

# McCarthy Asset Management, Inc.

Registered Investment Advisor

Wednesday, October 5, 2005

Dear Client,

All things considered, the stock market performed admirably for the third quarter, and most market indices are now modestly up for the year. In fact, the stock market rose for the month of September for just the 13<sup>th</sup> time in the past 35 years. This is especially impressive, given the economic impact of Hurricane Katrina and record high energy prices. I am hopeful that the positive momentum will carry through the fourth quarter of this year.

MAM portfolios continued to perform well relative to the S & P 500. Assuming this continues through the current quarter, 2005 would represent the sixth consecutive year that MAM portfolios outperformed the S & P 500.

With this report for the quarter ending September 30, 2005, I discuss the performance of the market and MAM portfolios for the quarter and first nine months of 2005. In addition, I provide an update on interest rates and the economic impact of Hurricane Katrina, and provide my outlook for the stock market. Furthermore, I announce the addition of Marilyn Blancarte to McCarthy Asset Management, Inc. and comment on tax reform and a new service that we will offer to track clients' invested assets.

Enclosed are four 9/30/05 investment reports:

- *Portfolio Position Analysis*: lists your investments and how each have performed
- *Portfolio Performance Summary*: 3<sup>rd</sup> quarter and year-to-date 2005 portfolio rate of return
- *Portfolio Comparative Performance Review*: ***I am excited to be providing this report for the first time. It displays the performance of your portfolio by year and cumulatively since inception.***
- *Realized Gains and Losses*: year-to-date 2005 investment gains and losses realized (included only for taxable accounts)

## **Stock Market Performance**

The stock market performed well in the third quarter of 2005. The S & P 500 rose 3.2% to 1229, the Nasdaq Composite climbed 4.6% to 2152, and the Russell 2000 jumped 4.4% to 668. These returns do not reflect reinvestment of dividends. For the first nine months of 2005, also unadjusted for dividends, the S & P 500 rose 1.4%, the Nasdaq Composite fell 1.1%, and the Russell 2000 rose 2.5%.

## **MAM Performance for the Quarter**

**In General:** For the quarter, 95% of the MAM portfolios out performed the S & P 500. The composite return of assets in MAM portfolios was a gain of 5.3% (after MAM fees) versus a gain of 3.6% 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 PIMCO Commodity (up 16.3%), Artisan International Small Cap (15.8%), Oakmark International Small Cap (10.8%), Dodge & Cox International (9.7%), North Track PSE Technology Index (9.5%), Capital World Growth & Income (9.0%), William Blair Small Cap Growth (7.4%), and American Growth Fund (6.8%).

**Worst Performers:** The eight worst performing MAM mutual funds for the quarter were Oakmark Fund (down 0.5%), Metropolitan West Strategic (up 1.4%), iShares Dow Jones Select Dividend Index (up 1.6%), Loomis Sayles Bond (up 2.0%), Income Fund of America (up 2.2%), Century Small Cap (up 2.3%), American Amcap (2.4%), and Pioneer High Yield (up 3.1%).

**Oldest Portfolio:** The MAM portfolio with the longest track record is a fairly aggressive portfolio fully invested on September 13, 1999. As of September 30, 2005, the original \$50,000 had risen to \$77,505, plus \$1,193 of cumulative withdrawals. This represents a cumulative return of 57.4% during the six plus years. During the same time, the S & P 500 (as represented by the Vanguard Index 500) lost 3.1%. For the quarter ended September 30, 2005, the portfolio rose 5.4%, while for the first nine months of 2005 it rose 5.1%. 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 Nine Months 2005**

For the first nine months of 2005, 95% of the MAM portfolios out performed the S & P 500. The composite return of assets in MAM portfolios was a gain of 5.8% (after MAM fees) versus a gain of 2.7% in the S & P 500 as represented by the performance of the Vanguard Index 500 fund (symbol VFINX) with reinvested dividends.

## **Interest Rates and the Economic Impact of Katrina**

**Interest Rates:** On September 20<sup>th</sup> the Federal Reserve raised the federal funds rate by 0.25% to 3.75%. This was the eleventh increase since June of 2004. The Fed signaled that more rate hikes were likely even as the country recovers from the devastating effects of Hurricane Katrina. In a statement, the Fed acknowledged Katrina's "tragic toll", but predicted it wouldn't derail the economy's expansion, but may aggravate inflation.

The Fed's goal is to push the federal funds rate up to a level where it is neither stimulating economic activity nor slowing it down. Many economists believe that level lies somewhere between 4.0 percent and 4.5 percent.

**Economic Impact of Hurricane Katrina:** There is little doubt overall economic output will take a sizable hit in the coming months. Recently the Congressional Budget Office estimated that Katrina

will knock one-half to one percentage point, at an annual rate, off second-half growth this year and wipe out 400,000 jobs.

Fed officials say there may be additional effects if sharply higher gasoline prices seriously erode consumer confidence. Sure enough, on September 27<sup>th</sup>, the Conference Board reported that consumer confidence plummeted almost 19 points in September, its biggest drop in 15 years as Americans worried about the economic fallout of Hurricane Katrina and rising gasoline prices. The longer term impact, though, of Katrina is unclear. Some economists feel that the rebuilding activity could extend the life of the current economic recovery.

My response to the tragic disaster has been to make no portfolio changes based on the short-term economic impact. Any changes that I may make will depend on the likely longer-term impact of Katrina, along with my sense of where the economy is headed over the next year or two.

### **Outlook for the Stock Market**

In his most recent Marketimer report, Bob Brinker, the well respected host of the nationally syndicated financial show Money Talk, reviewed the five root causes of a bear market: tight money, rising rates, high inflation, rapid growth, and overvaluation. Based on his analysis, he does not think we are currently at risk of entering a bear market.

In particular, in terms of “tight money” and “rising rates”, Brinker feels that the Fed is close to completing its series of interest rate hikes. As for “high inflation”, he feels that despite the run-up in oil prices, the outlook for inflation is benign.

Brinker feels that “rapid growth” is not currently a problem, as the 3% to 4% moderate real growth that we are experiencing is the primary reason why he believes we have had a bull market since 2003. He says the key to this scenario is moderate new jobs growth, with average monthly new jobs figures below 200,000.

Finally, Brinker feels the stock market is not currently overvalued. The current price-earnings ratio for the S & P 500, based on his new 2006 earnings estimates, is a very reasonable 15.9.

Although I don't claim to have any special ability to predict future stock prices, I do remain cautiously optimistic that the market will post moderate gains for full year 2005. As long as the economy continues to perform well, I think it is likely the moderate gains will continue into 2006. As this bull market ages, though, I become increasingly cautious. There are certainly a number of factors that could derail the economy and the stock market: the economic impact of Katrina, a war in Iraq that continues with no foreseeable end, twin deficits (federal and U.S. trade) that continue to grow, and fuel prices that are likely to crimp consumer spending.

As you know, I am not a market timer. I don't try to anticipate the right and wrong time to be invested, and move in and out of the market accordingly. History has shown that most investors who try to do so earn sub par returns. What I do try to do is to make portfolio adjustments based on my outlook for the stock market as a whole, and asset classes individually. Below I discuss the next portfolio repositioning I expect to undertake.

## **Next Portfolio Repositioning**

I expect to perform the next portfolio repositioning by the end of this year. At this point, the only changes that I am contemplating are:

- 1) The addition of a municipal bond fund (and a corresponding reduction in a taxable bond fund) in taxable accounts.
- 2) Possible further increases in international equities.
- 3) Probable increase in the allocation to the PIMCO Commodities fund.
- 4) Possible addition of an “emerging markets” short-term bond fund.

Currently, I expect the theme of the repositioning will be to increase the downside protection of portfolios. While I remain cautiously optimistic in my outlook for equities, I would like to try to protect against an eventual downturn in the stock market.

## **New Addition To McCarthy Asset Management, Inc.**

I am very pleased to announce that in September I have hired Marilyn Blancarte as the full-time Executive Assistant for MAM, Inc. We are very fortunate to have found someone as talented as Marilyn. For the last five years she has been the Executive Assistant to the portfolio managers and the President at The Portola Group Inc, a large investment advisory firm with six offices managing close to \$1 billion in assets.

Prior to joining The Portola Group Inc., Marilyn worked for two years as the assistant to the Operations Manager at Solomon Smith Barney.

Please say hello to Marilyn if you reach her when you call the office.

## **Tax Reform On Hold**

As a result of the burgeoning government deficit due to Hurricane Katrina relief efforts and reconstruction, two sets of tax bills have been put on hold. Prior to the Hurricane, there was hope that the bills would have been passed this year. At this point, it is not clear when they will be addressed again.

The first set of bills (Senate 1524, H.R. 1500, and H.R. 809) would have extended to 2010 the 15% tax rate on dividends and capital gains. The current law was enacted two years ago, and expires at the end of 2008.

The second effort was related to estate tax reform. Congressional Republicans have delayed plans for a vote on a bill that would eliminate tax on all estates except very large ones. Senate Majority Leader, Bill Frist, wanted to bring the bill to a floor vote in early September, and then backed off after Hurricane Katrina struck. The House passed H.R. 8, the Death Tax Repeal Permanency Act of 2005, in April, but the Senate has been sitting on the bill as lawmakers on both sides worked toward a compromise.

## **Tracking Your Invested Assets**

In the August 2005 Monthly Commentary that was sent via email, I mentioned that I was contemplating offering a new service where we would tailor an Excel spreadsheet that I have developed to track a client's invested assets. As mentioned in the Monthly Commentary, I feel the spreadsheet is the heart of a financial plan. It will help determine whether a client is financially on track to retire comfortably.

I have used the spreadsheet for myself for the last fifteen years. I update it once a year with year-end values. With the spreadsheet, I get a quick look at where I am now financially, as well as where I have come from.

My intent is to offer to develop the spreadsheet at no cost for clients whose managed assets are above a "to-be-determined level". The level depends in part on the demand that clients have for the service and the time commitment it takes us to tailor it to individual clients.

We will obtain the needed data for creating the initial spreadsheet by asking clients to complete a questionnaire listing the current value of their assets and liabilities. Once the spreadsheet is completed, we may post it to the client's personal (and secured) page on our Web site for ready access. I expect that annually we will update each client's spreadsheet.

I asked in the August Commentary for clients to contact me if they were interested in this service. Since then I have received affirmative responses from 24 clients. *If you are interested in this free service and have not contacted me, please send me an email at [steve@mamportfolios.com](mailto:steve@mamportfolios.com).* I hope to have the questionnaire completed and sent out on a limited basis starting next month.

## **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 \$6 million in net assets during the first nine months of 2005, bringing the MAM assets under management up to over \$75 million as of September 30, 2005, versus \$65 million at the start of the year.

I continue to welcome your referrals. The current minimum to become a new client is \$350,000. If managed assets continue to grow at the current rate, I expect to raise this minimum to \$400,000 effective January 1, 2006.

Very truly yours,

Stephen P. McCarthy, CPA

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