Market Watch

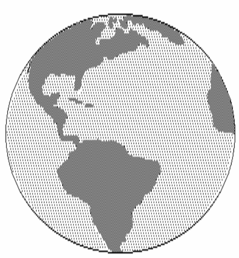
Q4 2005

FINANCIAL PARTNERS, INC.

formerly Boone Financial Advisors

Summary

- U.S. stocks were positive for both the quarter and the year. Mid-cap stocks led the way. Value outperformed growth-style investing for the year, although growth did better in the fourth quarter.
- The U.S. economy and corporate profits remained strong and grew at rates above expectations.
- Real Estate and Commodities were both strong categories within U.S. markets.
- International stocks outperformed U.S. stocks. Latin America and Asian stocks were especially strong but European and South African markets were also strong.
- Bonds were universally weak, but positive.



Mosaic Financial Partners, Inc.

San Francisco/Oakland

415.788.1952

www.MosaicFP.com

Overview

2005 was a turbulent ride but the markets finished in healthy fashion with both the equity and the fixed income markets experiencing positive returns in the 4^{th} quarter. The markets digested an abundance of bad news and yet still performed fairly well. Improving economic data, receding energy prices and an anticipated end to the Fed's tightening cycle fueled stocks and bonds late in the year.

For much of the year markets were flat or falling. While there were short periods when returns rose rapidly, timing these short bursts of performance would have been difficult. Most investors who tried failed. Patient investors with global equity exposure enjoyed a reasonably good year. Our approach—to avoid timing, diversify globally, and regularly rebalance back to target allocations—outperformed domestic benchmarks for the sixth year in a row.

Interestingly, the U.S. stock market was less volatile in 2005 than in any year since 1996.

U.S. Stocks

U.S. stocks were relatively weak during 2005, although most of the indices ended in positive territory. Only the Dow Jones Industrial Average finished the year with a loss, ending down 0.61%. Among the other U.S. stock averages, mid-caps turned in the best quarterly, semi-annual and annual performance in 2005. Furthermore, they were the only major domestic category with double digit returns.

Size: Mid-caps averaged 12.70% for the year, while large stocks averaged 4.87% and small-caps averaged 5.76%.

Investment Style: For the year, value continued its dominance over growth, with value-style funds of all size companies averaging 7.82% for the year; growth funds averaged 6.41% and core reached 5.19%.

The major indices are still well below their historical highs (all reached in the first quarter of 2000). The Dow ended the year 8.6% below its historical high. The S&P 500 Index is still 18% below its 2000 high, and the Nasdaq Com-

	2000	2001	2002	2003	2004	2005
Morningstar Large Cap						
Total Returns	–11.38	–15.10	–23.47	27.04	9.54	4.87
Price/Earnings	33.75	32.03	25.14	26.93	23.22	21.37
Price/Book	8.49	5.98	4.56	4.76	4.39	4.28
Dividend Yield %	1.02	1.29	1.80	1.54	1.62	1.77
Earnings Growth (5yr)	18.16	14.78	12.81	12.46	12.35	12.36
Morningstar Mid Cap						
Total Returns	6.94	–4.63	–18.06	38.38	19.66	12.70
Price/Earnings	27.01	26.96	25.97	25.89	24.60	23.90
Price/Book	5.35	3.96	3.19	3.86	3.89	4.00
Dividend Yield %	1.40	1.33	1.59	1.27	1.23	1.23
Earnings Growth (5yr)	17.74	16.14	13.94	12.57	13.03	13.62
Morningstar Small Cap						
TTotal Returns	7.66	5.26	–20.36	47.70	20.44	5.76
Price/Earnings	21.28	25.22	22.96	27.04	26.43	24.44
Price/Book	3.68	3.11	2.72	3.58	3.79	3.54
Dividend Yield %	1.35	1.18	1.56	1.09	0.97	1.15
Earnings Growth (5yr)	19.65	17.57	14.96	14.86	14.60	15.22

posite Index remains 56% below its record high.

Stock valuations are becoming more reasonable and this gives the market some upside potential. Both the economic and corporate profit growth exceeded expectations again in 2005. At the same time, stock prices held relatively steady. As a result, the year ended with the market P/E ratio of 18. This is modestly higher than the historical average of 15-16, but a substantial improvement over the almost 40 P/E reached in 2000's market top.

Real Estate Investment Trusts were again at the forefront of the domestic stock market. Real estate investment trusts delivered total returns (change in stock price plus dividends paid) of 12.3% in 2005, versus 32% in 2004 and 37% in 2003. A number of analysts believe these positive results can continue, in part due to acquisition interest from private equity firms. In addition, office rental rates are rising as employment increases, and fewer new buildings are available to meet demand. Top REIT sectors for 2005 included self-storage, regional malls, residential (apartment complexes) and specialty properties.

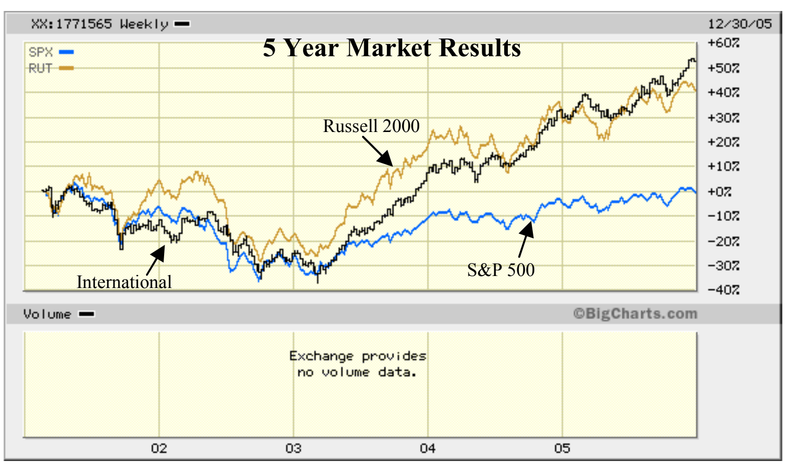
The largest typical holding in our alternative asset class is commodities. In this area, the Dow Jones-AIG Index rose 17.5% in 2005 and is up 55.2% over the last three years. Driving this were three primary components of the index: industrial metals were up 29.3% for the year, petroleum was up 26.4% and precious metals were up 16.7%. Most commodity categories ended the year off the highs achieved earlier in the year.

International Stocks

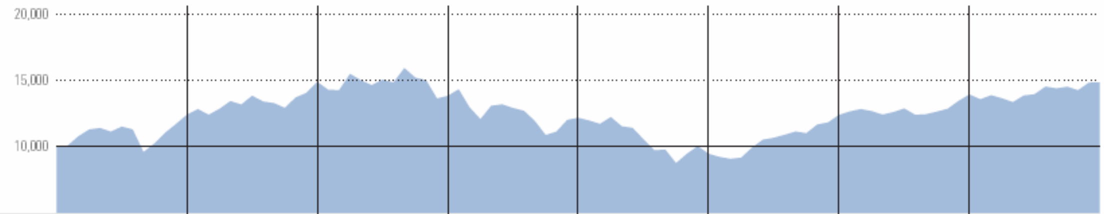
Most of the stock market action was overseas in 2005. Over the last three years, foreign markets have performed substantially better than the U.S. markets — with returns averaging 21.3% per year versus 14.0% domestically. Over the same period, emerging markets returns averaged 36% per year.

For the full year 2005, the Japanese market grew 32.6% (17.1% for the quarter). Latin America was up 53.8% and 5.7% respectively. Europe was up 14.6% and 2.6%. Diversified Pacific/Asia was up nearly 27% and 10.7%.

Mexico led the Americas with a 37.8% return in local currency in 2005. Brazil came in at 27.7% and Canada produced a return of 21.9%. Argentina was up 12.2% and Chile was up 9.1%. This was the third year in a row of double digit returns for Latin America.



Morningstar US Market Index (Growth of $10,000)



	1998	1999	2000	2001	2002	2003	2004	2005
Total Returns	23.86	19.79	−7.02	−11.88	−22.16	30.73	12.35	6.52
Price/Earnings	33.46	37.99	31.78	30.73	24.97	26.74	23.72	22.05
Price/Book	8.15	10.45	7.54	5.39	4.13	4.49	4.22	4.17
Dividend Yield %	1.25	1.09	1.12	1.29	1.74	1.45	1.49	1.61
Earnings Growth (5 Yr)	15.87	18.80	18.15	15.22	13.19	12.76	12.55	12.80

In Europe and in local currency, Norway led with 52.2% while Austria grew 50.8% and Denmark was up 42.7%. Others with at least double digit gains included Switzerland, Sweden, Finland, Germany, Netherlands, France, Belgium, Ireland, Spain, U.K., Italy and Portugal.

In local Asian currencies, South Korea, Pakistan, India and Japan all enjoyed returns exceeding 40%. Others with double digit returns included Australia, Indonesia, the Philippines, Singapore and New Zealand. Notably, China's two main indices (Shanghai A and Shenzhen A) were down 8.2% and 11.8% respectively.

South Africa's markets also did well, coming in with a 43.0% return for 2005.

In U.S. dollars, the world markets (excluding the U.S. itself) produced an average return of 14.4%. For U.S. investors, the best foreign markets were: South Korea (58.4% in U.S. dollars), Brazil (48.0%), Mexico (40.0%), the Philippines (26.8%), Canada (25.5%), Japan (25.3%), South Africa (23.5%), Denmark (21.9%) and Norway (21.0%).

Bonds

Taxable bond funds limped through the 4^{th} quarter, barely making it into the black for the year. This capped off what was a difficult year for fixed income investments. The year ended unusually, with the yield on short-term bond slightly higher than long-term yields—an "inverted yield curve." In the past, this inversion has often signaled a coming recession — though most observers do not believe that is a likely scenario this time around.

Despite the inversion, bond returns for the year were generally positive, although small. Cash (money market funds) in many cases outperformed bonds. This situation is likely to continue so long as the Federal Reserve continues its 18 month campaign of raising interest rates. With a new Fed chief, Ben Bernanke, replacing Alan Greenspan at the end of January, the Fed's actions are somewhat less predictable. However, since inflation fears have begun to ease, most observers believe that only one or two more rate hikes (on top of the 13 already taken) are likely. Once the rates hikes are complete, the yield curve (the relationship of interest rates levels at different maturities) is expected to assume a more normal picture. This should be good for both bonds and equities.

US taxable bond funds returned an average of 0.49% in the fourth quarter and 1.93% for the year. Short-term taxables were up 0.47% and 1.43% while intermediates averaged 0.40% and 1.79%. High yield bonds rose 0.88% for the quarter and 2.53% for the year. California short/intermediate-term muni bonds produced returns of 0.44% and 1.86% respectively. Emerging market bonds, where improving finances and ratings upgrades attracted big investment flows, produced the best bond returns in 2005 (12.0%).

Foreign demand helped U.S. bonds hold their value. In the first ten months of 2005 (the most recent data available), foreign investors purchased $311 billion bonds — more than in all of 2004. In addition, Wall Street continues to come up with innovative ways to help investors buy bonds and improve their yields (but not without adding to the level of risk involved). These instruments include credit-default swaps and derivatives which enjoyed a volume exceeding $12.43 trillion in mid 2005.

Money Market Funds provided an average yield of 3.19% in the 4th quarter and 2.43% for the year, according to iMoneyNet.com. The 4th quarter saw the largest jump in money market investments (nearly $110.2 billion net additions) since the last quarter of 2001. By contrast, bond funds attracted just $3.4 billion in net new money.

In their search for higher yields, many fixed income investors have looked to riskier sectors of the fixed income markets. In 2004, many of those sectors (mortgages, corporates, high-yield, emerging markets) performed especially well. But, as demand has risen, the traditional premium associated with these riskier sectors has declined to the point that the difference in returns has become minimal.

After a three-year slide of the dollar against the Euro, that trend reversed itself this year. In 2005, the U.S. dollar rose 12.6% against a basket of six other major currencies — its biggest gain since 1997. The biggest moves were relative to the Euro and the yen.

All else being equal, U.S. investors in non-U.S. securities benefit more when the dollar drops in value.

It is very possible that stock returns will more closely reflect the rate of growth of corporate profits.

Looking forward to 2006

As we head into the new year we take comfort in the reasonable valuations we see in most asset classes and the risk reduction we gain from prudent diversification. Major questions as we enter 2006 include: How strong corporate profits will be, whether the economy will continue to boom, whether inflation will return, what oil prices will do, the trade deficit, budget deficit, consumer debt levels, housing prices, how the midterm Congressional elections will affect stocks and how much longer the Federal Reserve will continue raising interest rates.

The answer to the Fed question rests on the direction of inflation itself. The Fed hinted after its December policy meeting that it could soon call a halt, or at least a pause, in its rate-increase campaign. The inflation picture, which will drive the Fed's decisions, depends on whether world economic growth continues (which would continue to raise the demand for oil) and to an extent on the weather picture. If the Fed decides to discontinue its rate hikes, stocks will likely benefit.

It appears likely that the global economy will continue to put off any day of reckoning for some time. As long as it is in the interest of Asian central banks to provide the funding for the U.S. consumer (when needed), the U.S. and the global economy is likely to experience adequate growth for the next several years. This is likely to occur within a backdrop of only moderate inflation — given healthy productivity growth, and an abundance of global labor and productive capacity. Thus, consumer spending, though slowing, will likely stay strong enough to support the U.S. economy. And, happily, Europe's economy is showing signs of strengthening as is the Japanese economy.

The U.S. housing market is showing signs of slowing in some areas and if this spreads it could slow consumer spending. However, we expect that this can be largely offset by a healthy corporate sector and improved growth in the rest of the developed world. While the imbalances cannot indefinitely continue to grow worse, the large supply of global capital is the ultimate reason why it seems likely that the day of reckoning is not near.

From 1896 to the end of 2004, the Dow Jones Industrial Average has increased an average of 7.6% per year. The common wisdom is that over the next few years, investors should expect little more than the average gain, if that. The logic is that stocks still are working off the excesses of the 1990's bull market, when business overspent on new capacity and investors starting thinking of double-digit returns as common. At the same time, with Price/Earnings ratios finally returning to the neighborhood of historical norms, it is very possible that stock returns will more closely reflect the rate of growth of corporate profits.

We wish you a healthy and prosperous 2006.

MOSAIC FINANCIAL ADVISORS, INC.

Sources: Wall Street Journal, Morningstar, Advisor Intelligence, New York Times, Big Charts