Market Watch

Q3 2005

MOSAIC FINANCIAL PARTNERS, INC.

formerly Boone Financial Advisors

Summary

- Equities enjoyed their best quarter of the year, bringing year-to-date results back into positive territory.
- Small cap stocks once again out performed large company stocks (3.6% versus 2.8%).
- Foreign stocks averaged better than 11% returns. Emerging markets rose more than 17% on average.
- Real Estate stocks again enjoyed positive returns — up 3.3% for the quarter.
- Rising prices, resulting from the hurricanes, higher energy prices and worldwide demand, are the biggest economic concern.
- Interest rates rose, following action by the Federal Reserve seeking to keep inflation in check. As a result, intermediate bonds were down about 1/2% and short-term bond returns were only nominally above zero.

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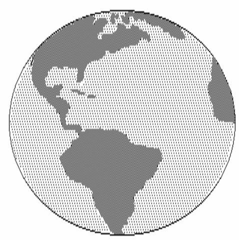
Equities have seen tepid returns year-to-date, but the third quarter was an exception. The large company S&P 500 rose 3.6%, bringing the year-to-date return to 2.8%. The small-cap Russell 2000 gained 4.7%. REITs picked up 3.8% following two very strong prior quarters. Foreign stocks did especially well, gaining 11.7%, as did commodity futures, up almost 17% (due in large part to soaring energy prices). The Lehman Aggregate Bond Index lost 0.7% in Q3, but is up 1.8% for the first nine months of the year.



The impact of hurricanes Katrina and Rita has been widespread, but not as bad as initially feared. Nearly 300,000 homes were destroyed (roughly twice the number of homes built in California each year) and many businesses have been wiped out. Crude oil production has been disrupted and natural gas production has been significantly impacted (the Gulf produces about 1/3 of US natural gas). This combination, along with continued worldwide demand, will keep gas prices high for a while. Economic activity in 2006 is likely to pick up as the rebuilding efforts provide stimulus.

Aside from hurricanes, there are plenty of other things to worry about these days: rising housing prices, massive current-account and federal-budget deficits, strife in Iraq, terrorist threats, rising inflation, and others. One of the biggest worries is the possibility that consumer demand is slowing down. The Consumer Confidence Index plummeted in September to its lowest level in two years. This is undoubtedly influenced by Katrina and Rita. Nonetheless, since consumer spending makes up approximately two-thirds of our Gross Domestic Product (GDP), sustained consumer spending remains critical. The issue at this juncture is whether the drop in consumer confidence is a short-term reaction or part of a deeper, more significant economic slowdown.

It's tempting to give in to these fears and assume a conservative investment posture, but this would ignore another—and perhaps more important — variable — stock valuations. Valuations matter because they provide insight into market's (i.e. investors') expectations.

Right now, the consensus seems to be the market is fairly valued or even slightly undervalued. The S&P 500 sells for 19 times "trailing" (i.e. the past four quarters) earnings and 17 times the consensus estimate of 2005 operating profits. While these "multiples" are somewhat above historical averages, they don't seem unreasonable given our current economic growth rates, comparatively low inflation rates and still low interest rates. Foreign valuations appear to be even better relative to their historical levels.

In the U.S., corporate profits are still growing at double-digit rates, and are expected to be near that in 2006. Companies in the S&P 500 generally have strong balance sheets (including nearly $2 *trillion* in cash) and they are generating some $366 billion more in free cash flow than they are spending. Unemployment has continued to gradually improve, standing at 4.9% in August and rose to only 5.1% after the hurricanes.

In addition, the major economic indicator, the Gross Domestic Product, increased 3.5% in the first six months of the year (excluding inflation). It is likely to be lower for the full year largely due to the hurricanes, rising short-term interest rates and steep energy prices.

While there are no guarantees, we believe that the economy continues to enjoy considerable strength. As a result, we expect continued growth in the stock market over the long-term.

US Stocks —

As can be seen in the following tables, both the 3rd quarter and the one-year period ending September 30, 2005 enjoyed strong returns — despite what has sometimes seemed like a struggling market. Small stocks outgained large company stocks over both periods, although third quarter results were closer. (the twelve month returns were strongly influenced by the excellent returns in the 4th quarter of 2004).

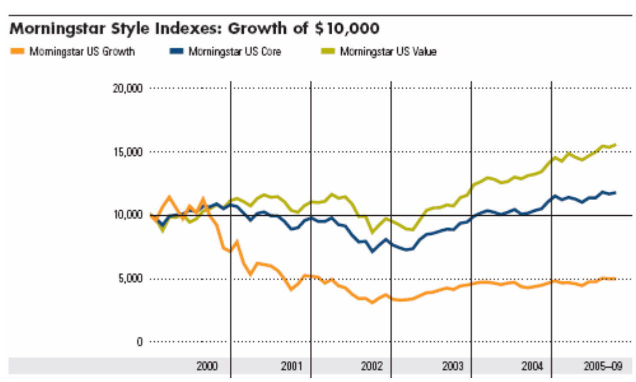
3rd Quarter Results

	Value	Growth
Large	3.55%	4.78%
Small	4.46%	5.61%

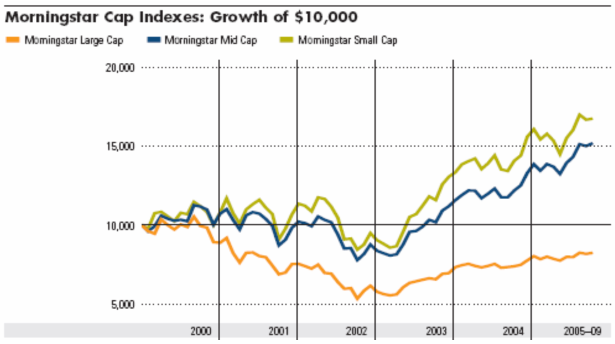
Last 12 month Results

	Value	Growth
Large	13.67%	13.39%
Small	18.61%	18.53%

Illustrating the economy's difficulties, of the ten business sectors making up the S&P 500 Index, a majority were mired in negative territory for the nine month period ending September 30. In contrast, eight of the ten showed positive results in the third quarter. Not surprisingly, energy was the biggest gainer in the quarter, up by nearly 17.8% (with utilities following, as a not so close second, at 6.37%). Telecommunications and consumer discretionary spending on non-essential goods had the worst quarterly results.



Looking at the market from a different perspective, as seen in the preceding graph, value stocks have pretty consistently outperformed growth and blend since the beginning of the year 2000. Similarly, but not as consistently, since the start of 2000, small company stocks have produced better results than their large company brethren.



Real estate stocks have produced better results than either large or small company stocks over 1, 3, 5 and ten year periods ending September 30, 2005. Real estate fell back a bit in the most recent quarter, but still produced a quite positive 3.30% quarterly return. The real estate sector represents commercial properties (office, warehouse, shopping center, hotel and large apartment complexes), not single family homes. While lower interest rates have benefited both sectors, real estate held in your portfolio is much more reflective of the broader economy than residential exposure alone.

Foreign Stocks —

Almost all foreign stock sectors were in double digits this last quarter. Large foreign companies in developed countries were up an average of 11.08% and 25.15% for the twelve month period. Smaller foreign companies (which usually are less correlated with U.S. markets) rose 11.69% for the quarter and 32.12% for the year. Diversified emerging market holdings were even stronger: 17.33% and 44.04% respectively.

In currency markets, which have big impact on the success of non-U.S. investments, the dollar lost a little ground during the quarter but remained stronger than its value in September 2004. So far this year, foreign demand for US fixed income investments coupled with a recent increase in imports has helped the dollar retain some of its newly gained strength. This would normally work against international investments, but the strong local (foreign) market returns speak for themselves.

Japan seems to have begun a turn-around. Japanese stock funds were up 18.20% for the quarter and 26.39% for the twelve months. Europe, on the other hand, was up 9.82% on average in Q3 and 27.79% for the year.

Among the developing world, Latin America has been spectacular—up 29.43% for the quarter and 77.07% for the year. The Asian/Pacific markets outside Japan were up 9.65% and 28.48% respectively.

Fixed Income —

In deciding how to use bonds in a portfolio it is important to think about their purpose. Is it to provide income? To provide big returns to the portfolio when tactical opportunities present themselves?

Our view is that bonds' most important function is to help offset equity losses when the markets are in flux. Obviously we are aware of — and sensitive to — the return prospects for different bond sectors, but the key driver is in assessing how they can help us "play defense" when times are tough for stocks. Should we experience a significant economic slowdown, bonds would likely experience some appreciation at a time when equity markets aren't performing well. So we see bonds as an important diversifier to help us manage portfolio volatility (risk).

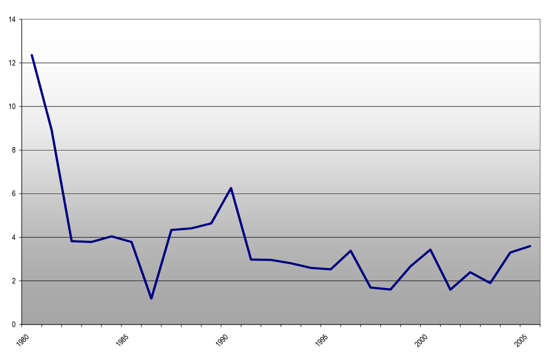
If we were primarily seeking returns in the bond sector, high yield ("junk") bonds and emerging market bonds would be well represented in our portfolios. But our research suggests that the returns these sectors may provide is more than offset by their volatility. If we want returns, we think the better choice is to add stocks to the portfolio. From bonds, we believe stability is the more important criteria for the benefit of the total portfolio. We make use of several strategies to try to realize this objective:

- We diversify the kinds of bonds we hold.
- We make active use of bonds which can adjust to economic conditions to produce more stable principal values (e.g. Treasury Inflation Protected Securities and Adjustable Rate Mortgages).
- We hold roughly half the bond allocation in shorter durations (maturities), which are also more stable.

As a result of the above, our portfolios have generally been less volatile than would have otherwise been the case. Despite the latest environment of rising interest rates and inflation, our bonds have generally remained quite stable, helping your portfolio.

This quarter, intermediate bonds lost 0.59%. They have returned 2.43% for the twelve month period. The more defensive short-term bonds gained a small amount this quarter (0.06%) and are up 1.31% for the year. National municipal bonds pretty well matched taxable bonds with results of -0.31% and +2.01%. California munis were slightly better (-0.10% and +2.22%)

Inflation—1980 to present



Inflation and Fed Policy —

Though Fed's policy of raising interest rates may curb inflationary pressures, this may be at the cost of consumers who have variable interest-rate debt (bad for the borrower, good for the lender and bond holder). Rising rates may contribute to a reduction in consumer spending in the months to come and slow-down economic growth in the near-term. So, for now, inflation appears to be a key indicator to watch (to see in which direction the economy may be heading).

The Federal Reserve's tightening of monetary policy continued to increase interest rates through the third quarter. The Fed increased the fed funds target rate (the lending rate the Fed offers to member banks) by a quarter percent at each of its two meetings in the quarter — August 9 and September 20. The target rate ended the quarter at 3.75% and pushed prime rates — which move in unison with the fed target — higher. The Federal Open Market Committee is scheduled to meet two more times in 2005. The expectation is that the Fed's tightening policy is likely to continue — particularly if inflation continues to rise as it has from the continued rise in oil prices.

Summary—

There are positives and negatives facing us now and into the future. The broader markets have largely recovered from the market decline of 2000-2002 and the economy seems to be on a reasonably stable footing. As always, there are plenty of things that could go wrong, but the strength of the economy appears to be persisting and Japan and parts of Europe hold out some hope for a stronger worldwide economy, all of which could bode well for the investment markets.

Sources: Whittier Trust Company, Morningstar, Advisor Intelligence, Alliance Bernstein