversed course in June with a very strong increase of 2.4 points to 53.8. One month certainly does not constitute a trend; however, it is very encouraging and serves to affirm Chairman Greenspan's comment about the economy's footing.



HIGH YIELD EQUITIES

This is a group of nontraditional securities characterized by high current dividend yields. In this period of low interest rates, we have used these securities as a partial alternative to fixed income investments as the yields tend to be 1 ½ to more than 2 times the yield on the ten year U.S. Treasury bond. These are not traditional common stocks, but neither are they fixed income securities. Corporate structures include real estate investment trusts, royalty trusts, master limited partnerships and limited liability companies. These entities pay out most of their cash flow in the form of dividends or royalty payments on a pretax basis resulting in higher current returns. As a result, a portion of the payment tends to be treated as a return of principal which leads to more complicated tax treatment to the recipient.

The businesses of these entities can cover a wide range including energy, minerals, asset management, transportation, timber and many types of real estate investment. We have attempted to diversify individual accounts by investing in a package of these securities. When interest rates rise, there is always concern that these companies will decline in value with falling bond prices. While this is partially true, there are mitigating factors. Most of these are ongoing businesses that are capable of delivering modest growth over time, allowing for some capital appreciation as well as high current returns. Although dividend rates are not fixed and can decline, so too can they rise with success in the underlying business. One of the key contributors to rising interest rates is inflation. Since hard assets such as minerals, timber and real estate underlie many of these companies, they can in fact benefit from some levels of inflation - thus offsetting some of the effects of rising interest rates. As a group, these investments have met income objectives and have provided relative outperformance to the stock market over the last several

years. While these companies are not widely followed or publicized, we feel that they can be an effective tool for us in meeting your investment objectives.

This week Northstar Investment Advisors celebrates its 10th anniversary. We are very proud of this accomplishment and we eagerly anticipate the next ten years and beyond. Most importantly, we appreciate your continued interest in Northstar. Your ideas, feedback and generous referrals are critical to our success.

Sincerely,

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