McCarthy Asset Management

Registered Investment Advisor
Certified Public Accountant
Certified Financial Planner

Friday, October 11, 2002

Dear Client,

This is the MAM report for the quarter ending September 30, 2002. To put it mildly, the performance of the stock market during the third quarter was dismal. The loss of 17.7% in the S & P 500 represents the worst quarterly performance since the market crash in the fourth quarter of 1987 (i.e. Black Friday). The damage was widespread, with growth, value, large-cap, small-cap and foreign stocks all experiencing double-digit declines. REITs and high-yield bonds were also hammered, though they declined much less than stocks. The only winner on the quarter was investment-grade bonds, as interest rates plunged in the face of a stalling economy and war fears. The ten-year Treasury returned over 11% for the quarter.

When will the stock market stop falling? How much lower can it go? Although I cannot answer these questions with any assurance, with this report I will give an historical perspective on the market and state my case as to why I expect that for the long-term, equities will be a favorable place to invest.

Enclosed are four investment reports for the quarter ending September 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 nine 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 nine months of 2002.

Stock Market Performance

The third quarter of 2002 was a very difficult quarter for the stock market. The S & P 500 slipped 17.7% to 815, while the Nasdaq Composite dropped 19.9% to 1172, and the Russell 2000 fell 21.8% to 362. The last time the stock market dropped three years in a row was 1939 to 1941. With a year-to-date decline of 29.0% in the S & P 500, it would take a very dramatic recovery for the fourth quarter to avoid 2002 becoming the third consecutive year of declines.

What caused the most recent drop in the market? Disappointing economic numbers was the main cause. During the first quarter of 2002 the U.S. economy staged a strong turnaround with annualized growth of about 5%. The recovery slowed during the second quarter and slowed further in the third quarter. The weakness is most apparent in the manufacturing sector. Consumer spending has held up reasonably well but some analysts are concerned that if the trend

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of increasing layoffs continues, consumer spending will ultimately slow. That would be trouble because consumer spending has been the primary positive in the economy. The weak economy is a problem because businesses are not as profitable when the economy is weak. Corporate earnings hit bottom in the first quarter and were expected to start recovering briskly by the third quarter. As poor economic numbers were released and companies pre-announced disappointing third quarter results, the expected recovery in corporate earnings for the third and fourth quarters of 2002 has been drastically scaled back.

There are certainly other factors hampering the market, including the fear of impending war with Iraq, continued terrorist threats, and additional accounting scandals. While these are having a negative impact in the short run, the most important determinate of stock prices is the state of the U.S. economy and the resulting impact on corporate earnings.

Outlook for the Stock Market

When will the stock market hit bottom? I believe it is impossible to know this with any certainty. Is there further downside? There could be. The economy could continue to weaken. Once the economy does start to improve, investors could continue to sell equities. In the short run the stock market is driven by investors' emotions. Faced with the third consecutive annual decline and the negative issues listed above, I think that investors panicked in the third quarter. The market will continue to fall until the selling pressure subsides. By the time the bottom is reached, equity prices will probably be very undervalued.

Why not sell your equities and wait for the next bull market? Studies have consistently shown that investors cannot successfully time the market. For most people, the best strategy is to buy and hold. With MAM, I modify the approach by making portfolio adjustments based on my market outlook. I call this "modified market timing". For instance, in the Summer of 2000, I reduced the weighting of technology stocks in almost all MAM portfolios. Since then I have added a meaningful weighting in bonds and REITs (real estate investment trusts).

Probably the biggest folly of investors is to allow their emotions (i.e. fear and greed) to influence their investments decisions. This is what caused some investors to buy high (late 1990's) and sell low (now?). To minimize the influence of emotions, I think it is insightful to view the stock market from an historical perspective. I have enclosed an article from Jeremy J. Siegel entitled "After the Bubble". Dr. Siegel is a professor at the University of Pennsylvania's Wharton School and author of "Stocks for the Long Run". In the article Dr. Siegel goes back over a century to examine dearly held beliefs about investing. Are our beliefs accurate? Have the boom years been the general pattern—or the rare exception? Dr. Siegel looks at the cold, hard data, as opposed to just anecdotal evidence to find the answers.

I give credit to Dr. Siegel for recognizing the stock market bubble. In his March 14, 2000 article in the Wall Street Journal (four days after the stock market peaked), he expressed his concerns about the inflated value of the large technology stocks. In his research he noted that no large-cap stock has ever been worth 100 times earnings on the basis of its future performance. But at that time, six of the top twenty stocks (in terms of market cap) exceeded 100 times earnings. During the next two and half years the Nasdaq plunged over 75%.

Dr. Siegel believes you can determine a reasonable level for the S & P 500 based on the "operating earnings of the companies in the S & P 500 index" multiplied by the "price-earnings ratio". For instance, based on core earnings of $40 for 2002 multiplied by a 20 price-earnings ratio results in a S & P 500 level of 800. The S & P 500 closed the quarter at 815.

What will the earnings of the S & P 500 be? According to Thomson First Call, in 2000, earnings for the companies in the S & P 500 reached $55.12 a share, excluding "goodwill" charges. For 2001, the S & P earnings posted their biggest drop ever, falling to $45.16. Per a September 4, 2002 article in the Wall Street Journal, analysts expect a slight rebound to $48.81 for 2002. Per Dr. Siegel, core earnings for the S & P 500 (which include goodwill charges) will be about $40 for 2002. Currently, Wall Street strategists who calculate these numbers (and whose track records in recent years have been less than stellar) are now saying core earnings in 2003 will jump over 10% to over $44.

What is an appropriate price-earnings ratio for the S & P 500? As pointed out in the third page of the article, "some bearish forecasters have maintained that the long-term average price-earnings ratio of 15 is appropriate and that the market thus has considerable more downside risk at current levels. Yet the market has been significantly above its long-term average for quite some time." Dr. Siegel thinks price-earnings ratios in the low 20's are quite reasonable for stocks (particularly when applied to the core earnings).

Why does Dr. Siegel feel that these higher price-earnings ratios are reasonable given the long-term average of 15? He writes, "over the past 50 years our macro economy-related events for equity prices have clearly become more stable. The two worst economy-related events for equity prices, the Great Depression of the 1930s and the double-digit inflation of the 1970s, will never happen again. The mistakes of the central bank during these two episodes are widely understood and can be easily avoided. *It was from these two episodes that equity markets were slammed and price-earnings ratios driven down to the single digits. Excluding these (two) episodes* (from the record), *leaves historical earnings multiples* (averaging) *in the high teens.*" Additionally, given the current level of interest rates (lowest in 40 years), a higher than average price-earnings ratio is warranted.

Dr. Siegel concludes on page five of the article, "with core earnings at $40, the equilibrium level of the S & P 500 Index (applying price-earnings ratios in the low 20s) should be somewhere between 800 and 1000. From current levels, there is no reason why stocks cannot achieve their long-term historical returns of 6.7% per year above inflation". He continues, "there is no question in my mind that stocks will beat government bonds hands-down over all intermediate and long-term periods…Going forward, the real returns on standard government bonds could be only 2% or less."

To summarize, in the short term stock prices are heavily influenced by investors' emotions. In the long run, however, stock prices are determined by the performance of the economy and corporate earnings. Over the next few months I will continue to monitor the economic reports for signs of an improvement in the economy.

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

<u>In General:</u> Although MAM portfolios declined significantly during the second quarter, they continued to perform well relative to the S & P 500. 92% of the MAM portfolios outperformed the S & P 500 loss of 17.7%. The composite return of MAM portfolios was a loss of 14.4% (after

MAM fees). Once again, generally the only portfolios that underperformed the S & P 500 were those that contained individual stocks.

Best Performers: The eight best performing MAM mutual funds for the quarter were Loomis Sayles Bond (down 1.2%), Cohen & Steers Realty (-8.8%), Pioneer High Yield (-9.1%), Vanguard Healthcare (-10.0%), Weitz Partners Value (-13.3%), Marsico Focus (-13.6%), Oakmark Select (-15.6%), and PBHG Clipper Focus (-15.9%).

Worst Performers: The MAM mutual funds that underperformed the S & P 500 for the quarter had significant technology or international stock exposure. The worst performing funds were White Oak Growth (-25.1%), Firstar Micro Cap (-23.1%), Oakmark Intl Small Cap (-22.3%), Artisan International (-21.4%), Acorn International (-19.7%), TCW Galileo Select Equities (-19.3%), Bjurman Micro Cap and Bogle Small Cap Growth (-19.0%), and Artisan Midcap (-18.1%).

Oldest Portfolio: 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 September 30, 2002, the original $50,000 had declined to $46,051 for a cumulative decline of 7.9%. During that time the S & P 500 lost 37.0%. For the quarter ended September 30, 2002, the portfolio lost 16.3%. 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 20.4% (net of MAM fees), versus a loss of 29.0% in the S & P 500. Adjusting for a year-to-date dividend yield of 1.2%, the year-to-date loss on the S & P 500 is reduced to 27.8%

I attribute the 7.4% positive performance of MAM portfolios relative to the S & P 500 due to three factors. The first is favorable asset allocation. Most MAM portfolios are underweighted in large-cap stocks, overweighted in small and mid-cap stocks, and have a significant weighting in REITs, high-yield bonds, and international stocks. The second factor is good fund selection. Most mutual funds used by MAM have outperformed their peer group. The third factor is that the typical MAM portfolio is less volatile than the S & P 500. While the S & P 500 is 100% invested in equities, the typical MAM portfolio is less than 80% invested in equities (with the balance in REITs and bonds--primarily high yield). Also the average MAM portfolio has an 11% weighting in technology stocks, versus a 14% technology weighting in the S & P 500.

Fund Spotlight

With this report I am providing information regarding a fund that I started using during the second quarter of 2002, PIMCO Total Return. The fund is run by Bill Gross, who some consider to be the guru of bond investing. In total he manages over *$160 billion* in bonds.
PIMCO Total Return, with assets in excess of $50 billion, is by far the largest mutual fund used by MAM. Unlike equity mutual funds where I feel large size handicaps a fund, a large asset base does not hamper the performance of a bond fund.

PIMCO Total Return invests in bonds of all types: government, mortgage, high quality corporate, high yield, and foreign. The fund has consistently outperformed its benchmark, the Lehman Brothers Government/Corporate Bond Index. See the enclosed for the most recent Morningstar report on PIMCO Total Return.

I am establishing a 3 to 6% position in this fund in accounts that have cash to invest. Although this fund will probably under perform all other MAM mutual funds once the stock market starts to recover, it would, in the meantime, reduce the volatility of portfolios and provide downside protection should the stock market continue to drop.

At this time I am not using the fund in MAM portfolios that are fully invested. Taking a long-term perspective, I believe now is not the time to sell equities and purchase bonds. ***For those of you who are very uncomfortable with the dramatic drop in the stock market and feel that you cannot stomach additional declines in your portfolio, I can sell a portion of the equities and establish a stake in this fund.*** I think this is a far superior strategy than selling all of your equities now and waiting until the stock market starts to recover. For instance a 5 to 10% shift in your portfolio from equities to bonds will lessen the volatility while still retaining most of the recovery potential. ***I am not advocating this strategy. I am just offering it to those of you who are very uncomfortable with the current stock market environment.***

Recent MAM Portfolio Activity

Portfolio Adjustments: During the third quarter of 2002, I completed the adjustments in the remaining MAM portfolios that I had started in June of 2002. With the latest repositioning, 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).

Current Portfolio Asset Allocation:

The typical MAM portfolio now has a 22 to 25% weighting in large-cap U.S. stocks, a 35 to 45% weighting in small-cap and mid-cap U.S. stocks, a 11 to 16% weighting in bonds (primarily high-yield), an 8 to 9% weighting in REITs, and a 14 to 16% weighting in international.

The fact that most MAM portfolios are under weighted in technology stocks and have a significant weighting in bonds and REITs, may cause them to under perform the S & P 500 when the stock market does start to recover. I feel that most MAM clients, however, are currently more concerned with downside protection than with trying to recover losses. Also, until investor sentiment improves and the selling pressure subsides, I am not convinced that the stock market has reached its lows. Once I am confident that the stock market is back on an upward track, I expect to become more aggressive. The earliest I expect to take this action will be well into 2003.

Assets Under Management

As of September 30, 2002, MAM assets under management were in excess of $29 million, flat with $29 million at the start of the year (and down from $32 million on June 30, 2002).

Miscellaneous

Recently, my assistant Marialyce contacted those of you for whom we do not have an e-mail address. I am contemplating sending a monthly e-mail to MAM clients regarding the state of the stock market. I feel that it is important to maintain frequent contact during these times of stock market turbulence. I plan to send the first e-mail early in November.

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
Article- After the Bubble- Jeremy J. Siegel
PIMCO Total Return Morningstar Report