McCarthy Asset Management, Inc.

Registered Investment Advisor

February 1, 2006

Monthly Investment Commentary- January 2006

Stock Market Performance for January: The stock market got off to a strong start for the new year—unadjusted for dividends, the S & P 500 rose 2.6%, the Nasdaq climbed 4.6%, and the Russell 2000 soared 8.9%. Foreign stocks, REITs, and commodities rose, while bonds were relatively flat.

MAM Performance: For the month, MAM portfolios out performed the S & P 500, with a composite return of 3.8% (after all fees), versus a rise of 2.7% for the Vanguard Index 500 fund (symbol VFINX) with dividends reinvested.

The five best performing mutual funds used by MAM were Bjurman Micro Cap (rise of 11.2%), Artisan International Small Cap (9.4%), William Blair Small Cap (8.0%), Artisan Small Cap Value (7.6%), Cohen & Steers REIT (6.7%).

The five worst performing mutual funds used by MAM were Nuveen High Yield Muni (drop of 0.1%), PIMCO Total Return (up 0.1%), Hussman Strategic Growth (up 1.0%), Oakmark Fund (up 1.0%), and PIMCO Commodity (up 1.6%).

Economy Slowed in 4th Quarter: On January 27th the Commerce Department released its Gross Domestic Product (GDP) report, showing that the U.S. economy grew at only a 1.1% annual rate in the fourth quarter of 2005. This marked a considerable loss of momentum from the third quarter's brisk 4.1% growth, and was the slowest pace in three years. Analysts had been projecting a fourth quarter GDP of 2.8% growth.

The major reason for the disappointing GDP performance was that consumer spending rose by just 1.1% in the fourth quarter, the slowest since the second quarter of 2001. Some economists believe the fourth-quarter GDP data will be revised higher once the government has more complete trade data. In addition, some economists feel that the slowdown in the final quarter was more of a temporary setback rather than an indication of a sustained period of economic weakness ahead.

Even with the slow growth in the fourth quarter, the economy registered respectable overall growth of 3.5% for all of 2005—a year when business expansion was undermined by devastating Gulf Coast hurricanes and consumers were hurt by rising interest rates and energy costs.

Short-term Interest Rates Continue to Rise: On January 31st the Federal Reserve raised interest rates for the fourteenth time since June of 2004. The Fed announced that it was raising its target for the federal funds rate, the interest that banks charge each other, by a quarter-point to 4.5%. Analysts believe that the Fed will raise rates one or two more times before ending its campaign to keep inflation in check.

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Corporate Earnings: The initial corporate earnings reports for the fourth quarter have been good. As of January 29th, half of the S & P 500 companies have reported results. It looks as though fourth-quarter earnings are on track to come in somewhere between 13% and 14% ahead of the fourth quarter of 2004. This would be the 10th consecutive quarter of double-digit percentage gains, the longest such run in over 30 years. Analysts do expect corporate earnings growth to slow in 2006.

Stock Prices: My feeling is that stocks are reasonably priced. With good performance from the economy and corporate earnings expected for 2006, along with the Fed ending its series of interest rate hikes, I am cautiously optimistic for the year. My major concerns at this point are a further increase in energy prices and/or the Federal Reserve repeating its past mistakes in going too far with its interest rate hikes (triggering a recession).

Save Early and Invest Well: You have undoubtedly heard many times of the importance of starting a systematic savings program at an early age (through your Company's 401(k) plan, an IRA, a taxable account, etc.). For years I have told my clients to try to save at least 10% of what they earn. If they start this when they are in their mid-twenties and they invest it well, they should achieve financial independence by retirement age.

The article by James K. Glassman, "From Piggy Bank to Pension", which appears in the February 2006 issue of Kiplinger's provides a good example of the powerful impact of saving at a young age. Ishmael begins at age 25 to put $2,000 a year into a diversified *tax-deferred* (i.e. IRA or 401(k)) portfolio with an annualized return of 10%. At age 35, he's contributed $20,000 into the fund. Then he stops investing entirely. But the value of Ishmael's holdings keeps rising, and by the time he is 65, he has a portfolio worth $556,000.

Now, consider Isabel. She, too, invests $2,000 a year at 10% in a tax-deferred portfolio, but she waits until age 35 to start. She keeps investing for a full 30 years—a total of $60,000 invested. At age 65, Isabel's portfolio will grow to only $329,000. *The point is, if you start later in life to save, it is very difficult to catch up.*

The second aspect to saving for retirement is "how do you invest the money you save"? I extracted the following from the 12/31/05 Performance Report for the Auxier Fund (a mutual fund which I am following): In the section titled "The Rewards of Diligent Saving and Investing" the report said "To illustrate the power of compounding and the potential rewards of sticking with a disciplined savings and investment program, it is useful to periodically revisit the Ibbotson Associates performance charts. From 1925 through December 31, 2004*:

$1 invested in treasury bills grew to $18
$1 invested in government bonds grew to $65
$1 invested in large stocks grew to $2,500
$1 invested in small stocks grew to $13,000

- Warning: The Ibbotson performance information is for illustrative purposes only and is not intended to reflect past or future performance of any asset allocation strategy or investment product. It is important to note that stocks and U.S. Government securities are two different and distinct asset classes. While all investments are subject to certain risks, stocks have a greater degree of price fluctuation risk than bonds. Therefore, from a risk/reward perspective, stocks are considered to have more risk (and greater potential reward) than bonds. Moreover, small cap stocks are subject to additional risks than is customarily associated with stocks of larger U.S. corporations."

I am not suggesting that you invest all of your savings in small stocks. That would be too risky as doing so could entail taking on greater portfolio volatility than what you are willing to accept. The lesson here is to invest your long-term savings in equities. My suggestion (and the approach taken by MAM) is that the equity exposure should be through a diversified portfolio that is suitable to your risk tolerance.

2005 Tax Reporting: For those of you who are tax clients, I want to remind you there is no need to fill out anything in the Tax Organizer related to your taxable Schwab account(s) managed by MAM. Schwab is sending us a copy of your Form 1099(s). In addition, for your mutual fund sales we have produced a gain/loss report that we will attach to your tax return.

For those of you who are not tax clients, in mid-January we mailed you the 2005 Realized Gains and Losses Report, along with instructions explaining how to reference and attach the report to your tax return. Be sure and provide this to your tax preparer, as having this information really simplifies preparation of your return.

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

Sincerely,

Stephen P. McCarthy, CPA, CFP