McCarthy Asset Management

Registered Investment Advisor
Certified Public Accountant
Certified Financial Planner

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Dear Client,

The stock market was moderately positive for the quarter and for the first six months of 2004. Bonds and REITs, however, performed poorly as strong job reports spooked bond investors and triggered a shift in the Federal Reserve to start raising interest rates.

With this MAM report for the quarter ending June 30, 2004, I discuss the performance of the market and MAM portfolios for the quarter and first six months of 2004. In addition, I provide an update on the economy, interest rates and corporate earnings, and provide my outlook for the stock market for the remainder of the year. Furthermore, I profile Hussman Strategic Growth Fund, which was recently added to most portfolios.

Enclosed are four June 30, 2004 investment reports:

- *Portfolio Position Analysis*: lists your investments and how each have performed
- *Portfolio Performance Summary*: Year-to-date 2004 portfolio rate of return
- *Portfolio Performance History*: portfolio rate of return since inception
- *Realized Gains and Losses*: Year-to-date 2004 investment gains and losses realized (included only for taxable accounts).

Stock Market Performance

For the second quarter of 2004 the S & P 500 climbed 1.3% to 1141, the Nasdaq Composite rose 2.7% to 2048, and the Russell 2000 climbed 0.3% to 592. For the first six months of 2004, unadjusted for dividends, the S & P 500 rose 2.6%, the Nasdaq Composite climbed 2.2%, and the Russell 2000 jumped 6.3%.

U.S. Economy and Interest Rates

The U.S. economy will face a tough test in the coming year. Now that the recovery includes job creation and the ability of companies to raise prices, interest rates are on the rise. As expected, on June 30, the Federal Reserve announced a one-quarter percentage point boost in the federal funds rate to 1.25%. The increase, the first in four years, is expected to be the first in a series of gradual rate hikes in an attempt to keep the economy and inflation on an even keel. How will the economy perform in a rising rate environment?

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The thirty-four economists surveyed by BusinessWeek in its midyear Economic Outlook survey are optimistic that policymakers will be able to bring the economy down for a soft landing without higher rates killing off the recovery. Despite recent increases in some of the price indexes, inflation is expected to remain under control, allowing the Fed to lift rates gradually. In addition, the economy has plenty of momentum. Jobs are coming back strong, bolstering the outlook for consumer spending. Businesses, buoyed by new optimism and strong profits, are set to increase their outlays for inventories and equipment. And, global growth is picking up, lifting prospects for U.S. exports.

The economists surveyed by BusinessWeek believe the Fed will continue to slowly raise the federal funds rate to about 2.5% by this time next year. Many forecasters expect the funds to hit the 3% to 4% range by the end of 2005. The yield on 10-year Treasury bonds is projected to rise from the present 4.7% to 5.3% by mid-2005.

The panel expects solid, if slightly slower growth, with no spike in inflation. Growth in real gross domestic product is expected to average 3.8% for the year ending June, 2005. That's down from 5.2% expected for the year ending mid-2004. With productivity moderating amid rising labor costs, profit gains will slip from spectacular to merely good.

Corporate Profits

Corporate earnings have been very strong. After rising 28.3% in the fourth quarter of 2003 (over the same period the previous year), earnings researcher Thomson First Call estimates that earnings for companies in the Standard & Poor's 500-stock index increased 27.5% in the first quarter of 2004. The second quarter of 2004 could be the fourth consecutive one with higher than 20% year-over-year earnings growth—for only the fifth time in 40 years. For the last three quarters of 2004, analysts expect profits to grow 20%, 14%, and 15%, respectively.

Until now, earnings growth has been driven by rising productivity, easy monetary policy, and falling labor costs. The sizzling job growth that has been reported for the last four months, however, indicates that wages costs are accelerating at a time when productivity is slowing down. In addition, as discussed above, the Fed has started to tighten monetary policy.

In the past, the combination of rising wages, slower productivity and rising interest rates had been a surefire recipe for a squeeze on profit margins and slower earnings growth. Fortunately, Corporate America is in a solid position to generate profits in the coming year, although not at the same spectacular pace of recent quarters.

The fact that positive trends for profits are coming at the same time as the renewed vigor in the job markets, means faster income growth for consumers. That's because economic growth is now better balanced between productivity and labor. And, for at least the next few quarters, investors, businesses, and consumers will all be reaping the financial benefits of a strong recovery.

Outlook for the Stock Market

After a three-year bear market, the stock market recovered sharply last year. For the first six months of 2004, equities have risen modestly. Unlike four years ago, equities aren't ridiculously overvalued. In March of 2000, the S & P 500 traded at a price-earnings ratio of 29. Currently, the S & P is trading at around 17 times the expected earnings of its components over the next 12

months, compared to the average price-earnings ratio of about 15 over the last fifty years. With interest rates still low, and bonds an unattractive alternative, a price-earnings ratio of 17 is not unreasonable. In addition, if corporate profits continue their rapid rise, the price-earnings ratio could fall while stock prices continue to rise moderately. I believe this is the most likely scenario for the next twelve months.

My expectations are that bonds will under perform stocks for at least the next twelve months. Bonds fall in value as interest rates rise. Although the Fed controls only short-term rates, long-term rates should also rise as the Fed raises the discount rate.

Given my expectation for bonds to under perform, why do most MAM portfolios have a 15% to 25% bond position? The answer is for downside protection. Nothing is certain with the stock market. A significant terrorist attack in America or on oil production facilities in Saudi Arabia would probably produce a sharp drop in stock prices. Bonds prices could help lessen damage to a portfolio from such an event. In addition, the MAM bond positions are primarily made up of short-term, convertible, high-yield, and foreign bonds. I expect these bonds to perform relatively well. There is very little exposure to high quality bonds, which are most vulnerable to rising interest rates.

MAM Performance for the Quarter

In General: For the quarter, 99% of the MAM portfolios underperformed the S & P 500. The composite return of MAM portfolios that were in existence for the whole quarter was a loss of 0.9% (after MAM fees) versus a rise of 1.7% 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 TCW Galileo Select Equities (rise of 7.1%), PBHG Clipper Focus (4.0%), Artisan Small Cap Value (3.9%), Oakmark International Small Cap (2.9%), William Blair Small Cap (2.6%), Oakmark Fund (2.2%), American Mutual (1.8%), and Oakmark Global (1.4%).

Worst Performers: The eight worst performing MAM mutual funds for the quarter were Cohen & Steers REIT (down 4.1%), Bjurman Micro Cap (-3.8%), Loomis Sayles Bond (-3.5%), Pioneer High Yield (-2.5%), Marsico Focus (-1.9%), Calamos Growth & Income (-1.7%), Thornberg International Value (-1.6%), and Artisan International Small Cap (-1.5%).

After four years of very strong relative performance, MAM portfolios under performed the S & P 500 during the second quarter. The primary reason was the negative impact resulting from the decline in bond and REIT funds. As discussed above, bond mutual funds are included in the portfolio to provide protection against a fall in the stock market. I believe that it continues to make sense. Too, I feel it is advisable to hold a REIT position, although in May I reduced the REIT exposure in most portfolios from about 7.0% to about 4.3%.

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, 2004, the original $50,000 had risen to $68,477 for a cumulative rise of 37.0%. During that time the S & P 500 lost 10.2%. For the quarter ended June 30, 2004, the portfolio lost 0.7% while for the first six months of 2004 it rose 2.7%. 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 2004

For the first six months of 2004, 96% of MAM portfolios underperformed the S & P 500. The composite return of MAM portfolios that were in existence for the six months was a rise of 2.5% (after MAM fees) versus a rise of 3.4% in the S & P 500 (adjusted for an assumed annual dividend yield of 1.6%).

For the last two years I have been saying that due to the defensive repositioning, MAM portfolios could under perform if the market were to rise. This defensive positioning helped portfolios suffer a loss of *only* 17% in 2002, when the S & P 500 lost 22%. Despite the defensive positioning, MAM portfolios had very good performance in 2003, rising 35% versus a rise of 29% in the S & P 500. I am pleased with the current positioning of the portfolios, and do not plan to make any asset allocation changes at this time.

Fund Spotlight

In 2003, when the S & P 500 rose 28.9%, the $1.1 billion Hussman Strategic Growth Fund (symbol HSGFX) rose 21.1%. Given its approach, the fund performed very well for its third consecutive year. During the bear market when most funds were awash in red ink, this fund was one of the few diversified equity funds to rack up double-digit returns. Since the fund's July, 2000 launch, it has returned, on average, 19.5% annually. What's more, the 41-year-old manager, John P. Hussman, PhD., produced these gains without making big bets in hot sectors, such as real estate and gold.

Hussman's edge is that he hedges his portfolio, which most funds as a matter of policy, do not. When he thinks market conditions are unfavorable, he purchases put options, which increase in value when stock indexes such as the S & P 500 and Russell 2000 fall. If conditions improve, as they did in 2003, Hussman removes all or part of the hedge. He's not a hyperactive hedger, making changes just once or twice a year. Nor does the hedging service add much to overhead. The expense ratio for this no-load fund was recently reduced to 1.29% annually, slightly below average.

Such flexibility sets Hussman Strategic Growth apart from bearish or short-selling funds, which go up when the market goes down, or from market-neutral funds, which seek to neutralize the market's impact. Most of those funds lost money in 2003.

Hussman developed his strategy as a PhD candidate in economics at Stanford University. In his thesis on "market efficiency and information economics", he concluded that by analyzing both stock valuations and price movements, one could identify favorable and unfavorable market climates. Hedging during unfavorable ones would produce higher returns with less risk.

Enclosed is the fund's most recent Morningstar report. Unlike most MAM funds, Hussman Strategic Growth is not part of Charles Schwab's one-source program. Schwab charges a minimum fee of $30 to purchase the fund. Since I have established a 3 to 4.5% position of the fund in portfolios, I have generally purchased it in portfolios worth more than $100,000.

Assets Under Management

I appreciate the confidence that existing and new clients have shown in adding to the assets that MAM manages. Existing and new clients added over $6 million in net assets during the first six months of 2004, bringing the MAM assets under management up to over $56 million as of June 30, 2004, versus $49 million at the start of the year.

As mentioned in last quarter's report, effective June 1, 2004, I have raised the minimum to become a new client to $300,000. This increase does not impact existing clients who have less than $300,000.

Miscellaneous

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: Morningstar report: Hussman Strategic Growth
Investment Reports