McCarthy Asset Management, Inc.

Registered Investment Advisor

September 4, 2007

Monthly Investment Commentary- August 2007

Stock Market Performance for August: The stock market exhibited dramatic volatility in August as turmoil in the credit markets unfolded. Actions taken by the Federal Reserve (including a 0.50% cut in the discount rate announced on August 17th) helped the stock market recover in the second half of the month. For the full month, unadjusted for dividends, the S & P 500 rose 1.3%, the NASDAQ climbed 2.0%, while the Russell 2000 rose 2.2%. Foreign equities and commodities fell, while bonds rose modestly.

MAM Performance for August: For the month, MAM portfolios under performed the S & P 500, with a composite rise of 0.5% (after all fees), versus a rise of 1.5% for the Vanguard Index 500 fund (symbol VFINX) with dividends reinvested.

The five best performing MAM investments for August were Allied Capital Corp (up 5.3%), Blackrock Health Science (up 3.5%), Pioneer Cullen Value (up 2.3%), iShares Select Dow Jones Dividend (up 2.1%), and American Amcap (up 2.0%).

The five worst performing MAM investments were PIMCO Commodity (down 3.5%), Oakmark International Small Cap (down 3.0%), Artisan International Small Cap (down 1.7%), PIMCO Developing Local (bonds) (down 1.4%), and Dodge & Cox International Stock (down 1.4%).

The 1.0% under performance of MAM portfolios relative to the S & P 500 was primarily due to the drop in the value of the international mutual funds and the fact that bonds rose less than stocks for the month.

Year-To-Date Performance: For the first eight months of 2007, unadjusted for dividends, the S & P 500 rose 3.9%, the Nasdaq climbed 7.5%, and the Russell 2000 rose 0.7%. MAM portfolios under performed the S & P 500 for these eight months, with a composite return of 3.3% (after all fees), versus a gain of 5.1% for the Vanguard Index 500 fund (symbol VFINX) with dividends reinvested.

Falling Real Estate Sales and Prices: On August 27th the National Association of Realtors reported that sales of existing homes in the U.S. dropped for a fifth straight month in July, falling to the slowest pace in nearly five years. Meanwhile Standard and Poors reported that U.S. home prices fell 3.2% in the second quarter, the steepest rate of decline since Standard & Poors began its nationwide housing index in 1987. This S & P/Case-Schiller quarterly index tracks price tends among existing single-family homes across the nation compared with a year earlier.

The CA real estate market is also being hit hard. The California Association of Realtors said sales of existing homes in the state slumped 22.7% in July compared with July 2006. The group said that both tighter standards for mortgage underwriting and "the adverse psychological impact" of ongoing bad news about foreclosures and subprime mortgages caused sales to

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decline. The association said that it would take 10.7 months to sell all the homes currently on the market in California at today's sales rate. That's a significant jump from last July, when there were 7.3 months worth of inventory on the market. A supply of about 6 months generally indicates a balanced market. "With credit drying up in recent weeks, we expect further weakness in sales over the next few months," Leslie Appleton-Young, the trade group's chief economist said in a statement.

Economy Performing Well: Despite the problems in real estate, recent reports on the economy have been good. On August 30th the Commerce Department revised upwards its second quarter of 2007 report on Gross Domestic Product (GDP) to 4.0%, up from its initial estimate of 3.4%. This represented the strongest growth since the first quarter of 2006, as solid improvements in international trade and business investment helped offset weakness in housing. Significantly, a key GDP inflation gauge that excludes food and energy rose by just 2% in the second quarter, compared to a year ago. That was better than a year-over-year gain of 2.4% in the first quarter. This inflation report is important because the Federal Reserve is seen as having more leeway to cut interest rates because inflation is easing.

Other recent reports indicate that the economy is performing well. Capital spending by businesses is gaining strength and manufacturing activity is strong. It is fortunate that the economy is performing well, as tepid consumer spending, weakening housing activity and credit-tightening suggest growth will slow significantly into next year. Analysts currently forecast that GDP growth will be between 2% and 3% in the current quarter before softening further. Most economists do not expect a recession to occur at this point (which is defined as two consecutive quarters of negative GDP growth).

Credit Market Turmoil Leads to Stock Market Correction: Prior to 2007 we had been through a multi-year period characterized by excess liquidity and an expanding tolerance for risk. Witness the ease with which even borrowers with weak credit were able to finance a home purchase with nothing down. Conditions started to tighten earlier this year, first in the subprime mortgage market. This spread to the corporate bond and other credit markets. Problems escalated with rising defaults, hedge fund blow-ups, and margin calls. Several mortgage companies entered bankruptcy proceedings triggered by margin calls from the firms' lenders. More disturbing, Countrywide Financial, the largest mortgage lender in the country, has been battered, its stock is down over 50%, and even the possibility of bankruptcy was rumored. Again, Countrywide's problem has been the drying up of funding sources and the inability to sell non-conforming loans.

The expanding credit market turmoil took its toll on stocks. From July 13th through August 15th the S & P 500 fell 9.4%. This sell-off was triggered when short-term liquidity in the credit markets all but froze up by mid-August. Things got so bad that major banks were unwilling to lend even to each other, immobilizing the global financial system. Whereupon the central banks of Europe, Japan, Australia and the U.S. stepped in to prop things up. It appears that the central banks actions so far have been effective based on the prompt rebound in the stock market.

The Federal Reserve and Outlook for Interest Rates: On August 17th the Fed cut the discount rate. This action only indirectly benefited consumers as the discount rate is the rate that banks can borrow from the Federal Reserve. Many analysts, however, believe that the odds are growing that the Fed will cut the federal funds rate, now at 5.25%, by at least 0.25% on September 18th at its next regularly scheduled meeting. The Fed hasn't lowered this rate in four years. Any drop in the federal funds rate will benefit consumer borrowers and holders of adjustable rate mortgages. While PIMCO, the largest bond manager in the U.S., is not convinced

that the Fed will cut the rate on September 18th, they do expect the federal funds rate will be lowered three or four times over the next year, dropping the rate to 4.25%.

Assuming the Fed succeeds in its efforts to relieve the pressures from the short-term liquidity squeeze, still to be determined is the longer-lasting effects of tighter credit conditions. The impact of the tightening will not be spread evenly over the whole economy. Housing and homebuilding will feel the greatest impact, as the subprime mortgage market shrinks and lenders begin to take a closer look at even prime borrowers' loan applications.

The biggest worry in the outlook is how the shift to tighter credit will affect consumer spending. So far, neither a sagging housing market nor soaring gasoline prices have kept consumers from spending. This is probably because job markets have been strong enough to generate healthy gains in income. Restricted access to credit will be consumers' next test in the coming year. Fortunately, much of the job growth has come from service-sector industries which account for 84% of jobs and are less sensitive to credit tightening. Also, gasoline prices through August 27th have dropped 47 cents per gallon since mid-May, a decline big enough to add significantly to the buying power of consumers in the second half 2007.

My Outlook for the Stock Market: Although I am heartened by the impressive recovery of the stock market over the last two weeks, it is hard to imagine that the downturn is over this quickly. The economy will be impacted by the tightening of the credit markets. Stock market volatility will probably remain high as I expect that some banks and other financial institutions will be reporting large credit losses in their third quarter reporting. In addition, additional hedge funds and mortgage lenders may go out of business. Furthermore, historically August through October has been the weakest performing 3-month period for the stock market.

A short-term risk is if the Fed decides to leave interest rates alone at its September 18th meeting. Currently, the interest rate futures market is counting on at least a 0.25% drop in the Federal Funds rate to 5.0%. If this interest rate cut does not occur, the stock market could take a hit in the short-run.

Despite these concerns, I am still cautiously optimistic. My view remains the same as what I said in my August 14th "Stock Market Update" (written when the S & P 500 had fallen 8.1% over the previous one month): "in summary, my feeling is that the stock market will remain volatile for the foreseeable future. I still don't think this is the start of a bear market, but is rather a healthy market correction". Any Fed cuts in the federal funds rate will further boost my confidence that the economy and stock market will weather the credit market turmoil.

Please call or email me if you have any questions or would like to discuss your portfolio(s).

Sincerely,

Stephen P. McCarthy, CPA, CFP