McCarthy Asset Management, Inc.

Registered Investment Advisor

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Monthly Investment Commentary- May 2006

Stock Market Performance for May: The stock market reversed course in May with a relatively sharp drop. Unadjusted for dividends, the S & P 500 fell 3.1%, the Nasdaq dropped 6.2%, and the Russell 2000 fell 5.8%. Foreign stocks fell sharply, REITs dropped, bonds were mixed, while commodities rose modestly.

MAM Performance for May: For the month, MAM portfolios underperformed the S & P 500, with a composite loss of 3.1% (after all fees), versus a loss of 2.9% for the Vanguard Index 500 fund (symbol VFINX) with dividends reinvested.

The five best performing MAM mutual funds for May were Nuveen High Yield Muni (up 0.9%), PIMCO Commodity (up 0.7%), Hussman Strategic Growth (no change), Loomis Sayles Bond (down 0.7%), and Dodge & Cox Balanced (down 1.2%).

The five worst performing MAM mutual funds for May were Artisan Intl Small Cap (down 7.1%), North Track PSE Technology (down 7.0%), Bjurman Micro Cap (down 6.5%), William Blair Small Cap (down 5.7%), and Oakmark Intl Small Cap (down 5.2%).

Year-To-Date Performance: For the first five months of 2006, unadjusted for dividends, the S & P 500 rose 1.8%, the Nasdaq fell 1.2%, and the Russell 2000 rose 7.1%. MAM portfolios out performed the S & P 500 for these five months, with a composite return of 4.1% (after all fees), versus a rise of 2.5% for the Vanguard Index 500 fund (symbol VFINX) with dividends reinvested. More importantly, MAM portfolios have outperformed the S & P 500 for each of the first six years of MAM's operations (2000 through 2005).

Recent Economic Reports and Interest Rates: On May 25th the Commerce Department revised its estimate of first quarter 2006 growth to an annualized rate of 5.3%. This was an increase from the initial estimate of 4.8%. Economists see the first-quarter number as a rebound from the unusually slow fourth quarter of 2005 (which was depressed due to the economic effects of Hurricane Katrina). Economists expect growth to slow to annualized rate of 3.0% to 3.5% in the coming quarters, hopefully a sustainable rate that will keep inflation subdued.

The housing market, which has been a pillar of the economy in recent years, continues to show signs of slowing. Although nationally most home prices are still rising, there is a growing backlog of unsold properties, which could put pressure on prices to fall. At April's rate of sales, it would take 5.9 months to sell all the homes on the market, up from 5.6 months in March, and up 40.5% from a year earlier (the largest year-on-year rise since 1982, when the Realtor's Association began collecting the data).

On May 10th the Federal Reserve, as expected, announced a 0.25% rise in the Federal funds rate to 5.0%, the 16th increase since June of 2004 (when the rate stood at 1.0%). In its

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statement announcing the interest rate increase, the Fed restated its bias to raise interest rates further because of the risk of higher inflation. It also laid out a forecast of slowing growth that would allow it to pause on rate increases. Growth has been "quite strong", the Fed said but will "likely…moderate to a more sustainable pace, partly reflecting a gradual cooling of the housing market and the lagged effects of increases in interest rates and energy prices."

Recent Drop in the Stock Market: Starting on May 10th financial markets around the world experienced a sell off, including a 5% drop in the S & P 500 between May 10th and May 23rd. This drop was exasperated by the release of the April U.S. consumer price data, which showed for the second consecutive month that the core rate (which excludes food and energy) of the consumer price index (CPI) rose 0.3%. Over the first four months of 2006 the core CPI was running at an annual rate of 3%, the fastest four-month clip since 1995. The fear is that the Federal Reserve will need to continue to hike interest rates to moderate inflation.

Is this recent sell-off a "healthy" 5% to 10% market correction, or is it the start of something worse? While I am hopeful it is the former, I do not know for sure. Market analysts feel that periodic sell-offs in the stock market are a healthy occurrence, as they "purge" the market of finicky investors and leave those who invest for the long haul. Since it has been a while since the market has experienced a correction, the recent drop is not necessarily a negative thing (as long as it is only a temporary correction).

I am encouraged that the stock market is reasonably valued. Currently, the "forward" price-earnings ratio (based on projected earnings for the next 12 months) has dropped to 15, the cheapest in more than a decade and close to its average over the last 58 years. Despite the positive performance of the market during the last 3 years, the market's price-earnings ratio has fallen sharply due to the dramatic increase in corporate earnings. At the end of last year, earnings for companies in the S & P 500 rose 14.4% above year-earlier levels. At year-end 2004, they were up 19.7%, after a 28.3% surge at the end of 2003. The first quarter of 2006 resulted in solid earnings growth of 14%. Although earnings growth is expected to slow in the coming quarters, it is still expected to remain strong.

Search for Alternative Assets: I continue to search for "alternative assets", which I define as investments that provide returns that are comparable to that of equities but with low correlation to the movement in stock prices. A good example is the PIMCO Commodity Fund, of which we established a 3% portfolio position starting in late 2004. Historically, commodities provide returns similar to that of equities. Although by themselves commodities have greater volatility than equities, they are inversely correlated to stock prices. Said another way, when stocks zig in one direction, commodities tend to zag in the opposite. Historically, if a commodity exposure is added to an equity portfolio, *the long-term return for the portfolio stays the same while the volatility drops*. This was illustrated this past month as PIMCO Commodity was one of only 2 MAM funds that rose for the month.

With the next portfolio positioning (which I plan to do in July), I expect to add Allied Capital to most portfolios. Allied Capital is the nation's largest business development company. I plan to profile the Company in the June 30th quarterly report.

Risk Assessment Questionnaire: In May we completed and mailed to all clients our new Risk Assessment Questionnaire (RAQ). So far we have received back 55 of them. Please complete and returns yours so that we can reflect it in the next portfolio repositioning. Once we receive your completed RAQ, I calculate the total "score" and send a letter and compare your total score, desired annual return, and desired maximum 1-year loss to the average for our clients.

Your RAQ score will enable us to better tailor your portfolio (s) to your risk tolerance. Investing involves the tradeoff between risk and reward. Although I feel that risk is mitigated by taking a long-term approach to investing, I need to focus on clients' tolerance for volatility. My philosophy in constructing a client's portfolio is to be as risky as the client can handle in a market downturn. To achieve attractive long-term rates of return, it is critical that investors "stay the course" during market downturns. Studies have shown that the market timing moves of individual investors causes many of them to significantly under perform the market. By not being able to "stay the course", they may be underinvested when the market hits bottom.

Client Meetings: In May I had meetings with 20 clients (including 2 "phone meetings" for clients who live out of the area). Items addressed in the meetings included discussion of the Net Worth Analysis, multi-year review of account performance, and discussions regarding alternative assets, the Risk Assessment Questionnaire, and eStatements. Please let me know if you would like to schedule a meeting. I still have a little time available for June (I already have 14 meetings scheduled and will be on vacation for part of the month). At this point I am not sure if I will be able to conduct meetings in July (due to quarterly reporting and portfolio rebalancing).

New Tax Act: On May 17th President Bush signed into law the Tax Increase Prevention and Reconciliation Act of 2005 (the "Act"). A major highlight of the Act is a two-year extension of the 15% capital gains and dividend rates. The 15% rate for long-term capital gains and qualified dividends will now expire after year 2010. This is a significant benefit for investors.

Another key provision was a 1-year extension (2006 only) of alternative minimum tax (AMT) relief by increasing the exemption amount which reduces the amount of income subject to AMT. Since this exemption amount is phased-out for higher income taxpayers, I still expect most of my tax clients to be subject to Federal AMT for 2006.

A surprising provision in the Act is the elimination of the $100,000 income limitation for Roth IRA conversions starting in year 2010. An interesting planning strategy will be to fund non-deductible IRA contributions starting in year 2006, and then convert the IRA assets to a Roth IRA in 2010. Only the appreciation on the non-deductible IRA contributions will be taxed upon the conversion.

A negative tax change from the Act involves "kiddie tax". The tax bill raises the age limit of the "kiddie tax", which subjects a child's income to his or her parent's higher tax rate. Under prior law, a child 14 and over could file a separate income tax return and pay tax at the regular rate(s). Under the new law, the child's income above $1700 would be taxed at the parents' higher rate until the child turns age 18.

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

Sincerely,

Stephen P. McCarthy, CPA, CFP