McCarthy Asset Management

Registered Investment Advisor
Certified Public Accountant
Certified Financial Planner

July 5, 2002

Dear Client,

This is the MAM report for the quarter ending June 30, 2002. It has been more than 60 years since the U.S. stock market experienced three consecutive negative calendar years. With the S & P 500 down 13.1% on the year through June, it will take a 15.1% increase over the next six months to avoid that fate (remember that it takes a 100% gain to offset a 50% loss—which makes outperforming in a down market so important in order to generate good long-term returns). Below, I discuss my outlook for the stock market with an explanation of the strategies currently employed in MAM portfolios.

Enclosed are four investment reports for the quarter ending June 30, 2002. The first is titled "Portfolio Position Analysis". It lists your investments that I manage and shows how each has performed. The second, "Portfolio Performance Summary", shows the rate of return on your investments for the first six months of 2002. The third, the "Portfolio Performance History", shows the monthly and cumulative rate of return on your portfolio since inception. The fourth report, "Realized Gains and Losses", is included solely for taxable accounts. It lists investment gains and losses realized during the first six months of 2002.

Stock Market Performance

The second quarter of 2002 was a difficult quarter for the stock market. The S & P 500 slipped 13.4% to 990, while the Nasdaq Composite dropped 20.7% to 1463, and the Russell 2000 fell 8.5% to 463.

Following the strong performance for the fourth quarter of 2001 and the mixed performance for the first quarter of 2002, the very poor performance of the market this past quarter was disappointing. The decline occurred despite evidence that the U.S. economy is slowly recovering as a result of the eleven interest rate cuts. In addition, corporate earnings have probably bottomed-out and should show gradual improvement. What then is ailing the stock market?

Outlook for the Stock Market

The bad news: Some of the following comments were taken from a recent investment commentary that I received from the Litman/Gregory Research Team which provides some of the research that I utilize in my investment management activities.

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There are several culprits for the market malaise:

1. Lack of Corporate Ethics: In 2001, the stunning collapse of Enron occurred. This year, Worldcom is following in its tracks. In both cases management mislead the public and overstated earnings. Independent auditors and investment analysts failed to protect investors from these corporate management misdeeds. As a result investors are losing confidence. The solution will be stricter regulation, corporate prosecutions, CEO embarrassments and pained investors paying attention (they weren't during the bubble of the 1990's). These efforts will drive change in corporate behavior and make the ethics issue temporary. While there are undoubtedly more shoes yet to drop, I believe that management at the vast majority of public companies is honest. Still, there is no question that we were in a greedy environment where far too many management teams were "ethically challenged". Regardless of my expectation for improvement in corporate ethics, the attention of the media will be another factor contributing to a general lack of confidence, thus leading to lower stock prices in the short term.

2. A related issue is the level of earnings. How many shenanigans have been going on? When I assess valuations, I must use an earnings number. Is the number valid or is it in the process of being restated downward? I believe that there will be more surprises, however, at this point, it is unlikely that earnings for the overall market are materially overstated given the huge earnings decline that has already occurred.

3. Foreigners invested $386 billion into U.S. stocks in the three years ended 2001. This year, the pace of flows has dropped by about 50%. With the U.S. image somewhat tarnished relative to other markets and foreign investors already heavily invested in the U.S., there is the risk that foreign flows will continue to be scaled back. To put the importance of foreign flows into perspective, note that foreign investment in U.S. equities wasn't far off the $490 billion net investment into U.S. equity funds over the same three-year period.

4. Terrorism is the wildcard. Many potential terrorist acts would probably not have a far-reaching economic impact. However, if the worst-case scenario involving weapons of mass destruction come to pass, a severe economic impact would be felt. This is not priced into the market (nor should it be—it is far too uncertain). Worst-case scenarios rarely happen and I have always tended to discount them (if not, how could someone have been invested in the stock market during the 1950's and 1960's when there was the potential of nuclear war with the Soviet Union?). But at the very least, the risk will lead to more defense and homeland security spending. These are not productivity-enhancing activities.

<u>The good news:</u>

1. <u>There are important positive factors that must not be forgotten.</u> Stocks are generally much cheaper than they were over two years ago and we are very likely to see a decent cyclical earnings rebound over the next year. The statistics show that the economy is clearly recovering and that alone could forge a cyclical rebound in the stock market. I don't make short-term bets and anything is possible. But there is a huge amount of cash on the sidelines earning very low returns.

2. <u>The fact that long-term potential stock returns from current levels could be decent, but not great, suggests the possibility of a more active approach to management of portfolios.</u> It is possible that I may become more active in managing the U.S. equity allocations in MAM

portfolios. Since the Fall of 1999, I have made two broad asset allocation changes. The first was in the Summer of 2000 when I reduced technology exposure and increased small cap value exposure. The second was this past quarter when I reduced U.S. equity weightings (by reducing both technology and value) and increased high-yield bonds and international exposure. Favorable asset allocation adjustments is one way that MAM has been able to enhance portfolio returns.

3. <u>I believe MAM portfolios are invested with superior managers who will continue, on average, to provide higher returns than their benchmarks.</u> It's worth mentioning that the brief love affair with individual stocks at the expense of mutual funds toward the latter end of the bull market seems to be reversing. The diversification offered by funds and the realization that good professional management can make a difference has again underscored the common-sense appeal of funds. And while there are plenty of mediocre funds out there, I believe discovering and utilizing good funds is one of my strengths.

4. <u>While I am not particularly excited about the long-term potential for stocks, I continue to view several other asset classes as quite attractive.</u> Most MAM portfolios currently have a 60 to 65% U.S. stock weighting. The balance is made up of high-yield bonds, REITs and foreign stocks. I believe that these three asset classes have a superior risk/reward relationship over U.S. stocks. Given my expectations for returns from these asset classes, my expectation for MAM portfolios falls into the decent-to-good range over the next several years (though I am not expecting the 1990s' double-digit returns).

<u>MAM Performance for the Quarter</u>

<u>In General:</u> Although MAM portfolios declined during the second quarter, they continued to perform well relative to the S & P 500. Of the fully invested MAM portfolios, 92% outperformed the S & P 500 loss of 13.4%. The composite return of MAM portfolios was a loss of 8.4% (after MAM fees). Once again, generally speaking, the only portfolios that under performed the S & P 500 were those that contained individual stocks.

<u>Best Performers:</u> The eight best performing MAM mutual funds for the quarter were Cohen & Steers Realty (up 4.6%), Loomis Sayles Bond (up 3.3%), Acorn International (down 1.2%), Artisan International (-2.0%), Artisan Small Cap (-2.8%), Bjurman Micro Cap (-2.9%), Pioneer High Yield (-3.8%), and Bogle Small Cap Growth (-5.2%).

<u>Worst Performers:</u> The MAM mutual funds that under performed the S & P 500 for the quarter had significant technology exposure. The worst performing funds were Red Oak Technology (-38.7%), Firsthand Technology Value (-35.6%), White Oak Growth (-25.8%), TCW Galileo Select Equities (-21.9%), Firstar Micro Cap (-16.7%) and Weitz Partners Value (-13.3%).

<u>Oldest Portfolio:</u> The MAM portfolio with the longest track record is a fairly aggressive $50,000 portfolio that was fully invested on September 13, 1999. As of June 30, 2002, the original $50,000 had grown to $55,022 for a cumulative return of 10.0%. During that time, the S & P 500 lost 23.9%. For the quarter ended June 30, 2002, the portfolio lost 9.2%. All returns quoted for this portfolio (and for all MAM portfolios) are net of MAM fees (0.25% per quarter). Also past performance is not necessarily indicative of future performance.

MAM Performance for the Year-To-Date

For the first six months of 2002, MAM portfolios performed well relative to the S & P 500. The composite return of MAM portfolios was a loss of 7.2% (net of MAM fees), versus a loss of 13.1% in the S & P 500. I attribute the 5.9% positive performance of MAM portfolios relative to the S & P 500 due to two factors. The first is favorable asset allocation. Most MAM portfolios are under weighting in large-cap stocks, over weighted in small and mid-cap stocks and have a significant weighting in REITs, high-yield bonds, and international stocks. The second favorable factor is good fund selection. Most mutual funds used by MAM have outperformed their peer group.

Fund Spotlight

With last quarter's report, I enclosed an article by Bill Nygren of Oakmark Select and Oakmark Fund. I asked you to provide feedback as to whether the article was of interest. All of the feedback that I received was positive. If I have similar articles in the future, I may include them.

With this report I am providing information regarding a fund that I recently started using: Oakmark International Small Cap. The fund has been managed since inception (1995) by David Herro and since 1997 by Michael Welsh. I was attracted to this fund for four reasons. First, I wanted to add an international fund as I increased foreign exposure in MAM portfolios (see discussion below regarding "Recent MAM Portfolio Activity"). Since the two international funds that I use invest in large (Artisan International) and mid-cap (Acorn International) international stocks, I wanted an international fund that invested in small cap stocks. Secondly, this fund has had very good performance since inception. For the three years ending May 31, 2002, it returned 10.18% (14.48% above the MSCI international index) and for the five years ending May 31, 2002, it returned 9.05% (8.72% above the MSCI international index). Thirdly, I am familiar with and confident in Herro and Welsh as I have personally owned for a number of years the Oakmark International fund that they also manage. And finally, the fund closed to new investors on May 10, 2002 (at an asset level of $529 million). Closing the fund to new investors was very important since it invests primarily in small cap stocks. For now this is a "soft close", meaning that as an investment advisor with an existing position in the fund, I can still establish new positions.

See the enclosed for the most recent Morningstar report on the fund.

Recent MAM Portfolio Activity

Portfolio Adjustments: During the second quarter of 2002 I made adjustments in portfolios representing about 93% of MAM assets. Due to time constraints, I did not adjust portfolios with less than $60,000 invested. I plan to adjust these remaining portfolios during this next quarter.

I sent a letter of explanation to clients as I did the portfolio repositioning. Generally, I reduced U.S. equity positions and increased the exposure to high-yield bonds and international stocks. In some cases, I also increased the amount invested in REITs. In reducing the U.S. stock exposure, I sold off most or all of the technology-only funds (Firsthand Technology Value and Red Oak Technology) and took some profits from the U.S. value funds (Artisan Small Cap Value, Oakmark Select, PBHG Clipper Focus and Weitz Partners Value).

One significant impact of these adjustments was to further reduce technology exposure to between 10 and 14% of the portfolios (the S & P 500 is approximately 19% in technology stocks). Although I took this action to lessen the volatility of the portfolios, I realize I am taking a risk. By being under invested in technology stocks, I run the risk of under performing the S & P 500 if the stock market turns sharply up. I am willing to take this risk as I feel MAM clients are currently most interested in downside protection. At some point, I will increase technology exposure, based on my belief that technology companies will prosper in the long run because technology spending increases the productivity of the economy.

The other significant impact of this quarter's adjustments was to increase international exposure from the current 10 to 12% of each portfolio to between 15 to 17%. I did this because I believe that foreign markets will outperform the U.S. market in the foreseeable future (the next two to three years). I believe this for the following two reasons:

1. Foreign stocks (especially Europe) are reasonably priced relative to U.S. stocks. Paraphrasing an article that appeared in the July 8, 2002 Wall Street Journal; "in the U.S. the average price-earnings ratio is 24.7 (i.e. companies are valued on average at 24.7 times annual earnings per share). In the United Kingdom the average P/E is 18.4 times, in Germany it is 13.4 times and in France it is 12.8 times". Valuations are still much higher in the U.S. because of the dramatic increase in stock prices during the 1990s.

2. The U.S. dollar may continue to fall. A falling U.S. dollar increases the U.S. dollar value of foreign stocks. During the last 9 months, the U.S. dollar has fallen relative to the Euro and other foreign currencies. This drop pales in comparison, however, to the dramatic rise in the dollar during the last ten years. This is one reason why foreign stocks under performed U.S. stocks during the 1990s. Based on my research, the U.S. dollar may still be 20 to 25% overvalued. Although it could take a number of years for this overvaluation to correct, a further drop in the U.S. dollar will provide an added boost to international funds that do not hedge their foreign currency positions.

Current Portfolio Asset Allocation:

The typical MAM portfolio now has a 19 to 21% weighting in large-cap U.S. stocks, a 39 to 42% weighting in small-cap and mid-cap U.S. stocks, a 10 to 14% weighting in bonds (primarily high-yield), an 8 to 9% weighting in REITs, and a 15 to 17% weighting in international. As I said last quarter, my expectations for the next year or two are:

- small companies will continue to outperform large companies
- REITs and high yield bonds will do well
- many international markets will outperform the U.S. market

Increase in Minimum Investment Amount

As of June 30, 2002, MAM assets under management were in excess of $33 million, up from $29 million at the start of the year. I have been able to continue to attract client assets during a declining market (assets were under $10 million back when the market peaked in March of 2000) due to good relative performance, added investments from existing MAM clients (e.g. 401(k) rollovers from former employers) and new clients from referrals. I very much appreciate your confidence in my efforts and promise to continue to work hard for you. As a reminder, effective August 1, 2002, I will be raising the minimum amount to become a MAM client to $250,000 (from $200,000).

Your Performance

Also enclosed is the invoice that shows my asset management fees for the quarter. Charles Schwab will automatically deduct these fees from your account.

Please call me if you have any questions or if you want to discuss your portfolio.

Very truly yours,

Stephen P. McCarthy, CPA

encl: Investment Reports
Morningstar Report on Oakmark International Small Cap