McCarthy Asset Management, Inc.

Registered Investment Advisor

Thursday, January 5, 2006

Dear Client,

Happy New Year! The market ended with modest gains for the full year. The returns generated by MAM accounts were well in excess of the gains for the S & P 500. MAM accounts have now outperformed the S & P 500 for each of the 6 years that MAM has been in existence.

With this report for the quarter ending December 31, 2005, I discuss the 2005 performance of the market and MAM portfolios, as well as my 2006 outlook for the economy and the stock market. In addition, I discuss the current positioning of MAM portfolios. Finally, I provide an update on our efforts to track clients' Invested Assets.

Enclosed are five 12/31/05 investment reports:

- *Portfolio Position Analysis*: lists each investment in the portfolio
- *Portfolio Performance Summary*: 4th quarter and full year 2005 portfolio rate of return
- *Portfolio Comparative Performance Review*: portfolio performance by year and cumulatively since inception
- *Position Performance Summary*: **This report is being provided for the first time. It provides a detailed portfolio analysis by position for full year 2005.**
- *Realized Gains and Losses*: full year 2005 investment gains and losses realized (included only for taxable accounts)

Stock Market Performance

The fourth quarter of 2005 was positive for the market. The S & P 500 rose 1.6% to 1248, the Nasdaq climbed 2.5% to 2205, and the Russell 2000 rose 0.8% to 673. These returns do not reflect reinvestment of dividends.

Full year results for 2005 were modest. *Unadjusted for the reinvestment of dividends*, the S &P 500 rose 3.0%, the Nasdaq Composite climbed 1.4%, and the Russell 2000 rose 3.2%.

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MAM Performance for 2005

For all of 2005, 95% of the MAM portfolios that were in existence for the whole year outperformed the S & P 500. The composite return of assets in MAM portfolios was a gain of 8.7% (after MAM fees) versus a gain of 4.8% in the S & P 500 as represented by the performance of the Vanguard Index 500 fund (symbol VFINX) with reinvested dividends.

How were MAM portfolios able to outperform the Vanguard Index 500 by 3.9% for 2005? The two biggest factors were the strong performance of international equities and good mutual fund selections across all asset classes. The international equity mutual funds used by MAM, which make up close to 20% of most portfolios, all rose over 10% for 2005. Indicative of good mutual fund selection, 8 of the 10 U.S. equity mutual funds used by MAM outperformed the S & P 500. Portfolio performance would have been even better were it not for the impact of bonds, which are used to provide downside protection in case the market were to fall.

MAM Performance for 4th Quarter of 2005

In General: For the quarter, 80% of the MAM portfolios out performed the S & P 500. The composite return of assets in MAM portfolios was a gain of 2.8% (after MAM fees) versus a gain of 2.1% 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 Oakmark International Small Cap (up 6.6%), Bjurman Micro Cap (5.8%), Artisan International Small Cap (5.8%), Growth Fund of America (5.0%), Oakmark Select (4.6%), Dodge & Cox International (4.6%), Capital World Growth & Income (4.6%), and Marsico Focus (4.4%).

Worst Performers: The eight worst performing MAM mutual funds for the quarter were PIMCO Commodity (down 4.2%), William Blair Small Cap (down 1.7%), Hussman Strategic Growth (down 1.2%), iShares Dow Jones Select Dividend (down 0.8%), Century Small Cap (down 0.4%), Artisan Small Cap Value (up 0.2%), Income Fund of America (up 0.4%), and Loomis Sayles Bond (up 0.8%).

Oldest Portfolio: The MAM portfolio with the longest track record is a fairly aggressive portfolio that was fully invested on September 13, 1999. As of December 31, 2005, the original $50,000 had risen to $79,396, plus $1,193 of cumulative withdrawals. This represents a cumulative return of 61.2% during the six plus years. During the same time, the S & P 500 (as represented by the Vanguard Index 500) lost 1.1%. For the quarter ended December 31, 2005, the portfolio rose 2.4%, while for all of 2005 it rose 7.7%. 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.

2006 Performance of Economy

Despite the impact of rising energy prices, climbing interest rates, and Hurricane Katrina, the economy has continued to perform well. The consensus forecast of 56 economists recently surveyed by The Wall Street Journal is that the nation's gross domestic product will grow at an annual rate of 3.5% in the first half of 2006 and 3.1% in the second half. While these rates would fall short of the 4.1% average of the past 2 ½ years, by historical measures they represent very respectable growth rates.

The two biggest concerns cited by the economists were the impact of high energy prices and a slowdown in the housing market. The booming housing market has been a major catalyst for growth in the economy in recent years. The boom has allowed millions of Americans to extract cash for spending by borrowing from the equity in their homes. Most of the economists predict that the housing market will slow, but not crash.

Strength in the business sector is expected to at least partially offset the slowdown in housing. As stated in an article in the December 26, 2005 issue of BusinessWeek, “For the past couple of years, housing and consumer spending have been in the driver’s seat. Now it’s time for the business sector to give the two a break. And by all indications, companies are ready to take over. They are optimistic, efficient, eager to expand their operations, and most of all, financially fit.”

The article further states, “Perhaps the most important reason to expect the business sector to contribute significantly to overall growth in 2006 is the extraordinary strength of corporate finances…To begin with, the balance sheets of nonfinancial companies are about as pristine as they have ever been. Based on recent Fed data, net worth for these companies in the third quarter rose at a 10.3% annual rate from the second quarter, close to the same annual pace during the past two years. That’s a strong and steady growth rate not seen since the technology-led stock market boom of the late 1990s.”

“Corporate debt, furthermore, is the most manageable in years. Over that same two-year period, liabilities have increased by $242 billion, but total assets have grown by more than 10 times that amount, by $2.5 trillion. Importantly, credit-market debt stood at only 45.5% of net worth in the third quarter, the lowest rate in 18 years.”

Rising interest rates will also have an impact on slowing down the economy. In the last year and a-half, the Federal Reserve has raised the Federal Funds rates 13 times, from a low of 1.0% in June of 2004, to the current rate of 4.25%. Rising interest rates tend to have a lagging impact on the economy, so the impact will probably be felt more in 2006. In addition, the Fed is expected to raise rates at least one more time. Moderating inflation, though, may convince the Fed to end its hikes early in 2006. Economists forecast inflation for the 12 months ending November of 2006 to be 2.3%, down from 3.5% for the 12 months ending November of 2005. The Federal Reserve ending its interest rate hikes could provide a boost to the market.

In summary, the consensus is for moderate but steady growth in the economy for 2006. This bodes well for the stock market.

Outlook for the Stock Market

One year ago, in the MAM report for the quarter ending December 31, 2004, I wrote: “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." The market did not rally substantially in 2005 and I did not see signs of a slowdown in the economy, so generally I did not make portfolio changes during 2005 to protect on the downside.

I am very satisfied with the investment results for 2005. It is not just because MAM clients earned very competitive returns. I am also pleased that, ignoring dividends, for 2005 the S & P 500 rose only 3.0% while corporate earnings for companies in the S & P 500 rose 13.6% (as estimated by company analysts polled by Reuters). This means the stock market was much cheaper at the end of 2005 than it was at the beginning of the year. At the end of 2004, the S & P 500 closed at 18 times 2004 earnings. Because of the sharp rise in earnings and the moderate increase in the price of the index, at the end of 2005, the S & P 500 closed at 16 times 2005 earnings. While not cheap by historical standards, this still represents the lowest S & P 500 price-earnings ratio in ten years.

While I am heartened to see that the stock market has become cheaper, I am not overly optimistic. I continue to feel that for the foreseeable future, the overall market will provide annual returns on average in the 5% to 7% range. Furthermore, I am still concerned about the impact of higher energy prices, and the risk that the Federal Reserve will go too far in raising interest rates. As with 2005, I will try to monitor for signs of a slowdown in the economy, and take defensive steps if I think it is appropriate. Furthermore, if the market were to rally sharply in 2006, I will seriously consider taking steps to protect portfolios on the downside.

Longer-term, my greatest concerns are our twin deficits: the Federal deficit and the foreign trade deficit. While the Federal deficit is a concern, my understanding is that the deficit, as a percent of the overall economy, is not too high compared to times in the past. Hopefully, as the economy continues to grow, the government will be more successful in balancing its books.

I have greater concerns about the foreign trade deficit. My understanding is that long-term interest rates have stayed relatively low because many foreigners have taken their dollars earned from the deficit and invested them in U.S. government bonds. If foreigners lose their appetite for U.S. government bonds, the implications for the U.S. dollar could be dire. This is partly why close to 20% of MAM portfolios are invested in foreign equities, which will benefit from the decline in the U.S. dollar. In addition, most portfolios have a 3% weighting in the PIMCO Developing Local Markets, which is a short-term bond fund held in foreign currencies.

Current Portfolio Positioning:

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

1. ***U.S. Equities (45% to 60% of most portfolios):*** Small cap stocks have substantially outperformed large cap stocks since the stock market peaked in March of 2000. Not wanting to overstay the party, I have been decreasing small cap exposure and increasing large cap since late 2003. I continued with this effort in 2005. Relative to the large-cap weighted S & P 500, MAM portfolios still have significant small cap exposure.

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, Capital World Growth & Income, Dodge & Cox Balanced, Growth Fund of America, Income Fund of America, Selected American, and iShares Dow Jones Select Dividends. With the exception of Income Fund of America and iShares Dow Jones Select Dividends, these funds significantly outperformed the Vanguard S & P 500 index fund for 2005.

2. ***Bonds (15% to 25% of most portfolios):*** The main purpose of investing in bond funds 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), high yield bonds (Loomis Sayles Bond), and foreign bonds (Pimco Developing Local Markets and Loomis Sayles Bond). There is only modest exposure to high quality, long-term U.S. bonds, which are most vulnerable to rising interest rates.

3. ***International Equites (17% to 20%):*** The international equity exposure provided a significant benefit to MAM portfolios in 2005. I continue to like international equities because (1) I feel many foreign markets provide a better investment opportunity than the U.S. market (2) investing in foreign equities reduces the volatility of an equity portfolio and (3) investing in foreign equities provides a hedge against the potential drop in the U.S. dollar.

4. ***Alternative Assets (8% to 12%):*** MAM portfolios invest in alternative assets to reduce the volatility of the portfolios. For 2005, alternative assets provided a boost to performance as three of the four alternative asset funds outperformed the S & P 500. The only laggard, Metropolitan West bond fund, was liquidated in the December repositioning.

Tracking Your Invested Assets

The response of clients to the offer of tracking their invested assets has been excellent. Since early September, 82 clients have requested that we generate the spreadsheet for them. We have sent out 79 questionnaires, 34 of which have been returned so far. The feedback has been positive for the 32 that we completed. We look forward to completing more of these prior to the start of tax season, but are waiting for the return of the completed questionnaires.

One of the questions that I have received from a client for whom we completed the analysis was "What would be an appropriate level of invested assets for someone at my age?" My response was "without knowing what your spending will be in retirement, it is difficult to know what level of invested assets will be needed. While someone with modest spending could retire on less than $1 million in invested assets, a high spending couple may need at least $4 million. If I know someone's projected annual spending in retirement, then I can give them a decent feel for what they will need. Eventually, I may incorporate projected spending into the analysis, but it will require much more input from clients."

In figuring out how much invested assets is sufficient, there's an interesting Web site www.choosetosave.org/ballpark. With this Web site, you answer some questions about your income, age, assets, etc., and get an estimate of how much you need to save for retirement.

Assets Under Management

As of December 31, 2005, MAM assets under management were in excess of $80 million, up from $65 million at the start of the year. While approximately one-third of this growth was from portfolio appreciation, existing and new clients added approximately $9 million in net assets. I continue to welcome your new client referrals. Effective January 1, 2006, the minimum amount to manage for new clients is $500,000.

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 a copy.

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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