

McCarthy Asset Management, Inc.

Registered Investment Advisor

Wednesday, April 5, 2006

Dear Client,

2006 has started out strong as the U.S. stock market posted its best first quarter returns in many years. International equities and REITs also rose, while bonds were mixed and commodities fell. With this report for the quarter ending March 31, 2006, I discuss the first quarter market and MAM portfolio performance, as well as my 2006 outlook for the economy and the stock market. In addition, I also discuss the expected increase in life expectancies and the impact on how retirement assets should be invested.

Enclosed are four 3/31/06 investment reports:

- *Portfolio Position Analysis*: lists each investment in the portfolio
- *Portfolio Performance Summary*: 1st quarter 2006 portfolio rate of return
- *Portfolio Comparative Performance Review*: portfolio performance by year and cumulatively since inception
- *Realized Gains and Losses*: 1st quarter of 2006 investment realized gains and losses (included solely for the few taxable accounts that had sales in the first quarter)

Stock Market & MAM Performance

The stock market performed very well for the first quarter of 2006. The S & P 500 rose 3.8% to 1295, the Nasdaq climbed 6.1% to 2340, and the Russell 2000 jumped 13.7% to 765. These returns do not reflect reinvestment of dividends.

For the quarter, 99% of the MAM portfolios that were in existence for the whole quarter outperformed the S & P 500. The composite return of assets in MAM portfolios was a gain of 5.4% (after MAM fees) versus a gain of 4.2% in the S & P 500 as represented by the performance of the Vanguard Index 500 fund (symbol VFINX) with reinvested dividends.

Best Performers: The eight best performing MAM mutual funds for the whole quarter were Artisan Intl Small Cap (up 15.5%), Cohen & Steers REIT (15.1%), William Blair Small Cap Growth (12.0%), Oakmark Intl Small Cap (11.9%), Dodge & Cox Intl (9.9%), Bjurman Micro Cap (9.8%), Artisan Small Cap Value (9.6%), and Century Small Cap (8.4%).

Worst Performers: The eight worst performing MAM mutual funds for the quarter were PIMCO Commodity (down 5.7%), PIMCO Total Return (bonds) (down 0.6%), Nuveen High Yield Muni (up 1.3%), Hussman Strategic Growth (up 1.7%), Oakmark Select (up 2.5%), Loomis Sayles Bond (up 2.6%), PIMCO Developing Local Market (emerging market bonds) (up 3.0%) and Selected American (up 3.0%).

Oldest Portfolio: The MAM portfolio with the longest track record is a fairly aggressive portfolio that was fully invested on September 13, 1999. As of March 31, 2006, the original \$50,000 had risen to \$83,587, plus \$1,193 of cumulative withdrawals. This represents a cumulative return of 69.6% during the six and a-half years. During the same time, the S & P 500 (as represented by the Vanguard Index 500) rose 3.1%. For the quarter ended March 31, 2006, the portfolio rose 5.3%. 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 an indicator of future performance.

Interest Rates and Performance of the Economy

Interest Rates: The Federal Reserve's first policy decision under new chairman Ben S. Bernanke came as no surprise. On March 28th the Fed lifted its target interest rate by a quarter-point for the 15th time in the past 15 meetings, to 4.75%. In the statement accompanying the announcement, the Fed forecast that economic growth appears likely "to moderate to a more sustainable pace". In addition, the Fed said "some further policy firming may be needed to keep" the risks to growth and of inflation "roughly in balance". Economists expect the Fed to raise rates to 5% at its May 10th meeting.

The initial reaction of the stock market to the Fed's announcement of possible further hikes was not pleasant. The Dow Jones Industrial Average, which had been up about 19 points before the Fed's afternoon announcement, finished the day down 96 points, or 0.9%. The fear is that the Fed will go too far in raising rates and trigger a recession. Furthermore, the market was disappointed that the Fed did not hint to an end to its interest rate hikes. In the past 22 years, the Fed has stopped raising interest rates five times. The average stock market response: a rise of 16 percent in the S & P 500 index in the 12 months following the end of a tightening cycle.

Performance of the Economy: After a slowdown in the 4th quarter of 2005, economists feel the pace accelerated in the first quarter of this year to an annual growth rate of 4%. Rising interest rates and a slowing housing market are expected to slow that growth down to the 3% level by the second half of 2006. The hope is that the slowdown accompanied by continued tame inflation, will lead the Fed to end its interest rate hikes later this year.

With the exception of reports about housing, most recent economic reports have been positive. For instance, on March 28th The Conference Board said that its consumer confidence index rose to a four-year high in March.

Corporate Profits and Outlook for the Stock Market

Corporate earnings have been on a tear. The long-term average annual growth rate in U.S. corporate earnings is 6%. The fourth quarter of 2005 represented the tenth consecutive quarter of

double-digit earnings growth, a feat that occurred only two other times since 1950. Analysts currently project that first quarter profits will grow at an 11% rate for companies in the S & P 500 index. For the full year 2006, analysts project that profit growth will slow to the high single digits. Historically, this still represents well above average growth.

This above average corporate profits growth, however, is not sustainable. As reported by the Commerce Department on March 31st, U.S. corporate profits accounted for 11.6% of gross domestic product in the fourth quarter of 2005. This represented the biggest share of the nation's income that companies have taken since 1966. Economists say profit growth is likely to slow this year as U.S. unemployment falls and workers regain some bargaining power.

During these last two years of double digit profit growth, the stock market produced moderate returns (the Vanguard Index 500 with dividends reinvested, rose 10.7% for 2004 and 4.8% for 2005). As a result, relative to current earnings, stocks are cheaper than two years ago. This may provide a cushion for the market as corporate profit growth slows. I was hoping this would be the case as I wrote in the MAM report for the quarter ending March 31, 2004:

“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...* 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”.

I continue to feel that we are in a moderate return environment with average annual returns of 5% to 7%. While I continue to be cautiously optimistic in my outlook for equities, if the stock market continues to rally sharply in 2006, I may take defensive steps in the next portfolio positioning. Longer-term, I am still very concerned about our huge foreign trade deficit and the risk to a dramatic drop in the value of the U.S. dollar.

Increased Life Expectancy- Impact on Retirement

Planning for a Long Life: On April 3rd I attended the Annual Northern California Financial Planning Association conference in San Francisco. The keynote speaker, Bernard Lietaer (author of “The Future of Money: Beyond Greed and Scarcity”) stated that 2/3 of the people that ever lived past age 65 are alive now. We are living longer! How long we live should have a major impact on how much we save and how we invest for retirement.

I read an interesting article in the December 2005 issue of Investment Advisor, which is a magazine catering to registered investment advisors. The article was titled “Into The Future- An Aging Population Coupled With a Leap in Longevity Will Change How Advisors Do Business”. The 7-page article made some interesting points regarding our retirements. If you are interested in reading the full article, let us know and we will send you a copy.

The article predicted that based on continued medical advances, people will regularly live to beyond age 100. Many people who were interviewed for the article responded to that claim with a question “why would I want to live that long?” That’s because our experience of advanced old age tends to be quite distressing and even depressing. Who wants to live another 20 or 30 years if those years will be spent in a declining physical health and with the specter of diminished mental capacity? According to the article, research in everything from nanotechnology to biotechnology suggests that old age will be longer and more enjoyable since we will be able to prevent many of the disabilities that we associate with old age, and treat those disabilities and diseases not only with advanced drugs but with tissues and organs and replacement parts grown from our own stem cells.

Increased longevity won’t mean 30 years of living a depressing life in a nursing home, but it will present opportunities for completely new careers and avocations. It won’t mean a time of depression and isolation, but rather increased years of learning, working for personal fulfillment, and connectedness. The research shows that people who live longer are connected to other people—to family and friends. The article stated that it is interesting that centenarians (those who live to 100) have this “connectedness” in common.

The relevance of the article to MAM is that a primary purpose of what we do is to help ensure that our clients do not outlive their money (“superannuation”). While you are working, we want to help you save and invest assets for a financially secure retirement. The Net Worth Analysis we provide is meant to track the invested assets that will provide the financial security for your retirement. Once you retire, however, a long life expectancy means that it will be crucial that your invested assets continue to grow, generating a rising income stream that will stay ahead of inflation. The longer the life expectancy, the greater the importance of investing in equities to provide that needed growth in invested assets.

eStatements

As discussed in the MAM Commentary for February 2006, Schwab is now able to provide eStatements, which is the electronic delivery of your monthly statements.

To sign up for eStatements, you need to do the following:

1. call the Schwab Alliance Service team at 1-800-515-2157, extension 4, and request a user id and password for the SchwabAlliance.com Web site.
2. the first time you log on to the Web site, you will need to select a new password.
3. to sign up for eStatements (and turn off mail delivery), hit the Account tab at the top of the home page
4. then hit the eDocuments tab on the right.
5. select “turn off mail delivery of your statements”
6. check the box “turn off paper delivery for all accounts”
7. check the box consenting to receive paperless documents and hit the “I Consent” tab.

eStatements can significantly reduce the amount of paper that you accumulate. Starting with the month you sign up, Schwab will start saving up to four years of monthly statements for you to access online (statements for the months prior to your enrollment will not be available). Schwab is also providing a financial motivation for those clients that sign up for eConfirms and eStatements: for households with assets at Schwab of less than \$1 million the commission rate for individual stock and exchange traded funds will be reduced from \$19.95 to \$12.95. If you have questions in signing up for eStatements, call either Schwab Alliance or Billy or Marilyn in our office.

Assets Under Management

I appreciate the confidence that clients continue to show in adding to the assets that MAM manages. Existing and new clients added over \$1.5 million in net assets during the first quarter, bringing the MAM assets under management to over \$85 million as of March 31, 2006.

I have never had a formal marketing program for MAM. Initially, the rapid growth of MAM was from my tax clients. As the tax practice has been scaled back to accommodate MAM's growth, the primary source of new clients is now referrals from existing clients. Years ago I discovered in operating my tax business that the best form of marketing is to provide great service to existing clients and then ask for referrals. I continue to appreciate your referrals. The minimum amount to manage for new clients is \$500,000.

Your Performance

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

Very truly yours,

Stephen P. McCarthy, CPA

encl: Investment Reports