McCarthy Asset Management, Inc.

Registered Investment Advisor

Wednesday, July 6, 2005

Dear Client,

Will the stock market's 2005 performance be a repeat of 2004? So far, it is looking that way. In the first quarter for both years, the market stumbled. There was then a modest recovery in the 2nd quarter. If the 2004 pattern is to continue, the market will decline modestly in the 3rd quarter and then post strong results in the fourth quarter. Of course, the stock market is unpredictable. In the past couple quarterly reports I have stated my belief that the market will produce modestly positive results for 2005. As the economy performs well and corporate profits exceed expectations, I continue to feel this way. Stay tuned for future quarterly reports to see if 2005 will provide positive market returns for the third consecutive year.

With this MAM report for the quarter ending June 30, 2005, I discuss the performance of the market and MAM portfolios for the quarter and first six months of 2005. In addition, I provide an update on interest rates and the economy, and provide my outlook for the stock market for the remainder of the year. I also comment on projects we are working on this year. Finally, I discuss concerns I have regarding current mortgage financing and the possible implications for the real estate market.

Enclosed are four 6/30/05 investment reports:

- *Portfolio Position Analysis*: lists your investments and how each have performed
- *Portfolio Performance Summary*: 2nd quarter and year-to-date 2005 portfolio rate of return
- *Performance Analysis*: portfolio rate of return by year since inception. *This is the first time I have provided this report. I welcome your feedback.*
- *Realized Gains and Losses*: year-to-date 2005 investment gains and losses realized (included only for taxable accounts)

Stock Market Performance

The stock market staged a modest recovery in the second quarter of 2005. The S & P 500 rose 0.8% to 1191, the Nasdaq Composite climbed 2.9% to 2057, and the Russell 2000 jumped 4.1% to 640. These returns do not reflect reinvestment of dividends. For the first six months of 2005, also unadjusted for dividends, the S & P 500 fell 1.7%, the Nasdaq Composite dropped 5.4%, and the Russell 2000 fell 1.8%.

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Interest Rates and Performance of the U.S. Economy

As expected, on June 30th, the Federal Reserve raised the federal funds rate by 0.25% to 3.25%. This increase was the ninth, and came exactly one year after the Fed began to lift rates from an extraordinary low level of 1.0%. But in that time, long-term interest rates, which are determined by market forces and are the benchmark for mortgages and corporate loans, have actually declined from 6.3% one year ago to 5.6% recently.

The decline in long-term rates has fueled a debate over whether the Fed is going too far or hasn't gone far enough. Some say the Fed should pause in its rate increases because the decline in long-term rates foreshadows slower economic growth. Others say short-term rates should keep rising because low long-term rates have given an extra boost to the economy—particularly housing.

For now, the Fed is in the latter camp. In the statement accompanying its June 30th decision, the Fed said, "Although energy prices have risen further, the expansion remains firm." That's a more upbeat assessment than the statement after its May 3rd meeting, which observed that growth had "slowed somewhat". The implication for the stock market of the future course of the Fed is important. If they continue to raise rates, the economy could slow and the stock market could stumble. On the other hand, the Fed ending its rate increases could provide a boost for the market.

Meanwhile most recent economic reports indicate that the economy is continuing to perform well. On June 29th, the Commerce department released its second upward revision to the gross domestic product (GDP) for the first quarter of 2005. It now estimates that the GDP rose at a 3.8% annual rate of growth from January through March, up from its earlier revision to 3.5% growth. In another report, the Conference Board reported that its index of consumer confidence hit a three-year high in June, standing at 105.8, from the revised 103.1 seen in May. This report suggests that consumers grew more optimistic about the economy last month amid rising optimism about business conditions and employment.

Outlook for the Stock Market; Recent Portfolio Repositioning

Although most stock market indices are modestly down for the first six months of 2005, I remain cautiously optimistic that the market will post moderate gains for 2005. At this point, I am not overly concerned about the need to provide downside protection to portfolios. If the market were to rally sharply or if signs start to emerge that the economy is turning down, than I would take defensive steps.

In June we repositioned portfolios for clients with managed assets in excess of $150,000. You received a "letter of explanation" for changes at that time. Generally, the adjustments made were to further increase large cap exposure, and for the first time in five years, to slightly increase technology exposure.

MAM Performance for the Quarter

In General: For the quarter, 81% of the MAM portfolios out performed the S & P 500. The composite return of assets in MAM portfolios was a gain of 1.5% (after MAM fees) versus a gain of 1.3% in the S & P 500 as represented by the performance of the Vanguard Index 500 fund (symbol VFINX) with reinvested dividends.

Best Performers: The eight best performing MAM mutual funds for the quarter were Cohen & Steers REIT (a rise of 15.3%), iShares Dow Jones Select Dividend (4.5%), American Amcap (3.5%), Marsico Focus (3.0%), Bjurman Micro Cap (2.9%), Loomis Sayles Bond (2.4%), Century Small Cap Select (2.3%), and Income Fund of America (2.1%)

Worst Performers: The eight worst performing MAM mutual funds for the quarter were PIMCO Commodity (down 3.3%), Oakmark International Small Cap (-2.7%), Artisan International Small Cap (-0.4%), Oakmark Select (-0.4%), Metropolitan West (up 0.6%), Capital World Growth and Income (up 0.7%), Dodge & Cox Balanced (up 0.9%), and William Blair Small Cap (up 0.9%),

Oldest Portfolio: The MAM portfolio with the longest track record is a fairly aggressive portfolio fully invested on September 13, 1999. As of June 30, 2005, the original $50,000 had risen to $73,529, plus $1,182 of cumulative withdrawals. This represents a cumulative return of 49.4%. During the same time, the S & P 500 (as represented by the Vanguard Index 500) lost 6.4%. For the quarter ended June 30, 2005, the portfolio rose 2.3%, while for the first six months of 2005 it lost 0.3%. 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 an indicator of future performance.

MAM Performance for First 6 Months 2005

For the first six months of 2005, 92% of the MAM portfolios out performed the S & P 500. The composite return of assets in MAM portfolios was a gain of 0.4% (after MAM fees) versus a loss of 0.9% in the S & P 500 as represented by the performance of the Vanguard Index 500 fund (symbol VFINX) with reinvested dividends.

Need To Save Confirmations?

I received an email recently from a client asking whether she needed to save confirmations she received for trades we did in her MAM account. This may be a question that others of you have wondered about. The answer is no. Our portfolio management software tracks the cost basis for positions in all accounts. Shortly after year-end, we produce a gain/loss report for taxable accounts to be used for tax reporting. The report is sufficient for IRS purposes. If the IRS ever wants to see further backup (*so far they have yet to ask*), then we can provide the detail they need.

"Infrastructure" Projects

The following is a list of goals for 2005 which I call "infrastructure" projects that relate to the operations of McCarthy Asset Management:

New Email Address: Recently I converted my email address to steve@mamportfolios.com. In the future please contact me at this address. I am using Microsoft Outlook with this email address, which is much more powerful than the email capabilities I had with AOL. For client servicing, the use of Outlook is a significant improvement, since I am now able to retain the previous emails sent to and received from clients. For regulatory reasons this is also important, as the SEC has mandated that SEC registered investment advisors retain their emails for a minimum of five years.

Installation of Computer Server: Last month we added a computer server to our computer system. The benefit is increased processing power and improved backup procedures. We now have a duplicate hard disk of our computer data files.

Installation of *Junxure-i:* In August or September, we hope to install a Customer Relationship Management (CRM) package called "*Junxure-i*". This is a powerful office management and automation system created specifically to meet the needs of a financial service office to organize client information. For instance with the system installed, when a client calls, we will have the ability to have immediate access to records of previous interactions (emails, letters and phone calls). In addition, the system has the capability of storing and reporting financial information.

In addition to these "infrastructure" projects, we have some client service goals for this year:

eConfirms: Recently we added a number of additional clients to eConfirms. Schwab has added a financial incentive to sign up, via a reduction in commissions for stock and ETF trades from $19.95 to $12.95. Please contact Billy at billy@mamportfolios.com if you want to be signed up.

"Financial Planning" Newsletter: Prior to the formation of McCarthy Asset Management (MAM), I wrote and sent a 4 to 6-page newsletter to my tax clients two or three times a year.
This letter covered topics that I felt were pertinent to my clients' financial lives. I often discussed investment, tax, estate planning, education fund, insurance and other financial issues. My goal was to raise the awareness of my clients in these important financial matters.

Due to the time demands of MAM, I have issued only a couple of newsletters in the last six years. As a result of the Client Satisfaction Survey that we conducted last year, it is clear that many of you miss the newsletter.

I hope to issue a newsletter in the Fall of this year. I plan to write this in conjunction with Derek Hobbs of Evart, Young, and Hobbs. This is the investment advisory firm that I share my Redwood Shores office with. They are also the firm I talked with in 1999 as I planned the formation of McCarthy Asset Management. Since then, Derek and I have become close friends, and have professionally helped each other, as we frequently discuss mutual funds and other investment management matters.

In future newsletters, I may ask other financial advisors to write about specific issues. For instance, Colleen McAvoy, the estate planning partner of the San Mateo law firm McGlashan & Sarrail, has offered to discuss important estate planning topics.

Please email me any financial topics which you would like to see addressed in a future newsletter.

Web Site Reporting: We recently made additions to the performance reporting on the "mamportfolios.com" Web site. Under the performance tab that appears as you review your portfolio, you can now see the portfolio's rate of return for the previous month, the year-to-date, since inception, year 2004, year 2003, and year 2002. I want to remind you to contact Billy at billy@mamportfolios.com if you are interested in training in the use of the Web site.

Real Estate Bubble?

Where's a better place to put your money: the stock market or real estate? These days, most people would probably say real estate. But is the accepted wisdom right? In recent years, yes! The Office

of Federal Housing Enterprise Oversight, part of the U.S. Dept. of Housing and Urban Development, reported that between the beginning of 1999 to the end of 2004, U.S. real estate prices increased more than 56%. The S & P 500 dipped nearly 6% during the same period. As most of you know, the returns for California real estate have been even more dramatic. From the beginning of 2000 through the end of 2004, California real estate values increased 102%.

Interestingly, if you take a longer view you can find periods where the S & P 500 has dramatically outperformed the national real estate market. For instance, per an April 7, 2005 article from Forbes.com, nationally from the start of 1980 to the end of 2004, home prices increased 247%. Not bad. Over the same period, however, the S & P 500 shot up more than 1000%! Of course, this was a particularly strong period for the stock market.

That is not to say that either stocks or real estate are a better investment. My concern now is that investors have become too enamored with real estate. Property values, particularly in areas like the Bay Area, have become very inflated relative to average income levels and rents. *This has been compounded by the availability of "creative financing"*. In a May 20, 2005 article in the San Francisco Chronicle, the author writes that "two out of three Bay Area home buyers are choosing interest-only loans, and some experts warn that the popularity of the controversial form of mortgage debt is a sign that the overheated housing market is boiling over."

The article continued, "these loans, which allow borrowers to avoid paying any principal for three years or more, have grown explosively in recent years to become the favored mortgage for buyers in the region, replacing the standby 30-year mortgage preferred a generation ago. They accounted for 70 percent of home purchases in the first two months of the year in San Francisco, Marin and San Mateo counties, up from 18 percent in 2002, and 59 percent in 2004".

"But housing experts warn that these loans are loaded with risk. Borrowers who put down small or no down payments and do not elect to pay principal rely almost exclusively on price appreciation to build equity. If home prices flatten or fall, borrowers could end up owing more than the home is worth." In addition, once principal payments become due, the amount of the loan payment rises dramatically.

"This is frightening, frankly" said U.C. Berkeley economist and real estate expert Ken Rosen (*my favorite professor when I obtained an MBA at U.C. Berkeley*). "I'm worried that more and more people are using (homes) as an investment vehicle and not as a consumption market, and that's true of the peak of housing markets. This is the edgiest we've been in the market for a long time. This reminds me of the late 1980s when people were speculating in the market."

I remember that in the 1990 to 1992 downturn, Bay Area real estate prices dropped 15% to 20%, and home foreclosures rose dramatically. I am not predicting that it will occur again. With the prevalent "creative financing" of many recent buyers, however, I can envision a scenario where a dip in real estate prices could deepen as some owners are forced to sell.

Don't get me wrong, I like real estate. For many people, the best investment they ever made was their home. I feel, though, that paying principal on the mortgage is an important way to build equity. Furthermore, I encourage my clients to try to pay their mortgage off by the time they retire. My concern is that in certain parts of the country (i.e. the Bay Area), prices have gotten frothy and

buyers are stretching beyond their means to make a purchase that will only make economic sense if prices continue to rise.

I also like rental real estate, and have been an investor for almost 20 years. With rental real estate, my philosophy is that the rents should at least cover all of the expenses. This way, the renters will help you build equity as you pay down your mortgage. Any appreciation is gravy.

My final point is, just because real estate has done so well for the last 5 years, don't expect it to consistently continue rising. I don't know of any investment that does that.

Assets Under Management

I appreciate the confidence that clients continue to show in adding to the assets that MAM manages. Existing and new clients added over $4 million in net assets during the first six months of 2005, bringing the MAM assets under management up to over $70 million as of June 30, 2005, versus $65 million at the start of the year.

I continue to welcome your referrals. As mentioned in the last quarterly report, effective April 1, 2005, I have raised the minimum to become a new client to $350,000. This increase does not impact existing clients who have less than $350,000 invested.

Your Performance

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

Very truly yours,

Stephen P. McCarthy, CPA

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