McCarthy Asset Management, Inc.

Registered Investment Advisor

Wednesday, April 2, 2008

Dear Client,

In a very volatile quarter, the credit crisis and likely onset of a recession caused U.S. and international stocks to post sharp losses, while bonds provided shelter and commodities yielded hard to find profits. With this report for the quarter ending March 31, 2008, I discuss the performance of the market and MAM portfolios for the first quarter, explain the credit crisis and discuss the dramatic actions the Federal Reserve has taken to alleviate the crisis, and provide some comments about the U.S. economy, the stock market, and real estate.

Enclosed are four 3/31/08 investment reports:

- *Portfolio Position Analysis*: lists your investments and how each have performed
- *Portfolio Comparative Performance Review*: portfolio performance by year and cumulatively since inception
- *Portfolio Performance Summary*: 1st quarter 2008 portfolio rates of return
- *Realized Gains and Losses*: 1st quarter 2008 investment realized gains and losses (included only for taxable accounts)

Stock Market & MAM Performance for First Quarter

The stock market had a difficult first quarter of 2008. The S & P 500 fell 9.9% to 1323, the Nasdaq dropped 14.1% to 22279, and the Russell 2000 fell 10.2% to 688. These returns do not reflect reinvestment of dividends.

MAM Performance: For the quarter, 99.5% of the MAM portfolios that were in existence for the quarter had performance that equaled or exceeded that of the S & P 500. The composite return of assets in MAM portfolios was a loss of 7.1% (after MAM fees) versus a loss of 9.5% in the S & P 500 as represented by the performance of the Vanguard Index 500 fund (symbol VFINX) with dividends reinvested.

The out performance of MAM portfolios was primarily attributed to bond funds achieving their purpose of providing downside protection. This downside protection was bolstered by the move we made in mid-January to reduce equity exposure by 5% and increase bond exposure by 5%. Although the PIMCO Commodities Fund makes up only 3% to 4% of most portfolios, its strong performance in the quarter also helped. Finally, good mutual fund selection was a benefit. Seven of the ten U.S. equity mutual funds used by MAM fell less than the S & P 500. International diversification, though, was a negative. Most foreign markets fell more than the S & P 500, although the weakening U.S. dollar helped cushion their drop.

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Best Performers: The eight best performing MAM investments for the quarter were PIMCO Commodity (up 14.2%), PIMCO Developing Local (emerging market bonds) (up 3.3%), PIMCO Total Return (bonds) (up 3.2%), Yieldquest Total Return (bonds) (down 1.2%), Loomis Sayles Bond (down 1.8%), T.R. Price Capital Appreciation (down 3.9%), FMI Large Cap (down 5.5%), and Pioneer Cullen Value (down 6.1%).

Worst Performers: The eight worst performing MAM investments for the quarter were Columbia Marsico 21st Century (down 13.3%), Allied Capital Corp (down 11.4%), Artisan International Small Cap (down 11.1%), Dodge & Cox International Stock (down 10.8%), Thornberg International Value (down 10.7%), iShares Russell 1000 Growth Index (down 10.1%), American AMCAP (down 10.0%), and Schwab S & P 500 (down 9.5%).

Oldest Portfolio: The MAM portfolio with the longest track record is a moderately aggressive portfolio that was fully invested on September 13, 1999. As of March 31, 2008, the original $50,000 had risen to $87,716, plus $1,193 of cumulative withdrawals. This represents a cumulative return of 77.8%. During the same time, the S & P 500 (as represented by the Vanguard Index 500) rose 9.1%. For the quarter ended March 31, 2008, the portfolio fell 6.9%. All returns quoted for this portfolio (and for all MAM portfolios) are net of MAM fees. Also, past performance is not necessarily an indicator of future performance.

The Economy & Stock Market- What is Going On?

In the following discussion I will attempt to succinctly explain what is going on with our credit markets and what actions the Federal Reserve has taken to stabilize things.

The Credit Crisis: Hints of the credit crisis emerged in 2006 when problems first surfaced within the subprime lending area when two Bear Sterns hedge funds faltered. As residential housing prices slumped and mortgage underwriting shortcomings were exposed (i.e. homes purchased with no down payment), securities backed by subprime mortgages plummeted. Many traditional banks, investment banks and other financial institutions were forced to write down a massive amount of these mortgages ($150 billion as of the end of February 2008), leaving them with depleted capital available for lending and other activities. The situation was exacerbated by an abrupt "flight to quality" where financial firms experiencing losses dumped assets at fire-sale prices in an effort to preserve capital, spurring another wave of losses and additional selling.

The bottom line is financial institutions have experienced a decline in capital that makes them less able to provide credit to consumers and businesses. Banking and credit are the lifeblood of an economy, and a threat to the financial system has the potential to have a major detrimental impact on economic growth.

The Federal Reserve was profoundly aware of this, particularly with its Chairman, Ben Bernanke, who has studied the mistakes made by the Federal Reserve during the Great Depression. As the credit crisis unfolded, the Federal Reserve has taken many steps in an effort to inject liquidity into struggling financial institutions. Most recently, the Fed has begun accepting mortgage-backed securities and other assets of questionable value, as collateral for loans for both banks and large investment banks. These loans provide relatively inexpensive financing and replace the currently illiquid (not easily tradable) assets with high-quality Treasury bonds that are broadly accepted.

<u>Did We Reach Rock Bottom With the Bear Sterns News?</u> The biggest move so far by the Fed was announced on March 16th. On that Sunday it was reported that the Fed brokered the fire sale of troubled investment bank Bear Sterns to JP Morgan Chase and announced that it would be willing to lend directly to major Wall Street brokers, which have never before had access to loans from the central bank. The news was shocking as it was announced that the venerable investment banking firm was being bought out at $2 per share, down from a March 3rd price of $70 and a 12-month high of $159. (The buyout price was subsequently raised to $10 per share.)

I think the dramatic actions of the Fed are critical to restore confidence in our financial system. The Fed has basically shown that they "will do whatever it takes" to prevent the credit crisis from worsening. Some are critical that certain Fed's actions may protect firms that exhibited reckless behavior. The feeling is that it could set a precedence that may encourage future risky investments by others (why not if you think the Fed will bail you out?). While this may be true, I think it was critical for the Fed to not let the credit crisis worsen. Furthermore, I expect that one of the byproducts of this crisis will be an increase in governmental regulation to guard against future reckless lending and protect against a similar crisis from reoccurring.

<u>Real Estate:</u> **W**e are experiencing the worst national real estate downturn in decades. In late March, the Standard & Poor's/Case-Shiller index reported its fifth consecutive month in which all 20 metropolitan areas declined. House prices fell 2.4% in January from December, and were down 10.7% from a year earlier. The real estate downturn, which triggered the credit crisis, is not showing any signs of bottoming. My feeling is that the drop in prices is simply the bursting of a real estate bubble that started in 2000 from lax lending standards and investor attitude that real estate was a fail-safe investment. I wouldn't be surprised to see prices not hit bottom until 2009, with a recovery not starting until 2010. The sad reality of this is that the victims will be millions of Americans who will lose their homes through foreclosure.

<u>U.S. Economy:</u> In Mid-March the majority (71%) of economists finally said in the Wall Street Journal's monthly survey that the U.S. has slid into a recession. The survey marked a precipitous shift toward pessimism from the previous survey conducted in early February. The economists now expect non-farm payrolls to grow by an average of just 9000 jobs a month for the next 12 months and that the unemployment rate will rise to 5.5% in December, up from 4.8% currently. Furthering the gloom was the February employment report which showed a loss of 63,000 jobs, the second consecutive monthly decline. The March employment report is due to be released on Friday, April 4th.

An additional dismal economic report was released on March 25th when the Conference Board reported that consumer confidence sank to a five-year low in March as tight credit markets, rising prices, and worsening job prospects deepened worries that the economy had fallen into a recession. The Consumer Confidence Index has been weakening since last July, and is watched because lower consumer confidence tends to reduce consumer spending, which makes up 70% of the U.S. economy.

I have felt since mid-January that it was likely the U.S. was in or was about to enter a recession. *The important question is how deep will the recession be and how long until the economy recovers.* Since mid-January the Federal Reserve has been very aggressive in lowering the Federal Funds rate. After its most recent meeting on March 18th, the Fed announced a further 0.75% reduction in the rate, which has now declined from 4.25% in mid-January to the current rate of 2.25%. Factoring in

the typical lag for interest rate cuts to have an economic impact, these dramatic cuts should provide an economic boost this summer. Furthermore, the IRS has announced that the rebate checks from the Economic Stimulus Act of 2008 (passed by Congress in January) will be sent out starting on May 2nd and continuing through the middle of July. I have read predictions that the tax rebate checks could boost our Gross Domestic Product (GDP) by 1% to 1.5%.

Stock Market: While I expect real estate to continue to sink for at least another year, and the economy to not hit bottom until at least this summer, the direction of the stock market is harder to predict. This is because the stock market is forward looking. Stocks typically decline as the specter of an economic downturn approaches, but they tend to stabilize as the downturn takes hold. *Most importantly for investors, stocks usually rebound significantly from the economic bottom.* The S & P 500 index rose 24% on average in the six months following ten of the last eleven recessions. The one exception was 2001 when stocks were overvalued heading into the downturn. Today, stocks are reasonably valued relative to historical standards. We entered this period of turmoil from a position of valuation strength. Indeed, since the last recession, corporate profits have doubled and price-earnings ratios have declined by almost 50%.

The only confidence I have in my short-term outlook for the stock market is that volatility will remain high. The S & P 500 volatility as measured by daily changes of at least 1% have soared since last summer's credit issues emerged and now stands at a 70 year high. In fact, during this most recent quarter, there were 32 trading days when the S & P 500 rose (14 days) or fell (18 days) more than 1% from the previous day.

High volatility serves an important purpose in weeding out the "weaker" investors from the market. This is a necessary process for the market to form a bottom. Unlike other things in life, an all-enveloping sense of fear often signals a great buying opportunity. We may have recently reached such a point. In Mid-March investor sentiment levels were at their lowest since 1990, and the second lowest since the American Association of Individual Investors (AAII) began tracking such behavior in 1987. In addition, the Investors Intelligence survey is registering five-year highs in bearishness among newsletter advisers.

For long-term investors, though, this volatility shouldn't matter. What is important is the performance of the market over time. Furthermore, as we reach the depth of the recession, based on history, good times for the market may be right around the corner. I am not ready to predict that the market has turned the corner, although the market has staged a strong recovery since the Federal Reserve announced the Bear Sterns bailout/buyout on March 16th.

ADV Part II: When you became a MAM client, I provided you with a copy of my ADV Part II. Along with other items, it contains information regarding my fees and educational background. During the first quarter, we filed our annual update of this 10-page document with the Securities and Exchange Commission. Please let us know if you would like a copy of our most recently revised ADV Part II.

Assets Under Management

As of March 31, 2008, MAM assets under management were in excess of $103 million, down from $110 million at the start of the year.

I really appreciate the referrals that some of you have made, as that is my primary source of new clients. While my minimum amount to manage for new clients remains at $600,000, I am willing to be flexible depending on the individual's situation.

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

Very truly yours,

Stephen P. McCarthy, CPA, CFP