McCarthy Asset Management, Inc.

Registered Investment Advisor
Certified Public Accountant
Certified Financial Planner

Wednesday, January 5, 2005

Dear Client,

Happy New Year! Boosted by a strong post-election bounce, the stock market posted solid results for 2004. Combined with a strong 2003 showing, the stock market has now surged since March of 2003. Hopefully, 2005 will continue to bring good news.

With this MAM report for the quarter ending December 31, 2004, I will discuss the 2004 market and MAM portfolio performance, as well as my outlook for 2005. In addition, I will discuss the current positioning of MAM portfolios and my outlook for the various asset categories. Finally, I want to remind you that next week we will be moving to our new Redwood Shores office. The new address, phone and fax numbers are listed at the bottom of this page. The phone and fax numbers should be operational by January 14th.

Enclosed are four 12/31/04 investment reports:

- *Portfolio Position Analysis*: lists your investments and how each have performed

- *Portfolio Performance Summary*: fourth quarter and full year portfolio rate of return

- *Portfolio Performance History*: portfolio rate of return since inception

- *Realized Gains and Losses*: full year 2004 investment gains and losses realized (included solely for taxable accounts).

Stock Market Performance

The final quarter of 2004 was very positive for the market. The S & P 500 rose 8.5% to 1210, the Nasdaq Composite climbed 14.7% to 2175, and the Russell 2000 rose 12.7% to 646. The returns do not reflect reinvestment of dividends.

Full year results for 2004 were also good. Unadjusted for the reinvestment of dividends, the S & P 500 rose 8.8%, the Nasdaq Composite climbed 8.6%, and the Russell 2000 jumped 16.0%.

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Outlook for the Stock Market

Will the stock market continue to rise in 2005? While no one knows for sure, my feeling is that the strong performance of the economy and the substantial amount of money still sitting in cash will continue to lead the market higher, for at least a while. I am becoming more cautious, though. Stocks are no longer priced cheaply, interest rates continue to rise, and at some point, the economy will turn down.

The Positives: The following is a list of factors that are benefiting the stock market:

- Steady economic growth
- Low inflation
- Relatively low interest rates (despite recent increases)

The negatives: The following are factors that pose a risk to the stock market:

- High oil prices
- Threat of terrorist attacks
- Continued unrest in Iraq
- Rapid decline in the U.S. Dollar
- Rising interest rates
- Large Federal budget deficit
- Large U.S. trade deficit

While the risks are extensive, the stock market should be able to weather them for the foreseeable future. While the high price of oil dampens consumer spending, it is very possible that oil prices will continue their recent downward trend. In addition, the threat of terrorist attacks and the continued unrest in Iraq are risks that will be with us for years to come, and are most likely reflected in current stock prices.

During 2003 and 2004, the U.S. dollar declined over 30% relative to the Euro. While this is bad news for Americans who want to travel abroad or purchase foreign goods, it improves the competitive position of American businesses at home and abroad. Short a plunge in the dollar, the economic impact of a falling dollar should be muted.

In December, the Federal Reserve raised interest rates for the fifth time since the Summer of 2004. The real funds rate is the current Federal rate (2.25%), less the rate of inflation (approximately 3%). This rate is still negative, which is a sign that the Fed policy is still highly conducive to economic growth. With inflation remaining low, the Fed is expected to continue its course of gradual interest rate increases.

While the large U.S. budget and trade deficits pose a long-term risk, most economists feel they will not derail the economic expansion anytime soon. In addition, there is hope that these deficits will be reduced during the next couple of years.

In summary, I believe for at least the next six months, stocks will remain somewhat attractive, particularly relative to alternative investments. The primary reason is the steady performance of the economy and corporate profits. The best way to obtain exposure to the stock market is through a diversified portfolio. My expectation is for returns to be moderate for the next few years (5% to

7% annually). If the stock market were to rally substantially in 2005, or if I see signs of a slowdown in the economy, then I expect to take defensive steps to increase the downside protection in portfolios.

MAM Performance for the Quarter

In General: For the quarter, 91% of the MAM portfolios out performed the S & P 500. The composite return of assets in MAM portfolios that were in existence for the whole quarter was a gain of 9.5% (after MAM fees) versus a rise of 9.0% in the S & P 500 (adjusted for an assumed annual dividend yield of 2.1%).

Best Performers: The eight best performing MAM mutual funds for the quarter were Artisan International Small Cap (rise of 19.6%), Cohen & Steers REIT (17.6%), William Blair Small Cap (16.2%), Bjurman Micro Cap (16.0%), Oakmark International Small Cap (13.4%), Capital World Growth & Income (13.1%), Thornberg International Value (12.6%), and Marsico Focus (12.0%).

Worst Performers: The eight worst performing MAM mutual funds were PIMCO Commodity (down 2.6%), Metropolitan West Strategic Income (up 1.7%), Pioneer High Yield (3.5%), Hussman Strategic Growth (3.9%), Loomis Sayles Bond (5.7%), American Mutual (6.9%), Income Fund of America (7.6%), and Oakmark Select (7.7%).

Oldest Portfolio: The MAM portfolio with the longest track record is a fairly aggressive portfolio fully invested on September 13, 1999. As of December 31, 2004, the original $50,000 had risen to $73,825, plus $1,094 of cumulative withdrawals. This represents a cumulative return of 49.8%. During the same time the S & P 500 lost 4.2%. For the quarter ended December 31, 2004, the portfolio rose 10.9% while for all of 2004 it rose 12.2%. 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 2004

For all of 2004, MAM portfolios performed well as 89% of MAM portfolios outperformed the S & P 500. The composite return of assets managed in MAM portfolios that were in existence for all of 2004 was a rise of 12.1% (after MAM fees) versus a rise of 10.9% in the S & P 500 (adjusted for an assumed annual dividend yield of 2.1%).

I am pleased about our 2004 absolute and relative performance. *Even more significantly, MAM portfolios have now outperformed the S & P 500 for each of the five years that MAM has been in existence.*

For the last two years, I have been suggesting that if the stock market rebounds, we could under perform the S & P 500. We were still able to outperform the S & P 500, despite the defensive positioning I did to protect against a decline in the market. Throughout 2004, most MAM portfolio had a 15% to 20% bond weighting. While the bond exposure limited performance in 2004, the mutual fund selection, small cap, and REIT exposure more than compensated for not being fully invested in equities.

Current Portfolio Positioning:

Almost all MAM portfolios were rebalanced during the fourth quarter. The following is a discussion of the current asset allocation of the portfolios:

1. ***U.S. Equities (45% to 65% of most portfolios):*** Since the stock market peaked in March of 2000, small stocks have substantially outperformed large stocks. During most of this time, we have over weighted small stocks and under weighted large stocks. This has been very favorable for relative performance. Like all investment trends, at some point, the under performance of large stocks will end. Based on my belief that small companies are no longer undervalued relative to larger companies, large cap stocks now outweigh small and mid-cap stocks in portfolios.

   The primary exposure to large cap stocks is through what I call "core" mutual funds. I define a "core" fund as a fund with low operating expenses, relatively low volatility, and good long-term performance relative to its peer group. The "core" funds currently used by MAM are American Amcap, American Mutual, Capital World Growth & Income, Dodge & Cox Balanced, Income Fund of America, Selected American, and iShares Dow Jones Select Dividends.

   An additional common trait of most of these "core" funds is that they tend to invest in high dividend paying stocks and have low technology exposure. This is especially true of iShares Dow Jones Select Dividend, an exchange traded fund that invests in 100 of the stock market's highest dividend-yielding, non REIT companies. I believe that for the foreseeable future, high-dividend paying stocks will outperform technology and other low-dividend paying stocks.

2. ***Bonds (15% to 20% of most portfolios):*** The main purpose for bond exposure is to provide downside protection in case equities start to decline again. The cost for this protection is that MAM portfolios could under perform the S & P 500 if the market continues to rise.

   The primary bond exposure is through convertible bonds (Calamos Growth & Income and Pioneer High Yield), high yield bonds (Pioneer High Yield), and foreign bonds (Loomis Sayles Bond). There is very little exposure to high quality, long-term U.S. bonds, which are most vulnerable to rising interest rates.

3. ***International Equites (15% to 18%):*** I continue to like international equities for three reasons. First, the most likely asset class to be currently undervalued is international equities. Secondly, historically, a significant international exposure reduces portfolio volatility. Finally, U.S. investors will benefit from international investments if the U.S. dollar continues to fall in value.

4. ***Alternative Assets (8% to 12%):*** I have renamed the "real estate investment trust" and "commodity" asset class as "alternative assets". Currently, there are four mutual funds that make up this class. Below is a listing of the four funds with a short description of each:

   a) Cohen & Steers Realty is the largest mutual fund specializing in real estate investment trusts.

b) Hussman Strategic Growth is an equity mutual fund that John Hussman manages similar to certain hedge funds. When Dr. Hussman feels the stock market is overvalued, he hedges the fund's portfolio positions to reduce the stock market exposure. Hussman Strategic Growth is one of the few equity mutual funds that has had positive returns each year since 2000.

c) Metropolitan West Strategic Income is a fixed income mutual fund managed similar to a bond hedge fund. So far the fund has exhibited very little interest rate risk, meaning that the fund has not been hurt by rising interest rates.

d) PIMCO Commodities is a mutual fund whose performance moves in line with commodity prices. A rise in inflation would benefit the fund.

In projecting a low return environment for the stock and bond markets, I am attracted to alternative assets. This is because they are not highly correlated to stock and bond prices, and they may do relatively well in a market downturn. If I decide later this year to reposition portfolios to provide further downside protection, I expect that I will be increasing the investment in alternative assets.

Assets Under Management

As of December 31, 2004, MAM assets under management were in excess of $65 million, up from $50 million at the start of the year. While over one-third of this growth was from portfolio appreciation, existing and new clients added over $10 million in net assets. I continue to welcome your new client referrals. Although my current minimum for new clients is $300,000, I expect to raise that minimum to $350,000 on April 1, 2005.

Miscellaneous

When you became a MAM client, I provided you with a copy of my ADV Part II. As a Registered Investment Advisor (RIA), I file this 10-page document with the Securities and Exchange Commission each year. Along with other items, it contains information regarding my fees and educational background. Each year, I am required to offer clients the opportunity to receive a copy of my most recent ADV Part II. Please let me know if you would like to receive it.

Also enclosed is the annual privacy notice that I am also required to send annually.

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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