McCarthy Asset Management, Inc.

Registered Investment Advisor

June 2, 2008

Monthly Investment Commentary- May 2008

Stock Market Performance for May: The stock market continued its recovery with the second consecutive month of positive returns for May. Unadjusted for dividends, the S & P 500 rose 1.0%, the NASDAQ climbed 4.6%, while the Russell 2000 rose 4.5%. Foreign equities rose less than U.S. equities, bonds fell slightly, and commodities continued their strong performance.

MAM Performance: For the month, MAM portfolios slightly under performed the S & P 500, with a composite rise of 1.2% (after all fees), versus a rise of 1.3% for the Vanguard Index 500 fund (symbol VFINX) with dividends reinvested.

The five best performing MAM investments for May were CGM Focus Fund (up 6.6%), American New World (up 3.7%), iShares Russell 1000 Growth Index (up 3.3%), American Growth Fund (up 3.0%), and FMI Large Cap (up 2.7%).

The five worst performing MAM investments for May were Allied Capital Corp (down 1.2%), PIMCO Total Return (bonds) (down 0.9%), Janus Contrarian (down 0.6%), Loomis Sayles Bond (down 0.6%), and Thornberg International Value (down 0.0%).

Year-To-Date Performance: For the first five months of 2008, unadjusted for dividends, the S & P 500 fell 4.6%, the Nasdaq dropped 4.9%, and the Russell 2000 fell 2.3%. MAM portfolios out performed the S & P 500 for these five months, with a composite loss of 2.3% (after all fees), versus a loss of 3.9% for the Vanguard Index 500 fund (symbol VFINX) with dividends reinvested.

U.S. Economy: It now appears that the U.S. economy might avoid experiencing a recession this year. Prospects for the current quarter, once widely expected to be the weakest of the year, have improved. Economic-stimulus checks are expected to help, at least temporarily. Nonetheless, economic growth has slowed to a crawl (Gross Domestic Product growth for the last two quarters has been less than 1%) and employment has been falling. Furthermore, the dramatic increase in energy prices is causing consumers to curtail non-energy expenditures, and real estate prices continue to drop as foreclosures rise. Not surprisingly, in May the Reuters/University of Michigan index of consumer sentiment dropped to its lowest reading since June of 1980. At best, the economy may narrowly avoid a recession, but any growth will probably remain subdued.

Outlook for the Stock Market: Predicting the short-term direction of the stock market is a guessing game. Back in March when the Bear Sterns debacle occurred, things were looking dire. At the time, I encouraged clients to take a long-term viewpoint of their investments, and resist the urge to follow their emotions to sell when things looked bleak. I felt that government efforts (particularly the moves by the Federal Reserve and the Federal stimulus payments), would allow the stock market to stage a recovery starting by summer. Frankly, I have been surprised to see how quickly stocks rose (since March 10th the S & P 500 has risen 10%). My guess is that

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the stock market recovery has gotten ahead of itself. In fact, with the May portfolio repositioning we took advantage of the recent recovery to become more conservative for those clients who expressed concerns during the stock market sell off. My philosophy is to set the asset allocation of a portfolio based on what a client can tolerate in a market downturn. I want to avoid the worst thing an investor can do: decide to sell out when stocks are depressed.

Portfolio Repositioning: Last week we completed portfolio repositioning for all clients. On the day we repositioned your portfolio(s), we sent a 2-page letter of explanation, an Excel spreadsheet showing the current asset allocation for each portfolio, and Morningstar reports for two new funds being purchased in most portfolios (American Funds Fundamental and Oakmark Equity & Income 1). There was little change made in the asset allocation of the portfolios. Generally, we became slightly more conservative because we replaced Oakmark Fund and Oakmark Select with Oakmark Equity & Income 1, a balanced fund with a 40% cash and bond weighting. Despite having such a high bond allocation, the fund has an outstanding long-term track record (11.6% annually for the ten years ended 2/29/08) that beat most funds invested solely in equities.

We did use the repositioning to add the aggressive CGM Focus fund to the larger accounts for clients with a Risk Assessment Questionnaire (RAQ) score of 40 and higher. CGM Focus is a fund that has been run since its 1997 inception by Ken Heebner, founder of CGM. While I have been intrigued by the fund, it does have its negatives. It is concentrated (25 or fewer stocks), aggressive (Heebner will short stocks that he feels are overvalued) and has very high turnover. Because of these negatives, last year I added the fund only to our most aggressive portfolios. The appeal, though, has been its incredible performance. For the last 1, 3, 5 and 10 years the fund ranks in the top 1% of its peer group (the Russell 1000 Growth Index). While the fund's performance will gyrate with the "bets" that Heebner makes, so far his calls have been very impressive. For instance, in 2007 approximately 80% of the fund's assets were invested in industrial and energy stocks which benefited from surging worldwide demand, while his early recognition of the financial crisis caused him to short Countrywide and other subprime lenders. These prescient moves propelled the fund to an 80% return for 2007.

Current Asset Allocation: The asset allocation of MAM portfolios continues to overweight U.S. large cap exposure and underweight small cap exposure. The additional downside protection added last January by adding 5% to bond exposure was kept in place. As discussed above, I continue to be concerned about the risks to the economy. We also left intact the commodity allocation, which has now grown to a 4% portfolio allocation (from an original 3% allocation) due to the strong performance of the PIMCO Commodity fund. Also left unchanged was the large international equity allocation (20% to 30% of most portfolios). Long term, I continue to feel that international equities will outperform U.S. equities as most foreign economies are growing faster than the U.S., the valuation of international equities remains reasonable, and I expect that over time the U.S. dollar will continue to depreciate against many of the foreign currencies (with the possible exception of the Euro). The short-term risk to the international allocation would be a partial recovery in the U.S. dollar, which many experts are predicting.

Northern CA FPA Conference: Last week Billy Alhorn and I attended the annual Northern California conference for the Financial Planning Association. The two-day event, which set a record for attendance with over 300 financial planners, is said to be one of the best regional planning conferences in the country. Each year I look forward to it as a great opportunity to network with other investment advisors. Between us we attended numerous sessions this year,

including ones on long-term care, social security planning, technology solutions for financial advisors, investment opportunities in China, and the U.S. Economic Outlook provided by Janet Yellen, President of the Federal Reserve Bank of San Francisco. Probably my favorite session, "Applying and Communicating Real-World Guardrails and Withdrawal Policies with Clients" was led by Jonathan T. Guyton, CFP, who is well known in the industry for his research on "a sustainable withdrawal rate" that retirees can take from their portfolios without depleting their assets.

"Sustainable Withdrawal Rates" for Retirees: As my client base ages (my average client was born in 1953), more of our efforts will shift from helping clients *build* Invested Assets to *utilizing* Invested Assets to provide a comfortable income in retirement. A critical issue for many retirees who depend on their Invested Assets for a significant portion of their income, is "How much can be withdrawn annually without running out of money?" This is called as "a sustainable withdrawal rate". The conventional wisdom in the industry is that the initial withdrawal rate should be set between 3% and 4% of "Invested Assets". The amount withdrawn can then be increased annually by the amount of the previous year's inflation (as measured by the Consumer Price Index).

In 2004 and 2006 Jonathan Guyton released the results of two studies that showed the initial withdrawal rate could be increased to just over 5% if two rules are followed. One rule is that if prior year's return on "Invested Assets" was negative, then no increase is allowed for the current year withdrawals. The second rule is that if the current withdrawal rate is more than 20% higher than the initial rate (i.e. the 5% rate grows to 6.1%), then the withdrawals must be reduced by 10%. These guardrails protect the portfolio during bear markets and periods of high inflation.

Jonathan discussed the concept of a "Discretionary Fund" which can help relieve the tension between "live for today" and "making sure the money lasts". The "Discretionary Fund" should be a separate account managed by the advisor similarly to managing a "college fund" for an older child (i.e. managed very conservatively). It is not covered by the Withdrawal Policies and should be initially set at between 2% and 10% of Invested Assets. Jonathan also introduced the concept of a "Withdrawal Policy Statement" (WPS), which is a written agreement between the Client and the Advisor that specifies the goals and policies to guide future decision making for ongoing portfolio withdrawals. While the WPS obviously cannot force clients to limit their spending, it can provide a framework for the Advisor to discuss when the client's withdrawals are not sustainable and the client runs the risk of depleting their assets.

I really liked the concepts that Jonathan presented and plan to eventually incorporate them into a set of formal procedures to help guide my clients as they progress through retirement. While I am excited to introduce this at a later date, for now we have plenty to work on with the Financial Checkup that we introduced last month. I am discussing these concepts now, to give you an introduction to retirement concepts that are being developed in the industry. Please let me know if you would like to discuss them further.

Also please call or email me if you have any questions or would like to discuss your portfolio(s).

Sincerely,

Stephen P. McCarthy, CPA, CFP