McCarthy Asset Management

Registered Investment Advisor
Certified Public Accountant
Certified Financial Planner

January 6, 2003

Dear Client,

Happy New Year! Or at least as many investors think, good riddance to 2002. After the dismal performance of the stock market during this past year (and following the down years for 2000 and 2001), investors are happy to start a new year. Although the market performed well in the fourth quarter, the positive returns were not enough to prevent 2002 from being one of the worst years ever for the stock market. With this MAM report for the quarter ending December 31, 2002, I will discuss the performance of the market for the quarter and the year, as well as my outlook for 2003. In short, while I think it is prudent to be cautious in the current market environment, for the long-term I continue to believe that equities will be a favorable place to invest.

Enclosed are four investment reports for the quarter ending December 31, 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 2002. 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 2002. Also enclosed is the MAM "Privacy Disclosure Statement". By Federal law I am required to annually provide this to clients.

Stock Market Performance

The final quarter of 2002 was a refreshing change for the stock market. The S & P 500 rose 8.0% to 880, the Nasdaq Composite climbed 14.0% to 1336, and the Russell 2000 recovered 5.8% to 383.

Full year results for 2002 were a different story. Unadjusted for dividends, the S & P 500 dropped 23.3%, the Nasdaq Composite plunged 31.5%, and the Russell 2000 fell 21.7%. The loss for the S & P 500 was its worst since 1974. Worse still, for the first time in 60 years, the stock market has declined for three consecutive years.

Outlook for the Stock Market

Will the stock market continue to fall in 2003 or has the three-year bear market ended? While no one knows for sure, I will discuss positive and negative factors that are likely to impact the market for the next twelve months.

1900 O'Farrell St, Suite 330, San Mateo, CA 94403, (650) 638-0667 Fax (650) 638-0222; e-mail: SteveMtax@aol.com

Bear markets can occur for three different reasons. First, share price declines may simply reflect a downturn in the economy and corporate earnings. Second, excessive valuations can collapse, as they did for many growth stocks over the past three years. Third, misguided government policies or major bank failures or other exogenous factors can paralyze the financial system, causing a persistent slump like the one that has afflicted Japan since 1989. The recent bear market has been more severe than the economy alone can explain. And there's clearly been a correction in stock valuations. But we haven't seen the pervasive problems in the economy that make for chronically depressed stocks prices.

Here are some negative factors affecting the stock market:

1. **Weak Economy, Weakening Consumer Spending and Lackluster Corporate Spending.** These negatives may become positives. The economy appears to be slowly recovering, consumer spending continues to prop up the economy, and corporate spending may be slowly reviving. These issues are discussed at further length in the next couple of pages.

2. **Protracted War with Iraq.** Although war with Iraq is looking more and more likely, it is possible that it could be avoided if Saddam Hussein steps aside. If war does break out, the impact of the stock market may be positive if the war is quick. There is risk to the market, though, if a long war occurs.

3. **Nuclear Threat from North Korea.** This is also a real threat that is difficult to measure. The hope is that through economic sanctions and/or pressure from China, Japan and South Korea, a crisis can be avoided.

4. **Potential for Terrorist Attacks.** This is an on-going threat that may be built into the current level of stock prices. If another large-scale attack does occur in the United States, however, there would probably be another dramatic drop in stock prices.

I believe that the negatives afflicting equity prices are more than offset by positive factors. These include:

1. **Improving Economy.** As discussed in the September of 2002 MAM report, in the long-run stock prices are determined by the performance of the economy and corporate earnings. Fortunately, the economy appears to be improving. The current consensus by economists is for the U.S. economy to expand by 3.2% during 2003. The growth will be slower early in the year and accelerate as the year progresses. The economy is receiving a boost from the three P's: policy, prices and productivity.

    a. **Policy:** The combination of monetary and fiscal policy is already as stimulative as it has been at any time since World War II. On the fiscal side, the policy boost can be seen in the swing in the federal budget. In fiscal 2002, which ended September 30, the budget took a record swing from a surplus of $127 billion in 2001 to a deficit of $159 billion, an economic thrust of $286 billion, or 2.8% of gross domestic product.

       The deficit is expected to widen further in 2003, to perhaps $225 billion. But the fiscal boost could be even greater than that, since the Bush Administration and the new Republican Congress are sure to push through another sizable stimulus package. Part of the federal lift will be offset by higher taxes and less spending at the state level. State budgets are expected to be in the red by $60 billion for the coming fiscal year, and unlike Washington, most states by law must balance their budgets.

Monetary policy is also very accommodative. The Federal Reserve is as stimulative now as anytime in the last twenty years. That's clear from the current level of the Fed's policy target, the overnight federal funds rates, adjusted for inflation. Based on the latest consumer price index—which shows yearly inflation at just 2.2% in November—and a Federal funds rate of 1.25%, the real policy rate is –0.9%, compared with a long-run average of about 2%. That's the widest gap and the most negative real rate of return since the 1980 recession.

b. **Prices:** The current low inflation rate doesn't mean that deflation will be a worry in 2003. On the contrary, with current policy helping to boost demand, prices are showing signs of firming up. In particular, commodity prices are rising. The Commodity Research Bureau's spot price index of industrial commodities, which does not include energy items, is 10.8% higher than it was a year ago and at its highest level in almost two years. Rising commodity prices are not an inflation indicator but a sign of healthier demand.

c. **Productivity:** The best yearly productivity performance in two decades is supplying its own boost to demand by lifting the profitability of businesses and the real wages of workers. In fact, the recovery is looking more and more like the expansion of the early 1960's—a period of high productivity, characterized by low inflation and interest rates, and rising profitability and real wages.

2. **Increase in Corporate Earnings and Spending.** The rebound in corporate profits started in 2002 and is expected to accelerate in 2003. According to a January 3, 2003 article from the Wall Street Journal, government measured profits across the economy are up 12% from a year ago. Free cash flow is a better measure of financial health than profits because it reflects capital outlays and excludes non-cash charges. It has doubled to 6% of sales since early 2001, well above the long-term average of 4.4%.

   Capital spending is vital to the economy's long-run health. The more businesses invest, the faster productivity will grow. Increased productivity lets businesses pay higher wages and earn more profits without raising prices. For productivity growth to continue, companies will have to resume investing. This is starting to happen, as it becomes harder to postpone investment.

   Finally, in a tentative sign that the nation's hard-hit industrial sector is beginning to heal, a widely watched indicator of manufacturing activity expanded in December for the first time since late summer. On January 2, 2003, the Institute of Supply Management said that its December index of manufacturing activity rose to 54.7 from 49.2 in November, the largest increase since June of 1991 and a much larger rise than economists were expecting. Readings above 50 indicate expansion of activity in manufacturing sector, while readings below 50 denote contraction.

3. **Consumer Spending.** Consumer spending is the main engine of the U.S. economy, accounting for two-thirds of gross domestic product. Consumers are in pretty good shape. Despite layoffs, unemployment has not gone much above 6%. Pessimistic economists make much of the buildup in consumer debt—and it's true that debt levels are at a peak.

But that burden is more than offset by low interest rates. Consumer debt payments are still lower relative to income than they were in the 1980's. The impact of mortgage refinancing can't be ignored either. Over the past couple of years mortgage rates have fallen from above 8% to less than 6%. As a result, refinances have soared to a record of more than $400 billion a quarter. It is estimated that each household that refinances, on average, frees up $200 per month that can be spent on consumer goods and services.

4. **Reasonable Stock Prices.** Based on current prices, the market, as measured by the S & P 500, sold at 17 times analysts' 2003 consensus earnings estimate. The S & P's historical average price-earnings ratio is 15. That includes periods, though, when inflation and interest rates were much higher. In fact, assuming that interest rates were to rise 1%, current stock prices are still reasonable.

5. **Third Year of Presidential Cycle.** Since 1939 stocks have risen in every third year of a presidency.

6. **History.** Four consecutive years of losses happened only once during the 20th Century, from 1929 to 1932. It also only occurred once in the 19th century, from 1836 to 1839.

MAM Performance for the Quarter

In General: For the first quarter in two years, MAM portfolios under performed the S & P 500. The composite return of MAM portfolios was a gain of 5.3% (after MAM fees) versus a rise of 8.0% (excluding dividends) in the S & P 500.

There are two reasons for the underperformance. The first is that stocks were lead by large cap stocks. Smaller cap stocks and international stocks rose less than the S & P 500. In addition, REITs broke even and bonds rose only a little. The second reason is that MAM portfolios are under weighted in technology stocks, which led the market last quarter.

Best Performers: The eight best performing MAM mutual funds for the quarter were Firstar Micro Cap (rise of 14.4%), TCW Galileo Select Equities (13.5%), Weitz Partners Value (10.9%), Oakmark Select (10.0%), Artisan Small Cap Value (9.0%), PBHG Clipper Focus (8.9%), Loomis Sayles Bond (8.2%), and Oakmark International Small Cap (8.1%).

Worst Performers: The eight worst performing MAM mutual funds for the quarter were Marsico Focus (down 4.5%), Cohen & Steers REIT (-0.4%), Bogle Small Cap Growth (up 1.3%), PIMCO Total Return (2.1%), Acorn International (3.6%), Bjurman Micro Cap (4.3%), Artisan International (5.2%) and Vanguard Healthcare (5.3%).

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 December 31, 2002, the original $50,000 had declined to $48,597 for a cumulative decline of 2.8%. During that time the S & P 500 lost 31.7%. For the quarter ended December 31, 2002, the portfolio rose 5.5%. For all of 2002, the portfolio lost 18.5% (versus a loss of 21.7% in the S & P 500 adjusted for dividends). 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 2002

For all of 2002, MAM portfolios performed well relative to the S & P 500. 88% of the MAM portfolios outperformed the 21.7% loss in the S & P 500 (adjusted for an assumed dividend yield of 1.6%). The composite return of MAM portfolios was a loss of 16.2%.

MAM portfolios have now outperformed the S & P 500 for each of the three full years that MAM has been in existence. I attribute the 5.5% positive performance of MAM portfolios for 2002 relative to the S & P 500 to three factors. The first is favorable asset allocation. Most MAM portfolios are under weighted 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 factor is good fund selection. Most mutual funds used by MAM have outperformed their peer group. According to Lipper, the mutual fund tracker, the average equity mutual fund lost 22.4% for 2002.

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 a 9% 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 third quarter of 2002, Marsico Focus. I am adding this fund to portfolios to increase the large-cap growth exposure. I have been under weighting this area for the last couple of years. In fact, I used this fund back in 1999 and 2000, but sold it to reduce large cap growth exposure.

Tom Marsico has managed the fund since its 1987 inception. Prior to that, Marsico ran the Janus 20 fund, where he built a strong track record. For a large-cap growth fund, Marsico Focus has performed relatively well during the last three years. For the three years ending November 30, 2002, the fund was down 12.0% per year, 0.9% ahead of the S & P 500. During this period the fund outperformed the Russell 1000 Growth Index (a large cap growth index) by over 8.0% per year. Tom Marsico is a stock picker and his Focus fund is a concentrated portfolio of twenty to thirty stocks. Although he had a 40% concentration in technology stocks back in 1999 and early 2000, currently the portfolio is heavily weighted in health care, retail and defense companies.

For more information, enclosed is a 4-page article from the January 2003 issue of Money Magazine profiling Tom Marsico.

Current Portfolio Asset Allocation:

The typical MAM portfolio now has a 25 to 28% weighting in large-cap U.S. stocks, a 32 to 38% weighting in small-cap and mid-cap U.S. stocks, a 11 to 18% weighting in bonds (primarily high-yield), a 7 to 9% weighting in REITs, and a 13 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 if the stock market does continue to recover. I still feel that the risks in the present environment are significant enough to warrant a cautious approach. Once I am confident that the stock market is back on an upward track, I expect to become more aggressive.

Assets Under Management

As of December 31, 2002, MAM assets under management were in excess of $32 million, up from $29 million at the start of the year.

Miscellaneous

I am now sending a monthly e-mail to MAM clients for an update on the stock market. I still do not have the e-mail address for all clients. If you have not been receiving the monthly e-mail and you have an e-mail address, please provide it to us. The best way to do that is to send me an e-mail at stevemtax@aol.com.

When you became a MAM client, I provided you with a copy of my ADV Part II. As part of the process of being a Registered Investment Advisor (RIA), I file this 10-page document with the Securities and Exchange Commission each year. Along with other items, it contains information regarding my fees and educational background. Each year, as an RIA I am required to offer clients the chance to get my most recent ADV Part II. Please let me know if you would like to receive a copy.

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
Money Magazine article on Tom Marsico
Privacy Disclosure Statement