MOSAIC
FINANCIAL PARTNERS, INC.
a Wealth Advisory firm

Market Watch
3rd Quarter 2009

Summary

- The market continued its rebound and nearly every asset class benefitted.
- Large U.S. stocks (the S&P 500) rose 15.6% in the quarter.
- Small company stocks (Russell 2000) rose 19.3% this quarter with the smallest of stocks (Russell Micro Cap) gaining 20.9%.
- The U.S. dollar weakened, adding value to overseas investments for American investors. Large non-U.S. companies gained 19.5% and smaller companies were up even more.
- REITs rebounded and finished up 33.3% this quarter, best of all major asset classes.
- Emerging market stocks were up 21.0%.
- Alternative investments produced broadly positive results, with our commodity fund up 9.4% and the currency fund up 7.4%.
- Bonds generally enjoyed positive returns this quarter.

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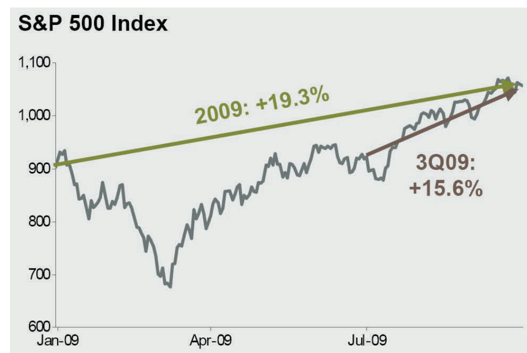
The third quarter saw the economy continue its healing and the equity markets continue their rally. The six months since the market's March 9 lows were the two best consecutive quarters since 1938. In September, Ben Bernanke, the Chairman of the Fed, said "The recession is in all probability over."

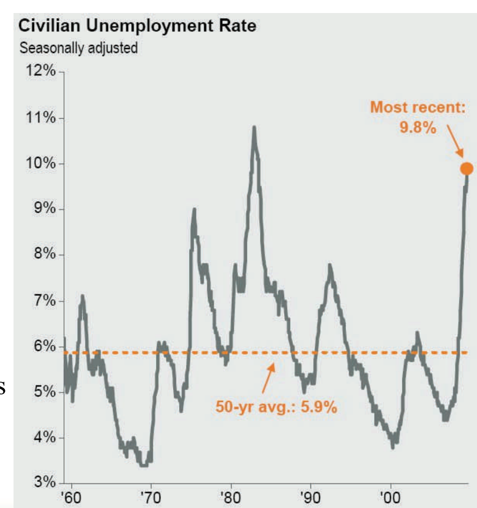
Almost all asset classes did well this quarter. The S&P 500 finished up 15.6% for the third quarter and is up 19.3% since the start of the year. The Dow Jones Industrial Average and NASDAQ also jumped during the quarter, rising 15.9% and 15.8%, respectively. Small stocks did better than large stocks, value did better than growth, and overseas generally did better than domestic. Even most bonds performed well.



The jump in share prices since March can partially be attributed to expectations that consumers and producers will continue their spending. The fears early in the year about reduced corporate revenues and profits now appear to have been excessively negative. Thus, the last six months have represented a rebound from what now appears to have been an overly-severe reaction to the bad news of 2008 and early 2009. With an apparent general agreement that the financial crisis now is squarely behind us, stock prices are now looking for a more reasonable "normal." While the pendulum could continue its swing to the upside, we think it more likely that we are closer to a stasis in which stocks will settle into a much narrower range.

An Overview of the Economy

Rising Unemployment



In September, unemployment hit 9.8%. Less talked about, but probably of equal importance, is the "U-6" unemployment rate. The U-6 measures total unemployed workers plus all workers who have looked for a job in the last year but have now stopped looking (so called "discouraged" workers) plus those who are working part time but desire full time employment.

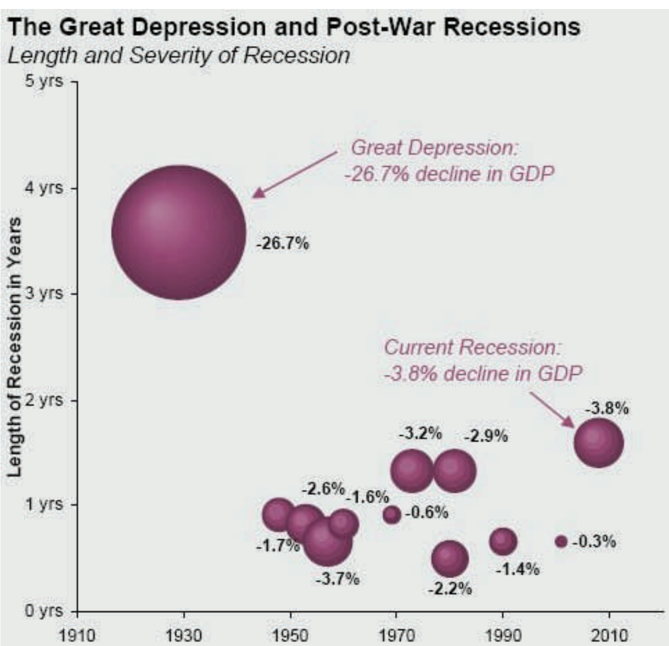
This rate has increased from 11.2% in September of 2008 to roughly 17.0% today.

Despite the historically high unemployment rate, the good news is that the rate of new unemployment appears to be slowing. Unfortunately, employment opportunities aren't likely to rebound as quickly as they usually do in a market recovery. Workers are remaining unemployed longer. In many cases, their skills are obsolete or irrelevant relative to the opportunities available. Those unemployed 15 weeks or longer and still actively looking for work has more than doubled, from 2.4% a year ago to 5.4% this last August.

The number of those who are discouraged over job prospects and have thus left the work force has also increased. The number of discouraged workers has risen from 467,000 in September of 2008 to 706,000 one year later. Most economists expect the unemployment rate to hit or exceed 10% before it starts to finally fall. America's move toward a service economy has reduced the percentage of jobs which are associated with the manufacture of goods. Traditionally, employment rises and falls with the need to produce goods, but the demand for services isn't as responsive. As a consequence, a quick job rebound is not likely to materialize in this recovery. This will limit the potential for full economic recovery.

The Overall Economy

Government estimates for the second quarter indicate that the US economy shrunk for the fourth consecutive quarter, by an annualized rate of 0.7% (we do not yet have third quarter figures). The stimulus package helped hold the economy together as consumer and corporate spending sank. Except for the "Cash for Clunkers" program, consumer spending would have fallen further during the quarter. Imports declined even more than exports during the quarter as the falling dollar made foreign goods more expensive.



The private sector contraction was offset by government spending, which increased by 11.4% during the quarter. The government has distributed over $100 billion in stimulus funds with twice as much still left to be paid out. This bodes well for the near-term future. As the economy continues to recover and confidence returns, the stimulus package should provide a financial tailwind.

Housing

Housing was, and still is, one of the most significant areas of economic concern. The housing market appears to have recently stabilized. According to the Case-Shiller 20-City Index, June was the first month to exhibit positive growth since May of 2005.

Locally, average Bay Area home prices are near 2002 values, having dropped nearly 42% from their peak. Prices seem to be stabilizing but any significant rise in foreclosure activity could reverse this positive trend.

In August, housing construction, as measured by national housing starts, rose 2.7% from July but was still lower than August 2008 by 32%. The slowdown in construction has both positive and negative implications: while the lack of work is pushing unemployment numbers up, the inventory of available housing is finally shrinking. Once the housing supply and demand for homes are in better balance, housing prices will stabilize. To help encourage more buyers, the government has offered an $8,000 credit to many first time homebuyers. Due to its popularity and boost to the economy, Congress is considering renewing the program when it expires in November.

There are still hurdles ahead for housing. Many banks still own foreclosed homes and are said to be waiting for the market to improve before releasing their holdings onto the market. A significant jump in the number of houses for sale would put a halt to any rebound in home prices. Mortgage delinquencies also remain a problem and are continuing to default at historically high rates.

Commercial real estate carries its own set of threats for the economy. With business failures rising and unemployment high, the demand for office and retail space has dropped. As a result, property revenues have fallen—in some cases dramatically. This is making it more and more difficult for some property owners to pay their mortgage costs and other expenses. Adding to the problem, an unusually high amount of commercial property debt is coming due over the next three years. With credit hard to get and with the borrowers (landlords) seriously weakened, investors have been concerned about bankruptcies and forced liquidations.

The Consumer

Consumer confidence continued to improve in September, hitting its highest level in two years. Despite overall confidence returning to positive levels, Americans are still concerned about the fall in the value of their homes and investment accounts and the loss or reduction of pension benefits. These concerns have led consumers to reduce debt and increase savings. As a result, consumer spending, which has accounted for 70% of the American economy, has slowed significantly.

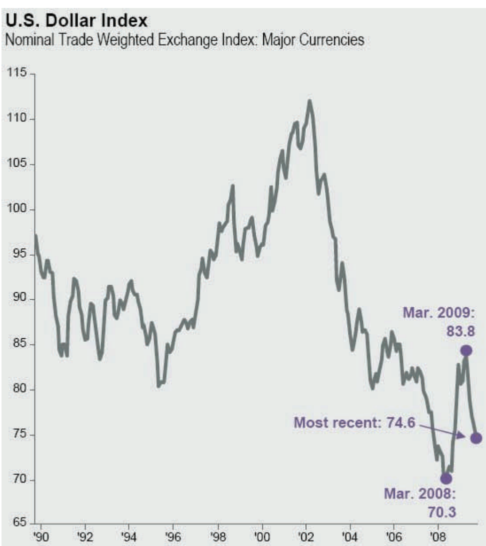
Savings rates have jumped to more than 4% of disposable income. While good for the economy in the long run, the resulting lower spending has hurt businesses, which have seen slower sales and lower revenues. Without more spending, growth in jobs becomes less likely. Without more jobs, people aren't likely to spend as they have in the past.

Corporate Earnings

In the fourth quarter of 2008, the S&P 500 reported its first ever negative operating earnings for a full year. While we have seen positive improvement since last year's fourth quarter, though improving and growing, earnings for the last two quarters were still significantly lower than earnings figures from a year or two earlier. Second quarter earnings were down 18.9% from 2008 and 42.6% from 2007.

Due to the general pessimism about the economy, most analysts underestimated corporate earnings at the beginning of 2009. More than 60% of companies in the S&P 500 beat initial analyst estimates this year. Analysts have since adjusted upward their estimates of future earnings. These increased estimates have helped contribute to the stock market's rise as the estimates are widely used as a measure for stock valuations.

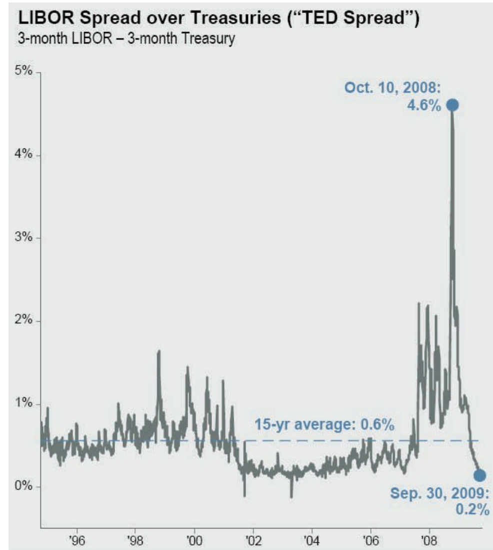
The Sliding Dollar



The US dollar fell heavily against most major currencies this quarter. During the fear of 2008, investors worldwide moved money into the dollar believing it to be the safest place in a global economic crash. With panic subsiding, the dollar has steadily fallen as funds have flowed from the dollar into other world currencies. The falling dollar is a dual edged sword—it helps American producers as their goods become cheaper in foreign markets but it also hurts the American consumer as the price of foreign goods rises. We are seeing this effect as imports have dropped dramatically.

The Credit Market

After being virtually frozen last fall, the credit markets appear to be stabilizing. Liquidity has returned and banks are beginning to lend again. A sign of the market's recovery is the shrinking "TED spread." The "TED" measures the relative amount of very short term credit risk. From record highs at the end of last year, it is now actually below its historical average. The TED spread, LIBOR minus treasuries, is a general indicator of credit risk in the economy. The drop in the spread can be interpreted as positive sign for lending in the economy. The market has responded positively to this improvement as the availability of credit allows business to finance operations and longer term growth.



In September, the Federal Reserve met and chose to hold interest rates steady, continuing at the December 2008 level of 0% to .25%. The Fed reaffirmed its commitment to buy $1.25 trillion of mortgage-backed securities and up to $200 billion of agency debt, both of which should help further strengthen the credit markets.

To finance the stimulus and support the enormous budget deficits, it is crucial that the US government find investors willing to lend it money. Long term yields (interest rates) have crept up partly because of the increase in borrowing. Though still near historical lows, higher yields attract lenders but at the same time make borrowing more expensive. This may become a growing concern as the Congressional Budget Office has projected the national deficit to surpass $10 trillion by 2012. This is nearly double the debt totals that existed at the beginning of 2008. The amount of debt this country is planning to take on represents a long term threat to our national economic well-being.

One way to address deficits is to raise taxes, which seems inevitable. Historically, higher taxes reduce economic growth. Higher borrowing brings higher costs. Higher taxes are expected to slow the economy. It's not a good indicator for the U.S.

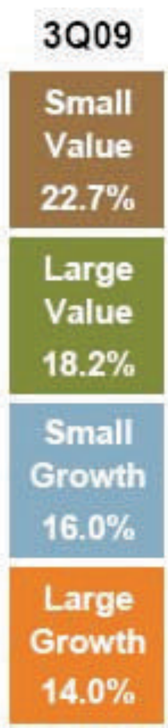
Low Inflation:

Inflation remained low last quarter, which is good for corporate profits and the markets. Economists do not see inflation rising in the near future, despite the enormous amount of money being pushed into the system by the Federal Reserve. This is largely because workers have such little leverage to negotiate higher wages. Rising wages generally result in higher costs to produce goods and therefore higher prices, while stable wages help keep consumer prices stable.

Economic Summary:

The sigh of relief coming from Wall Street in the spring was audible. As people realized that Armageddon would be avoided, investors rushed in to buy the assets they had discarded while the market was falling. In hindsight, it now looks as though the market over-reacted in in falling to its March depths — and the pendulum has now swung in the other direction over the last six months. Where the "right" valuation lies is hard to say, but we are probably much closer today than we were in March.

Commercial real estate faces lowered rent revenues and looming debt payments. Consumer debt (both mortgages and credit cards) remains high and troubled. Banks may be forced to face significant additional write downs to their loan portfolios resulting from these two concerns. Until these problems are confronted and resolved and until we see a meaningful employment recovery, the economy is likely to struggle.



If the economy and corporate profits stay weak, investors who have hoped for a quick recovery are likely to be disappointed. Stock prices could suffer. However, the markets are still well below 2007 levels and there is an unusual amount of investable cash still on the sidelines. So there may still be legs left in this rally.

Investment Review

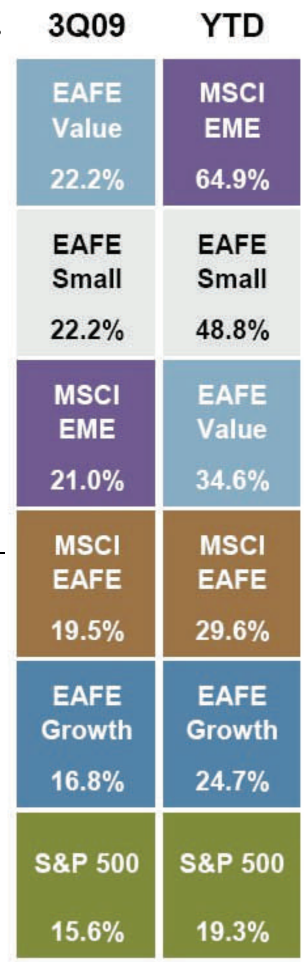
Domestic Stock Markets:

Markets frequently overshoot and, like a pendulum, they swing back towards their intrinsic value, sometimes passing it again going the other way. The March lows overshot on the negative side, and we have since enjoyed a nice return to more sensible values. Among the hardest hit, the financial sector has led the way in this recovery, returning 25.5%. Value stocks (think about it as "stocks that were on sale") greatly underperformed Growth in 2008 but have outperformed it in 2009 by 0.7%.

Small company stocks, which historically lead coming out of a recession (because they are more nimble and quicker to adapt) have produced solid returns. They have outperformed larger stocks both this quarter and for the year. Our portfolios generally over-weight small company stocks; similar to the 2nd quarter, this bias benefitted investors last quarter. The S&P Small Cap 600 returned 18.7% in the 3rd quarter, outpacing the large company S&P 500 index by 3.1%. Small cap stocks are up 19.5% for the year. Microcap stocks, the smallest 10% of publicly traded companies, were badly damaged in 2008, but they continued their swing back this quarter, returning 20.9%, and are up 28.1% for the year.

Real Estate:

Real estate stocks lost 38.8% in the fourth quarter of 2008 and 31.9% in the first quarter of 2009. The "pendulum effect" was again evident as real estate returned 33.3% in the third quarter and is now up 17.0% year to date. Real Estate Investment Trusts (REITs) must pay out at least 90% of their income. This makes it difficult for REITs to accumulate savings to finance additions to their stable of properties. To grow, most REITs rely on their ability to borrow the money they need to acquire more properties. When credit became tight, many investors feared that REITs would be unable to roll-over maturing loans and thus many were expected to face bankruptcy. The re-opening of credit markets has benefitted REITs more than any other asset class. REITs still face significant challenges in the future but the terrain has significantly improved. They still must address reduced rents and fewer tenants, but at least they once again can borrow.



International Stocks:

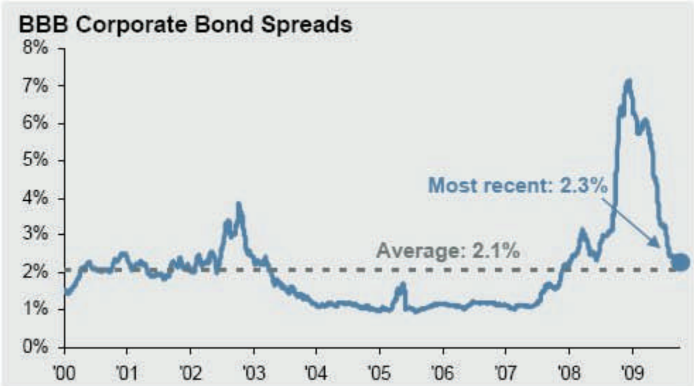
The dollar fell against most major currencies again this quarter, providing a welcome tailwind for American investors. So, while in local currencies, the MSCI EAFE (the mostly widely used index to track non-US stocks) underperformed the S&P 500, American investors saw their portfolios benefit due to currency differences. The EAFE index returned 19.5% for American investors in the third quarter.

Similar to US investments, those assets traditionally considered 'riskier' were the best performers. Stocks of small international companies returned 22.2%, outperforming their larger brethren. Emerging markets, which were battered last year, also swung back with excellent returns of 21.0% and are up 64.5% for the first nine months of 2009. Some of the best performers in the quarter were Brazil and Russia, respectively returning 27.5% and 27.1%.

Japan, the world's third largest economy, has been mired in an extremely severe recession. Japan's economy contracted by 14.2% in the first quarter but returned to positive growth in the second quarter, growing 2.3%. A new political party was elected recently to lead Japan, ousting the former party for the first time in a half century, helped in part by the economic climate. Japanese equities singularly produced negative returns during the quarter for Japanese investors, though Americans saw slight positive returns due to the currency movements.

Fixed Income (Bonds):

The pendulum effect was prominent in the bond market as well. High yield bonds lost a lot of their value in 2008 due to



concerns around rising defaults. So far in 2009 they have swung back, returning 49% year to date. Other bonds that fell last year, such as corporate and municipal bonds, have all bounced backed this year. Corporate (U.S. Corporate Index) and municipal bonds (BarCap Municipal Index) returned 8.1% and 7.1%, respectively, in the 3rd quarter. During the rush to quality investments in the panic of 2008, Treasuries traded near their face value, but have fallen in price this year and closed out the quarter down 2.3%.

TIPS, which return a yield equal to inflation plus a premium, returned 3.1% last quarter. The low inflation expectations and current lack of inflationary concerns have lowered the attractiveness of TIPS.

Alternative Investments:

A rising tide lifts all boats, and that was case with alternatives. We utilize alternatives to help add to returns while relying on different sources than stocks and bonds for their returns. In 2008, everything fell. This year has returned to greater normalcy.

Both our currency funds, DBV, PowerShares DB G10 Currency Harvest, and PLMIX, PIMCo Developing Local Markets, have enjoyed great years, respectively returning 18.5% and 19.6% year-to-date, due in large part to the dollar's slide.

Plum Creek Timber was significantly more stable than the market last year, so with less pendulum effect to be had, it has failed to excite this year. It was up 4.3% this quarter but still down 8.2% for the year.

The Merger fund was up 1.7% for the quarter and 6.6% for the first nine months.

Commodity prices were driven to record highs last year because of concerns regarding emerging market consumption and the finite supply of commodities in the world. However, when the world economy slowed in 2008, commodity prices tumbled in the last half of the year. During 2008, for instance, the price of a barrel of oil rose to a high of $149 before falling to the low 30s near year end. Commodities have rebounded from last year's lows and have had improved returns this year. The Dow Jones/ UBS Commodity Index returned 9.1% so far this year, with 4.2% coming this quarter. The weak dollar has also contributed to price appreciation. Gold, a traditional dollar hedge, touched the symbolic $1000 an ounce milestone in the week before the quarter closed and continued rising in October.

Summary:

The third quarter continued the momentum of the second quarter. The growing fear and pessimism that ruled the market from October 10, 2007 to March 9th, 2009 and contributed to a 49% drop in the S&P 500 now seems to have been excessive. The market growth this year reflects primarily a return to normalcy. However, problems still are present: unemployment, commercial real estate, the huge national debt, coming higher tax rates and the threat of trade protectionism arising from the desire to protect domestic jobs. With consumers, which make up about two thirds of the economy, being more cautious and restricting their spending, we will not soon be bouncing back to 2007 corporate profit levels and the higher market valuations that go with them. But, with credit beginning to loosen, the housing market stabilizing and with huge amounts of investor cash sitting on the sidelines, signs of economic progress may encourage continued growth in investor confidence, which could lead to continued stock price growth.

Over the last two years we have seen markets swing in both directions well off their intrinsic values before returning to more appropriate levels. We saw both the excess highs in late 2007 and the excess lows at the beginning of 2009. Looking back, it appears that neither of those levels accurately reflected the underlying value of the market. When you are in the moment at either end of the pendulum swing, it is nearly impossible to detect the "real" fundamental values. The lesson learned seems to be that we would do best to focus on our longer-term goals and discipline our investing to avoid the extreme emotions of the short-term swings. Looking at short term market movements will often cause pain and frequent misinterpretation. Trusting that the market will eventually return to its appropriate inherent level is difficult, but would serve us well.

As always it's a pleasure to serve you. If you have any questions or would like to discuss your portfolio please contact us.

The Mosaic Team