

McCarthy Asset Management, Inc.

Registered Investment Advisor

April 3, 2007

Dear Client,

In a turbulent quarter, the U.S. stocks posted positive returns while foreign equities, bonds, REITs and commodities also all rose. This quarter may be remembered for the return of volatility.

With this report for the quarter ending March 31, 2007, I discuss the first quarter stock market and MAM portfolio performance, the return of volatility to the stock market, and my 2007 outlook for the economy and the stock market. In addition, I provide a brief explanation of alternative minimum tax and, for the benefit of those with college-age children, a discussion of how low-income taxpayers will be exempt from long-term capital gains tax for 2008 through 2010.

Enclosed are four 3/31/07 investment reports:

- *Portfolio Position Analysis*: lists your investments and how each have performed
- *Portfolio Performance Summary*: 1st quarter 2007 portfolio rate of return
- *Portfolio Comparative Performance Review*: portfolio performance by year and cumulatively since inception
- *Realized Gains and Losses*: 1st quarter of 2007 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 was modestly positive for the first quarter of 2007. The S & P 500 rose 0.2% to 1421, the Nasdaq climbed 0.3% to 2422, and the Russell 2000 rose 1.6% to 801. These returns do not reflect reinvestment of dividends.

In General: For the quarter, 98% of the MAM portfolios that were in existence for the quarter had performance that equaled or exceeded that of the S & P 500. The composite return of assets in MAM portfolios was a gain of 1.3% (after MAM fees) versus a gain of 0.6% in the S & P 500 (as represented by the performance of the Vanguard Index 500 fund with dividends reinvested).

Best Performers: The eight best performing MAM investments for the quarter were Oakmark International Small Cap (up 5.8%), PIMCO Commodity (up 5.4%), Dodge & Cox International Stock (up 5.0%), Artisan International Small Cap (up 4.3%), Artisan Small Cap Value (up 3.5%), Capital World Growth & Income (up 2.4%), Cohen & Steers REIT (up 2.2%), and American Amcap (up 2.1%).

Worst Performers: The eight worst performing MAM investments for the quarter were Allied Capital Corp (down 9.9%), Oakmark Select (down 2.1%), Cambiar Opportunity (down 1.4%), Calamos Growth & Income (down 0.1%), Selected American (up 0.4%), Nuveen High Yield Muni (up 0.7%), Pioneer Cullen Value (up 0.9%), and American Growth Fund (up 1.4%).

Oldest Portfolio: The MAM portfolio with the longest track record is a moderately aggressive portfolio that was fully invested on September 13, 1999. As of March 31, 2007, the original \$50,000 had risen to \$92,037, plus \$1,193 of cumulative withdrawals. This represents a cumulative return of 86.5%. During the same time, the S & P 500 (as represented by the Vanguard Index 500) rose 15.1%. For the quarter ending March 31, 2007, the portfolio rose 1.1%. All returns quoted for this portfolio (and for all MAM portfolios) are net of MAM fees. Also, past performance is not necessarily an indicator of future performance.

Return of Volatility

Until this past quarter, the Dow Jones industrials hadn't declined as much as 2% from a high in more than seven months and hadn't declined 10% in almost four years. That is an exceptionally long time without a significant drop. The average U.S. stock fund has made money in each of the past four calendar years, averaging a 16% annual gain.

The calmness in the stock market changed on February 27th. After a 9% fall in the Shanghai stock market, the Dow Jones Industrial Average fell 416 points (3.3%), the S & P 500 dropped 3.5%, the Nasdaq declined 3.9%, and the Russell 2000 fell 3.8%. Since then the Chinese stock market has fully recovered from its dramatic drop, while the U.S. markets have only partially recovered.

Prior to the February 27th drop, investment professionals struggled to find out why things had been calm for so long. It was probably the combination of rising corporate profits and low interest rates. One problem with the lack of volatility was that it created a sense that the financial markets were not as risky as they used to be. In turn, the return of volatility surprised some unprepared investors.

I feel the return of volatility is good. Risk is the reason why historically the stock market has provided an average annual rate of return of just over 10 percent. Investors are compensated for the risk of investing in stocks by earning a return that is significantly in excess of what bonds and most other investments provide. The great news is that while stocks are volatile in the short run (historically there is a 25% chance that stock market returns will be negative for any given year), volatility is dramatically reduced over longer periods of ten years or greater. To invest in equities, investors should have a long range investment horizon. Also, investors should not take on more risk than they are comfortable with.

If stocks remain volatile for the foreseeable future, one repercussion could be a shift in the leadership within the stock market to blue-chip stocks over riskier investments. Fortunately, during the last year, MAM portfolios have shifted more heavily toward large cap stocks while small cap stock exposure has been reduced.

Performance of the U.S. Economy

Sub-Prime Woes: The slump in housing has recently been exasperated by the meltdown of the sub-prime lending market. Almost overnight, the ability of home buyers to purchase with “nothing down” has gone away. I view this as a positive for the long-term health of the U.S. economy and the housing market. While sub-prime delinquency rates have surged, prime-borrower delinquency rates, though also higher, remain at historically low levels.

Sub-prime borrowers do not have a significant impact on the U.S. economy. Those who take out sub-prime loans tend to be lower income, less-credit worthy consumers, who contribute a relatively small share to overall consumer spending. Specifically, according to the Labor Department, the bottom fifth of U.S. households with the lowest incomes account for only about 8% of total consumer outlays, while the top fifth account for nearly 40% of overall spending.

I believe the key driver for the majority of the mortgage market is the outlook for jobs. As long as the labor market is healthy, and income growth remains solid, the prime-mortgage holder should remain in good shape. Fortunately, the most recent (February) payroll reports confirmed the relatively robust state of the labor market, given upward revisions to previous months and a further drop in the unemployment rate. The less volatile six-month moving average unemployment rate is now at 4.5%, a six-and-a-half-year low.

A Greater Economic Threat: Weak Capital Spending: Business outlays for new equipment and facilities have slowed sharply over the past year. When businesses expand their operations they also add to their payrolls. Job growth over the past couple of years has been the primary support for consumer spending, so any sharp slowdown in capital spending would most likely have an even broader impact on consumers than the weakness in housing.

What’s odd is that this weakness is occurring at a time when businesses are earning record profits and the cost of borrowing remains relatively cheap. Companies also sport exceptionally high levels of corporate cash and solid balance sheets. Apparently many companies are being cautious. After all, companies have been rocked by one uncertainty after another since 2000, including recession, corporate scandals, terrorist attacks, war, and a tripling of gas prices. Recent news that sales of new single-family homes plunged to the lowest level in more than six years, along with new evidence of falling home prices, only reinforces managements’ desire for caution.

Outlook for the U.S. Economy: The recent economic reports on the U.S. economy have been mixed. The key to continued consumer strength remains the labor market. Here, steady growth in payrolls and incomes, in combination with gains in household net worth, is supporting consumer spending and confidence despite the ongoing slowdown in housing. Any further slowdown in the U.S. economy could lead the Federal Reserve to cut short-term interest rates. In fact, in its most recent meeting in March, the Federal Reserve formally dropped its stated bias to raise interest rates, giving itself flexibility to cut interest rates in coming months if economic growth decelerates further.

Outlook for the Stock Market

All in all, I remain positive yet cautious. I expect the recent stock market volatility to continue. As I mentioned in my February Monthly Commentary, “a drop in the market was needed to restore investors’ sense of caution and prudence, key factors that allow the market to climb on a sustainable basis”.

Meanwhile, while the economy and corporate earnings growth are slowing, stocks are not expensive. The S & P 500 is now trading at 14.8 times expected forward 12-month earnings, close to the 14.5 level when the index hits its low last year. As long as the economy and corporate profits continue to grow moderately, I feel that the stock market is likely to provide decent returns for investors. Any cut in interest rates by the Federal Reserve will be a big plus.

Alternative Minimum Tax

The most common question I have heard this tax season is “why am I subject to alternative minimum tax (AMT) and what can I do about it?” AMT was created by Congress years ago to ensure that the wealthy pay their “fair share of tax”. That was back in the day when tax shelters enabled high income taxpayers to sharply reduce or even eliminate their tax liabilities. Since then, the reach of AMT has grown such that millions of Americans are now subject to it.

The best way for me to explain how someone becomes subject to AMT is to describe how it is calculated. The calculation of AMT starts with “regular taxable income”. Adjustments are then made to add in “preference income”. The most significant preference adjustments are to add back the deduction for state income tax and property tax. The result is “AMT income”. An exemption of up to \$62,550 for married filing jointly and \$43,500 for single taxpayers is then subtracted. Unfortunately for many of my clients, this exemption starts to be phased out if “AMT income” exceeds \$150,000 for married filers and \$112,500 for single taxpayers. “AMT” income less any exemption allowed results in “tentative minimum taxable income”. This income is then taxed at a graduated 26% and then 28% flat rate, resulting in “Tentative Minimum Tax”. The excess of this “Tentative Minimum Tax” over their regular tax is what is called “AMT”.

How can you minimize or eliminate AMT? The solutions are not appealing. You can earn less money (i.e., your exemption will not be phase out), move to a low-tax state (i.e., lower adjustment for state income tax) or sell your home (i.e., no adjustment for property tax deduction). Taxpayers have pressured Congress to reform or eliminate AMT. In my opinion, this will not happen because AMT generates very significant revenue for the U.S. government. I predict that AMT relief will occur from an increase in the regular tax rates by the next Administration. This will lead to higher regular taxes for higher income taxpayers. Since AMT is the excess of tentative minimum tax over regular tax, the increase in regular rates (assuming the AMT rates are left unchanged), will result in lower AMT.

Cutting Your Capital-Gains Tax Bill to Zero

Beginning in 2008 and continuing through 2010, the Federal tax rate on **long-term capital gains** from sales of stocks, mutual funds and other securities is scheduled to drop to **zero** for people in

the two lowest ordinary income tax brackets. Currently, these low-income taxpayers are subject to a 5% Federal rate on long-term capital gains. For higher-income taxpayers, the top Federal long-term capital gains rate is scheduled to remain at 15%.

For single taxpayers for 2007, the lowest two tax brackets are for taxable income up to \$31,850 and for married taxpayers it is taxable income up to \$63,700. For 2008, these income amounts will be adjusted upwards for inflation.

I see the opportunity for my clients to take advantage of this tax break with kids or grandchildren that will be 18 or older in 2008 through 2010. Highly appreciated stock can be gifted to shift the capital gains. The gifting can start this year. For 2007, there is a \$12,000 exemption amount for gifts. For annual gifts in excess of \$12,000, a gift tax return is to be filed.

Retaining Financial Records

Enclosed is the article "Get Your Financial House in Order", from the April edition of Money Magazine. This timely article provides tips on how long to save tax records, how to efficiently file financial records and receipts, and how to maintain a record of your various passwords.

Assets Under Management

As of March 31, 2007, MAM assets under management were in excess of \$105 million, up from \$100 million at the start of the year. For the quarter, existing and new clients added over \$3 million in net assets to their managed accounts. I continue to welcome your new client referrals. Effective January 1, 2007, the minimum amount to manage for new clients was raised to \$600,000.

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

Very truly yours,

Stephen P. McCarthy, CPA, CFP

encl: Investment Reports

Article: Get Your Financial House in Order