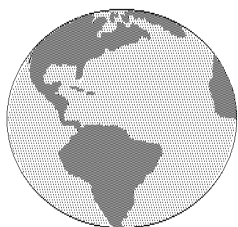


### Summary

- Another good quarter and the second good year in our recovery from 2007-09.
- U.S. large stocks were up 10.7% for the quarter and 15% for the full year while small stocks were up 16.2% and 26.8% respectively.
- Growth somewhat outperformed value over both the quarter and year.
- International large stocks in Europe and Japan were up an average of 6.6% for the quarter and 8.2% for the full year. Small non-U.S. companies performed even better, up 11.8% and 22.4% respectively.
- Emerging Market investments also did well, rising 7.4% for the quarter and 19.2% for the year.
- REITs had another impressive year, rising 7.4% and 28% for the year.
- Bonds generally fell for the quarter as interest rates rose, but gained 2-6% for the year, depending on maturities, and credit quality. Longer term bonds fell more this quarter and gained more over the whole year.
- Commodities enjoyed another good year, rising 15.8% for the quarter and 16.8% for the year.



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### Continued Market Momentum for 4<sup>th</sup> Quarter ...

During the 4<sup>th</sup> Quarter the financial markets continued the positive momentum that began in March 2009. The S&P 500, reflecting the largest U.S. companies, finished up almost 11% for the quarter and just over 15% for the year. Since March 9<sup>th</sup> 2009, the S&P 500 has now gained 93% and is just 14% off its October 2007 peak. Small stocks performed even better. Market returns were helped by the improving economy, the Federal Reserve Bank's efforts and the year end extension of the Bush era tax cuts.

Foreign equity markets, based on the MSCI EAFE Index (the mostly widely used index to track non-U.S. stocks in developed countries) rose almost 7% in the 4<sup>th</sup> quarter and was up 8% for the year. Emerging markets outpaced the developed world with a return for the year of 19%. The best international returns came from Russia, Germany and India.

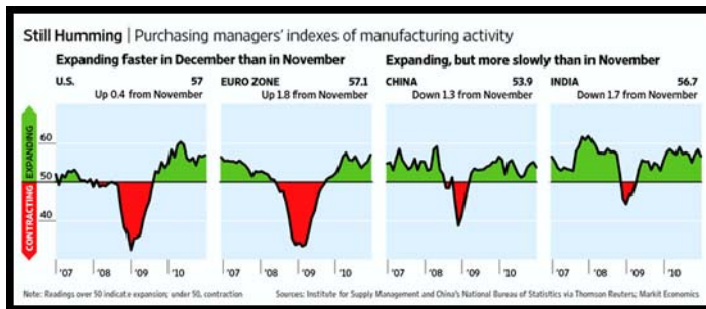
Globally, 2010 was a strong year and in some instances an excellent one for most financial markets. Commodities outperformed both stocks and bonds, rising nearly 16.8% due to strong demand (especially from China), a slightly weaker U.S. dollar and a continuation of the emerging markets growth story. The broad bond market gained over 6% for the year thanks to lowered interest rates. Investors became more willing to accept risk in their search for yield, finding attractive returns from high yield bonds, REITs, Master Limited Partnerships and emerging market bonds. Gold closed the year at \$1,405 per ounce gaining 29% in 2010. As we enter 2011, the economy appears poised to continue its recovery.



## U.S. Economy

### Economic Growth and Manufacturing...

The U.S. GDP growth rate for the third quarter was revised upward for a second time, to 2.6%. While this is better than the economy's 20 year average growth of 2.5%, it is still quite low for recovery periods. Manufacturing activity continues to improve, both in the U.S. and globally, [as evidenced in the Purchasing Manager's Index of Manufacturing Activity chart below—Readings above 50 (green) indicate expanding activity]. This was the 17th consecutive month of expansion. So far, weak consumer demand has been only half of normal relative to the prior seven recoveries. Growth has come more from business equipment purchases and inventory rebuilding.



### Employment and Housing...

The December unemployment rate declined to 9.4%. This is the lowest level since May 2009 and the biggest monthly fall in more than a decade. Unfortunately, the biggest change was in the number of people who had stopped looking for work. The U.S. unemployment rate has now been above 9% for 20 months and is unlikely to fall much below that mark until monthly growth in new jobs exceeds 200,000 or more (about double our current rate of job creation). The U.S. has now experienced the longest stretch of 9% or greater unemployment since the Second World War.

For the third consecutive month, home prices dropped in October from the prior month, according to data from S&P Case-Schiller. That was its lowest level since May. Prices are still 18% below the 2007 level, restrained by a glut of distressed properties, reluctant homebuyers and tighter lending practices. We currently have approximately eight to nine months of homes-for-sale inventory. Until inventories decline, housing is likely to remain troubled.

### The Consumer and Inflation...

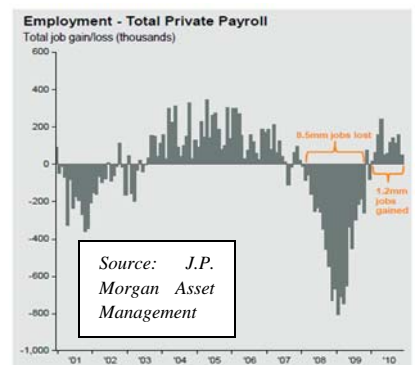
Consumers are giving out mixed signals. The Conference Board's Consumer Confidence Index®, which rose to a high of 62.7 in May, declined to 52.5 in December from November's 54.3. This was still an improvement from September's 48.5 reading. Despite the official end of the recession, the confidence data reflects ongoing weakness in the labor market and consumers' continuing uncertainty and apprehension about the future state of the U.S. economy and our fiscal policy. At the same time, recent holiday sales showed a significant improvement from the prior year.

As a result of continued weakness in the economy, inflation remained muted in November. The November Headline CPI, the most watched inflation indicator, suggested the cost of living was 1.1% higher than a year earlier. This compares to the most recent five year average of 1.9%, the 50 year average of 4.0% and the Fed's target of 2%.

Oil prices, and the gas prices derived from them, are an important influence on consumer confidence in an economic recovery. Oil closed the year at \$90 per barrel, reflecting growing demand coming from a strengthening global recovery.

### Bush Era Tax Plan Returns...

At the end of the year, Congress extended the Bush era tax cuts. The core of the plan is a two-year, across-the-board extension for 2011 and 2012. This includes a continuation of the 2010 individual tax rates, a reduction in the payroll tax for 2011 only (from 6.2% to 4.2%), an estate tax exclusion of \$5 million (with a top rate of 35%), an increased Alternative Minimum Tax exemption for 2010 and 2011, and a retention of the cap on dividend and capital gains taxes at 15%. Items in the bill aimed at the middle class include a child tax credit, earned income tax credit, a credit to help students afford college, and the preservation of extended jobless benefits for 13 months. The tax plan also hopes to fuel business expansion by allowing all businesses



to expense 100% of their equipment purchases in 2011 retroactive to September 2010, and by providing for a 2-year extension of the research-and-development tax credit.

### **World Economy**

Global economic growth continues, albeit at a generally slower rate than in the U.S. Europe remains weighed down by reduced spending, tax hikes and poor Euro-zone policy coordination. The most positive economic conditions exist in Germany, which has allowed them to provide essential support for the European Central Bank. The ECB has thus been able to increase its purchases of troubled-nation debt and push for a second round of bank stress tests. The earlier problems with Greece were compounded with new bailouts needed in Ireland. Spain and Portugal also appear likely to also need help. There is still a reasonable chance that with continued economic improvement and coordinated efforts of support for more troubled members, the continent's outlook could improve.

On the other side of the developed world, Japan also has serious problems. It has been overtaken by China as the world's No. 2 economy. Japan is struggling with deflation, an overly strong currency, a 31% decline in exports after the great recession and a contracting workforce due to low population growth and an aging population. Their fourth prime minister in the last three years resigned this year. Japan's debt levels are among the world's most extreme (currently at 218% of GDP and is predicted to grow to 246% by 2014). With its political gridlock and a culture slow to embrace change, Japan seems unable to find solutions.

Key emerging market countries are experiencing more robust growth than developed economies, and their generally stronger public and private sector balance sheets have helped to foster growing domestic consumption. GDP growth rates for China and India were over 8% and 14%, respectively, in 2010. The Chinese economy is likely to continue contributing meaningfully to global growth, as it begins to transform from an export-driven to a consumption-oriented economy. Additional growth for China may come from construction spending, infrastructure development and improved government support for healthcare, education and social services.

### **Investments – U.S. Equities**

All U.S. equity sectors posted strong gains during the 4th quarter. Growth stocks slightly outpaced value stocks in both the quarter and for the year. Returns for large growth versus large value stocks were 12% and 11% respectively, in the 4th quarter and 17% vs 16% for the year. For both periods, small company stocks outperformed large ones. Small growth and value produced 4th quarter returns of 17% and 15%, while full year returns were 29% and 25%, respectively.

The S&P 500 was up 15% for the year, but if you missed just three key days in 2010, your total gain would have fallen to 3.4%. Despite our emotional concerns, it almost always pays to stay in the market.

Using forward P/E (the current stock price divided by forecasted 2011 earnings), the S&P 500 is now priced at 13.1 times forecasted earnings, versus a 15 year average of 17.2. The small stock Russell 2000 is now priced at 20.5 times forecasted earnings, closer to its historical average. Both suggest stocks are fairly valued now with possible further room to rise.

### **Investments – International Stocks**

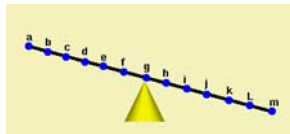
Virtually all countries posted gains during the 4th quarter, enhanced by currency changes. Generally the weaker the dollar, the more attractive international stocks become for U.S. investors. Large companies based outside the U.S., as best represented by the MSCI EAFE index, gained almost 6% (in local currency) for the fourth quarter and 5% for the full year. However, due to the weakening of the dollar, the index returned to U.S. investors almost 7% for the quarter and 8% for the year. Small non-U.S. stocks outperformed large ones with a return of almost 12% for the quarter and 22% for the year to U.S. investors.

Emerging markets rose 6% for the quarter and over 14% for the full year (in local currency). For U.S. investors, these returns translated to 7% and 19% for the 4<sup>th</sup> quarter and the year, respectively. The best performing developing country this quarter was Russia, with a gain of almost 17% to U.S. investors. India was the best performing developing country over the full year, returning 21%. Gains for both of these countries in 2009 were over 100%. Latin America produced returns for U.S. investors of 6% for the quarter and nearly 15% for the year.

## Investments – REITs

The FTSE NAREIT All-Equity REIT Index outperformed most other asset classes, with a gain of 7% for the quarter and 28% for the year. Global REITs performed similarly for the quarter and were up 20% for the year. All sectors of the U.S. REIT market had positive returns in 2010, with top-performing sectors being apartments, lodging/resorts, and commercial-mortgage financing.

## Investments – Fixed Income



Like a see-saw, when interest rates rise bond values fall, and vice versa. Longer maturities exacerbate that effect. Interest

rates rose in the fourth quarter while falling over the full year. As a result, the overall bond market, as represented by the BarCap Aggregate Bond Index, declined about 1% for the quarter while gaining almost 7% for the year. Two-year U.S. treasuries virtually remained unchanged for the quarter; while in response to rising interest rates 10 year and 30-year treasuries saw 4<sup>th</sup> quarter declines of almost 6% and 10%, respectively.

When economies are growing, the riskiest bonds often do the best. During the 4<sup>th</sup> quarter high yield bonds returned more than 3% and they rose 15% for the year. Emerging Market Debt also enjoyed a strong year at 13%. At the same time, safer mortgage backed Securities (MBS) and 2 year treasuries each returned only 2% for 2010.

As you may recall, to protect against increasing inflation we allocate a significant portion of our clients' intermediate bonds to TIPS. These bonds tie their coupon payments to inflation, producing returns over time equaling inflation plus a real interest rate. TIPS declined 0.7% last quarter but gained 6.3% for the year.

Municipal bonds declined a bit over 4% while corporate bonds declined close to 2% for the quarter, while returning 2% and 9%, respectively, for the year.

## Investments – Alternative investments

Our alternative investments are intended to help dampen the overall volatility of the portfolio while still contributing to portfolio returns. Most of our alternative holdings enjoyed good returns for both the fourth quarter and the year, with performance being helped by a declining dollar, demand for yield and resources.

The best results for the quarter among the alternatives included 15% for commodities, nearly 12% for the Alerian Index, while timber and managed futures rose 7% and 6% respectively. For those holding them for the entire year, the 2010 leaders included commodities (24%) and the Alerian Index (33%) and emerging market bonds (11%). The Alerian Master Limited Partnerships ETN (investing in energy transportation and storage), was introduced to most portfolios during 2010. Its returns benefited from the aggressive search among investors for yield, given the lower return on most interest-bearing investments. Commodity prices rose during the 4<sup>th</sup> quarter due to a weaker dollar and rising global demand for resources.

## Summary

Last year offered another reminder that many global imbalances remain, albeit in evolving forms. Instead of a subprime meltdown, we experienced the risk of sovereign debt, resulting from undisciplined entitlement spending in much of the developed world and exacerbated by demographic trends. While the debt problem that derailed the global economy in 2007 was largely one of private debt (mortgage holders and the institutions that bought and sold them), as governments borrowed and spent at unusual levels, the problem in 2010 moved to public balance sheets.

While concerns remain, much was accomplished in 2010. The U.S. "Great Recession" was officially ended. There was global improvement in manufacturing activity. Growing emerging markets continued to lead the world. Bank lending spigots began to open. The extension of the Bush era tax plan and the Federal Reserve's Quantitative Easing program offered hope for continued business growth and improved consumer confidence. All of these should provide a foundation for the economy's transition from recovery to expansion over the next couple of years.

While market results can never be promised, it is our hope and expectation that during 2011 we will continue to assist you in reaching your long term financial goals. We look forward to your questions and comments and to continuing our opportunity to serve you.

Your Mosaic team

*Sources: Morningstar, JP Morgan, Financial Post, Bureau of Labor Statistics, Ibbotson, The Federal Reserve, Reuters, Forbes, Bloomberg, Standard & Poors, The Economist*