MOSAIC FINANCIAL PARTNERS, INC.
a Wealth Advisory firm

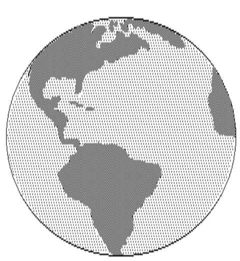
Market Watch
Fourth Quarter 2006

Summary

It was an eventful year in 2006, with energy prices, the housing market, and Fed policy all impacting the investment landscape. Early in the year investors feared rising rates, but once the Fed ended its string of rate hikes the market climbed steadily higher.

This was the fourth consecutive year of positive stock market returns. REITs and foreign stocks did especially **well, while domestic equities provided returns in the mid to high teens.**

Despite rising stock prices, equity valuations remain attractive thanks to strong earnings, suggesting either that stocks are undervalued or that the market does not believe there will be a material slowdown in the economy any time soon.



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The Investment Environment in 2006

2006 was an lively and at times tumultuous year. The ongoing difficulties in Iraq and the related shift in power in Washington D.C. were two big stories, but not as interesting from an investment standpoint as several others.

After beginning the year around $60 per barrel, oil peaked near $80 per barrel and fostered the belief among some industry watchers that higher oil prices (many predicted $100 per barrel oil) would continue indefinitely. Fortunately, the ending price of crude oil was only 1¢ higher than it was at the year's start. Lower energy prices seemed to help fuel a retail revival, pushing the economy forward. Americans spent 16% less at filling stations in November than they did in August, when the price of gasoline peaked. Even so, U.S. households spent about a tenth of their consumer dollars at the pump in 2006—10.1% more than they spent on gas in 2005. Spending in most other major retail categories increased by 5% to 8% during 2006.

Even so, U.S. corporations continued to gain profitability, which helped to fuel the market moves. For the year, S&P 500 companies are expected to report a 14.9% advance in operating earnings, putting 2006 on track to be the best year ever for profit growth. As a result of such strong profits, P/E multiples have decreased from 20 five years ago back to historical norms of 15, using forecasted earnings. (Technology stock multiples are back to approximately 20.) Lower price earnings ratios suggest that the market still has plenty of room to grow.

In addition to strong profitability, two other positive influences on stock prices continued strong. Dividend payments among S&P 500 members reached a record $224 billion in 2006, while those same companies spent $437 billion (also a record) on share buybacks.

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The housing bubble burst in 2006. While some regions were hit hard, the magnitude and spill-over into the broader economy was minimal.

Fed policy was a big driver of the markets in 2006. Early in the year, investors were growing concerned that the new Federal Reserve Chairman Bernanke would push up interest rates too far, causing a recession. By summer, the Fed had hiked rates by another 125 basis points (1.25%), and stocks were flat for the first half of the year. Once the Fed announced that it was on hold for future hikes, the markets spent the rest of the year pushing higher.

Judged by data rather than sentiment, the job market in the fourth quarter radiated health. Unemployment dipped to a five-year low of 4.4% in October and U.S. businesses added an estimated 407,000 new positions to payrolls during the fourth quarter. Average hourly wages edged higher, finishing 2006 up 4.2% over 2005 levels, which some worried could contribute to increased inflationary pressures.

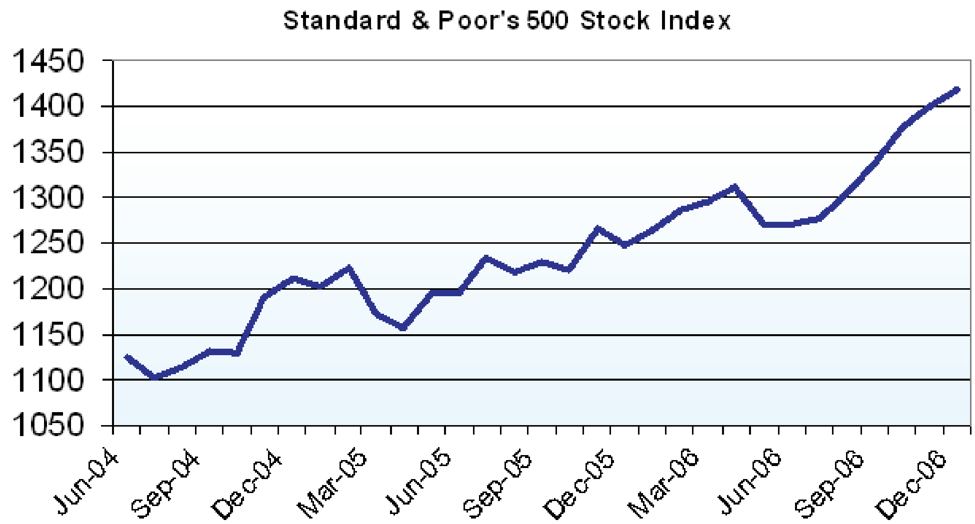
For now, the overall economic picture remains balanced, with the economy in what many describe as a "sweet spot" offering both moderate growth and acceptable inflation. Sophisticated investors, while cautious, seem to remain relatively optimistic.

U.S. Stocks

2006 was the fourth consecutive year of positive returns for the U.S. market after the 2000-2002 declines. Virtually all of the year's movement came in the last two quarters, which was enough to move most categories into double digit returns.

A year ago, investors were worried about the risk of slower economic growth, inflation and more Federal Reserve interest rate increases. None of that turned out to be a problem. Most equity asset classes did well in 2006, with small stocks once again leading large-caps for the year, as they have generally done since 1999. The small-cap Russell 2000 index was up 18.2% for the year, while the large-cap Standard & Poor's 500 climbed 15.6%, hitting six-year highs. The Dow Jones Industrial Average, composed of 30 bellwether U.S. companies, gained 16.29%, crossing the 12,000-point milestone for the first time in the fourth quarter and set new highs 22 times before the year ended. Technology stocks, represented by the Nasdaq Composite Index, gained a relatively subdued 9.52%, most of which arrived in the fourth quarter.

Broad U.S. Market S&P 500



All of Standard & Poor's 10 sector indices moved up, though some gains were marginal. Energy and materials producers returned to favor after a weak third quarter, leading the way during the fourth with returns of 10.73% and 10.74%, respectively. A decline in gasoline prices seemingly gave consumers more money to spend, helping shares in the consumer discretionary sector jump 9.82%. Meanwhile, health care and consumer staples companies, among the market's third-quarter darlings, became the laggards this time around, gaining just 0.99% and 2.94%, respectively. For the year, the previously battered telecommunications sector performed best with a 32.12% return, followed by a 22.21% gain for energy.

Real estate stocks surprised most observers with another good year, rising 33.61% (10.07% in the fourth quarter).

With the exception of the first quarter of 2006—which favored small growth companies—value investing was in favor for most of the year.

U.S. Stocks in 2006			
	Growth	Blend	Value
Large	6.93%	14.15%	18.18%
Mid	9.01%	13.92%	15.89%
Small	10.49%	15.06%	16.26%

Results in the fourth quarter were generally similar to those of the year: value outdid growth in all size categories. Small stocks outperformed large during the quarter. Most of the year's returns for growth stocks came in the last quarter.

U.S. Stocks in the 4th Quarter			
	Growth	Blend	Value
Large	5.56%	6.74%	7.19%
Mid	6.86%	7.75%	8.04%
Small	7.89%	8.39%	8.44%

Foreign markets

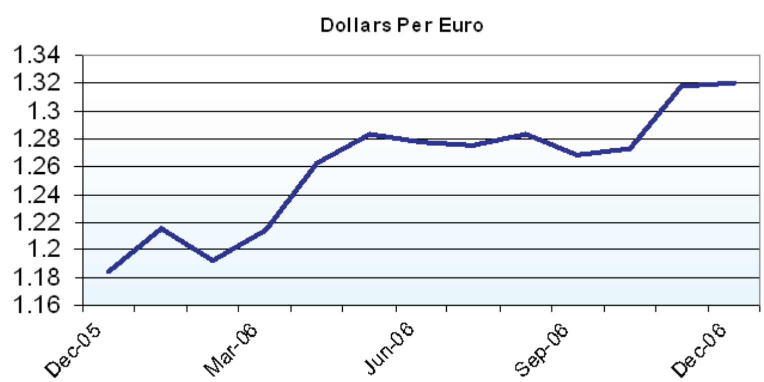
Foreign markets performed extremely well in 2006, roughly doubling U.S. stock returns. For the year, the best-performing region in 2006 was Asia (excluding Japan), which earned a remarkable 45.81% return. Latin America did nearly as well, jumping 44.35% (which was actually below their three-year average return of 45.47%). While suffering by comparison, European stocks were still up 33.55% and diversified emerging market funds rose 32.38% over the year. In strong contrast, investments in Japan actually fell 1.76% over the year. In a nutshell, virtually any non-Japan exposure in the year would have benefited U.S. investors.

Fourth quarter results told a similar story. Latin American stocks were up 22.40% and Pacific Asia ex Japan was up 21.16%. Diversified emerging markets rose 17.85% and Europe was up 12.62%. Japan actually had a decent quarter (+3.74%) but it seemed anemic juxtaposed against results from the rest of the world.

Breaking things down by company size rather than geography, small and mid-sized non-U.S. stocks did slightly better than large ones as they rose 26.73% for the year 2006 and were up 13.64% in the last quarter. The larger foreign stocks were up 24.82% and 10.42% for the respective periods. Growth versus value had little impact on returns.

With European interest rates continuing to climb while U.S. rates remained flat, currency investors favored the euro over the dollar. For the year, the dollar shed 11.5% of its value against the European currency—the euro also outperformed the Japanese yen—and the dollar lost ground as well to the British pound, Swiss franc, and other currencies.

Dollar versus Euro



Bonds and Bond-Replacements

On the fixed-income side, domestic high-quality, intermediate-term bonds had a respectable year, with the Lehman Aggregate Bond Index gaining 4.3%. Foreign bonds were aided by a currency tailwind (as the value of the dollar falls, foreign investments held by US investors benefit), lifting developed markets foreign bonds to a 6.1% gain.

Emerging Market bonds performed best among all bond categories during the last quarter (4.88%) and during the year (10.96%). In addition to benefiting from the overall decline in the dollar, emerging-market short-term local-currency bonds have higher yields than U.S. bonds of similar maturity. In addition, many emerging-market countries are experiencing improving fundamentals.

High Yield bonds also experienced attractive returns (4.04% for the fourth quarter and 10.14% for the year). Returns from intermediate bonds (1.29% and 4.12%) and short-term bonds (1.11% and 4.01%) reflected the low interest rates. California Short/Intermediate bonds were lower (0.70% and 3.71%) as a result of their double tax-free status. Inflation-protected bond funds didn't do as well this year, producing a small loss (-1.28%) in the quarter and were only slightly above break-even for the year (0.09%).

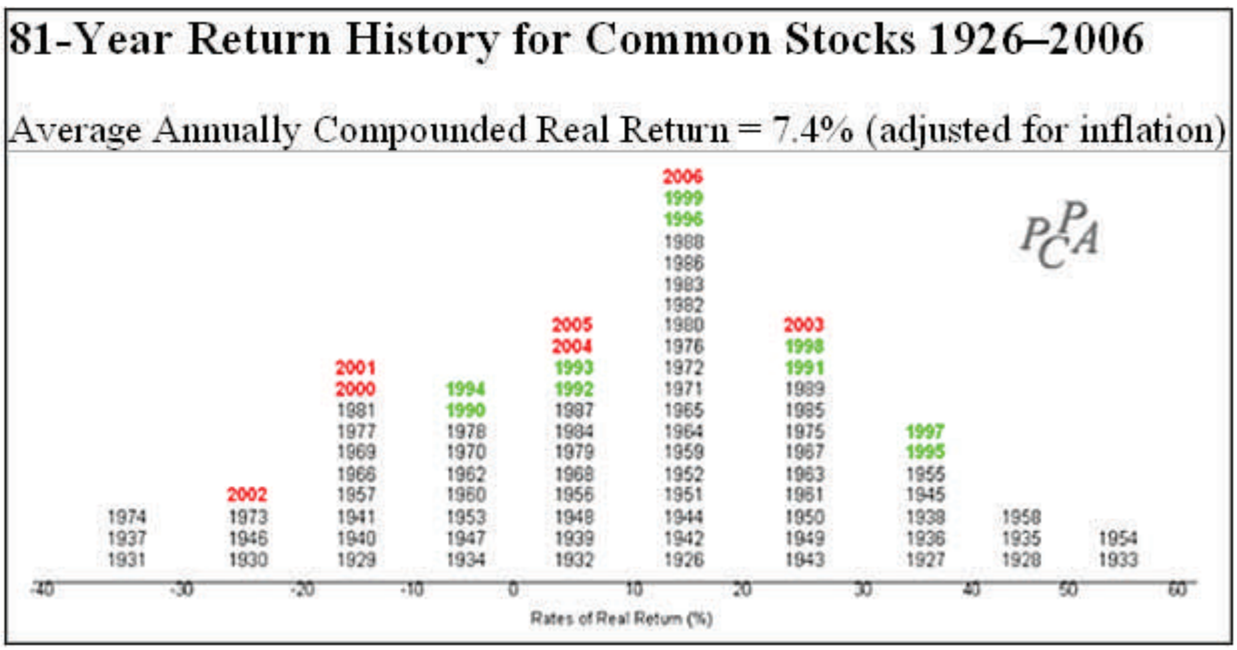
Bond returns going forward are expected by most observers to be generally in line with their long-term historical averages, based on current yields and expected inflation.

Among our alternative sectors, Commodity futures, as an asset class, are generally expected to be volatile and lived up to expectations in 2006, with big quarterly swings in returns. Oil prices were up and down, precious metals rose and agricultural products were facing increased demand as an energy alternative. Long-short funds produced normative returns this period, averaging 2.46% for the last quarter and 7.06% for the year.

81-Year History

It is sometimes helpful to get a broader perspective on how things have been going. The following histogram shows real returns (in excess of inflation) on the S&P 500 index over the past 81 years. The 1990s are shown in green, and the 2000s are shown in red.

As the chart points out, the markets of the 2000s have not been kind to investors whereas the prior decade was extraordinary. Not one year during the 1990s had a return below -10%, whereas three of the most recent seven years have been worse than -10%. Only two of the past seven years have been above average, including this past year.



Source: Surz Market Review

Bonds (the Citigroup High Grade Corporate Bond Index), on the other hand, have been near the historical average of 3.1% above inflation per year during this decade, with the exception of 2004. Note also that bond returns are more tightly distributed than stocks, reflecting the fact that they generally carry lower risk.

Source: Surz Market Review

History of risk and return

The final historical perspective we'd like to share with you is the history of risk and return in the capital markets. The table on the following page shows risk-reward relationships over various time periods.

Note that stocks have delivered about the same return in the most recent 41 years as they did in the previous 40 years, but seemingly with less risk ("standard deviation", based on monthly returns). At the same time, inflation in the most recent 41 years has been significantly higher on average than it was over the prior 40 years (4.66% versus 1.49%). As a result, an indicator of investing efficiency known as the Sharpe ratio, (return above Treasuries divided by standard deviation of returns) is considerably lower in the more recent past. In other words, stock investing has been less efficient than it used to be. By the same standard, bond investing has also become less efficient.

As the first row in the table indicates, the volatility of stock returns for in 2006 (see "Standard Deviation") was unusually low. In fact, volatility of stock returns were actually lower than bond return volatility (5.6% versus 7.8%) for the year.

Finally, looking at the last row in the table, as a result of the 2000-2002 market declines, returns of this last seven-year period were about as poor as any before it.

	STOCKS			BONDS		
	Return	Standard Deviation	Sharpe	Return	Standard Deviation	Sharpe
2006	15.81	5.64	1.83	3.24	7.79	-0.22
81 Years						
1926-2006	10.43	19.17	0.33	6.15	6.93	0.33
40 Years						
1926-1965	10.43	22.69	0.39	4.54	3.96	0.75
41 Years						
1966-2006	10.42	14.98	0.28	7.74	8.9	0.18
7 Years						
1930-1936	2.3	40.02	0.04	9.64	5.32	1.64
1937-1943	0.36	25.35	0.01	4.65	2.26	2
1944-1950	14.75	13.6	1.03	2.51	1.85	0.99
1951-1957	15.69	12.86	1.05	2.96	6.16	0.18
1958-1964	15.07	11.49	1.05	3.45	3.26	0.24
1965-1971	6.11	13.39	0.07	2.32	7.54	-0.35
1972-1978	3.3	16.07	-0.16	5.49	7.22	-0.07
1979-1985	17.58	14.43	0.44	11.3	14.67	0.05
1986-1992	14.68	17.14	0.46	11.32	7.2	0.64
1993-1999	21.53	12.88	1.25	6.79	5.37	0.37
2000-2006	1.16	14.44	-0.14	8.3	7.71	0.64

Source: Surz Market Review

We continue to believe that a well-diversified portfolio, exposed to the world's variety of asset classes, and managed with discipline and attention to costs will serve most clients well.

With the New Year upon us, we wish everyone a prosperous 2007. As always, we appreciate your confidence and trust.

Sources: Advisor Intelligence, Advisor Products, Wall Street Journal, Surz Market Review, Morningstar