McCarthy Asset Management
Registered Investment Advisor
Certified Public Accountant
Certified Financial Planner

Thursday, April 17, 2003

Dear Client,

It was a difficult first quarter with virtually every equity asset class showing losses. Uncertainty over the prospect of war with Iraq was a drag on the markets through the first two months, followed by further unrest over the progress of the war as the quarter came to a close. There was a strong rebound, though, between March 13th and March 21st, when the outbreak of war with Iraq appeared imminent, followed by the initial hope that the conflict would be short.

Enclosed are four investment reports for the quarter ending March 31, 2003. The first, "Portfolio Position Analysis", lists your investments and shows how each has performed. The second, "Portfolio Performance Summary", shows the rate of return on your investments for 2003. The third, "Portfolio Performance History", shows the monthly and cumulative rate of return on your portfolio since inception. The fourth report, "Realized Gains and Losses", is included solely for taxable accounts. It lists investment gains and losses realized during 2003.

Stock Market Performance for the Quarter

For the first quarter of 2003, most indexes showed losses in the single digits, with large-caps outperforming small caps, and growth stocks—led by the Nasdaq—outstripping value stocks. Junk bonds were the star performers, besting both stocks and investment-grade bonds. For the first quarter of 2003, the S & P 500 fell 3.6% to 848, the Nasdaq Composite rose 0.4% to 1341, and the Russell 2000 dropped 4.7% to 365.

Impact of Investor Psychology on the Stock Market

It's no secret that in the short run, investor psychology has a significant impact on financial market volatility. The huge volatility in the prices of individual stocks over any given year does not reflect the actual change in the value of the underlying businesses. Stock prices are volatile; business values are much less so. Stock price volatility reflects change in what investors are willing to pay for a share of those businesses. And while this is sometimes driven by fundamentals, it is more often driven by emotion. When investors are driven by greed they tend to downplay risk. Clearly this is what occurred in the late 1990's and early 2000 when the market became hugely overvalued. Conversely when investors are driven by fear, risks are overblown and the positives are downplayed. Although only time will tell, excessive pessimism could be driving volatility now.

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In light of the events of the last few years, this is a good time for all investors to review their risk tolerance. First, think back to your view of risk and return in early 2000. At that time, many investors were more concerned about missing out on the roaring bull market. If investors' views were detached from reality back then, what does it suggest about the wisdom of trusting an emotional point of view today? Shouldn't the stock market be a better investment now that the S & P 500 has dropped almost 50% and the Nasdaq 80%? Why then are some investors fleeing the stock market for "safer" investments?

The lesson here is to not give in to your emotions. Trying to time the market can be fruitless. John Bogle, the founder and former chairman of The Vanguard Group, is an active advocate for mutual fund investors. In a speech he gave on January 8, 2003, he said, "Investors now tend to hop in and out of (mutual) funds. The average fund-holding period has dropped from 16 years in the 1950s to 2 ½ years now. And investors have done a pretty horrendous job of timing those hops. From 1984 through the end of 2001 when the S & P 500 advanced at a compound annual rate of 14.5% and the average equity mutual fund rose 11.5%, actual fund investors made just 4.2% a year, according to financial research firm Dalbar."

Wow, under-performing the market by 10% a year over a 17-year period! How can that be? By allowing your emotions to influence your investment decisions. Many investors who were buying aggressively three years ago, are now looking to bail out of the market.

What do you do if you are very uncomfortable with owning equities given all the uncertainties in the current environment? During the last two months I have had several clients contact me about their concerns with the stock market. I told them, "I don't know where the market is headed in the short run. It is possible prices could go lower. The problem is if you sell now, when do you buy back in?" Almost by definition, it will be when prices are higher. So on the one hand, I want clients to hang in there. On the other, I am concerned that if I convince them to stay put, and then the market goes lower, they may panic and sell at the bottom. For some of these clients I reduced the equity exposure in their portfolio. This helped to relieve their anxiety while still keeping them with some equity positions. When the stock market recovers, these clients will benefit to the extent they retained equity exposure.

Keys to Successful Investing

Now more than ever, a disciplined approach is needed to be a successful stock investor. Three points come to mind:

1. *Diversification is especially important in this environment:* During 2000 through the middle of 2002, MAM portfolios maintained a significant exposure to small cap stocks and REITs. During this time small cap stocks outperformed large cap stocks by a wide margin and REITs generated positive returns. This helped the vast majority of MAM portfolios to significantly outperform the S & P 500. Throughout 2002, I increased the high-yield bond exposure in most portfolios. The strong performance of high-yield bonds and REITs this past quarter, more than offset the recent under-performance of international equities and small cap stocks.

2. *Invest in line with your risk tolerance:* The last three years have demonstrated the significance of risk tolerance. Three years ago many investors wanted to be aggressive. Many now realize they are more risk adverse than they previously thought. Of course, the worst bear market in many decades has been a real eye opener.

If you take the premise that for most investors it is foolish to try to time the market (remember the John Bogle quote which indicates how awful the average mutual fund investor has been at that), a better approach is needed. The solution is to create a portfolio that is compatible with your risk tolerance. This will allow you to stay the course during both good and bad times.

3. *Periodically rebalance your portfolio:* A proven technique to improve portfolio performance is to periodically rebalance your portfolio among the asset classes. This is a disciplined way to "buy low and sell high". But it is counter-intuitive and difficult to implement. Here is how it works. On a periodic basis (e.g. annually) sell a portion of those investments that have performed well and reinvest the proceeds in asset classes that have performed poorly. Doing this would have led you to sell large-cap technology stocks back in 1999 and 2000, and to purchase small cap value stocks, bonds and REITs. Although in hindsight this sounds like it was an obvious move to make, at the time most investors were doing the opposite.

   I rebalance MAM portfolios on at least an annual basis. During 2002 my main efforts were to reduce the exposure to small cap value funds and in some cases REITs (where they had grown to over a 7% portfolio position), and purchase high-yield bonds, large-cap stocks, and international equities. So far, with the exception of international equities, the portfolio changes have been beneficial to portfolio performance.

In summary the approach I recommend (and practice through MAM) is to ***build a diversified portfolio that is compatible with your risk tolerances. Based on market events, periodically rebalance the portfolio to adjust for the changing investment dynamics. Finally, view your portfolio and the stock market with a long-term investment horizon. Don't become overly influenced by the day-to-day gyrations of stock prices and try not to let your emotions dictate your investment decisions.***

Where's the Market Headed Now?

The short answer is, "I don't know". I am not a market timer, so I don't try to predict the short-term direction of the market. It may be insightful, though, that a number of influential market timers recently turned bullish. For instance, in mid-March, MarketTimer's Bob Brinker issued a buy signal for stocks (after exiting the market in January of 2000). Other notable market timers that recently turned bullish are Dan Sullivan, editor of the Chartist newsletter, Louis Navellier, editor of the Blue Chip Growth Stock newsletter, and Richard Bank of Profitable Investing.

In last quarter's letter, I reviewed the positive and negative factors that may affect the stock market. Since that time, a significant negative has been lessened. War with Iraq is no longer an uncertainty. The war occurred and it was relatively short. We now face the daunting task of rebuilding Iraq. North Korea remains a serious concern, although recently China has started to assert her influence to relieve the tensions.

Many of the economic reports that have been recently released are disappointing. I am hopeful, though, that consumer and business spending will be boosted by our success in Iraq. In addition, if necessary, the Federal Reserve is prepared to cut interest rates further. Finally, President Bush's fiscal stimulus package is working its way through Congress. Although Congress has reduced the scope of the tax cuts, it should survive in some modified form.

MAM Performance for the Quarter

In General: For the quarter, 66% of the MAM portfolios out performed the S & P. The composite return of MAM portfolios was a loss of 2.7% (after MAM fees), versus a loss of 3.2% in the S & P 500 (adjusted for an assumed annual dividend yield of 1.6%).

The positive return from high-yield bonds and REITs helped cushion the losses from equities in MAM portfolios. Hurting performance was the dismal performance of international equities, the under performance of small cap stocks relative to large cap stocks, and the under weighting of technology stocks in MAM portfolios. The Nasdaq, led by technology stocks, rose for the quarter, while the vast majority of MAM portfolios are under weighted in technology stocks. I continue to feel that technology stocks are overvalued (at least relative to the overall stock market).

Best Performers: The eight best performing MAM mutual funds for the quarter were Pioneer High Yield (up 8.0%), Loomis Sayles Bond (6.8%), TCW Galileo Select (4.4%), PIMCO Total Return (2.2%), Cohen & Steers REIT (0.5%), Marsico Focus (-0.1%), Oakmark Select (-0.5%), and Calamos Convertible (-1.1%).

Worst Performers: The eight worst performing MAM mutual funds for the quarter were Artisan International (down 14.1%), Oakmark International Small Cap (-12.2%), PBHG Clipper Focus (-10.4%), Firstar Micro Cap (-7.7%), Acorn International (-6.4%), Selected American (-5.2%), Weitz Partners Value (-4.3%), and Oakmark Fund (-4.0%).

Oldest Portfolio: The MAM portfolio with the longest track record is a $50,000 portfolio that was fully invested on September 13, 1999. As of March 31, 2003, the original $50,000 had declined to $46,918 for a cumulative decline of 6.2%. During that time the S & P 500 lost 33.9%. For the quarter ended March 31, 2003, the portfolio lost 3.5% (versus a loss of 3.2% in the S & P 500 (adjusted for dividends)). 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 indicative of future performance.

Current Portfolio Asset Allocation:

The typical MAM portfolio now has a 25 to 30% weighting in large-cap U.S. stocks, a 30 to 38% weighting in small-cap and mid-cap U.S. stocks, a 11 to 20% weighting in bonds (primarily high-yield), a 7 to 8% weighting in REITs, and a 12 to 15% weighting in international equities.

The fact that most MAM portfolios are under weighted in technology stocks and have a significant weighting in bonds and REITs, may cause them to under perform the S & P 500

when the stock market does recover. I continue to feel that the risks in the present environment are significant enough to warrant a cautious approach. Once I am confident that the stock market is back on an upward track, I expect to become more aggressive.

Assets Under Management

As of March 31, 2003, MAM assets under management were in excess of $31 million, down up from $32 million at the start of 2003.

Miscellaneous

If you have not been receiving the monthly MAM Commentaries via e-mail, please provide us with your current e-mail address. The best way to do that is to send us an e-mail at stevemtax@aol.com.

If your portfolio has a position in PIMCO Total Return fund, there is a small discrepancy between the enclosed statements and the March 31, 2003 statement for your account(s) that you received from Charles Schwab. The dividend that was paid by the PIMCO Total Return fund on March 31, 2003 is reflected in the enclosed statements, but excluded from the Schwab statements. (It will be shown as an April 1st transaction on your April Schwab statement.)

Your Performance

Also enclosed is the invoice that shows my asset management fees for the quarter. Charles Schwab will automatically deduct these fees from your account.

Please call me if you wish to discuss the stock market or possible changes to your portfolio.

Very truly yours,

Stephen P. McCarthy, CPA

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