McCarthy Asset Management

Registered Investment Advisor
Certified Public Accountant
Certified Financial Planner

Monday, October 13, 2003

Dear Client,

It seems almost too good to be true. For the second consecutive quarter, the stock market performed well. After a three-year plunge, the market has bounced back sharply since mid March 2003. If the gains hold this quarter, the stock market will have its first up year since the end of the booming 1990's.

With this MAM report for the quarter ending September 30, 2003, I will discuss this year's performance of the market and MAM portfolios, as well as my outlook for the future. In addition, I will explain the portfolio adjustments that I recently did in most accounts. Finally, I will discuss two mutual funds that have been added to most portfolios.

Enclosed are the following four investment reports for the quarter ending September 30, 2003:

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

Stock Market Performance

The stock market performed well for the third quarter of 2003. The S & P 500 rose 2.3% to 996, the Nasdaq Composite climbed 12.9% to 1832, and the Russell 2000 rose 8.9% to 488. For the first nine months of 2003, unadjusted for dividends, the S & P 500 rose 13.2%, the Nasdaq Composite soared 37.1%, and the Russell 2000 climbed 27.4%.

Outlook for the Stock Market

Priced for Perfection? Were it not for a decline late in September of 2003, the stock market would have risen for seven consecutive months. I attribute the rise to improving prospects for the U.S. economy and corporate profits, and a lessoning of global tensions. As the market has risen, stock prices have gone from being undervalued to possibly being overvalued. Recently, according to market research and money management group Birinyi Associates in Westport,

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Connecticut, the S & P 500 companies were trading at about 28 times earnings for the past year and at 18 times forecast earnings for the coming year. This frothy valuation leaves little room for disappointment. For the market to continue to rise, corporate profits will probably need to meet or exceed consensus earnings estimates. Recently, Thomson First Call reported that analysts' consensus estimates for operating earnings of the S & P 500 companies suggest a rise of 15.7% in third quarter earnings (compared to the year ago period) and a rise of 21.5% for the fourth quarter (compared to the fourth quarter of 2002).

The Positives: In my June 30, 2003 quarterly report, I discussed four factors that were helping the stock market. The four factors were:

- Low Interest Rates
- Tax Cuts
- Increased Corporate Profits
- Decreased Global Tensions

I believe these four factors are still providing a boost to the market. In addition, I have two additional factors to add. First is the lack of promising alternative investments. Money market rates are paying less than 1% and bank deposits are earning less than 2%. Ten-year Treasuries are paying less than 4%, and could lose value if interest rates continue to climb. What else is an investor to do than purchase equities? After all, a solid stock like Chevron Texaco Corp pays a dividend of 4%, and the Federal tax on that dividend has been reduced to 15%.

Secondly, the global economy finally seems to be on the mend. This is important because it should lead to growth in U.S. exports. In a forecast prepared for its annual meeting in Dubai on September 23 and 24, the International Monetary Fund predicted that world economic growth will accelerate to 4.1% in 2004 from 3.2% this year and 3.0% in 2002.

Much of this growth is due to stronger demand in the U.S. The global upswing, though, appears to be widespread. Japan, the world's second largest economy, is picking up and starting to generate home-grown growth, rather than just relying on exports. Emerging economic powerhouse China has shaken off the SARS scare, and is on a roll. Even in Europe, where the economy all but stalled in the first half of the year, business confidence is starting to perk up.

The Risks: There still remain several important risks to the economy that could jeopardize the sustainability of the expansion. Probably the biggest is the weak job market. Despite a pickup in economic growth, employers have not started hiring new workers. Per a front page article that appeared in the September 12, 2003 Wall Street Journal, "nearly half of the economists surveyed said a lack of job creation posed the biggest threat to the nascent expansion."

But all is not dire. The article continued, "Yet most economists now expect payrolls to start rising by the end of the year. Thirty-seven of 53 economic forecasters surveyed expected payrolls to expand by one million or more over the 12-month period. On average, the group expected the economy to produce almost 1.4 million new jobs between this month (September 2003) and September 2004. This averages about 115,000 a month, a clear improvement from the past three years, though still not enough to significantly reduce the unemployment rate. The jobless rate is expected to remain at 6.1% through this November and then to decline slightly to 5.9% by May 2004".

Corporate and stock brokerage scandals are also a continuing concern. The most recent scandals included improper earnings adjustments at Freddie Mac, excessive pay at the New York Stock Exchange, and improper trading at mutual funds. On a positive note, these recent scandals have barely caused a ripple in the stock market. This may be because unlike the corporate misbehavior leading to the Chapter 11 bankruptcy-protection filings of Enron Corp and WorldCom Inc. (which caused investors billions of dollars in losses), the latest scandals left shareholders relatively unscathed.

MAM Performance for the Quarter

In General: For the quarter, 95% of the MAM portfolios out performed the S & P 500. The composite return of MAM portfolios in existence for the whole quarter was a gain of 5.4% (after MAM fees) versus a rise of 2.7% 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 Bjurman Micro Cap (rise of 14.8%), Artisan International Small Cap (14.5%), Oakmark International Small Cap (14.1%), Bogle Small Cap Growth (12.5%), William Blair Small Cap (12.4%), Firstar Micro Cap (11.9%), Cohen & Steers REIT (10%), and TCW Galileo Select (7.5%).

Worst Performers: The eight worst performing MAM mutual funds for the quarter were PIMCO Total Return (down 0.5%), Oakmark Select (0.0%), Oakmark Fund (up 0.3%), Loomis Sayles Bond (1.9%), Selected American (2.3%), Calamos Growth & Income (2.8%), Pioneer High Yield (3.1%), and Artisan Small Cap Value (4.0%)).

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, 2003, the original $50,000 had risen to $59,327 for a cumulative rise of 18.7%. During that time, the S & P 500 lost 21.7%. For the quarter ended September 30, 2003, the portfolio rose 6.5% while for the first nine months of 2003 it rose 22.1%. 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 Nine Months of 2003

For the first nine months of 2003, MAM portfolios performed very well relative to the S & P 500. 96% of the MAM portfolios (in existence for the whole period) out performed the 14.4% 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 19.3%.

I have been very pleased about the absolute and relative performance of the MAM portfolios this year. While most portfolios significantly out-performed during the 2000-2002 bear market, for the last year I have been suggesting that they may under-perform if the S & P 500 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% REIT exposure. The bond exposure has hurt performance 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 under-investment in technology stocks.

Portfolio Adjustments:

During the third quarter, I did minor repositioning in most portfolios. In the process I made the following changes:

1. *U.S. Equities:* Although almost all MAM portfolios continue to be under-weighted in large-cap stocks and over-weighted in small and mid-cap stocks, I did make a small increase in the weighting of large-cap U.S. stocks. As small-cap stocks continue to outperform large-cap stocks, I feel they no longer clearly represent a bargain.

   One equity fund change that I made was to sell Weitz Partners fund. This fund has been a good performer and has a 4-star rating from Morningstar. I am selling it to make room for the William Blair Small Cap fund. This is a tiny fund (less than $100 million in assets), which has performed very well since its 1999 inception. Please see the "Fund Spotlight" section below for a discussion of this fund.

2. *Bonds:* Most MAM portfolios have a 10% to 20% weighting in bond funds. During the recent repositioning, I did not change the amount invested in bonds. I did eliminate PIMCO Total Return and reduced the investment in Loomis Sayles Bond. I reinvested the proceeds in either Pioneer High Yield or Calamos Growth & Income. The former funds contain a sizable position in high quality bonds, while the later funds contain a large weighting in convertible bonds. If the U.S. economy continues to recover and interest rates rise, high quality bonds will under-perform while convertible bonds may benefit.

3. *REITs:* Real Estate Investment Trusts have been a very strong performer since I started using them in the Summer of 2000. Normally I establish a 7% portfolio weighting in REITS when I invest a portfolio. In some cases the strong performance of REITs has caused this weighting to grow well above 7%. While I still feel REITs are a compelling investment, following my philosophy to buy low and sell high, I have scaled back the REIT position to between 7.0% and 7.5%.

4. *International:* In most MAM portfolios, I made a small increase in international exposure to 15%. I continue to like international equities for three reasons. First, adding an international element to an equity portfolio reduces volatility, because U.S. stocks do not move exactly in step with international equities. Secondly, international equities are cheap relative to U.S. equities. Finally, U.S. investors will benefit from international investments if the U.S. dollar continues to fall in value.

   While increasing international exposure, I also eliminated Acorn International, one of the three international funds used by MAM. Although Acorn International's relative performance has been decent, the long-tenured manager of the fund recently stepped down. I took the manager change as an opportune time to replace the $1.3 billion fund with an initial purchase of tiny Artisan International Small Cap. Please see the "Fund Spotlight" section below for detailed discussion of this fund.

Fund Spotlight

As discussed above, two new funds were added to most portfolios this quarter: Artisan International Small Cap and William Blair Small Cap Growth. Below is a short discussion and enclosed are recent Morningstar reports on these two funds.

Artisan International Small Cap: I have closely monitored this fund since its 2001 inception. As I generally do for mutual funds that I consider using for MAM portfolios, I established a small position in the fund in one of my personal accounts and started following its performance on a daily basis. Since then, I have decided to use the fund for three reasons. First, is my confidence in manager Mark Yockey, who is also skipper of the $4 billion Artisan International fund. Secondly, its performance has been impressive. From its inception on December 21, 2001 through August 31, 2003, the fund generated an annual return of 18.2%, which was 3.7% better than the MSCI EAFE Small Cap Index. And finally, was the promise from Artisan to close the fund to new investors while it still had a manageable asset basis. True to its word, Artisan closed the fund on September 25, 2003. Fortunately, since McCarthy Asset Management clients have invested over $1 million with Artisan funds, my new clients are exempt from this closure.

William Blair Small Cap Growth fund: This Blair fund was launched late in 1999. For the three years ending July 31, 2003, it returned 7.2%, which is 19.2% better than the Russell Growth Index. Since inception, the fund has had two managers: Michael Balkin and Karl Brewer. A risk with any successful mutual fund is that the manager(s) leave. Fortunately, the William Blair Company has a unique partnership structure that provides incentive for these managers to stay. My greatest concern is that as the fund becomes “discovered”, assets could balloon. My expectation is that management will close the fund to new investors before that happens.

Paper Reduction Actions

Over 75% of you have responded to the notice we sent regarding the Paper Reduction Actions. These clients should now be seeing a reduction in the quantity of mailings received from Charles Schwab. For the 25% of you who have not responded, please do so. If you have any questions, please call and discuss them with Marialyce or myself.

Web Site in Development

In August, in conjunction with Schwab Advisor Web Center, we commenced efforts to develop our new Web site, “MAMportfolios.com”. We hope to have the Web site operational by this December. “MAMportfolios.com” 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 (probably $150,000 or more) will be able to securely access account information, such as current values, cost basis, and performance. In addition, as a possible phase II implementation, qualified clients will have the ability to link their non-Schwab accounts so that through one Web site they can review the current balance of most of their assets and liabilities.

Assets Under Management

As of September 30, 2003, MAM assets under management were in excess of $40 million, up from $32 million at the start of 2003. Part of this growth has been from client referrals. I continue to welcome your referrals of new investment clients. My current minimum for new clients is $250,000.

Your Performance

Also enclosed is the invoice reflecting 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
 Morningstar Report: Artisan International Small Cap
 Morningstar Report: William Blair Small Cap Growth