McCarthy Asset Management
Registered Investment Advisor
Certified Public Accountant
Certified Financial Planner

Wednesday, October 6, 2004

Dear Client,

The stock market declined for the quarter, remaining flat for the first nine months of 2004. Bonds and REITs, however, performed well as the economy slowed. The drop in the stock market represents the first quarterly decline since the first quarter of 2003.

With this report, I provide performance figures for the market and MAM portfolios for the September quarter as well as the first nine months of 2004. In addition, I include an update on the economy, discuss the bond market, and provide my outlook for the stock market. I also comment on the next portfolio repositioning, discuss a reduction in commission rates that Schwab is providing to MAM, announce the upcoming office move to Redwood Shores, and comment on a few other items.

Enclosed are four September 30, 2004 investment reports:

- *Portfolio Position Analysis*: lists your investments and how each have performed
- *Portfolio Performance Summary*: Third quarter and YTD 2004 portfolio rates of return
- *Portfolio Performance History*: portfolio rate of return since inception
- *Realized Gains and Losses*: Year-to-date 2004 investment gains and losses realized (included only for taxable accounts).

Stock Market Performance

For the third quarter of 2004, the S & P 500 fell 2.3% to 1115, the Nasdaq Composite dropped 7.4% to 1897, and the Russell 2000 fell 3.2% to 573. For the first nine months of 2004, the S & P 500 rose 0.3%, the Nasdaq Composite dropped 5.3%, and bucking the trend, Russell 2000 rose 2.9%. These returns do not reflect reinvestment of dividends.

U.S. Economy

Last spring, the recovery was looking shaky. Growth in the economy was slowing as consumers struggled with high gas prices and many businesses put their hiring plans on hold. Inflation was picking up, potentially putting the Federal Reserve in the difficult position of having to raise rates in a slowing economy.

1900 O'Farrell St, Suite 330, San Mateo, CA 94403, (650) 638-0667 Fax (650) 638-0222;
email: SteveMtax@aol.com Web site: mamportfolios.com

Despite the decline in stock prices, the economic outlook improved in the third quarter. Much of the data suggests that consumer demand, industrial output, job gains, and overall economic growth rebounded from their second-quarter dips. The data also shows that inflation cooled, a turnaround which is presently supporting stronger household buying power.

In fact, it now appears the second quarter slowdown was not as sharp as first thought. On September 29th, the Commerce Department said the nation's gross domestic product---*the broadest measure available of the output of goods and services*---rose at a 3.3% seasonally adjusted annual rate from April to June. That was faster than the 2.8% growth rate estimated by the government last month. Although it still represents a slowdown from growth rates in excess of 4% in the four previous quarters, it took an edge off the rising worries about the economy's momentum.

At 3.3%, the pace of activity in the second quarter was only slightly below the economy's long-run trend, recorded since 1930, of 3.5% growth annually. Economists surveyed by *The Wall Street Journal Online* believe the economy expanded at a 3.6% annualized rate in the third quarter and will expand at a 4% annualized rate in the fourth.

Bond Market

The long-term bond market had a very strong quarter. As the Federal Reserve steadily increased short-term rates over the past few months, long-term bond prices rose and yields fell. Indeed, the yield on the Treasury's 10-year note eased to 3.98% on Sept 22nd, its lowest point in nearly six months, one day after the Fed bumped up short rates another quarter percentage point.

While the decline in long-term bond yields could indicate that the economy is weakening, the more likely cause is that it reflects reduced inflation fears. That bodes well for the economy. As long as investors are convinced that inflation will remain low, the Fed can afford to take its time raising rates to more normal levels, giving the economy time to adjust.

Outlook for the Stock Market

My outlook for the stock market continues to be characterized with guarded optimism. Interest rates remain low. Inflation, though stirring in certain sectors like energy and health care, generally remains subdued. Corporate profits should continue to grow in 2005, probably in the upper single digits or low double digits.

Given these positives, stocks would appear to be reasonably valued. The S & P 500 index is currently quoted at about 18 times the past 12 months' operating earnings (before unusual items). That's comfortably below the 20 times average since 1988, and only a little above the 15.6 times average going back to 1935.

However, with the stock market nothing is certain and significant risks still exist. High oil prices, which are hovering near $50 per barrel, could slow economic growth. In addition, the continued unrest in Iraq and ever-present threat of terrorist attacks both at home and abroad, could dampen consumer confidence. And the uncertainty of the Presidential election outcome could hold back the market for the next month.

Peter Lynch, the esteemed former manager of Fidelity Magellan fund, was recently asked whether it makes sense to invest in the current environment, or whether investors should wait for signs that the market is improving? Mr. Lynch responded "There's always bad news. Do you remember 1990? We had 500,000 troops deployed against Iraq. We had a recession. And we had a banking crisis. Savings and loan companies were failing right and left."

"Well guess what? 1991 was one of the best stock market years ever. The S & P 500 gained more than 30%. If you're a long term investor, you've got to ignore the bad news---because it is always there. And don't forget, there's also been a lot of good news. Just think of the advancements in health care alone, with the introduction of drugs that extend life expectancy and improve the quality of life. If you're going to get shaken out of the stock market just because of bad news, you probably don't belong in stocks in the first place."

I don't think Lynch is saying he expects the market to rise 30%. His point is that the market can perform well in the face of numerous risks and uncertainties. My guess is that the market will rise moderately over the next few years: 5 to 8% annually. While this is poor relative to the historical performance, it is good relative to the alternative investments.

MAM Performance for the Quarter

In General: For the quarter, 97% of the MAM portfolios outperformed the S & P 500. The composite return of assets managed in MAM portfolios that were in existence for the whole quarter was a loss of 0.1% (after MAM fees) versus a loss of 1.9% in the S & P 500 (adjusted for an assumed annual dividend yield of 1.7%).

Best Performers: The eight best performing MAM mutual funds for the quarter were Cohen & Steers Realty (rise of 9.5%), Loomis Sayles Bond (6.7%), Oakmark International Small Cap (3.7%), iShares Dow Jones Select Dividend Index (3.1%), Pioneer High Yield (2.9%), Income Fund of American (2.6%), Capital World Growth & Income (2.1%), Metropolitan West (1.7%), and Artisan Small Cap Value (1.6%).

Worst Performers: The eight worst performing MAM mutual funds for the quarter were Bjurman Barry Micro Cap (down 7.9%), TCW Galileo Select Equities (-5.3%), Bogle Small Cap Growth (-3.3%), Oakmark Global (-2.9%), Hussman Strategic Growth (-2.4%), William Blair Small Cap (-1.8%), Selected American (-0.9%), and Calamos Growth & Income (-0.9%).

Oldest Portfolio: The MAM portfolio with the longest track record is a $50,000 portfolio that was fully invested on September 13, 1999. As of September 30, 2004, the original $50,000 had risen to $67,360 for a cumulative rise of 34.7%. During that time the S & P 500 lost 12.3%. For the quarter ended September 30, 2004, the portfolio lost 1.6% while for the first nine months of 2004 it rose 1.0%. 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 indicative of future performance.

MAM Performance for First Nine Months of 2004

For the first nine months of 2004, 84% of MAM portfolios outperformed the S & P 500. The composite return of assets managed in MAM portfolios that were in existence for the nine months was a rise of 2.4% (after MAM fees) versus a rise of 1.6% in the S & P 500 (adjusted for an assumed annual dividend yield of 1.7%).

Portfolio Repositioning

I plan to reposition portfolios during the next two months. The emphasis will be to further implement my goal of utilizing core funds. I define core funds as funds that have low operating expenses, relatively low volatility, and good long-term performance relative to its peer group. I feel that using funds with low operating expenses and higher dividend yields makes sense in the low return environment I anticipate for the next five to ten years. The core funds that are currently in most portfolios are American Mutual, Capital World Growth & Income, Oakmark Select/Oakmark Fund, and Selected American. In addition, during August, Dodge & Cox Balanced was added to portfolios of $125,000 or greater.

iShares Dow Jones Select Dividend Index (symbol DVY), is a core exchange traded fund that invests in large and mid-cap high-yielding stocks. It was profiled in the July 2004 MAM Commentary. In this next repositioning, I plan to purchase DVY and the large cap growth fund, American Amcap, in portfolios of $50,000 or greater.

Reduction in Schwab Commission- Non-One Source Mutual Funds

Most of the mutual funds purchased by MAM are part of Schwab's "One Source" program. This means that there is no transaction fee for the purchase or sale (if held at least 90 days) of these funds. Schwab receives compensation for these "One-Source" funds from the mutual fund company by receiving a portion of the operating expenses charged by the fund.

Certain mutual funds used by MAM are not part of the "One-Source" program (Bogle Capital Mgmt, Hussman Strategic Growth, Dodge & Cox Balanced). This is because the fund company is not willing to pay part of the operating expenses to Schwab. In the future, I expect to increase the use of "non-One Source" funds (also called "transaction fee" funds) in portfolios because some of the best, low-cost mutual funds are transaction fee funds.

This summer I approached Schwab Institutional and asked them to reduce the commissions charged to MAM clients for transaction fee funds. After analyzing the growth of MAM and the profile of MAM clients, Schwab agreed to provide a reduction in transaction fees of between 6% and 27% for purchases and sales of $35,000 or less. For transaction amounts above $35,000, the maximum commission remains $99.

While my discussion did not focus on further discounts in the future, Schwab did indicate the importance of increasing the average size of MAM accounts. The current average is approximately $125,000. I was told that the average for most other Investment Advisors is $250,000.

Although it is not realistic to double the average account size, a goal for MAM next year is to reduce the number of small accounts. For instance, as of Sept 1st over 100 of MAM's 500 accounts had assets of less than $10,000. Schwab incurs a cost to hold accounts, although as institutional accounts, Schwab does not charge fees for maintaining accounts. For retail accounts, my understanding is that Schwab charges maintenance fees for accounts less than $50,000. I hope to eliminate some of these small accounts by having clients merge them into one of their other existing MAM accounts.

Miscellaneous

Billy Alhorn: As I announced in the August Monthly Commentary, Billy Alhorn was hired by MAM on August 10th. Given Billy's investment management background (six years with Charles Schwab and a Certified Financial Planning candidate), it is not surprising that he is off to a fast start. Already he has been assisting with trading, reporting, and regulatory compliance.

Office Move: I am very excited to announce that on October 5th I signed a lease for office space located at #3 Lagoon Drive in Redwood Shores. Ironically, I had an office in the same building fifteen years ago. The new office is larger with four private offices and a conference room. In addition, it is beautifully situated on the water facing the Hotel Sofitel.

Another reason for my excitement is that we will be sharing the office with Evart, Young & Hobbs Asset Management. Like MAM, the firm of Evart, Young & Hobbs is a registered investment advisory firm that holds client assets at Schwab. It is the investment advisory firm that I have worked most closely with during the five years of McCarthy Asset Management's growth, and I am very good friends with one of the principals, Derek Hobbs.

The expectation is that the tenant improvements to the new office will be completed in November, with the move occurring late November or early December.

Client Satisfaction Survey: During the current quarter, I plan to send out a client satisfaction survey. In it, I will ask for feedback about various aspects of MAM. I am anxious to get this feedback about your level of usage and satisfaction with MAM services (Quarterly Reports, Monthly Commentary, Web site, etc.), and I look forward to your suggestions for improvement.

Schwab eConfirms: Charles Schwab offers eConfirms as an option to replace the mailed trade confirmations. With eConfirms, you receive an email each time a trade is done in one of your accounts. Most clients have opted for them as one of the *Paper Reduction Actions* we undertook last year.

We recently discovered that a least a couple of clients who asked for eConfirms failed to respond to an email from Schwab when we signed them up. Please let us know if you are not receiving eConfirms, but would like to.

Assets Under Management: I appreciate the confidence that existing and new clients have shown in adding to the assets that MAM manages. Existing and new clients added over $8 million in net assets during the first nine months of 2004, bringing the MAM assets under management up to over $58 million as of September 30, 2004, versus $49 million at the start of the year.

Please call me if you wish to discuss the stock market, possible changes to your portfolio(s), or other financial matters. As always, I continue to appreciate your referrals.

Very truly yours,

Stephen P. McCarthy, CPA