



■ BUILDING AND MAINTAINING A STOCK PORTFOLIO IN UNCERTAIN TIMES

Need equity exposure, but leery of risk? Multiple signs are pointing towards a market rotation away from low-quality, stocks to the steadier high-quality stocks that Madison Mosaic prefers.

One of the more difficult investment challenges is maintaining an asset allocation strategy in volatile and uncertain markets. Recent mutual fund flows paint the picture: a massive move away from equities as the market crashed in 2008 and continued outflows well into the recovery. Positive flows into equity funds became significant only nine months into the rally and quickly reversed with the market drops we've seen recently.

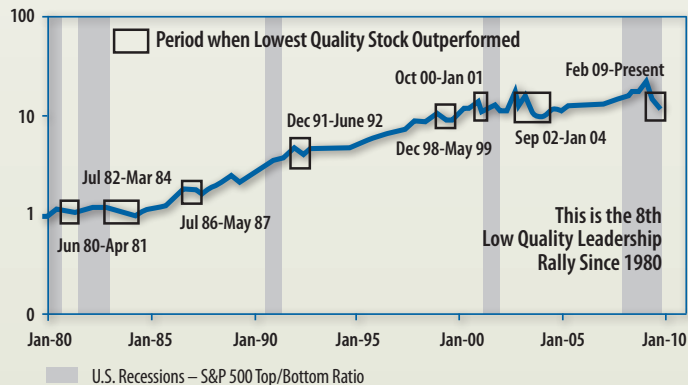
So how do you establish and maintain an equity exposure when the market and economy seem so fragile? One logical answer is to build a core investment around the strongest possible companies – companies which, at the time of this writing, happen to be trading at the low-end of relative valuations. At Madison Mosaic we follow a strict discipline in our equity investments; one which focuses on investing in high-quality, attractively-priced companies to produce long-term results. We recognize that this style will not always be in favor. It was clearly not in favor during the steep market rally that began in March of 2009. That may very well soon change.

Low-Quality Stocks Historically Lead Recoveries – But Not for Long

Since 1980 there have been eight low-quality rallies, as tracked by Standard & Poor's quality segments. The average rally has lasted 10 months, and although we would not posit that the market collapse and rally of the past two years has been typical, there are reasons to believe that this most recent low-quality rally is aging.

Lowest Quality Stocks have Rallied Briefly and Sporadically

S&P 500 Ratings-based Returns, Highest vs. Lowest Rated Stocks



Source: Royal Bank of Canada (RBC) Capital Markets Quantitative Research. Last data point 11/30/09. The S&P 500 Index is a measure of the performance of U.S. large-cap stocks. Indices are unmanaged and their returns assume reinvestment of dividends and do not reflect any fees of expenses. It is not possible to invest in an Index. Past performance is no guarantee of future results.

The End of the Beta Rally?

Beta is a measure of a stock's price volatility. While low-quality and high-beta stocks are not synonymous, they are cousins. Quality is based on fundamentals, such as price-to-book and earnings predictability. While the market may drive the price of a high-quality company in a volatile pattern, it is much more likely to show steadiness than a company lacking in consistent fundamentals.

So how does it end?

Relative performance of High Beta in 2002-2004 versus today

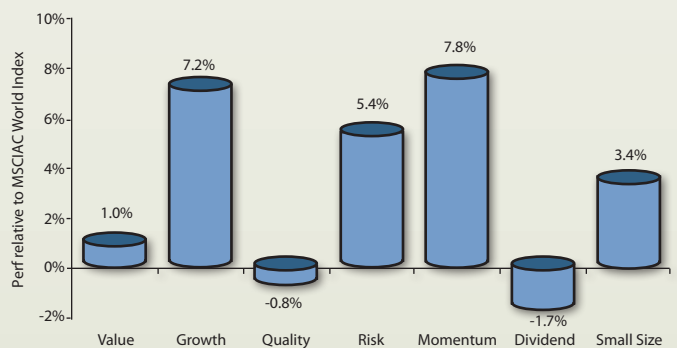


Source: BofA Merrill Lynch US Quantitative Strategy. Past performance does not predict future results.

The Stage is Set for Rotation

Everyone knows that asset classes and investment styles move in and out of favor. But how do you know what is hot and what is about to be cold? Keeping an eye on recent trends is the first step to making a correct contrarian call. As you can see from the following chart, high-quality equity investments have been decidedly out-of-favor through mid-May.

Global Style Relative Performance Year-to-date¹



Source: BofA Merrill Lynch Global Quantitative Strategy, MSCI, IBES

Building and Maintaining a Stock Portfolio

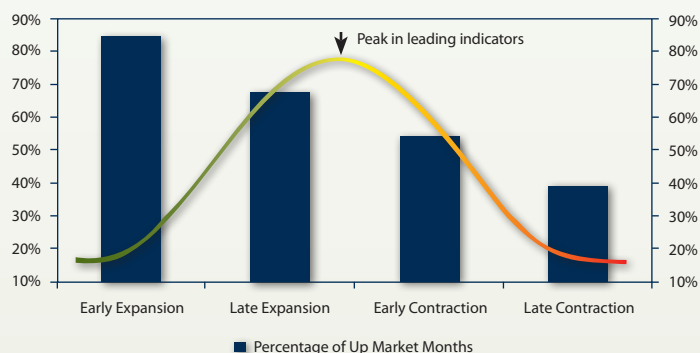
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The Leading Economic Indicator Story

Francois Trahan, a principal of Wolfe-Trahan Inc., has been Institutional Investor magazine's top-ranked portfolio strategist for four of the past five years. For a number of months he has been making a compelling case that leading economic indicators are peaking and about to roll over. His analysis of what this means to investors is summarized in the following graphics.

As we enter a period where market returns might be considerably less robust than the past year, market leadership could rotate, providing new opportunities to add value through stock selection:

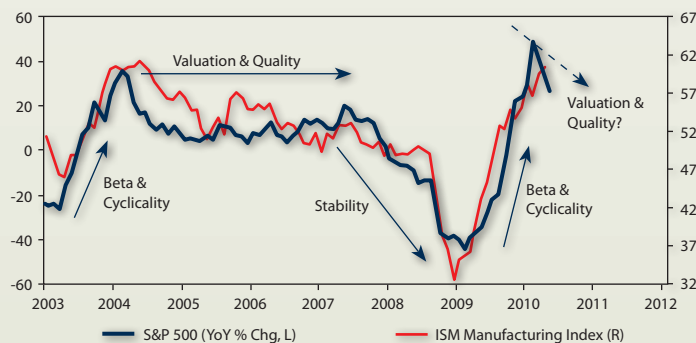
Peak in Leading Indicators Ushers in a Better Environment for Stock Pickers



Source: Wolfe Trahan & Co.

In the early expansion period, it is difficult to differentiate yourself as a stock picker when everything is hot – as illustrated by the far left column, showing broad and steady market advances. It is when we are entering a contraction, as Wolfe Trahan suggests we are, that “lower stock market returns favor stock pickers over passive investors.”

An Example of Factor Rotation in the Past Cycle



Source: Wolfe Trahan & Co.

In 2009 high-beta and cyclical stocks outperformed. If history is any indication, 2010 could be the right backdrop for quality and valuation to take the lead.

Summary

The market correction of May could very well set the stage for a shift in leadership from low-quality, high-beta stocks to steadier, high-quality ones. A growing accumulation of evidence points in this direction. In the meantime, investors who were deeply shaken in 2008 are likely quick to find any market dips disconcerting. Maintaining an equity exposure may be easier with a portfolio concentrated in high-quality stocks. These kinds of companies can not only engender more confidence in investors, but may actually be poised to perform better than the overall market over the months ahead.

Definitions

Beta: A measure of non-diversifiable risk. It is calculated by analyzing the prior 60 months of price performance versus that of the S&P 500. High beta securities have more volatility than the Index.

ISM Manufacturers Index: A monthly index released by the Institute of Supply Management which tracks the amount of manufacturing activity in the previous month.

S&P 500 Index: A measure of the performance of U.S. large-cap stocks.

S&P Quality Ratings: Standard & Poor's has provided Earnings and Dividend Rankings, commonly referred to as Quality Rankings, on common stocks since 1956. Quality Rankings reflects the long-term growth and stability of a company's earnings and dividends.

¹ The seven global styles represented in this chart are based upon Merrill Lynch's Style Portfolios: Quantessential Value, Growth, Quality, Risk, Momentum, Dividend and Small Size. Each portfolio is designed to be relatively sector and regionally neutral to the MSCI EAFE Global Index. The Growth Portfolio consists of 30 stocks that are characterized by high earnings revisions, high earnings-per-share forecasts and high seven-year trend growth. The Value Portfolio consists of 30 stocks that are characterized by low EV/EBITDA, low trailing price to sales and low price/earnings forecasts. The Quality Portfolio consists of 30 stocks that are characterized by high quality rankings and high free cash flow/equity. The Risk Portfolio consists of 30 stocks that are characterized by high 60-month beta and high one-year price volatility. The Momentum consists of 30 stocks that are characterized by trailing one-year high-price trend. The Dividend Portfolio consists of 30 stocks that are characterized by high reported dividend yield, high-year dividend growth and low five-year dividend payout. The Small Size Portfolio consists of 30 stocks that are characterized by low market capitalization and small capitalization relative to turnover.

HOLDING BONDS, MANAGING RISK

Investors typically look at their fixed income allocation as a risk hedge. Is it?

If investors were beginning to forget the risk dynamics of 2008, the market dislocations of this quarter probably brought back memories. As the stock market cascaded into what, for a moment on May 6, looked like a free fall, many bonds did just what most investors want: they maintained or actually increased in value.

However, not all bonds act alike, and investors who had reached deeply into the lower-credit quality market seeking increased yield found that these bonds did not provide much cushion during this mini-crisis. Regardless of how the market anomalies play out, or what the cause of the stock market dislocation proves to be, the lesson here holds. Bond investors need to be looking far beyond yield if they truly want to diversify risk through fixed-income investments.

The High-Yield Conundrum

In early 2009 we identified corporate bonds as the most attractive area of the bond market. We were actively overweighting corporate bonds in our portfolios that allow these holdings.

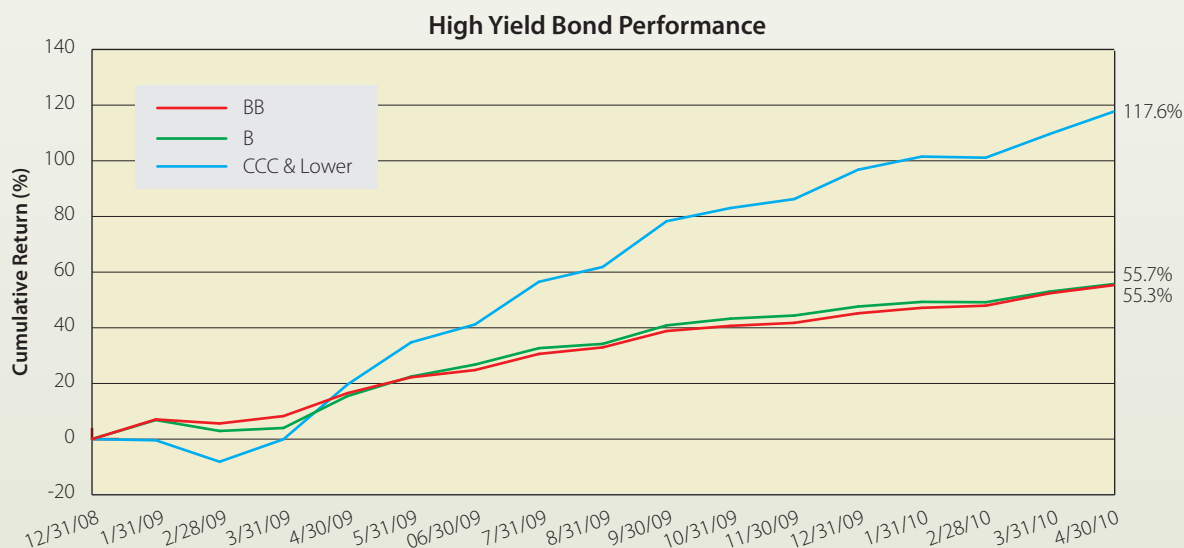
Although Madison Mosaic's bond funds do not typically have exposure to the lowest quality "junk" bonds, we recognized that corporate bonds of all ratings had the best risk/reward characteristics. What was remarkable about 2009 was the tremendous rally in low-quality bonds, with the Barclay's CAA segment (considered "junk bonds") of their U.S. Corporate Bond Index up 89.8% for the year. But the rally rewarded investment-grade bond holders as well, with the A segment of the same Index up 13.6% for the calendar year. As you can see in the chart below, the one-year returns of various segments of the corporate market have had a substantial run. The upswing has been particularly steep in lower-rated bonds.

Long before the stock market went through the shocks of the week of May 3, Mosaic's bond management had been saying that the easy money had been made in corporate bonds and that the valuations of high-yield bonds were stretched beyond reason. As a result, we have been orienting our corporate/government

portfolios with a lower-risk bias, focusing on shorter, highly rated corporates.

Outlook

We believe investors should take a long, hard look at their bond holdings and assess what they are holding in terms of riskier issues as well as interest rate risk, which can be measured by looking at portfolio duration. If holdings appear to be concentrated too highly in high-yield bonds or long maturity holdings, we believe investors should consider rebalancing to a more conservative posture. While we see muted upside even in high quality bonds over the short term, conservative bonds should continue to hold the potential to provide risk reduction during difficult times. In difficult markets, seeking to preserve capital takes on special value. We believe this meets the needs and expectations of most fixed-income investors. Moreover, capital preserved can be capital ready to deploy should we move into a higher-yield environment over the upcoming months and years. ■



Source: Bloomberg

Performance based on the Merrill Lynch Global Bond Indices for B, BB and CCC & Lower. These indices can not be invested in directly and do not represent the performance of any MadisonMosaic portfolio. The Merrill Lynch Bond Indices are designed to reflect the worldwide bond markets and reflect the performance of bonds in their local currency. The Merrill Lynch Index composite rating algorithm is based on the average of Moody's, S&P and Fitch, with Fitch replaced by DBRS in Canadian credit markets only.

FUND PERFORMANCE*

MADISON MOSAIC STOCK FUNDS

FUND	2ND QTR	YTD	1 YR	3 YR	5 YR	10 YR	SINCE INCEPTION	INCEPTION DATE	EXPENSE RATIO
Investors	-12.25%	-8.69%	11.55%	-7.19%	-1.02%	1.22%	10.13%	11/1/78	0.99%
Balanced	-7.85%	-4.81%	10.38%	-1.36%	1.71%	3.04%	6.83%	12/18/86	1.25%
Mid-Cap	-7.61%	-3.35%	14.37%	-9.03%	-0.42%	5.51%	8.97%	7/21/83	1.26%
Small/Mid-Cap	-7.37%	-3.02%	13.49%	—	—	—	16.50%	12/31/08	1.25%
Disciplined Equity	-11.18%	-7.98%	12.13%	-6.50%	0.59%	1.58%	2.72%	12/31/97	1.10%

MADISON MOSAIC BOND FUNDS

FUND	30 DAY SEC YIELD	2ND QTR	YTD	1 YR	3 YR	5 YR	10 YR	SINCE INCEPTION	INCEPTION DATE	EXPENSE RATIO
Government	1.72%	2.34%	3.30%	4.64%	6.20%	4.51%	4.75%	6.67%	7/21/83	0.68%
Core Bond	2.90%	3.02%	4.58%	7.27%	6.90%	4.92%	5.25%	6.58%	7/21/83	0.70%
Institutional Bond	1.83%	2.14%	3.24%	5.83%	6.59%	5.08%	5.01%	5.10%	5/1/2000	0.49%

MADISON MOSAIC TAX-FREE BOND FUNDS

FUND	30 DAY SEC YIELD	TAX EQ YIELD	2ND QTR	YTD	1 YR	3 YR	5 YR	10 YR	SINCE INCEPTION	INCEPTION DATE	EXPENSE RATIO
Virginia Tax-Free	3.39%	5.53%	1.74%	2.17%	5.59%	4.95%	3.44%	4.68%	5.74%	10/13/87	1.03%
Tax-Free National	3.57%	5.50%	1.76%	2.30%	5.66%	4.86%	3.33%	4.48%	6.31%	12/30/82	1.06%

MADISON MOSAIC MONEY MARKET FUND

FUND	7 DAY YIELD	ANNUAL YIELD	MATURITY DAYS	EXPENSE RATIO
Government Money Market	0.00%	0.00%	35	0.89%

CHECK YOUR MADISON MOSAIC TICKER...

Investors Fund	MINVX	Disciplined Equity Fund	MADEX	Virginia Tax-Free Fund.....	GTVAX
Balanced Fund.....	BHBFX	Government Fund	MADTX	Tax-Free National Fund.....	GTFHX
Mid-Cap Fund	GTSGX	Core Bond Fund	MADBX	Gov't Money Market	GITXX
Small/Mid-Cap Fund	MADMX	Institutional Bond Fund	MIIBX		

*Returns greater than one year are average annual returns.

Investment returns and principal value will fluctuate, so that investors' shares, when redeemed, may be worth more or less than the original cost. Data quoted represents past performance. Past performance does not guarantee future results and current performance may be lower or higher than the performance data quoted. For performance current to the most recent month-end, call us or visit our web site. Government backing applies to timely repayment of principal and interest of the Government Money Market and Government Funds and not shares of these funds.

Please consider the investment objectives, risks, charges and expenses of any Madison Mosaic fund carefully before investing. Call for a free prospectus that contains this and other information and read it carefully before investing. Madison Mosaic Update is published quarterly for shareholders of Madison Mosaic® Funds.

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The Disciplined Equity Fund changed its name from Foresight Fund on May 1, 2008. Prior to January 1, 1998, the Disciplined Equity Fund had different investment objectives and the historical performance for such period is not presented. Had the Adviser not waived a percentage of the Disciplined Equity Fund's expenses beginning April 1, 2008, its returns would have been as follows: -11.26% (qtr), -8.06% (ytd), 12.15% (1 yr), -6.53% (3 yr), 0.57% (5 yr), 1.57% (10 yr) and 2.71% (since inception). The waiver may end at any time.

The Core Bond Fund changed its name from Intermediate Income Fund on May 1, 2008. Prior to July 1, 1999 the fund was known as the Mosaic High Yield Fund and had different investment policies.

Taxable equivalent yield assumes a taxpayer is in the 35% federal tax bracket, and for the Virginia Tax-Free Fund, the 5.75% Virginia tax bracket. Some income may be subject to Alternative Minimum Tax. Tax-Free National income may be subject to state and local taxes.

An investment in a money market fund is not insured or guaranteed by the FDIC or any other government agency. Although the fund seeks to preserve the value of your investment at \$1.00 per share, it is possible to lose money by investing in the fund. Had the Adviser not waived a percentage of fund expenses, Government Money Market's 7-day yield and annual yield would have been -0.75% and -0.75%, respectively. The waiver may end at any time.



fund performance