

McCarthy Asset Management, Inc.

Registered Investment Advisor

November 2, 2005

Monthly Investment Commentary- October 2005

Stock Market Performance: October was a down month for the stock market. For the month, the S & P 500 fell 1.8%, the Nasdaq dropped 1.5%, and the Russell 2000 fell 3.1%. There was no where to hide as foreign stocks, bonds, commodities, and REITs also fell.

MAM Performance: For the month, MAM portfolios underperformed the S & P 500, with a composite negative return of 2.3% (after all fees), versus a drop of 1.7% for the Vanguard Index 500 fund (symbol VFINX) with dividends reinvested.

The five best performing MAM mutual funds were Metropolitan West (rise of 0.2%), Selected American (rise of 0.1%), American Amcap (drop of 0.7%), Bjurman Micro Cap (drop of 0.8%), and Loomis Sayles Bond (drop of 0.9%).

The five worst performing MAM mutual funds were: PIMCO Commodity (drop of 7.8%), Artisan Intl Small Cap (drop of 4.9%), Artisan Small Cap Value (drop of 4.4%), William Blair Small Cap (drop of 4.0%), and Causeway International (drop of 3.6%).

For the first nine months of 2005, unadjusted for dividends, the S & P 500 fell 0.4%, the Nasdaq dropped 2.5%, and the Russell 2000 fell 0.8%. *For the year-to-date, the composite return of MAM portfolios was a positive 3.3% (after all fees), versus a rise of 1.0% for the Vanguard Index 500 fund (symbol VFINX) with reinvested dividends.*

Performance of U.S. Economy: On October 29th, the Commerce Department reported that the U.S. economy grew at a robust 3.8% annualized rate in the third quarter, marking the 16th consecutive quarter of growth and confirming that the economy weathered the hurricanes that devastated the Gulf Coast. This compares with the 3.3% rate of growth in the Gross Domestic Product (GDP), for the prior quarter. GDP has now expanded at a rate between 3% and 4.5% for eight consecutive quarters, the longest streak of such growth since World War II.

An inflation measure released with the GDP report showed prices rose at a 3.7% rate in the third quarter, the fastest pace in over a year. Consumer prices excluding food and energy (the measure preferred by the Federal Reserve), however, rose just 1.3%, the lowest quarterly reading in two years.

Interest Rates: As expected, on November 1st, the Federal Reserve raised the federal funds rate a quarter point to 4.0%. This represents the 12th consecutive quarter-point rise since June of 2004 and the highest rate since June of 2001. In its accompanying statement, the Fed indicated that further increases should be expected. The current consensus is for additional 0.25% increases in December and January, resulting in a federal funds rate of 4.5%. At that

point, the Federal Reserve (without retired Chairman Alan Greenspan) will decide whether further increases will be needed to forestall an increase in inflation.

Corporate Earnings: Of the companies in the S & P 500 that have reported 3rd quarter earnings so far, 68% have exceeded expectations, 13% matched expectations and 19% failed to match estimates. Presently, forecasts call for a 15%+ increase in 3rd quarter earnings for companies in the S & P 500. The steady increase in corporate earnings for the last few years has led to a decrease in the price-earnings ratio for these companies. Assuming earnings growth continues in upcoming quarters, stocks at some point could become undervalued.

Outlook for the Stock Market: What caused the drop in the stock market this month? Probably the main culprit was fear of rising inflationary expectations by consumers, which could lead to continued increases in short-term interest rates by the Federal Reserve. My belief is that with the exception of energy prices, inflation will not be a problem for at least the next few years. This is because of the tremendous impact that the global economy has in moderating prices. Energy prices, though, are a wild card.

As I said in the September 30, 2005 quarterly report, while I remain cautiously optimistic about the stock market, I expect with the next portfolio repositioning to increase the downside protection for portfolios.

Next Portfolio Repositioning: At this point I plan to do moderate portfolio repositioning later this month or early in December. Here are my current thoughts about the moves I will be making:

1. U.S. Large Stocks vs U.S. Small Stocks: 2005 may represent the 5th consecutive year that small cap stocks outperform large cap stocks. This is a long time for an investment trend, so I expect to continue to decrease small cap U.S. exposure.
2. Bonds: The one change I expect to make is to add PIMCO Developing Markets to most portfolios. Please see below for a discussion of this new fund.
3. Alternative Assets: I plan to increase the investment in PIMCO Commodities and possibly Hussman Strategic Growth.
4. International: Possible further increase in international equities.

PIMCO Developing Local Markets: This fund, which was started in May of 2005, invests in local currency and debt of emerging markets. It provides access to an investment area that previously was not accessible via a retail mutual fund. While normally I am leery of investing in new funds, I have high regards for the PIMCO mutual fund family, and this fund presents an interesting way to achieve competitive returns while increasing the diversification of MAM portfolios. Initially, I plan to establish a 2% to 3% weighting of this fund in portfolios.

Unlike emerging-market bonds, which are primarily dollar-denominated emerging-market debt, local-market debt is denominated in emerging-market currencies. The returns from investing in this fund will come from two sources: the level of local interest rates (or yield), and currency appreciation or depreciation relative to the dollar. Unlike the United States with its massive

foreign account deficit, many of these emerging market countries are generating current account surpluses. Over time, I expect these currencies to perform well relative to the U.S. dollar.

PIMCO has been investing in developing local markets for over five years. PIMCO believes that emerging markets are on a secular (long-term) growth path due to improving macroeconomic fundamentals of emerging markets such as improved credit ratings, higher foreign-currency reserves, sounder economic policies, and a broader investor base (local investors are larger players in emerging markets than in the mid-1990s).

Since its inception in 1994, the J.P. Morgan ELMI+ Index (which is the comparable index for this new fund) has generated annualized returns in the high single digits and has beaten the U.S. three-month Treasury Bills in almost 90% of the three-year rolling periods. The ELMI+ returns are below the low-teens returns of emerging-market bonds, but the ELMI+ index has substantially lower volatility (less than half that of emerging market bonds).

This fund should provide diversification benefits to MAM portfolios. Developing local markets typically exhibit very low correlation with other asset classes. The correlation of the ELMI+ over the last 10 years with the S & P 500 is less than 0.50 and is actually negative with U.S. Treasuries and the Lehman Brothers Aggregate Bond Index. In addition, the asset class itself also has favorable diversification characteristics. There are 22 different countries in the index without significant concentration in any one country. The countries are influenced by different things and can have offsetting influences.

Tracking Your Invested Assets: So far 37 MAM clients have indicated an interest in the service we will provide to develop a Net Worth Analysis spreadsheet for clients. I have created the questionnaire to gather the needed information from clients and have started to send it out on a staggered basis to clients. If you are interested in this service, and have not yet notified us, please do so by sending me an email (steve@mamportfolios.com).

Please call or email (steve@mamportfolios.com) if you have any questions or would like to discuss your portfolio(s).

Sincerely,

Stephen P. McCarthy