McCarthy Asset Management

Registered Investment Advisor
Certified Public Accountant
Certified Financial Planner

Wednesday, January 7, 2004

Dear Client,

Happy New Year! And what a year 2003 was for the stock market! After three consecutive down years, the stock market bounced back sharply in 2003. Hopefully, 2004 will continue to bring good news.

With this MAM report for the quarter ending December 31, 2003, I will discuss the 2003 market and MAM portfolio performance, as well as my outlook for 2004. In addition, I will explain the substantial portfolio rebalancing begun in the middle of December. Furthermore, I will briefly discuss three mutual funds that have been added to most portfolios. Finally, I will briefly comment on our new Web site "mamportfolios.com" which was introduced in November, and the 2003 mutual fund scandals.

Enclosed are four 12/31/03 investment reports:

- *Portfolio Position Analysis*: lists your investments and how each have performed
- *Portfolio Performance Summary*: 4th quarter and full year portfolio rate of return
- *Portfolio Performance History*: portfolio rate of return since inception
- *Realized Gains and Losses*: full year 2003 investment gains and losses realized (included solely for taxable accounts). This report does not segregate the long-term gains subject to the 15% bracket. That report will not be available until late January.

Stock Market Performance

The final quarter of 2003 was another strong quarter for the market. The S & P 500 rose 11.6% to 1112, the Nasdaq Composite climbed 9.3% to 2003, and the Russell 2000 rose 14.1% to 557.

Full year results for 2003 were very impressive. Unadjusted for dividends, the S & P 500 rose 26.4%, the Nasdaq Composite soared 49.9%, and the Russell 2000 climbed 45.4%.

1900 O'Farrell St, Suite 330, San Mateo, CA 94403, (650) 638-0667 Fax (650) 638-0222
email: SteveMtax@aol.com Web site: mamportfolios.com

Outlook for the Stock Market

Will the stock market continue to rise in 2004? Has a new bull market started, or is this just a temporary recovery within a bear market? While no one knows for sure, my feeling is that the strong performance of the economy will continue to lead the market higher for at least a while. Although stocks are no longer priced cheaply, there is still a substantial amount of money sitting in cash. As the economic recovery continues, some of this cash will be directed into equities as alternative investments remain unattractive.

Recovering U.S. Economy, Surging Corporate Profits, Low Interest Rates: Both the U.S. economy and corporate profits staged a strong turnaround in 2003, while interest rates hit a 40-year low. Consumer and business confidence is up, rising corporate earnings are exceeding expectations, productivity growth is robust, and the outlook for jobs is brightening. After two years of false starts and dashed hopes, all indicators are finally pointing to a healthy recovery.

While the economy cannot sustain the sizzling 8.2% growth rate it recorded in the third quarter, the pace of 2004 growth is likely to be a robust 4 to 4.5%, compared with 3% overall in 2003. Larger-than-usual tax refunds next spring and decent income growth should help keep consumer spending strong. With the outlook for low inflation, the Fed should be very patient before raising interest rates, perhaps waiting until after the November elections before making a move.

The last piece to fall into place has been the rise in business confidence. Chief financial officers are as upbeat about the economy as they've been since 2000, according to the latest quarterly survey by Duke University's Fuqua School of Business. "More important, their purse strings are loosening up", says Duke finance professor John Graham. Spending surged 11% in the third quarter of 2003, and increased outlays on computers and other equipment will help solidify the recovery. Hopefully, the improved business confidence will lead to sustainable employment growth.

Stock Market Valuation: The largest current negative is that the stock market is not cheap. Companies in the S & P 500 now sell for 18 times 2004 consensus analysts profit estimates. Historically, the market has traded at roughly a price-earnings ratio of 15. The strong recovery in corporate profits and the low interest rate environment probably justifies the current higher level. In addition, for much of the 1990s, the market's price-earnings ratio fluttered in the 20s despite higher interest rates and inflation. Nonetheless, I would be more bullish if stocks were less expensive.

Downside Protection: While I couldn't be happier with the recovery in stock prices, I always try to look ahead. At some point the stock market will fall again. This could be driven by the market becoming overvalued, rising interest rates, or an exogenous event such as a major terrorist attack in the U.S. The challenge is to provide downside protection should this occur. For the last 30 years, diversifying into high quality bonds was an excellent way to cushion a portfolio from a major collapse in stock prices. This diversification came at little cost as bonds benefited from the significant drop in interest rates. The period of falling interest rates, however, has probably ended as rates hit bottom in the Summer of 2003. An increase in interest rates could lead to a decline in both stock and bond prices.

MAM Performance for the Quarter

In General: For the quarter, 80% 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 12.3% (after MAM fees) versus a rise of 11.6% 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 Artisan Small Cap Value (rise of 19.3%), Oakmark International Small Cap (17.8%), Bogle Small Cap Growth (17.2%), Bjurman Micro Cap (16.9%), Artisan International Small Cap Value (16.8%), William Blair Small Cap (15.2%), Firstar Micro Cap (14.9%), and Selected American (14.6%).

Worst Performers: The eight worst performing MAM mutual funds were Loomis Sayles Bond (up 6.8%), Pioneer High Yield (7.5%), Calamos Growth & Income (9.9%), Cohen & Steers REIT (10.0%), Marsico Focus (10.2%), American Mutual (10.8%), TCW Galileo Select (11.3%), and Oakmark Fund (11.3%).

Oldest Portfolio: The MAM portfolio with the longest track record is a fairly aggressive $50,000 portfolio fully invested on September 13, 1999. As of December 31, 2003, the original $50,000 had risen to $66,690 for a cumulative return of 33.4%. During the same time the S & P 500 lost 12.6%. For the quarter ended December 31, 2003, the portfolio rose 12.4% while for all of 2003 it rose 37.2%. 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 2003

For all of 2003, MAM portfolios performed very well relative to the S & P 500. 98% of the MAM portfolios outperformed the 28.0% appreciation in the S & P 500 (adjusted for an assumed annual dividend yield of 1.6%). The composite return of portfolios in existence for all of 2003 was a rise of 34.1%.

Obviously I am very pleased about our 2003 absolute and relative performance. Even more significantly, MAM portfolios have now outperformed the S & P 500 for each of the four full years that MAM has been in existence.

At the beginning of 2003, I was suggesting that if the stock market were to rebound, we could under perform the S & P 500. This was because of the defensive positioning I had done as the bear market ensued through its third year. By the beginning of 2003, the typical MAM portfolio had a 10% to 15% bond and 7% REIT exposure. While the bond exposure limited performance in 2003, the mutual fund selection and small cap exposure more than compensated for not being fully invested in equities.

Portfolio Adjustments:

Below is a discussion of substantial portfolio changes that were made beginning in mid

December. By December 31, 2003, portfolios representing over 90% of MAM assets had been repositioned. The remaining portfolios will be adjusted this January.

1. ***U.S. Equities:*** For the last few years we have over weighted small stocks and under weighted large stocks. This has been very favorable for relative performance. Like all investment trends, at some point, the under performance of large stocks will end. Based on my belief that small companies are no longer undervalued relative to larger companies, I have made adjustments so that large cap stocks are now equally weighted with small and mid-cap stocks.

   To increase large company exposure, positions in American Mutual and Selected American fund were increased. In addition, one or two new global large cap funds, Capital World Growth & Income and Oakmark Global were purchased. To decrease small/mid cap stocks, Artisan Mid-Cap was fully sold in most portfolios, as was a portion of Bjurman Micro Cap, Bogle Small Cap, and Firstar Micro Cap.

   Selling positions in small cap funds may seem premature. Proper repositioning means selling a portion of your winners and reinvesting in areas that have under performed. Although this may seem counter-intuitive, there are many investors who wished they had made a comparable move in late 1999 by reducing their winning technology holdings. I am not suggesting, however, that small and mid-cap stocks will collapse or under perform. I just don't think that it makes sense to continue to over weight them.

2. ***Bonds:*** After the recent moves, most portfolios now have a 14 to 20% exposure to bonds. The main reason for this is to provide downside protection in case equities start to decline again. The cost for this protection is that MAM portfolios could under perform the S & P 500 if the market continues to rise.

   The primary bond exposure is through convertible bonds (Calamos Growth & Income and Pioneer High Yield), high yield bonds (Pioneer High Yield), and foreign bonds (Loomis Sayles Bond). There is very little exposure to high quality U.S. bonds, which are most vulnerable to rising interest rates. For the first time, with the December repositioning I have added a balanced fund (Income Fund of America). This fund has about 46% of assets in large U.S. stocks, 14% in small and mid-cap U.S. stocks, and 40% in bonds and cash equivalents.

3. ***REITs and Commodities:*** Real Estate Investment Trusts performed very well again this year. Since March of 2000, REITs have dramatically outperformed equities. In the future, I do not expect REITs to continue to outperform, although I feel they do provide a hedge against a potential decline in equities. I have reduced the REIT weighting to between 6.5% and 7.0% in each portfolio.

   During 2003, commodity prices rose dramatically due to strong demand from China. As the world economies continue to recover, commodity prices may continue to rise. Diversifying with a commodity exposure reduces portfolio volatility because commodity prices have a negative correlation to stock and bond prices. At this point I am establishing

a minor position. In portfolios with assets of $200,000 or more, I have added a 1% position in the PIMCO Commodities fund.

4. ***International:*** For three reasons, I have generally increased international exposure from 14 to 15% to between 15% and 17%. First, of all the assets classes, I feel the most likely to be undervalued is international equities. Secondly and historically, a significant international exposure reduces portfolio volatility. Finally, U.S. investors will benefit from international investments if the U.S. dollar continues to fall in value (as happened dramatically in 2003).

   While increasing international exposure, I eliminated Artisan International and replaced it with Thornberg International Value and the two global funds mentioned above.

Fund Spotlight

With this report, I am providing information regarding three funds that were added to most portfolios in December. Oakmark Global and American Funds Capital World Growth & Income are both large-cap global funds. A global fund invests in both American and foreign companies. The third fund added was American Funds Income Fund of America. This is a balanced fund that invests in large cap U.S. value stocks and bonds. Since all three of these funds invest in large cap stocks, adding them helped increase the large-cap weighting in portfolios. Enclosed are recent Morningstar reports on these funds.

Oakmark Global: Oakmark Global is a relatively new fund, having been established in 1999. During that time it has amassed an impressive track record. During the three years ending 10/31/03, the fund returned 21.1% annually, out performing the S & P 500 by 27.2% annually and the MSCI World index by 28.8% annually. Importantly, the fund closed to new investors last month. Since I am an investment advisor with an existing position in the fund, I am still able to get clients into the fund.

The one possible negative is the recent departure of Greg Jackson, the manager of the domestic portion of the fund. My concerns are alleviated, as his replacement Clyde McGregor, built an impressive track record managing the Oakmark Equity & Income fund. There has been significant overlap in the domestic portion of the fund with that of Oakmark Equity & Income, suggesting a smooth transition to the new manager.

American Funds Capital World Growth & Income: This global fund emphasizes value stocks that pay a high dividend. Although its performance has not been as strong as Oakmark Global, it is less volatile. In addition, I feel it's strategy of purchasing high dividend stocks will be beneficial as investors start to pay more attention to the reduced 15% Federal tax rate on dividends. I am able to purchase this loaded fund for no fee and no-load for clients.

American Funds Income Fund of America: This is a large balanced fund ($29 billion in assets), which emphasizes yield by purchasing large-cap value stocks paying a high dividend, and high yield bonds. This is also a loaded fund that I am able to purchase for no fee and no-load through Schwab Institutional.

Mamportfolios.com Web Site

During November, the MAM Web site became operational. The public portion of the Web site is useful for those who want to find out more about McCarthy Asset Management, including investment philosophy and approach. A library of past quarterly reports and monthly Commentaries is included.

So far about 1/3 of eligible MAM clients (those with managed assets over $150,000) have logged onto the client portion of the Web site. They have found it useful to view their current holdings, performance, asset allocation, and year-to-date gains and losses. Some have started to use the Account Aggregation feature, which allows them to create a consolidated view of many of their financial accounts. These include bank accounts, brokerage accounts, 401(k)s, mortgages, and credit cards. Additionally, with a click of the mouse, recent transactions for any of the financial accounts can be viewed.

Mutual Fund Scandals

In my e-mailed November 2003 MAM Commentary (available on the MAM Web site), I discussed at length the 2003 mutual fund scandals. I will summarize those comments here. Certain mutual fund companies (Alliance Funds, Bank of America, Janus, Putnam, Strong) made deals with outside investors allowing them to "time" their funds, generating profits for themselves and thereby diluting profits of long-term shareholders. With what has been revealed so far, the impact on shareholder returns of the implicated fund companies was negligible.

The real problem is when some fund companies put their profit motives ahead of their fiduciary responsibility to shareholders. This has been displayed in such ways as failing to manage expenses responsibly, allowing excessive asset growth, launching new funds based on marketing considerations rather than investment merit, and failing to communicate openly and honestly with shareholders.

Focusing on fund asset growth has helped me avoid the implicated fund companies. More than half of the equity mutual funds used by MAM are closed to new investors. A decision to close a fund is not only positive for managing the fund's assets, but shows the willingness of fund company management to put shareholder interest ahead of their profit motives.

The short-term impact of the scandals has been that specific fund companies (Janus, Putnam, Strong) absorbed the brunt of the damage as investors sold their funds. In the long run, rules will be instituted which will provide better protection to shareholders. Bottom line, I feel the mutual fund industry will continue to play a huge role in the investment industry.

Assets Under Management

As of December 31, 2003, MAM assets under management were in excess of $49 million, up from $32 million at the start of the year. While most of this growth was from portfolio appreciation, existing and new clients added over $7 million in net assets. I continue to welcome

your new client referrals. Although my current minimum for new clients is $250,000, I expect to raise that minimum later in 2004 if assets continue to grow rapidly.

Miscellaneous

When you became a MAM client, I provided you with a copy of my ADV Part II. As 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, I am required to offer clients the opportunity to receive a copy of my most recent ADV Part II. Please let me know if you would like to receive it.

Also enclosed is the annual privacy notice that I am also required to send.

Please call me if you wish to discuss the stock market or your portfolio(s).

Very truly yours,

Stephen P. McCarthy, CPA

encl: Investment Reports
3 Morningstar Reports
Privacy Disclosure Statement