McCarthy Asset Management

Registered Investment Advisor
Certified Public Accountant
Certified Financial Planner

Monday, July 7, 2003

Dear Client,

What a difference one quarter can make. After three years of what seemed like a relentless drop, the stock market turned around sharply this quarter. In fact, the quarter ending June 30, 2003 was the biggest gain for the S & P 500 since 1998 and for the Nasdaq since late 2001.

With this MAM report for the quarter ending June 30, 2003, I will discuss the performance of the market and MAM portfolios for the quarter and the first six months of 2003. In addition, I will discuss the performance and my outlook for the various asset classes used by MAM. Finally, I have a brief discussion of three upcoming projects: paper reduction actions, proxy voting procedures, and the MAM website.

Enclosed are four investment reports for the quarter ending June 30, 2003. 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 2003. The third, "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 2003.

Stock Market Performance

The stock market exhibited strong performance for the second quarter of 2003. The S & P 500 rose 14.9% to 974, the Nasdaq Composite climbed 21.0% to 1623, and the Russell 2000 soared 22.7% to 448. For the first six months of 2003, unadjusted for dividends, the S & P 500 rose 10.7%, the Nasdaq Composite climbed 21.5%, and the Russell 2000 rose 17.0%.

Outlook for the Stock Market

Will the stock market continue to rise? The market has risen quite a bit in a short period of time. I wouldn't be surprised to see some consolidation before the market rises further. Furthermore, unless there are concrete signs during the next few months that the economy is recovering, I am concerned that the stock market could become overvalued.

The following are four factors that may continue to help the stock market:

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1. **Low Interest Rates-** The actions of the Federal Reserve continue to be very stimulative. On June 25, 2003, the Federal Reserve cut its key interest-rate target by 0.25% to 1.0%, its lowest since 1958. The central bank indicated that the federal funds rate would remain there "until the risk of deflation is extinguished". This means that interest rates should remain very low until after the economy is growing briskly. By contrast, in previous business cycles, the Fed would usually increase interest rates pre-emptively, long before inflation started rising again.

2. **Tax Cuts-** President Bush's $350 billion tax-cut package signed in May will help stimulate the economy by reducing the burden on taxpayers. In addition, the reduced Federal bracket of 15% until 2009 on dividend income and long-term capital gains specifically benefits stock investments relative to other alternative investments.

3. **Increased Corporate Profits-** Corporate profits were better than expected for the first quarter of 2003. Analysts expect profits to rise further this quarter, followed by 13% in the third quarter and 21% in the fourth. While it remains to be seen if these profit forecasts are realistic, it is clear that profit margins have been widening steadily at most corporations. That's because the restructuring initiatives of the past couple of years (shrinking head counts, closing unprofitable operations, and reducing debt) are finally paying off. The last time there was a turnaround in profit margins was in 1992, and it helped to set the foundation for the late-1990's bull market. Cost cutting, though, can help only so much. At some point, corporate sales will need to rise in order for profits to continue to climb.

4. **Decreased Global Tensions-** While the reconstruction of Iraq remains a major question mark, there are glimmers of hope from the Middle East in the Arab-Israeli conflict. Also tensions with North Korea seemed to have lessened and authorities in Asia appear to be getting a handle on the SARS epidemic. Of course, any significant terrorist attack in America could have a dramatic negative impact on stock prices.

MAM Performance for the Quarter

In General: For the quarter, 83% of the MAM portfolios out performed the S & P 500. The composite return of MAM portfolios that were existence for the whole quarter was a gain of 16.4% (after MAM fees) versus a rise of 15.3% in the S & P 500 (adjusted for an assumed annual dividend yield of 1.6%).

Best Performers: The eight best performing MAM mutual funds for the quarter were Firstar Micro Cap (rise of 34.1%), Oakmark International Small Cap (29.2%), Bjurman Micro Cap (28.3%), Bogle Small Cap Growth (24.4%), Artisan International (23.1%), Acorn International (21.5%), PBHG Clipper Focus (20.2%), and TCW Galileo Select Equities (19.9%).

Worst Performers: The eight worst performing MAM mutual funds for the quarter were PIMCO Total Return (up 2.7%), Pioneer High Yield (9.8%), Loomis Sayles Bond (11.1%), Cohen & Steers REIT (13.6%), Marsico Focus (14.2%), Artisan Midcap (15.2%), Oakmark Select (16.2%), and Oakmark Fund (16.9%).

Oldest Portfolio: The MAM portfolio with the longest track record is a $50,000 portfolio that was fully invested on September 13, 1999. As of June 30, 2003, the original $50,000 had risen to $55,700 for a cumulative rise of 11.4%. During that time the S & P 500 lost 23.7%. For the quarter ended June 30, 2003, the portfolio rose 18.7% while for the first six months of 2003 it rose 14.6%. 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 First Six Months of 2003

For the first six months of 2003, MAM portfolios performed very well relative to the S & P 500. 90% of the MAM portfolios (that were in existence for the whole period) outperformed the 11.5% rise in the S & P 500 (adjusted for an assumed annual dividend yield of 1.6%). The composite return of MAM portfolios was a gain of 13.2%.

I have been pleasantly surprised by the relative performance of the portfolios this year. While most MAM portfolios significantly outperformed during the 2000 through 2002 bear market, for the last year I have been suggesting that they may under perform if the market were to rise quickly. This is because of the defensive repositioning I did as the bear market ensued. The typical portfolio now has a 10% to 15% bond and 7% to 9% REIT exposure. As expected, these areas have lagged so far this year. In addition, most portfolios are under weighted in this year's hottest sector--technology stocks. Fortunately, the mutual fund selection and small cap and international positions, more than offset bond and REIT exposure and the under investment in technology stocks.

Current Portfolio Asset Allocation:

Below is a discussion of the five asset classes I use to diversify portfolios. Included are the current weighting in a typical MAM portfolio, comments regarding upcoming portfolio changes, and my thoughts regarding the outlook for the asset classes.

1. U.S. Equities- Large Cap (20% to 30% portfolio weighting): Since mid-2000 MAM portfolios have been significantly under weighted in large-cap U.S. stocks. This has been very beneficial because large-cap U.S. stocks (particularly technology stocks) was the worst performing asset class during 2000 through 2002. During the last year I have been increasing large-cap exposure by purchasing Marsico Focus, Selected American and American Mutual. At some point, large companies will once again outperform smaller ones, although my feeling is that the time is not yet here.

2. U.S. Equities- Small and Mid Cap (32% to 40% portfolio weighting): This asset class has been a source of significant MAM out performance during the last three years. Back in 2000 I felt that smaller companies were undervalued relative to larger companies. I sought and found a number of small cap mutual funds with superior management that were willing to close their funds with a low asset base (Artisan Small Cap Value, Bjurman Micro Cap Growth and Bogle Small Cap). Recently I have taken some profits.

   I am particularly pleased with Bjurman Micro Cap Growth. The fund recently closed again at an asset level of about $400 million. As of June 30, 2003, $2.6 million in MAM assets were invested in the fund, making it MAM's second largest fund (after Cohen & Steers

Realty). For the five-years ended April 30, 2003, the fund returned 17.2% annually, versus a loss of 2.4% in the S & P 500 and a loss of 7.9% in the Russell 2000 Growth index.

The most recent Morningstar report on the fund states "Stemming asset flows is good news for any micro-cap fund, and we think this offering, with about $400 million in assets, can easily maintain its 150-stock portfolio's focus on tiny names. The fund's $250-million average market cap is much smaller than that of the typical small-cap growth fund. The fund's assured ability to maintain its style, while important, isn't its main attraction. Rather, we think manager Tom Barry's growth approach…works well in the micro-cap territory. That's because the stocks are largely ignored by Wall Street analysts and by large institutional investors and fund shops whose big asset bases prohibit their participation here. That trait increases inefficiencies, making common investment criteria more powerful."

3. <u>Bonds (10 to 20% portfolio weighting):</u> To reduce the volatility of MAM portfolios, I have steadily increased the bond weightings during the last two years. Newer MAM portfolios have a higher bond weighting because I have been hesitant to sell depressed equities to purchase bonds in existing portfolios. With interest rates currently at a 45-year low, does it make sense to invest in bonds? Bond prices move inversely to interest rates. Once rates start to rise again, bond prices will fall. I have read that for every 1% increase in interest rates, a 30-year bond drops 7 to 8% in value. The bonds most vulnerable to a rise in interest rates are long-term, high quality bonds (particularly government).

   With the exception of PIMCO Total Return, the bond funds used by MAM (Loomis Sayles Bond, Pioneer High Yield, Calamos Growth and Income) invest primarily in high-yield, convertible and foreign bonds. High-yield and convertible bonds should benefit from an improving economy, so they will be hurt less by rising interest rates. Foreign bonds should be a good investment if the U.S. dollar continues to fall.

4. <u>REITS (7% to 8% weighting):</u> Real Estate Investment Trusts (REITs) performed terribly back in 1998 and 1999, as investors sold them to invest in surging technology stocks. As a value investor, this led me to purchase Cohen & Steers REIT starting in the Summer of 2000. Since then REITs have performed very well, so recently I have been taking some profits. I still like the asset class, though, for several reasons. One is for diversification, as REITs share prices have a low correlation to the stock market. A second reason is the current dividend yield of about 6%. Given this 6% dividend yield and 2% to 3% assumed growth of the underlying real estate, an 8% to 9% annual return for this asset class seems reasonable for the next few years. A third reason is the inflation protection provided by real estate. For twenty-two years inflation has fallen (from double digits back in 1981 to about 2% now). At some point I would expect inflation to start increasing, which will benefit real estate prices.

5. <u>International Equities (13% to 15% weighting):</u> Like all asset classes, international stocks go in and out of favor. During much of the 1970s and 1980s, international investments outperformed U.S. stocks. This reversed dramatically in the 1990s. For the foreseeable future, I believe international stocks will perform relatively well. One reason for my optimism is that foreign companies have attractive valuations. Recently the price-earnings ratio of European stocks was about 30 percent lower than that of U.S. stocks. A second reason is the possibility of further declines in the value of the U.S. dollar which will

boost the value of foreign investments. An added benefit of investing in foreign stocks is diversification. This is particularly true for smaller foreign companies, which have a low correlation with the U.S. stock market.

Paper Reduction Actions

How would you like to dramatically reduce the quantity of mailings that you receive from Charles Schwab? During the next two months I plan to offer four steps that can be taken to reduce unwanted mail. If you elect to take all of the actions, all you will receive will be one mailing with your monthly statement(s), one copy of an occasional Schwab Agreement or Disclosure document, certain prospectuses, and an email for prospectuses and trade confirmations. The four actions are as follows:

1. Bundling- Applicable if you have more than one account. By electing to bundle, you will receive one envelope each month for your statements.

2. Schwab eConfirms- Every time I conduct a trade for you, a trade confirmation is mailed to you. By electing to eConfirm, the confirms will be sent via email.

3. Interim Mailings- Interim mailings include annual, semiannual and quarterly reports. It is at your option to receive these. If you are receiving these reports and not reading them, I will give you the opportunity to stop receiving these. Also, with Electronic Delivery, there is the option to receive these electronically.

4. Electronic Delivery- Electronic Delivery is a free email service that provides regulatory materials (prospectuses and supplements) and interim mailings via email instead of regular mail. For those corporations and fund companies that are not participating in Electronic Delivery, documents will still be sent via mail.

During the next two months I plan to send clients a letter describing these steps and offering the opportunity to elect them.

Proxy Voting Procedures

The SEC has adopted new rules that address an investment adviser's fiduciary obligation to clients when the adviser votes their proxies. Many investment advisers have chosen to not accept the responsibility, causing clients mandatory receipt of proxy voting material. As long as the new rules are not too onerous, I plan to continue to have MAM vote proxies. We have adopted Proxy Voting Policies and Procedures. Please let us know if you would like a copy of them. In addition and in accordance with the new rules, we are maintaining a log of how we vote proxies. Please let us know if you want a copy of the log.

Web Site in the Planning

Recently we have taken initial steps to set up our Web site, "MAMportfolios.com". To assist in creating and maintaining the Web site, we have selected Schwab Performance Technologies. As envisioned, the Web site will provide information on McCarthy Asset Management, including a library of past quarterly reports and newsletters. In addition, MAM clients who have invested over a certain level (possibly $100,000) will have the ability to securely access account information, such as current values, cost basis, and performance. In addition, as a possible phase II implementation, you will have the ability to link your non-Schwab accounts so that you can review the current balance of most of your assets and liabilities through this one website.

Assets Under Management

As of June 30, 2003 MAM assets under management were in excess of $37 million, up from $32 million at the start of 2003. Part of this growth is from client referrals. I continue to welcome your referrals of new investment clients.

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 wish to discuss the stock market or possible changes to your portfolio.

Very truly yours,

Stephen P. McCarthy, CPA

encl: Investment Reports