McCarthy Asset Management, Inc.

Registered Investment Advisor

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Monthly Investment Commentary- July 2007

Stock Market Performance for July: The stock market experienced a difficult month for July. Unadjusted for dividends, the S & P 500 fell 3.2%, the NASDAQ dropped 2.2%, while the Russell 2000 dropped 7.0%. Foreign equities and REITs also fell, while commodities rose and bonds were mixed.

MAM Performance for July: For the month, MAM portfolios out performed the S & P 500, with a composite loss of 2.7% (after all fees), versus a loss of 3.1% for the Vanguard Index 500 fund (symbol VFINX) with dividends reinvested.

The five best performing MAM investments for July were PIMCO Commodity (up 3.5%), Artisan International Small Cap (up 3.1%), PIMCO Developing Local (bonds) (up 0.8%), Loomis Sayles Bond (down 0.6%), and YieldQuest Total Return (bonds) (down 1.1%).

The five worst performing MAM investments were Allied Capital Corp (down 8.5%), Artisan Small Cap Value (down 7.0%), Oakmark Select (down 6.8%), Cambiar Opportunity (down 5.4%), and iShares Select Dow Jones Dividend (down 5.1%).

The 0.4% out performance of MAM portfolios relative to the S & P 500 was due to the downside protection provided by the bond exposure. For the year-to-date, the bond exposure has hurt performance as bonds have still underperformed stocks.

Year-To-Date Performance: For the first seven months of 2007, unadjusted for dividends, the S & P 500 rose 2.6%, the Nasdaq climbed 5.4%, and the Russell 2000 dropped 1.5%. MAM portfolios under performed the S & P 500 for these seven months, with a composite return of 2.8% (after all fees), versus a gain of 3.6% for the Vanguard Index 500 fund (symbol VFINX) with dividends reinvested.

As indicated by the year-to-date loss in the Russell 2000, after an eight-year run, small cap stocks are underperforming large cap stocks. During the portfolio repositioning of the last two years, small cap exposure has been significantly reduced. Since the S & P 500 is an index of large-cap stocks, however, MAM portfolios still have a larger weighting in small caps compared to the S & P 500. I expect that this will always be the case as I don't expect to completely exit this significant asset class. If large caps continue to outperform, this may continue to be a drag on portfolio performance when compared to the S & P 500.

Performance of Economy: On July 27th the Commerce Department released its initial estimate of Gross Domestic Product (GDP) growth for the second quarter of 2007. GDP, the broadest measure of U.S. economic growth, rose at an annualized rate of 3.4% in the second quarter compared with an expected increase of 3.2%. The rise in second-quarter GDP reversed the anemic 0.6% growth in the first quarter. Increases in exports, government spending, commercial construction, and business inventories accounted for the improvement. Hurting GDP growth was the slowdown in the housing sector and sluggish consumer spending.

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The outlook for the economy has recently dimmed. The latest reading for spending on plant and equipment, which grew at a tepid 2.3% pace in the quarter, was disappointing. Rising inventories of unsold homes, falling prices and tighter lending terms on subprime loans for marginal borrowers offer little hope that housing is stabilizing. The impact on American's wealth from the recent downturn in the stock market could also hurt consumer spending.

A silver lining is that the Federal Reserve may decide to cut interest rates. The interest rate futures market, which speculates on Fed interest rate changes, now indicates that it is likely the Fed will cut interest rates before the end of this year.

Is the Bull Market Over? Since peaking on July 13th, the S & P 500 has fallen 6.3%. Small stocks have fared even worse, as indicated by the 9.4% drop in the Russell 2000 during this same time. This is the sharpest market correction in several years. What is going on? The current sell-off can be attributed to tightening credit conditions as a spill over from the devastation of the subprime lending market.

A correction was probably long overdue. As I wrote in the June 30, 2007 quarterly report, "Given its strong performance during the past quarter, the consistent rise for the last five years and the recent increase in volatility, I would not be surprised to see a short-term drop in the stock market. Such a correction could be healthy as bull markets typically experience one or more 10% corrections."

I don't try to time these market dips. I continued to write "I think it is foolish for investors to try to time these short-term market movements, and studies show that most investors fail miserably in such efforts." While I don't try to time the stock market, I try to be proactive when I feel the market environment has changed. For instance, I reduced technology stock exposure in the summer of 2000 when it became clear to me that technology stocks were vulnerable to further weakness. The shift from small cap stocks to large cap stocks and the near complete elimination of REITs from portfolios are examples of more recent portfolio changes.

While I don't try to time the stock market, I do practice what I call "modified market timing". If I feel that the stock market is likely to fall much further, I would take steps to protect on the downside. This could entail further reduction in small cap exposure, along with an increase in large cap, bonds or balanced funds. The very difficult part of this is to know whether the current downturn is a "healthy" market correction, or the start of a bear market.

There are two schools of thought in trying to determine the future direction of stock prices. One is called fundamental analysis, and the other is technical analysis. While by nature I am much more comfortable with (and confident of) fundamental analysis, I do pay attention to technical analysis as well.

Technical Analysis: Technical analysts (also called "chartists") rely on statistical measures to predict the movement of stock prices. They feel that past movements in prices and trading volumes can be used to detect current and future trends. Most technical analysis is short or intermediate-term and is based on the tenet that history tends to repeat itself.

To a technical analyst, a typical market top looks like a roof, with indexes bumping up against it until they sag. Indexes hit a series of new highs, but over time fewer and fewer stocks join in. Big multinational companies gradually take over leadership from the smaller, more-volatile stocks that typically lead a bull market's early stages. The stock market looked a lot like this before its peaks in 1987 and 2000. Today, it has some, but not all, of these characteristics.

My favorite technical analysis service is Lowry's, which has been publishing stock market analysis reports since 1938. The primary Lowry's report comes out each Friday. Until the most recent two reports, Lowry's has been fairly consistent in saying that based on the lack of early warnings signs that typically appear near a market peak, the probabilities favored at least 4 to 6

months of further gains before the final market top. The last two reports have been less clear as to their outlook. In the most recent report (July 27th), they indicated the further weakness in the current downtown is likely.

Fundamental Analysis: Fundamental analysis focuses on fundamentals such as economic growth, corporate profits and interest rates. I generally address each of these in my Monthly Commentary. In my view, based on fundamental analysis, the current correction is a normal, healthy adjustment. The U.S. economy continues to grow, the global economy continues to surge, and interest rates remain low by historical standards. The risk is that the credit crunch caused by the carnage in the subprime lending sector and the sharp slowdown in residential housing will spread to other sectors. One or more Fed interest rate cuts, though, could mitigate that risk.

I pay a lot of attention to how expensive the stock market is relative to corporate earnings. This is reflected in the price earnings ratio. In the dot com bubble of 2000, the price-earnings ratio for the S & P 500 was over 30. Based on an August 1st analysis issue by Howard Silverblatt, an analyst with Standard & Poors, the price earnings ratio on the Standard & Poors 500 is close to or below historical levels. In fact, the ratio has continued to fall during the bull market since 2003 because corporate earnings growth has outpaced the increase in stock prices. Per Mr. Silverblatt's report, here is what has happened to the price earnings ratio based on the S & P 500 operating earnings;

2003 P/E	2004 P/E	2005 P/E	2006 P/E	2007 P/E	2008 P/E
20.33	17.93	16.33	16.17	15.39	13.71

The 2007 and 2008 figures are based on analysts' estimate of S & P earnings. These estimates are subject to change, of course. So far for the second quarter of 2007, earnings have been coming in ahead of expectations. With 73% of the S & P 500 companies having reported, the 5.2% original estimate of the increase from the prior year now is projected to be an 8.2% gain.

These price-earnings ratios suggest that the stock market is becoming cheap. As long as the economy and corporate earnings continue to grow, my belief is that the current correction is not the start of a bear market.

What Is An Investor To Do?: My advice has remained consistent: invest based on your risk tolerance, stay diversified, and maintain a long-term outlook. Deviating from any of these three principles could lead to inferior investment results. In particular, as long as your portfolio is invested consistent with your risk tolerance, you should be able to weather any market downturn to enjoy the superior long-run returns provided by the stock market.

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

Sincerely,

Stephen P. McCarthy, CPA, CFP