McCarthy Asset Management, Inc.

Registered Investment Advisor

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Monthly Investment Commentary- November 2007

Stock Market Performance for November: November was a difficult month for the stock market. The S & P 500 was down 4.4%, its worst month since December 2002. The overall market was even worse, as the NASDAQ fell 6.9% and the Russell 2000 fell 7.2%. Foreign equities and REITs also fell, while commodities and bonds were mixed.

10% Correction- Finally: On November 26th stocks ended their second longest stretch without a 10% correction (on a closing basis) when the S & P 500 dropped 10% from its October 9th peak. The previous 10% correction occurred in early 2003. It remains to be seen whether November 26th was the bottom of the correction. The futility of trying to time the dips in the market was shown once again, as the S & P 500 staged a sharp 5.3% recovery in the subsequent four trading days ending November 30th.

MAM Performance for November: For the month, MAM portfolios fell comparably to the S & P 500, with a composite drop of 4.2% (after all fees), versus a drop of 4.2% in the Vanguard Index 500 fund (symbol VFINX) with dividends reinvested.

The five best performing MAM investments for November were Blackrock Health Science (up 0.6%), PIMCO Commodity (up 0.3%), YieldQuest Tax Exempt (bonds) (down 0.6%), Loomis Sayles Bond (down 1.0%), and PIMCO Developing Local (down 1.0%).

The five worst performing MAM investments were Allied Capital Corp (down 17.5%), Oakmark International Small Cap (down 9.9%), Oakmark Select (down 9.1%), Artisan International Small Cap (down 6.8%), and Cambiar Opportunity (down 4.8%).

Year-To-Date Performance: For the first eleven months of 2007, unadjusted for dividends, the S & P 500 rose 4.4%, the Nasdaq climbed 10.2%, and the Russell 2000 fell 2.5%. MAM portfolios under performed the S & P 500 for these eleven months, with a composite return of 4.4% (after all fees), versus a gain of 6.1% for the Vanguard Index 500 fund (symbol VFINX) with dividends reinvested.

What trigged the November downturn? Excluding small cap stocks, the stock market is still up for the year. But it has been a rocky ride. After a relatively calm first six months of 2007, the market suffered a near 10% correction in mid-July as the credit crisis unfolded. Following an unexpected Fed interest rate cut in August, stock prices fully recovered their losses over the subsequent two months. The recent 6-week 10% correction started in October when concerns spread that the subprime lending crisis and $100 barrel price of oil would trigger a recession.

Are these fears founded? Personally, I have mixed feelings about high oil prices. While I am concerned that high gasoline prices will reduce consumer spending, I hope that sustained high oil prices may finally force the U.S. to put forth a coherent, long-term energy strategy for reduced dependence on foreign oil. Reducing our need for Middle Eastern oil may help us avoid future quagmires such as the war in Iraq. After twenty years, Congress is finally serious about

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significantly raising auto fuel standards (to a very obtainable 35 miles to the gallon by year 2015). Furthermore, there are numerous public and private efforts toward alternative energy. Since writing a paper on the benefit of a high energy tax (similar to that in Europe) 21 years ago when I was at the Berkeley Haas School of Business, our lack of a long-term energy policy has been my greatest source of frustration with our government. In short, my feeling is that the short-term pain that will result from high oil prices is worth the long-term benefit of reduced dependence on foreign oil.

What about fears of a recession? Clearly, there is a greater risk that we could enter into a recession within the next year. Some economists (including Former Federal Reserve Chairman Alan Greenspan), quantify that risk at between 30% and 50%. At this point, my belief is that the effort of the Federal Reserve to cut interest rates and Congress to mitigate the subprime mess (including a possible freeze in interest rate adjustments for certain subprime borrowers), along with strong international economies will probably keep the U.S. out of a recession.

Outlook for the Stock Market: I am probably less confident in my "cautiously optimistic" outlook for the stock market than at any time in the last four years. The subprime lending crisis which has triggered the worst national residential real estate downturn in decades is real. Based on past history (i.e. the 1990 to 1992 CA real estate downturn), I expect for it to take a couple of years for the real estate correction to run its course. Furthermore, I think we can expect further fallout from the subprime lending crisis as large financial institutions (Citibank, Merrill Lynch, Countrywide, Washington Mutual, E*Trade) continue to announce large write downs from loan defaults.

I feel the best course of action is for investors to stay the course *assuming their portfolios are invested consistent with their risk tolerance.* History has shown investors fail miserably when they try to time the stock market. For long-term success, it is critical for investors to not sell when the market is depressed. *If you feel you cannot ride out a 10% or 20% market drop, adjustments should be made now to make your portfolio more conservative. Please let me know if you want to discuss this further.*

While I have uncertainty with my short-term outlook for equities, I can not ignore the many positives:

1. **Strong Global Economic Growth**: While global economic growth may slow in 2008 from this year's 4% to 5% growth, the expected strength in the global economy should continue to provide a strong boost to U.S. exports. Furthermore, 20% to 30% of MAM portfolios are invested in international equities, which should benefit from the strong global growth.

2. **Worldwide Inflation Remains Low:** Despite soaring energy and other commodity prices, the forces of global competition continue to place powerful downward pressure on prices. Within the U.S., core CPI inflation has been in a steady decline, now running at 2.2% annually, down from its peak of 2.9% in September 2006. Inflation remaining muted is very important, as it will allow room for the Federal Reserve to continue to cut interest rates if needed.

3. **Stock Market Reasonable Valued:** Based on current earnings estimates, the S & P 500 is trading at approximately 14 times 2008 earnings. This is very reasonable. Furthermore, factoring in the current low level of interest rates, stocks prices appear to be almost cheap. While corporate earnings growth has been slowing (and contracted for the

first time in years this past quarter), strong foreign operations should continue to support U.S. corporate earnings.

4. **Potential further Federal Reserve Interest Rate Cut(s)**: Hints last week that the Fed is open to at least one more interest rate cut sparked a 5.3% 4-day rise in the S & P 500. Assuming inflation remains muted, the Fed appears ready to help the U.S. avoid a recession in the upcoming Presidential election year.

Alternative Minimum Tax (AMT) Relief ?: For 2006, Congress passed a bill which provided a 1-year fix to keep middle-income Americans out of AMT. This temporary fix, in the form of increased AMT exemption amounts, expired at the end of 2006. Although Congress was expected to extend this fix through tax year 2007, the Bill is currently stalled in Congress. If Congress doesn't act, the number of taxpayers subject to AMT is projected to increase from 4.24 million in 2006 to 23.19 million in 2007! (Source: Joint Committee on Taxation, March 5, 2007)

Long-term budget forecasts for AMT are ominous. According to the nonpartisan Congressional Budget Office, if Congress does not pass long-term AMT relief, 65% of American households will pay the AMT tax by 2050. Roughly 15% of individual income tax liability would be generated by the AMT, compared with about 2% today. Personally, I believe the most likely long-term AMT relief will be as a result of an increase in the regular taxes (i.e. reversal of the Bush tax cuts), while AMT will be left untouched.

Financial Planning Software: We are in the process of evaluating three financial planning packages which are commonly used in the financial planning industry. During 2008, we plan to select one of the packages to expand on the financial analysis we currently provide with the Net Worth Analysis. These planning packages address retirement planning, insurance planning (life, disability and long-term care), education planning and estate planning. While we do not charge clients for preparing a Net Worth Analysis, it remains to be seen whether and how much we will charge for generating a financial plan. One possibility is to not charge fees for clients who have MAM-managed assets above a certain level.

In choosing among the 3 software packages, I am asking for help from one or two clients. I would like to have us generate a financial plan from each of the packages. Based on the experience, we will then determine which package to purchase. I then hope to offer use of the financial planning software for clients later in 2008.

Please send me an email or call if you are interested in being part of our testing of these financial planning packages. The benefit to you will be a free financial plan. In return, I am looking for a client who will promptly complete and return a financial planning questionnaire, as well as provide us feedback regarding the resulting financial plan. I apologize in advance if I receive more requests than we can satisfy with this initial evaluation of the software. I will look first to those clients that respond when we roll out use of the software later in 2008.

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

Sincerely,

Stephen P. McCarthy, CPA, CFP