

McCarthy Asset Management, Inc.

Registered Investment Advisor

Thursday, July 3, 2008

Dear Client,

After staging a partial recovery early in the quarter, stocks fell to their lows for the year as the quarter came to a close. As measured from last October's high, stocks prices have now fallen close to 20%, almost reaching the definition of a bear market. With this report for the quarter ending June 30, 2008, I discuss the second quarter and year-to-date performance of the market and MAM portfolios. I also explain what is causing the recent downturn in stock prices, discuss possible 2009 changes to tax rates and capital gains rates, explain why I think it now makes sense to lock in a fixed rate mortgage loan, and describe the Financial Checkup service that we introduced in May.

Enclosed are four 6/30/08 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*: 2nd quarter and YTD 2008 portfolio rates of return
- *Realized Gains and Losses*: YTD 2008 investment realized gains and losses (included only for taxable accounts)

Stock Market & MAM Performance for Second Quarter

Stocks generally fell for the quarter. The S & P 500 fell 3.3% to 1280, the Nasdaq rose 0.61% to 2293, and the Russell 2000 climbed 0.3% to 688. These returns do not reflect reinvestment of dividends.

MAM Performance: For the quarter, 98.0% 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 0.9% (after MAM fees) versus a loss of 2.8% in the S & P 500 as represented by the performance of the Vanguard Index 500 fund (symbol VFINX) with dividends reinvested.

Best Performers: The eight best performing MAM investments for the quarter were PIMCO Commodity (up 14.2%), PIMCO Developing Local (emerging market bonds) (up 2.1%), Blackrock Health Science (up 1.5%), iShares Russell 1000 Growth Index (up 1.5%), Oakmark Equity Income (up 1.4%), American Growth Fund (up 1.3%), American New World (emerging market equities) (up 0.9%), and Yieldquest Total Return (bonds) (up 0.7%).

Worst Performers: The eight worst performing MAM investments for the quarter were Allied Capital Corp (down 21.2%), Janus Contrarian (down 7.9%), Artisan International Small Cap (down 6.4%), Pioneer Cullen Value (down 4.1%), Dodge & Cox Balanced (down 3.6%), Columbia Marsico 21st Century (down 3.2%), Schwab S & P 500 (down 2.7%), and Income Fund of American (down 2.6%).

Stock Market & MAM Performance for YTD 2008

For the first six months of 2008, the S & P 500 fell 12.8%, the Nasdaq dropped 13.5%, and the Russell 2000 fell 10.0%. These returns do not reflect reinvestment of dividends.

For the first six months of 2008, 100% of the MAM portfolios that were in existence for the whole period had performance that was equal to or greater than that of the S & P 500. The composite return of assets in MAM portfolios was a loss of 8.0% (after MAM fees) versus a loss of 12.0% in the S & P 500 (as represented by the performance of the Vanguard Index 500 fund with dividends reinvested).

Explanation of MAM performance: The 4.0% out performance of MAM portfolios was primarily due to the downside protection provided by the bond funds. 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%. The repositioning that was done during the second quarter was also beneficial with the purchase of the conservative Oakmark Equity Income fund.

Two specific investments also impacted performance. PIMCO Commodity, which makes up approximately 4% of most portfolios, provided a significant benefit with its strong performance (up 30.4% for the year through June 30th). On the other hand, the credit crisis continued to drag down Allied Capital, which makes up approximately 1.5% of most portfolios. Reflecting reinvested dividends, the stock has fallen 31.3% this year. Despite its dismal performance since it was added to MAM portfolios in June of 2006, I am not ready to give up on this long term winner (18% annual return from 1960 through 2005). In fact, assuming the stock does recover, the drop in the share price could prove beneficial as we are reinvesting the large quarterly dividend into the stock.

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 June 30, 2008, the original \$50,000 had risen to \$86,594, plus \$1,193 of cumulative withdrawals. This represents a cumulative return of 75.6%. During the same time, the S & P 500 (as represented by the Vanguard Index 500) rose 6.1%. For the quarter ended June 30, 2008, the portfolio fell 1.3%. 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.

What is Ailing The Stock Market?

After climbing back from earlier declines, the S & P 500 closed the quarter close to the lowest level of the year. Why the latest downturn?

The crux of the problem is that the U.S. economy is experiencing slow growth while inflation is rising—perhaps the worst of all worlds. The Federal Reserve reduced the Fed Funds target rate from 5.25% in September 2007 to 2.00% in April of 2008 to help the economy get through the credit crunch last summer. However, inflation is on the rise, and raising interest rates to combat rising prices could hurt the still-fragile economy.

Here are some of the particular concerns weighting on investor sentiment:

- **Continued financial sector woes.** Many banks, brokerages, and insurance companies have continued to warn about mortgage-related losses, weak earnings, dividend cuts, or the need to raise additional capital to replenish their balance sheets. With the sector representing nearly 16% of the S & P 500 at the end of May, weakness in the sector is dragging down the rest of the broad market.
- **Housing market weakness.** The residential real estate market remains weak, with foreclosures and mortgage delinquencies increasing, and housing prices falling. Falling home prices can depress consumer spending as homeowners sense that their net worth is declining and have less equity to tap via home equity loans.
- **Rising food and fuel costs.** Rising food and energy costs act like a tax on consumers that reduce the amount that can be spent on other goods and services.

What does the latest downturn mean for investors?

Falling stock prices can make investors nervous, particularly as the media tends to sensationalize the negative. This fear can then influence investors' decisions, causing them to ignore their long-term goals. Here are some suggestions:

- **Stick to your long-term investment strategy.** While selling your equities in favor of safer investments, such as Treasuries or money market securities, may seem to make sense if you think stock prices will continue falling, keep in mind that fixed-income investments—particularly with today's relatively low yields—are unlikely to help you reach retirement goals, especially if they are 20 or 30 years away.
- **Resist the temptation to try to time the market.** Studies have shown that the average mutual fund investor dramatically underperforms the market averages due to poor market timing and performance chasing. Almost by definition if you sell when there is fear and wait until the fear subsides before you reinvest, you will be buying at higher prices.
- **Keep contributing to your long term accounts.** I believe it was Warren Buffet who said something like “stocks are the one thing that buyers don't like to purchase on sale”. If your financial goals are many years from being achieved, you shouldn't let falling stock prices in the short run discourage you from contributing to your retirement and other long-term portfolios.
- **Stocks are now probably reasonably valued.** Assuming the economy is able to muddle through the current slowdown, prices may actually be quite cheap. That's not to say they won't become even cheaper in the short run because the stock market tends to exaggerate both on the upside as well as on the downside.

Presidential Election and Outlook for Tax Rates and Capital Gains Rates

Who becomes our next President is likely to determine what happens to tax rates for at least the next four years. Sen. Barack Obama has been quoted as wanting to raise the Federal long-term capital gains rate to between 20% or 25%, while Sen. John McCain would like to leave them at 15%. Obama has called for letting the Bush tax cuts expire and raising taxes on those making over \$250,000 while McCain would like to leave the Bush tax cuts intact. Furthermore, Obama's plan for payroll taxes would raise the cap on income subject to Social Security withholding, which is currently at \$102,000. Obama would allow wages above the \$200,000 level to be subject to Social Security taxes. McCain has not indicated any plan to change payroll taxes. Obama has also called for cutting taxes for people making less than \$75,000 a year and eliminating taxes on senior citizens who make less than \$50,000 per year.

My guess is that Sen. Obama will win the election and the Democrats will add to their majority in the House and Senate. As a result, Obama may have an easy time getting Congress to enact his proposed tax increases. **The implication of this is that if you have highly appreciated assets that you plan to sell within the next few years, from a tax standpoint it may make sense to realize those gains before any tax increases are approved.**

Mortgage Loans- Appeal of a 15-year or 30-year Loan

When I bought my first home in 1981, mortgage rates were in the double digits. Over the next twenty plus years, mortgage rates fell sharply. Numerous times I took advantage of falling rates to refinance my mortgage. I often did this by doing a "no-cost" refinance to a mortgage that had a fixed rate for between five and ten years. I am no longer a fan of these mortgages that have a fixed rate for only a short period of time. This is because my expectation is that within the next few years mortgage rates will rise. One reason for this is that inflation is on the rise. Furthermore, I fear that the U.S. federal deficit will increase over time (fueled by the impact of the retiring baby boomers on the Medicare and Social Security systems). Increasing Federal deficits could increase interest rates as the Fed needs to borrow more money.

As a result of my expectation for rising mortgages rates, with one exception, I now recommend that borrowers obtain a 15-year or 30-year fixed rate loan. The exception is if you expect to own your home for a limited number of years. For example, for those who plan to sell their home within the next five years, then a five-year fixed rate loan would be appropriate. *Another implication is that if you plan to continue to own your home for the long-term and your current mortgage is a variable loan, or will convert to a variable loan within the next few years, I suggest you look into refinancing into a fixed rate loan.*

Financial Checkup

Introduction: In the April 2008 Monthly Commentary we introduced our latest service we call the "Financial Checkup". The Financial Checkup ("Checkup") is designed to be used in conjunction with the Net Worth Analysis (NWA). Like the NWA, the Checkup is an Excel template that I have developed. Whereas the NWA tracks a client's Invested Assets to help in determining whether they are on track to retire, the Checkup addresses a variety of financial planning concerns including retirement planning, life insurance, disability insurance, long-term care, debt management, education planning, and estate planning.

Description: The Checkup is not a comprehensive financial plan. It is a tool to gather information regarding these areas, with the result being a three to four page report that makes specific recommendations pertinent to the client's financial situation. The Checkup can be described as the financial equivalent of your annual physical where your doctor evaluates your health. If she uncovers anything of concern, you are sent to a specialist or lab for further testing.

Cost: We do not charge MAM clients for the initial creation or annual update to the NWA or Checkup.

How to Get Started: Since May we have been sending the questionnaire for the Financial Checkup along with the questionnaire for the annual update for the client's NWA. **If you are interested in having us prepare a Financial Checkup for you and you don't want to wait for the annual update to your NWA, or we haven't prepared a NWA for you, please send me an email.**

Assets Under Management

As of June 30, 2008, MAM assets under management were in excess of \$102 million, down from \$104 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

encl: Investment Reports