McCarthy Asset Management, Inc.

Registered Investment Advisor

Re: Fourth Quarter 2008 MAM Letter

Monday, January 5, 2009

Dear Client,

After the worst year since 1937, many investors are relieved that 2008 has ended. At a time when some stock prognosticators are telling people stocks are cheap, understandably many investors have become risk adverse and are fearful of committing new money. At some point, experts agree, the stock market will hit bottom and move higher. Some analysts believe it happened in November, when stocks hit multiyear lows and then began an upswing. Others think stocks will sag again and won't bottom out until later, perhaps some time in 2009.

As the market plunged in October and November, we repositioned portfolios twice to increase the downside protection by reducing equities and adding bonds. The market steadied during December, with modest gains for the month. MAM portfolios significantly outperformed the S & P 500 for the month as bond prices started to recover and the U.S. dollar slipped. My outlook is that the stock market is still at risk to further downside before undertaking a sustainable recovery. For now I am satisfied with the current positioning of MAM portfolios. Most portfolios have a 30% plus weighting in bonds, which should help if the market drops further.

With this report for the quarter ending December 31, 2008, I discuss the performance of the market and MAM portfolios for the quarter and year, as well as my outlook for the economy and the stock market. In addition, I discuss the great opportunity to refinance to an attractive fixed-rate loan, the requirement for minimum IRA distributions has been suspended for 2009, and the Madoff Scandal.

Stock Market & MAM Performance for Fourth Quarter

The stock market performed very poorly for the fourth quarter of 2008. The S & P 500 fell 22.6%, the Nasdaq dropped 24.3%, the Russell 2000 fell 26.7%, and the international equity index MSCI EAFE fell 20.3%. These returns do not reflect reinvestment of dividends.

In General: For the quarter, 99% of the MAM portfolios that were in existence for the whole quarter had performance that equaled or exceeded that of the S & P 500. The composite return of assets in MAM portfolios was a loss of 18.6% (after MAM fees) versus a loss of 21.9% in the S & P 500 as represented by the performance of the Vanguard Index 500 fund (symbol VFINX) with dividends reinvested.

Explanation of MAM out performance: Although MAM portfolios declined significantly for the quarter, they out performed the S & P 500 due to a strong December. For the month, MAM portfolios rose 3.6% versus a rise of 1.1% in the Vanguard Index 500 fund. This performance was driven by a recovery in bond prices and a weakening in the U.S. dollar. Other than U.S. Treasuries, I feel the outlook for bonds is very favorable and long-term I expect the U.S. dollar to continue to fall.

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Stock Market & MAM Performance for 2008

Full year results for 2008 were also very poor. *Unadjusted for the reinvestment of dividends,* the S & P 500 fell 38.5%, the Nasdaq Composite dropped 40.5%, the Russell 2000 fell 34.8%, and the international equity index MSCI EAFE plunged 45.1%. For all of 2008, 91% of MAM portfolios that were in existence for the whole year had performance that equaled or exceeded that of the S & P 500. The composite return of assets in MAM portfolios was a loss of 34.7% (after MAM fees) versus a drop of 37.0% in the Vanguard Index 500 (symbol VFINX) with reinvested dividends. MAM portfolios have now outperformed the S & P 500 for seven of the nine full years that MAM has been in existence.

Oldest Portfolio: The MAM portfolio with the longest track record is a moderately aggressive portfolio that was fully invested on September 13, 1999. As of December 31, 2008, the original $50,000 had risen to $61,057, plus $1,193 of cumulative withdrawals. This represents a cumulative return of 24.5%. During the same time, the S & P 500 (as represented by the Vanguard Index 500) fell 24.1%. For the quarter ended December 31, 2008, the portfolio fell 18.9%, while for all of 2008 it fell 35.2%. All returns quoted for this portfolio (and for all MAM portfolios) are net of MAM fees. Also, past performance is not necessarily an indicator of future performance.

Stock Market Outlook for 2009

What is my outlook for 2009? Clearly investors are nervous after 2008's dismal performance. This can be seen by the large outflows from equity mutual funds during the fourth quarter of 2008 and the huge amount of cash sitting in CDs, money market funds and Treasuries. Investors have become so skittish that the demand for U.S. Treasuries has driven their yield down close to 0%. What follows is a discussion of factors that will likely affect the 2009 performance of the stock market.

U.S. Economy in a Deep Recession: It took seven economists 11 months to decide what should seem obvious given all the foreclosures, bank failures and layoffs—the United States is officially mired in a recession. On December 1st the National Bureau of Economic Research declared that the U.S. economy has been in a recession since December of 2007. The condition of the economy is expected to deteriorate over the next three to six months. Unemployment will continue to climb, and may reach 8% or 9%. Historically, unemployment peaks late in a recession. Currently, many economists predict that modest economic growth will resume by summer of 2009.

Monetary and Fiscal Stimulus: Although Fed Chairman Ben Bernanke initially underestimated the fast-moving credit crisis, he has now taken aggressive action. As a student of the Great Depression, Bernanke does not want to go down in history as the Fed chairman who allowed the U.S. to slip into the worst slump since the 1930s. Investors should not underestimate the impact of the massive monetary and fiscal stimulus that the federal government has applied to the economy. The Federal Reserve has cut short-term interest rates from 5.25% to a range of zero to 0.25%. The monetary supply has soared. And most significantly, the government has made an unambiguous commitment to doing whatever it takes to shore up the financial system, including buying troubled derivatives and other securities and limiting home foreclosures. President-elect Barack Obama's new economic team is impressive, and I look for him to "hit the ground running" with a new stimulus package of up to $1 billion targeting middle-class tax cuts and massive spending on infrastructure and alternative energy.

Also encouraging are the steps the rest of the world is taking to fortify the global financial system and global economy. For example, the United Kingdom is buying the preferred shares of its banks to bolster their capital, China is launching an economic-stimulus package nearly as big as our own, and many countries have slashed their interest rates. Such coordinated, synchronized effort among the world's governments and central banks is like nothing we've ever seen before.

My feeling is that the U.S. economy will stabilize as 2009 progresses. Historically, the recovery in the stock market precedes the recovery in the economy by three to six months.

Impact of Housing: I feel that an important key to the economic recovery is housing. The credit crisis was triggered by the bursting of the real estate bubble. Nationally prices doubled between 2000 and mid-2006. As reported on December 31st, the Standard & Poor's/Case-Shiller home-price index has now fallen 23.4% from its mid-2006 peak, pushing prices back down to March 2004 levels. Housing experts predict that real estate prices may fall another 8% to 10% before hitting bottom. The latest action by the Fed is to make housing purchases more affordable via lower mortgage rates. There is already evidence of progress. Since the Fed said in late November that it would be buying up mortgage-back securities, 30-year mortgage rates have fallen to 5% and refinance applications have more than tripled. Falling home prices combined with very low mortgage rates have made homes more affordable than they have been in years. Eventually a revival in home demand will shore up home prices, which will put a floor under the value of mortgage-backed securities. As the value of the bank assets firms up, lending and the economy can begin growing again.

Short-term Caution: While I am cautiously optimistic that stocks will rebound in 2009, I am uncertain as to when the recovery will start and I have concerns that stocks could struggle in the early part of the year. MAM portfolios are currently positioned with a 25% to 50% weighting in bonds. I plan to maintain this downside protection until I am confident that the stock market has started a sustainable recovery. The market-timing service Lowry's internal analysis of the market shows that the rally since the market low on November 20th can be attributed to a reduction in selling pressure (investors have been less inclined to sell) rather than a strong rise in buying power (investors demand for buying equities). According to Lowry's, the combined pattern of weak Supply and timid Demand is more typical of bear market rallies than new bull markets.

2009 Cautious Optimism: While I am concerned the market could fall further over the next few months, I do expect a recovery at some point in 2009. The December 1st announcement that the U.S. economy has been in a recession since December of 2007 is actually good news. Stocks typically start to rally about mid-way through a recession. Per an article written by Liz Ann Sonders, Chief Investment Strategist, Charles Schwab & Co, excluding the current one, the U.S. has endured 10 recessions since the end of World War II. During these recessions, the market typically peaked about seven months before the recession began, but bottomed quite decisively by about six months into (or 60% of the way through) the recession.

Another article, this one from Jennison Dryden, shows that since 1953, there have been 9 recessions (excluding the current one) lasting an average of 10 months. The average stock market loss from six months before the start of the recession to the recession low was 21%. On average, stocks hit bottom right about at the halfway point of the recession. The good news is that history has shown some of the deepest bear market bottoms and/or greatest buying opportunities have come during the depths of recessions. For the last nine recessions, the average return from the recession low to six months after the recession end was 36%.

There is no doubt that we are not in a typical recession. The length and depth of this recession will be greater than any we have had for decades. The aggressive fiscal and monetary policy response by the Feds, though, is unprecedented. At some point, the stock market should experience a sharp, sustainable recovery as it anticipates the recovery in the economy.

Miscellaneous

Mortgage Rates: One of the latest actions of the Federal Reserve is to buy up to $600 billion of mortgage-back securities by June of 2009. Since the late November announcement of the plan, 30-year fixed-rate mortgage rates have fallen from above 6% to right around 5%. With the Fed set to absorb most of the expected net supply of newly generated mortgage-back securities in 2009, some analysts feel that rates could fall to as low as 4.5%. I think that the next few months should provide a great opportunity to lock in a fixed rate loan.

It pays to shop around as rates can vary significantly between lenders. Per Wells Fargo's Web site (www.wellsfargo.com/mortgage/rates), as of January 5th their rate for a 30-year fixed rate conforming loan was 5.50% (APR of 5.719%) and 5.125% (APR of 5.494%) for a 15-year conforming loan. These rates are for loans with closing costs and are for loan amounts of up to $625,500 for homes located in eligible high-cost areas.

I have been a long-time fan of "no-cost" refinances. With these loans, the lender absorbs all of the costs of the refinance. The beauty of a "no-cost" loan is that if rates fall moderately further, it makes sense to do another refinance. For years Fremont Bank has been a major provider of "no-cost" loans. Amazingly, Fremont Bank's rates are lower than Wells Fargo currently, even though the borrower incurs no closing costs with the Fremont loans. Per their Web site (www.fremontbank.com), as of January 5th their "no-cost" rate for a 30-year fixed rate conforming loan was 5.375% (APR of 5.375%) and 4.875% (APR of 4.875%) for a 15-year fixed. The Web site shows that the maximum loan amount is $417,000. I called Fremont to find out if they could offer this competitive rate on larger loans. I was told that they may be increasing the maximum loan amount later in January.

The one caveat that I have regarding refinancing your mortgage is that I highly recommend that you pay off the new loan at least as quickly as you were paying off the old loan. In other words, if you are now five years into a 30-year loan, I suggest paying off the new loan in no longer than 25 years. If instead you pay off the new loan over 30 years, you are really worse off doing the refinance because, in this example, you will have to make mortgage payments for an additional five years. Please call or email if you would like to discuss your mortgage situation.

Minimum IRA Distributions Suspended for 2009: On December 11th, Congress approved the Worker, Retiree and Employer Recovery Act of 2008, which, among other things, eliminates required minimum distributions for 2009. This one-year suspension can benefit IRA holders over age 70 ½ and inherited IRAs holders of any age. Later this month I will contact clients who received minimum distributions in 2008 to see if they want to receive IRA distributions for 2009.

Madoff Scandal: On December 11th, Bernard Madoff, who had been a force on Wall Street for decades, was arrested and charged with running a $50 billion "Ponzi scheme", perhaps the biggest scam in Wall Street history. Investigators charged the one-time Nasdaq chairman with operating a classic Ponzi scheme, paying off early investors with funds from subsequent clients to keep the illusion of profit alive. Since its founding in 1960, Madoff Securities won wealthy clients—among them hedge funds, charities, and the rich and famous—by delivering steady profits through bull and bear markets. In early December, the truth emerged as investors, spooked by the battered economy, decided to pull out their money out of his hedge fund.

I have avoided utilizing hedge funds for MAM-managed accounts due to my concerns of lack of regulation and lack of transparency. Madoff's hedge fund is the best example of my concern. Madoff was very secretive about how he invested the funds and how he managed to earn consistent, attractive returns year after year. Mutual funds may benefit from the scandal at the expense of hedge funds. Most mutual funds have diversified portfolios of widely traded securities, and fund assets are held by independent custodians. Investment advisory firms like MAM, Inc. provide the additional protection that the mutual fund portfolios are held in Charles Schwab accounts, versus the Madoff hedge fund where clients were not able to review and verify their holdings. Finally, once again, this massive Ponzi scheme proves the rule, "if it sounds too good to be true, it probably is".

Other

ADV Part II: 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 12-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 a copy.

Assets Under Management and Referrals

As of December 31, 2008, MAM assets under management were approximately $70 million down from $100 million at the start of the year. I really appreciate the referrals that some of you have made, as that is my primary source of new clients. While my minimum amount to manage for new clients is $300,000, I am willing to be flexible depending on the individual's situation.

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

Very truly yours,

Stephen P. McCarthy, CPA, CFP