McCarthy Asset Management

Registered Investment Advisor
Certified Public Accountant
Certified Financial Planner

Wednesday, April 14, 2004

Dear Client,

The powerful stock market rebound that started just over a year ago continued in the first quarter, though most of the gains occurred during the first few weeks of the year. Small-caps and foreign stocks were especially strong, and both outperformed the S & P 500. High-yield and convertible bonds managed to deliver good returns, while investment-grade bonds did quite well as interest rates declined. Far and away, the biggest winner during the quarter was the REIT market, which moved higher in every month and even managed to make money in March, when equities were generally negative.

With this MAM report for the quarter ending March 31, 2004, I will discuss the first quarter market and MAM portfolio performance, as well as my outlook for the remainder of 2004. I will also describe a savings account that provides a 2.0% annual yield, and discuss why I like rental real estate. Finally, I will mention the increase to $300,000 as the minimum amount to become a MAM client, effective June 1, 2004.

Enclosed are four 3/31/04 investment reports:

- *Portfolio Position Analysis*: lists your investments and how each have performed
- *Portfolio Performance Summary*: 1st quarter 2004 portfolio rate of return
- *Portfolio Performance History*: portfolio rate of return since inception
- *Realized Gains and Losses*: 1st quarter 2004 investment gains and losses realized. This report is included solely for the few taxable accounts with sales activity during the quarter.

Stock Market Performance- Bull Market Over?

The first quarter of 2004 was an overall positive one for the market. The S & P 500 rose 1.3% to 1126, the Nasdaq Composite dropped 0.4% to 1994, and the Russell 2000 rose 5.9% to 590. Performance, however, weakened as the quarter progressed.

After a very strong stock market in 2003, 2004 started off well for investors but soon turned bumpy. Has the one-year old bull market ended? For several reasons, I believe the answer is no. First, the short-term correction we recently experienced is a healthy ingredient of a bull market. Secondly, the technical indicators that I follow suggest that the market has further room to rise.

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Finally, further improvements in the economy and corporate profits, and rock bottom interest rates continue to provide important stimulants for a bull market. There continue to be risks, though, which I will also discuss.

Why Short-Term Dips Are Good: The recent short-term correction was healthy. Between February 11 and March 24, the S & P 500 fell 5.8% while between late January and late March, the Nasdaq fell 10.1%. Why is a pullback good? Minor declines are needed to prevent excessive optimism from building up in the market. According to *Net Davis Research*, the period up to the February 11th high had been an unusually long run without at least a five percent correction—317 calendar days. Since 1900 there have been only 25 other rallies that lasted in excess of 200 days without at least a five percent correction. Of those, the recent rally ranks 12th in duration, and the 34.6 percent gain that the Dow posted places it 13th in percentage gain. According to Davis, once the correction is over, higher prices should prevail. "While the correction marked the start of a new bear market in five of the twenty-five cases, the DJIA (Dow Jones Industrial Average) has usually recovered to rise substantially above the previous peak, gaining a median of 18 percent to a bull market top more than a year later."

Technical Analysis: I am the first to say that it is difficult, if not impossible, to predict the short-term direction of the stock market. Nonetheless, I do quite a bit of reading and analysis to understand what is driving the stock market. One of my favorite publications that I subscribe to is Lowry's. Lowry's Reports is the oldest continuously published Technical Advisor in the United States. Lowry's analysis is based on the study of the basic forces of stock market Supply versus Demand. As they wrote in their March 19 report, "Many seem to think that, based on high valuations, the recent market weakness has been just a warm-up for a major decline. Others, based on more pragmatic evidence, believe that a normal short-term correction has taken place and, despite some backing and filling on the "quadruple witching Friday", the bottom is already in place."

The report continued, "We are always guided by the probabilities derived from the 70+ year history of the Lowry Analysis. As previously noted, virtually none of the classic warning signs of a major market top were in evidence prior to the start of the recent market weakness. And, little has occurred since that time to change the positive outlook for the months ahead. Therefore, the probabilities indicate that we have recently witnessed nothing more than a normal short-term correction. And, a number of our Supply vs. Demand indicators suggest that the recent pullback could have already run out of steam on the downside, setting the stage for a recovery rally in the days ahead".

Performance of the Economy, Corporate Profits and Interest Rates: Various indicators of economic activity reveal that the U.S. is progressing along the strong growth path policymakers intended when they cut interest rates and taxes, and increased spending. The consensus forecast for GDP growth this year is 4.2 percent, according to nearly 50 financial economists tracked by Blue Chip Indicators. This would be the first time since 1999 that the GDP grew by more than 4%. Despite strong economic growth, inflation remains moderate at the approximate rate of 1.7%.

Recent surveys of business activity by the Institute of Supply Management and the National Federation of Independent Business, show a marked improvement in orders, hiring, and general business confidence. In particular, after several months of disappointing reports, on April 2 the U.S. Department of Labor announced that the American economy added 308,000 jobs in March. This represented the largest increase in jobs since April 2000, and was almost triple what economists were projecting. Although one month does not make a trend, the report was welcomed

news that gave an immediate boost to the stock market and a sharp negative jolt to the bond market.

Corporate profits are continuing to rise rapidly. As the first-quarter earnings season begins, analysts expect profits of the Standard & Poors 500 companies to increase 16.7% from the previous year, according to Thomson First Call. The number has risen steadily since the beginning of the year, when the consensus forecast was for a rise of 13.4 percent. In addition, the results could be even higher, given the pattern of steadily upward revisions to expectations.

What Could Go Wrong: While I am cautiously optimistic for the stock market in 2004, there are risks. First, international terrorism and the continued fighting in Iraq could negate much of the positives. The deadly bombings in Spain last month are a reminder that no one is safe with terrorist preferring to hit soft targets. The U.S. hopes to hand power over to the Iraqis on June 30, however, that may be very difficult, given the sharp increase in fighting recently.

A second risk is the possibility of the Federal Reserve increasing interest rates. Rates near their 40-year low continue to provide a major stimulant to the U.S. economy and stock market. After a meeting in January, however, the Fed revised the wording saying that it will be 'patient' before raising rates. In previous announcements, the Fed said it would keep rates on hold for a 'considerable period'. The markets interpreted this to mean the Fed changed its mind from "not thinking about raising rates" to "contemplating raising rates". This change in wording, in part, led to the recent stock market correction discussed above.

Long-Term Projections

Long-Term Concerns: Longer-term, I have some real concerns. First, the budget deficit is rising, reflecting efforts to stimulate the economy and firm up our military defenses. Second, the U.S. global trade imbalance continues to mount, as we pay ever more for our consumption of foreign oil and manufactured goods made overseas. These are factors I will continue to monitor.

Longer-Term Stock Market Returns: Stock market returns are significantly influenced by whether equities are undervalued or overvalued. I believe stock prices currently are in fair value range. When the market hit its 2004 peak, stocks in the S & P 500 sold for an average of 18.3 times earnings forecasts for the coming year. Stocks historically have sold for 15 or 16 times earnings. My hope is that continued strong profit growth will bring this price-earnings ratio down as stock prices rise moderately. According to a March 26, 2004 article in the Wall Street Journal, "For all of 2003, total pretax corporate profits rose 18%, compared with a 17% increase in 2002. Profits declined modestly in 2001 and 2000…Economists think profit growth will slow but remain strong. A panel of about 50 economists polled by Blue Chip Economic Indicators of Kansas City, Mo., shows a combined forecast of 17% profit growth this year and 10% for 2005."

What is not realistic is to expect the stock market's price-earnings ratio to rise in the long run (i.e. like it did in the late 1990's). If this were to occur, I would expect to take further defensive steps to protect MAM portfolios from another stock market bubble. Without a rise in the market's price-earnings ratio, over an extended period it is likely that the return on stocks will equal their dividend yield plus their earnings growth. *If true, this could put intermediate and long-term expected returns in the 5 to 7 percent annual range.* While this would be disappointing relative to the historic returns provided by equities, it would be decent relative to the returns currently provided by alternative investments.

MAM Performance for the Quarter

In General: For the quarter, 96% of the MAM portfolios out performed the S & P 500. The composite return of MAM portfolios in existence for the whole quarter was a gain of 3.4% (after MAM fees) versus a rise of 1.7% in the S & P 500 (adjusted for an assumed annual dividend yield of 1.6%).

Best Performers: The eight best performing MAM mutual funds for the quarter were Cohen & Steers Realty (rise of 11.9%), William Blair Small Cap (8.7%), Artisan Intl Small Cap (7.1%), Oakmark Intl Small Cap (6.5%), Bogle Small Cap Growth (5.5%), Thornberg Intl Value (4.9%), Firstar Micro Cap (4.0%), and Capital World Growth & Income (4.0%).

Worst Performers: The eight worst performing MAM mutual funds for the first quarter were Bjurman Barry Small Cap (down 4.2%), PBHG Clipper Focus (-3.8%), TCW Galileo Select (-0.2%), Bjurman Micro Cap (up 0.8%), Marsico Focus (1.0%), Oakmark Fund (1.4%), American Mutual (1.5%), and Income Fund of America (1.9%).

Oldest Portfolio: The MAM portfolio with the longest track record is a fairly aggressive $50,000 portfolio fully invested on September 13, 1999. As of March 31, 2004, the original $50,000 had risen to $68,948 for a cumulative return of 37.9%. During the same time the S & P 500 lost 11.4%. For the quarter ended March 31, 2004, the portfolio rose 3.4%. 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 MAM Portfolio Positioning

Most MAM portfolios currently have the following asset allocation:

U.S. Equities- Large Cap Stocks	25 to 35%
U.S. Equities- Small & Mid Cap Stocks	22 to 33%
Bonds (primarily Convertible & High Yield)	15 to 25%
REITs and Commodities	6 to 8%
Foreign Equities	15 to 17%

Technology stocks within the mutual funds represent between 9 and 11% of the portfolios. I feel that most MAM portfolios are positioned somewhat less aggressively than the S & P 500.

Cost of Downside Protection: At the beginning of 2003, I suggested that if the stock market were to rebound, MAM portfolios could under perform the S & P 500 because of the defensive positioning I had done previously to protect against a further drop in the market. While the bond exposure limited performance in 2003, the mutual fund selection and small cap exposure more than compensated for not being fully invested in equities. Although MAM portfolios have gotten off to a good start in 2004 relative to the S & P 500, I again suggest that if the stock market were to rise sharply for the remainder of the year (which I don't expect), the portfolios could under perform.

INGdirect.com – A Place to Earn 2.0% on Savings

It is a sign of the times when earning 2.0% annually on your savings account is a good deal. It wasn't too long ago when most money market accounts paid well in excess of that. Now most money market accounts (including Schwab's) pays less than 1.0% annually.

ING is a European financial company. They are aggressively advertising in America as they gather savings deposits. I have been very pleased with the savings account that I set up with them in January. The account pays 2.0% annual interest. There are no fees and the account has the $100,000 FDIC insurance.

ING is able to pay such competitive rates because of their low cost structure provided through automation. ING offers no retail branches. Accounts are set up over the Internet and are linked to your existing bank account. You are not able to write checks on your ING account. Instead, you transfer money to and from the linked bank account. You initiate the transfer by logging on to your ING account via the Internet or by phoning them. From what I can tell, there are no transaction fees or other fees.

If you keep more than $10,000 in liquid savings and are earning less than 1%, I recommend that you set up an account. Their Web site address is "www.INGdirect.com".

Rental Real Estate- A Good Way to Invest For Retirement

I have often told clients that the two best investments (other than your own business) are a diversified equity portfolio and rental real estate. Of course, I directly manage for clients their diversified equity portfolios. For the rental real estate, you are more on your own. In preparing tax returns, I have seen many instances of the significant long-term benefit of rental real estate investments. I believe the key to success is positive cash flow and patience. Rental purchases should initially provide at least close to breakeven cash flow. Then over time, rental increases should lead to positive cash flow. In addition, the rental income is used to pay the mortgage principal, so that after thirty years the mortgage is paid off. Finally, of course, the property should appreciate in value.

Assuming a 20% to 25% downpayment, how do you find rental property in the Bay Area with breakeven cash flow? You probably don't. (If you do, please give me a call!) Although tremendous appreciation has made Bay Area rental property an outstanding investment for many years, the problem for new investors is rents that are currently very low relative to values. To

purchase a rental property now, you will either have a very large negative cash flow or you will have to put a substantial amount down. Therefore, significant appreciation will be necessary for a current purchase to be a good investment.

Personally, I would rather not make that bet. That is what led me in 1989 to purchase my first rental: a home in Houston, Texas. Since then the home has appreciated well (about 50%), although modest by comparisons to California real estate during this time. More importantly, the monthly rent increased from $525 in 1989 to the current rate of $930. The cash flow, which was slightly negative when I bought, is now significantly positive. More recently, I have been purchasing new duplexes in San Antonio.

I feel that rental real estate is a great asset to own in retirement. The expected increase in monthly rent should provide increased cash flow to protect against inflation. In addition, rental real estate assets provide good diversification to an equity portfolio.

Increase in Minimum Amount for New Clients

I appreciate the confidence that existing and new clients have shown in adding to the assets that MAM manages. I mentioned in the last quarterly report that I would be raising the minimum investment amount for new clients if managed assets continued to grow rapidly. Existing and new clients added over $3 million in net assets during the first quarter, bringing the MAM assets under management up to over $53 million as of March 31, 2004, versus $49 million at the start of 2004.

With the intent of keeping the number of MAM clients at a manageable level, effective June 1, 2004, I will be raising the minimum to become a new client, to $300,000 (up from the existing level of $250,000). This increase does not impact existing clients who have less than $300,000.

Miscellaneous

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

Very truly yours,

Stephen P. McCarthy, CPA

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