

Market Watch

2nd Quarter, 2005

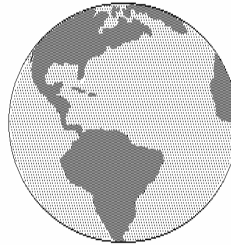


SUMMARY

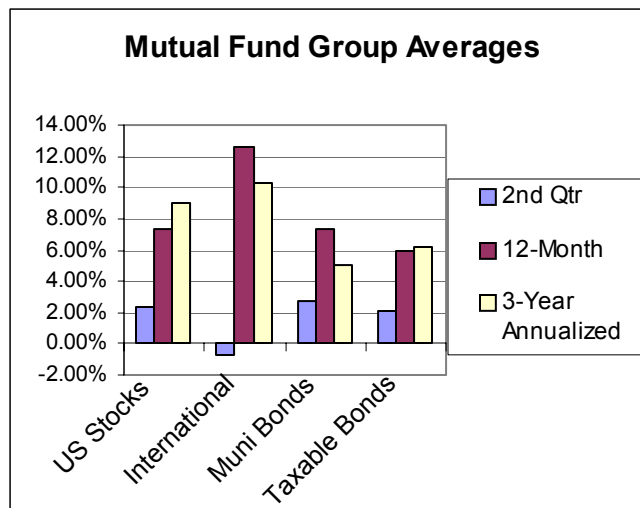
- Results were generally positive this quarter. All major domestic stock categories rose during the quarter, led by growth over value and small companies over large.
- The real estate sector was the biggest winner for the quarter.
- Due to the surprising rise in the value of the dollar, most foreign sectors were down slightly for the period, with the exception of diversified emerging market funds, which benefited from the jump in Latin American stock prices.
- Bonds were positive across the board, helped by a slight drop in interest rates.

The second quarter was a positive surprise all around. Showing the value of disciplined diversification, the market upended prognosticators' expectations on several fronts:

Reversing recent trends, large company stocks were finally supposed to outperform small. In fact, while large-cap growth stock funds posted solid gains of 2.59 percent, small-cap growth funds did even better, climbing 3.63 percent on average, according to Morningstar. The performance difference between large and small stocks was even more exaggerated among value-style investments.



International funds have been strong performers the last couple of years, in part because of the falling dollar (and current cash flows into international mutual funds suggest that many investors may be chasing this past performance). However, domestic stock funds actually outperformed international in both the second quarter and the first half of the year. This is because the dollar strengthened unexpectedly as the rejection of the European Union constitution by French and Dutch voters created political uncertainties in Europe. As a result, the dollar gained 7 percent against the euro during the quarter and 11 percent over the first half of the year. The average European stock fund fell 0.6 percent in the quarter. Latin American funds were up 10.17% and the Pacific Region was up 1.18%.



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Heading into the quarter, one of Wall Street's biggest assumptions was that bond prices would fall. Long-term interest

rates were expected to climb and this would reduce the underlying value of older bonds in fixed-income portfolios. But despite two additional increases in short-term interest rates by the Federal Reserve Board during the second quarter, yields on 10-year Treasury securities actually fell, to 3.94 percent at the end of June from 4.50 percent at the end of March (since the quarter ended, those yields have moved back up to around 4 percent). As a result, the average intermediate term taxable bond fund gained 2.60 percent in the quarter and was up 6.08 percent over the 12 months through June. Long-term government bond funds also did well, returning 3.4 percent in the quarter. That brought their 12-month gains to 7.23 percent. Short-term bonds were up 1.26%.

Many market pros decided that the run up in prices for real estate stocks was over several quarters ago. Interestingly, one of the big winners this quarter was, once again, the real estate sector, which soared 13 percent.

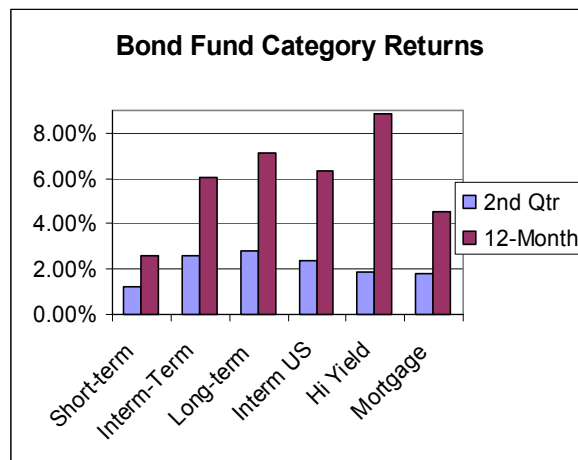
The lesson to be learned? The experts are guessing when they make their market predictions and those predictions are often wrong. Relying too heavily on market prognosticators for investment decisions can be bad for your financial health.

The “Conundrum” in Bonds

A few weeks ago, Federal Reserve Chairman Alan Greenspan admitted that he found the continuing low level of bond yields (interest rates) to be a “conundrum.” He and others had been suggesting that bond yields would steadily rise to more “normalized” levels. This would reduce the value of existing bonds (bond prices fall in response to rising interest rates). Many experts, and some of our clients, strongly suggested that bonds were now “too dangerous” and that the fixed income section of our portfolios should either move to cash or take some other more protective stance. Bond yields have moved up and down, but year-to-date, overall returns have been OK.

The premier analyst and manager of bonds in today’s world is Bill Gross, who manages several of the PIMCO holdings in our client accounts. Gross recently broke significantly from the pack and explained that he now expects 10-year treasury yields to remain stuck in the 3 percent to 4 percent range for the next few years. Because of his forecast for low-but-stable long-term rates, Mr. Gross is now recommending a strategy that few thought safe at the start of the year. He says bond investors should gravitate toward longer-maturity bonds as opposed to short-term issues, which are typically regarded as safer plays in an environment of rising rates. "It's a new reality," Mr. Gross said. "Under these circumstances, a bond holder should be thinking about being long duration as opposed to having a shorter duration."

There are a number of factors that have



combined to help keep interest rates low. One factor has been that foreign central banks have been big buyers of US Treasury securities (as they attempt to keep their currencies — and, in turn, their goods and services — from getting even more expensive relative to the dollar). Global liquidity, attributable to trade imbalances and high savings rates overseas, has produced a growing appetite for Treasury securities — especially

from China and other Asian nations. The US dollar continues to be the dominant currency in world financial markets and our bonds have long been considered a safe haven by international investors. Further, our short and long interest rates are higher than those in many other major economies. The dollar’s recent rally has also boosted returns to foreign holders of US securities. Private investors around the world have built up a “savings glut”, and have used those savings to purchase trillions of dollars of US stocks and bonds. All this demand helps keep US securities prices up, making it likely the low rate environment will continue.

Our approach with portfolios will continue to be one of moderation, not making too big a bet on any particular direction. Client bond holdings are roughly half short-term and half intermediate-term

maturities. We have also been emphasizing Treasury Inflation Protected Securities (TIPS) that will maintain a real return regardless of the inflation rate. In many portfolios we've increased exposure to adjustable rate instruments and to foreign bonds as well. All these strategies are designed to make sure that whatever actually happens, we'll have some winners and that our investors are protected on the down-side.

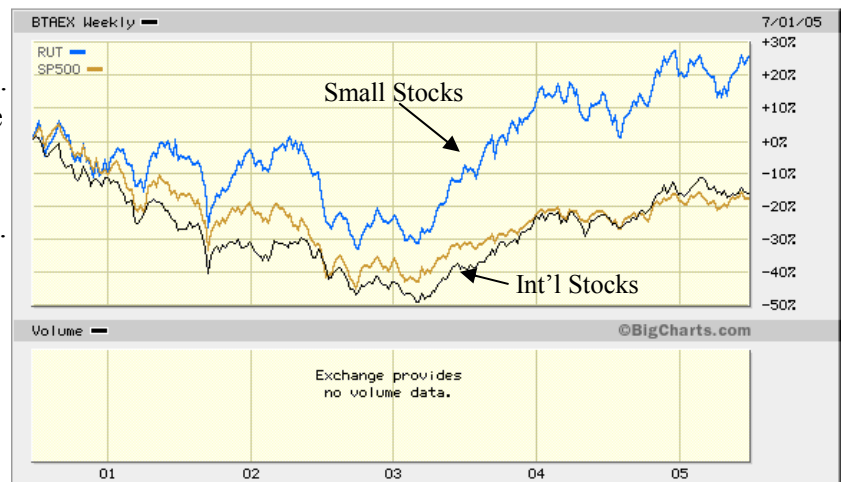
One additional note of interest: during the second quarter the bonds issued by long-time industrial stalwarts General Motors and Ford were downgraded by Standard & Poors to "junk" status.

Domestic Stocks

The American economy appears to have eased into a moderate, sustainable growth rate. While low bond interest rates and rising energy prices continue to surprise investors, the unemployment rate fell to 5.0% in June, and other measures of labor conditions showed greater strength. GDP growth is decelerating, but the 3.8% annualized increase in Q1 was still modestly above historical averages. Home sales have been strong, and consumer confidence reached a three-year high. Manufacturing activity has grown for 25 consecutive months. All of this supports the positive results of the second quarter.

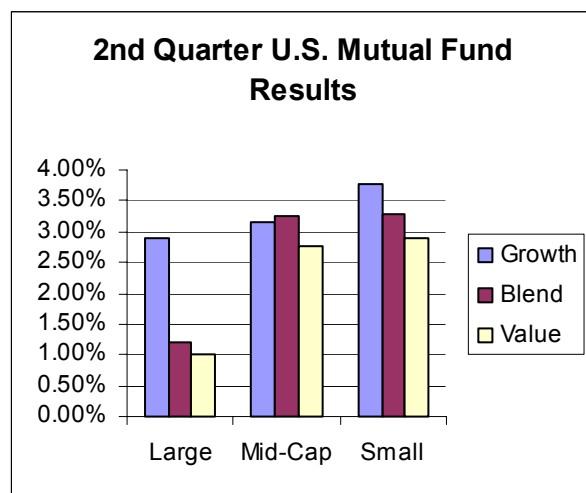
As we all know, a three-year stock market downturn began in March of 2000. Five year market charts can be helpful in getting a perspective on one's own experience. From where we sit now, most markets fell for the first half of that three year period and then began their recovery (with small stocks providing a more complete recovery than the others). In fact, on a price-only basis, the S&P 500 (large stock) index and the international EAFE index have not yet fully recovered.

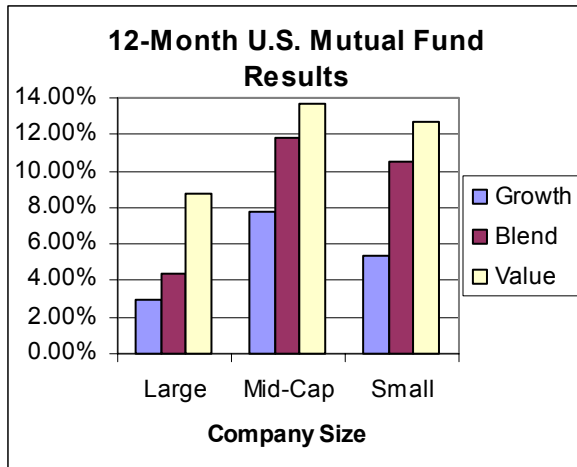
Five Year Chart as of 7/1/05 for S&P 500, Russell 2000 and International EAFE index



Despite seeing oil rise above \$60 a barrel during the quarter, U.S. stocks performed well reflecting healthy corporate profits and a steadily growing economy. Every diversified domestic-stock fund category tracked by Morningstar gained money for the quarter ending June 30, 2005.

While value funds brought up the rear for the quarter, they continue to lead for the 12- and 36-month periods ending in June.





Real estate funds once again outperformed all other domestic-stock fund categories during the quarter, rising 13.13%, more than erasing the category's 6.7% loss in the first quarter of 2005. Only Natural Resource-focused funds (read energy) outperformed the real estate sector for the prior twelve months (37.65 versus 31.88%).

At this juncture, US stocks seem reasonably priced. The S&P 500 sells for 17 times Wall Street's estimates of 2005 operating profits. This is only a slight premium over the historical average market valuation of 14 to 15 times. In the domestic picture, the economy continues to grow, inflation is controlled, and corporate profits are still rising.

International Stocks

Foreign funds were down in the second quarter of 2005, thanks to the rising strength of the U.S. dollar compared with other currencies. Diversified international funds fell 0.75% for the quarter but are up 12.75% for the twelve month period. The European market funds fell 0.62% for the quarter, but are still up 17.31% for the twelve month period. Japanese stocks fell 2.05% for the quarter and are down 3.05% for the last year.

Emerging market funds continued their

positive streak, gaining 3.88% for the quarter and +32.39% over the last year. Emerging market bonds were also strong. The Latin America group continued to perform well. Its 10.13% gain for the period made it the top-performing international-stock category, as it was for the full year. Optimism about the Brazilian and Mexican economies has fueled this run.

Rising demand and limited supplies have put upward pressure on energy prices, recently moving them to above \$60 per barrel. Higher energy prices hurt global economic activity—when consumers pay more at the gas pump, they have less to spend on other things. In addition, the costs of transporting products rise, which drives up the prices of those products. Most experts do not expect oil prices to go much higher in the near term, but prices could continue to rise longer term.

Global investors generally anticipate modest inflation. Economies are sluggish in Japan and much of Europe, where unemployment is a much bigger problem than inflation. While oil and other commodity prices have been bid up, the prices of most goods and services have been restrained by productivity gains and the increasing supply of global labor. Workers in “emerging markets” like China and India are winning jobs from workers in countries with higher wages.

Conclusion:

As is usual, there is a lot of both good and bad news available for the market to digest. Fundamentally, the markets appear to be fairly priced and reflective of a more positive than negative outlook.

Sources: Wall Street Journal, Morningstar, New York Times