McCarthy Asset Management, Inc.

Registered Investment Advisor

September 1, 2006

Monthly Investment Commentary- August 2006

Stock Market Performance for August: The stock market performed well for August. Unadjusted for dividends, the S & P 500 rose 2.1%, the Nasdaq jumped 4.5%, and the Russell 2000 rose 2.9%. Foreign stocks, bonds, and REITs rose, while commodities fell.

MAM Performance: For the month, MAM portfolios underperformed the S & P 500, with a composite return of 1.9% (after all fees), versus a rise of 2.4% for the Vanguard Index 500 fund (symbol VFINX), with dividends reinvested.

The five best performing MAM investments for August were Allied Capital (up 8.7%), Artisan Small Cap Value (up 4.1%), Artisan International Small Cap (up 3.4%), Cohen & Steers REIT (up 3.4%), and Oakmark International Small Cap (up 3.0%).

The five worst performing MAM investments for August were PIMCO Commodity (down 1.7%), Hussman Strategic Growth (down 0.1%), PIMCO Developing Local (up 0.6%), Selected American (up 0.6%), and Bjurman Micro Cap (up 0.9%).

Year-To-Date Performance: For the first eight months of 2006, unadjusted for dividends, the S & P 500 rose 4.5%, the Nasdaq fell 1.0%, and the Russell 2000 rose 7.1%. MAM portfolios underperformed the S & P 500 for these eight months, with a composite return of 5.6% (after all fees), versus a rise of 5.7% for the Vanguard Index 500 fund (symbol VFINX), with dividends reinvested.

Oil Prices and Real Estate: As you know, oil prices have risen sharply during the last couple of years. It seems logical that with the rising demand from China and India, oil prices will only continue to climb. Many people seem to agree with this. In fact a few clients have asked why I don't invest in an energy sector mutual fund. My response has been that I would rather have my favorite mutual fund managers decide how much to invest in the energy sector rather than pick a fund that by definition must invest in 100% in energy stocks. I will never forget what happened to the technology mutual funds (which had to invest in technology stocks) in the tech-wreck days of 2000 through 2002.

A natural tendency of investors is to extrapolate the recent past into the future. Could this be happening with oil prices? Last week I listened to an Alliance Bernstein conference call on the long-term impact of hybrid car technology. The speaker said that the next generation of hybrids, called plug-in hybrids, will allow for batteries to be recharged by plugging into an electric outlet at home, promising much greater fuel efficiency than today's hybrid. As a result of technology innovations such as this, along with oil sands production and ethanol, which will result in the development of new energy supplies, Alliance Bernstein predicts that the worldwide demand for oil in thirty years will be no greater than it is today.

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While I do not know the future direction of oil prices, if technology innovation does help reduce energy demand and increase energy supply, the impact on investments could be significant. Rising oil prices act like a "tax" on consumers and businesses, reducing economic growth. A drop in oil prices should provide a boost to the economy.

Nationally, real estate prices have had a tremendous run for the last seven years (and in California the price rises have been even more dramatic). Combined with the 2000 to 2002 bear market in the stock market, some investors fled the stock market for the "safety" of real estate. While I have always been a proponent of complementing a diversified stock portfolio with rental real estate, I don't think that real estate prices are immune to a fall (remember 1990?). While I don't know if real estate prices will fall over the next year or two, it is clear that nationally there has been a sharp slow down in demand, accompanied with a sharp rise in the number of homes for sale. Again, extrapolating the recent past (the seven-year bull market in real estate) can be a mistake.

Long-Term Economic Outlook: Typically in these Monthly Commentaries I comment on the recent performance of the economy and the outlook for the next year. With this month's Commentary, I am taking a different approach and discussing one publication's economic outlook for the next several years. These comments are taken from the August 25, 2006 issue of Value Line Investment Survey, which is an excellent publication for researching individual stocks:

"…Assuming that the current softness in housing does not mushroom into a full-blown downturn, economic growth should hold in the area of 2.5% to 3.0% over the next 12 to 18 months. We then expect a moderate pickup in activity to evolve during 2008, and for that uptrend to continue through the final years of the decade. This benign scenario does not build in a recession forecast, although we would not preclude such a setback for the economy at some point during our extended projection period. However, the most probably outcome, in our view, is that we will enjoy a durable business expansion—modeled after those in place during the 1980s and the 1990s—over the next few years."

Value Line states that their economic growth projections for 2006 and 2007 assumes oil averages $70 to $80 a barrel, that the Federal Reserve maintains short-term rates at present levels through the end of this year and then gradually reduces them in 2007. "GDP growth of 3%, or slightly better, is our forecast for 2008, with a step-up in growth, into the 3.5% range, by 2009 to 2011".

As for corporate earnings, "We think earnings will continue to move higher over the next several quarters, although the moderating pace of GDP growth is likely to limit the range of prospective profit gains to 10% to 12% in the current half. A reduced rate of profit growth is likely in 2007. Earnings will probably begin to accelerate as we proceed through the final years of this decade, with income gains possibly nearing the 10% level. Earnings are likely to remain generally supportive for the stock market over this time frame."

If Value Line's projections prove to be close to the mark, the implications for the stock market should be positive. With annual earnings growth of close to 10%, stock prices could support 10% annual returns. While this is in line with the long-term annual returns from stock market, I still remain cautious in feeling that we are in a low return environment (with annual average gains of 5% to 7%). In part, I would like to have clients reduce their expectations and then be pleasantly surprised with the actual results.

Billy Nygren Article: Attached is a PDF of the August 7, 2006 Wall Street Journal article written about Bill Nygren, manager of Oakmark Fund and Oakmark Select. I have used either Oakmark Select or Oakmark Fund as a significant position in portfolios since the inception of MAM 7 years ago. Why am I including the article? I feel that, as an astute and experienced investor, Bill's comments will be of interest. Although his two funds have underperformed the market for the last few years, I believe in his approach to buying "fallen" growth companies. Although time will tell, I am still confident that investing with Bill Nygren will be a winning strategy.

Nygren launched Oakmark Select in 1996 and took over management of Oakmark Fund in 2000. Through year 2002 his performance has been outstanding. For instance, Oakmark Fund beat the S & P 500 by 20.9% for 2000, 30.2% for 2001, and 7.7% for 2002, while Oakmark Select beat the S & P 500 by 18.9% for 2000, 38.0% for 2001, and 9.6% for 2002.

During the last 3 years, however, the performance of the two funds has been very poor relative to the S & P 500. About three years ago Nygren starting selling some of the value stocks that held up so well during the market downturn, and starting buying the battered shares of the "growth" companies that had fallen hard. As he likes to say, he has been buying "above-average businesses selling at average prices". Has Bill lost his touch? I don't think so, although I will closely monitor the two funds and look for improved performance.

As Bill stated in the article, "there's a fine line between being early and being wrong. There are lots of investors who don't have the patience to see our strategy be out of favor for multiple years. I see a lot of similarity to the situation we were in during the late 1990s…By March 2000, when our strategy started working we had a lot fewer investors." Based on the performance of his two funds during the 2000 through 2002 timeframe, those investors were sorry they decided to sell.

Schwab Discount: This past month I was successful in negotiating with Schwab Institutional a discounted commission schedule for MAM clients for the purchase of mutual funds that are subject to a transaction fee. The fee is now $25 for the purchase or sale of up to $12,500 for a mutual fund that is not on Schwab's non-transaction fee platform. For larger transactions, the fee increases from $25 and then is maxed out at $50 (for transactions greater than $25,000). As a result of this discount, I will be more inclined to use transaction fee funds which have lower annual operating expenses than "no-fee" funds. In many cases the transaction fee will be more than offset by the lower operating expenses within 12 months. The success in getting Schwab to offer the discounted fee schedule for MAM clients is due in part to the growth in the average size of my clients' portfolios.

Please call or email me if you have any questions or would like to discuss your portfolio(s).

Sincerely,

Stephen P. McCarthy, CPA, CFP