McCarthy Asset Management

Certified Public Accountant
Certified Financial Planner

July 5, 2001

Dear Client,

Enclosed are four investment reports for the quarter ending June 30, 2001. The first is titled "Portfolio Position Analysis". It lists your investments that I manage and shows how each has performed. The second, "Portfolio Performance Summary", shows the year-to-date rate of return on your investments for 2001. The third is the "Portfolio Performance History". It shows the monthly and cumulative rate of return on your portfolio since inception. The fourth report, "Realized Gains and Losses", is included only for taxable accounts. It lists the investment gains and losses that were realized during the first quarter of 2001.

Stock Market Performance

The second quarter of 2001 was good for the stock market. For the quarter the S & P 500 rose 5.5% to 1224, the Nasdaq Composite rose 17.4% to 2161, and the Russell 2000 climbed 13.8% to 513. This was the first positive performance in five quarters. For the year-to-date, however, most stocks are still down. For the first six months of 2001, the S & P 500 fell 7.3%, the Nasdaq dropped 12.6%, while the Russell 2000 rose 6.1%.

I wrote in last quarter's report that as of March 31st I was more bullish due to the interest rate cuts and the possible tax cut (which has now become a reality). At that time the Federal Reserve had made three interest cuts since January 2001. Since then the Fed has cut rates three more times, the most recent being a ¼% cut that was announced on June 27th. In less than six months, the Federal Reserve has cut interest rates by 2.75% (i.e. the federal-funds rate, the rate banks charge on overnight loans, has dropped from 6.5% to 3.75%).

This dramatic slash in rates is very bullish for the stock market. In last quarter's report I provided a table that showed the performance of the stock market after a second rate cut by the Fed. The table showed that in all twelve instances since 1942, the stock market had appreciated twelve months after the second rate cut. Per the July edition of Richard E. Band's "Profitable Investing", in the post-World War II era there have been 10 cases where the Fed has cut interest rates five times in a row (which now is six). One year after the fifth cut, the Dow Jones Industrial Average always has been higher. The average one-year return after the fifth cut was 28.1%. Because stock market prices are currently at a high level (relative to earnings), I expect the return this time to be less than the 28.1% average. Given the current low rate of return on alternative investments (CDs, money market accounts, bonds), I believe many investors would welcome even a 10% return.

Why is a decrease in interest rates positive for equities? There are at least four reasons. The first is that consumer spending tends to increase because consumer finance costs are lower. This

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is particularly true for industries such as housing and autos where purchases are often financed. These sectors then provide a boast to the U.S. economy. The second reason is that as rates fall it becomes cheaper for companies to finance new spending. Therefore companies spend more. The third reason is that companies that have significant debt receive a boast in earnings as a result of a decline in their borrowing costs. These first three reasons lead to an increase in corporate earnings that then lead to an increase in stock prices. The final reason is that investors invest more of their savings in the stock market as interest rates decrease. This is because as interest rates fall, the yield on alternative investments such as certificates of deposits and money market accounts decline. For instance money market rates have fallen from over 6.50% last December to less than 4.00% now.

I still describe my outlook for the stock market as "moderately" bullish. While I am confident that the interest rate cuts and tax cut will have a positive impact, the stock market is not out of the woods yet. There are reasons why the Fed has cut rates so much this year. The U.S. economy is growing very slowly at best. As a result corporate earnings for the second and third quarter of 2001 will be terrible. Only time will tell whether current stock prices factor in these poor earnings. Most economist, however, expect the economy to start growing by the fourth quarter.

Economists Predict Recovery for U.S. Economy by Year's End

The following was taken from an article that appeared in the July 2nd, 2001 edition of the Wall Street Journal. "Despite the doom and gloom that run rampant in corporate boardrooms, many economists see a brighter future for the U.S. economy and are forecasting that a recovery will begin by year end. The economy grew a sluggish 1.2% in the first quarter of 2001 and is expected to remain in low gear through the third quarter of this year. But the consensus forecast of the 54 economists in the Wall Street Journal's semiannual forecasting survey calls for real gross domestic product to advance 2.7% by the fourth quarter and 3.1% in the first half of next year."

"The optimism of most economists is based on the combination of the monetary stimulus of the six Fed interest rate cuts and the fiscal stimulus from the $40 billion tax cut that will be sent to taxpayers this Summer. The combination of tax cuts and lower interest rates, say economists, will entice consumers to raise their level of spending. Once businesses see the economy stabilizing, their capital-spending plans—which have plummeted—might also stabilize."

MAM Performance

The second quarter of 2001 was good for MAM portfolios. 90% of the portfolios outperformed the S & P 500. The six best performing funds utilized by MAM were Van Wagner Emerging Growth (rise of 33.3%), Bjurman Micro Cap Growth (26.3%), Bogle Small Cap (16.4%), TCW Galileo Select (10.3%), Cohen & Steers Realty (9.8%), and Artisan Small Cap Value (9.6%). Once again small and mid-cap funds outperformed large cap funds.

The worst performing MAM funds for the quarter were international. Liberty Acorn International lost 3.0% and Artisan International Fund gained only 2.3%. International funds have performed very poorly during the last fifteen months due in part to the strong U.S. dollar. I still believe in using international mutual funds to diversify a portfolio and I am confident that these two funds will do well in the future.

Enclosed is a 1-page report from the May 25, 2001 issue of Morningstar that highlights two of the funds that are in almost all MAM portfolios: Artisan International and Bjurman Micro-Cap

Growth. Despite the recent poor performance of the Artisan International fund, it is one of the best international funds around. The Bjurman Micro-Cap Growth Fund is one of my favorite mutual funds and is present in almost all MAM portfolios. Interestingly, this May 25th, 2001 article on the fund was the first time it appeared in the Morningstar publication. By the time the article was sent to subscribers, the fund had already closed to new investors. Therefore most readers never had an opportunity to purchase the fund. For new MAM clients that do not own Bjurman Micro Cap, I will be using Bjurman All Cap Growth. This fund, which started last month, is the second mutual fund offered by Bjurman Funds and is also managed by Thomas Berry.

The MAM portfolio with the longest track record is a fairly aggressive $50,000 portfolio that was fully invested on September 13, 1999. As of June 30th, 2001 the original $50,000 had grown to $61,837 for a return of 23.7%. During that time the S & P 500 lost 0.22%. For the quarter ended June 30th, 2001 this portfolio rose 9.7% (while the S & P 500 rose 5.5%).

Continued Growth in MAM

Assets under management for MAM have continued to grow. As of June 30th, 2001 assets reached $25.5 million, up from $22 million on March 31st, 2001.

I continue to welcome and appreciate any referrals that you have for MAM. For new clients the minimum to invest remains at $150,000. I anticipate raising this to $200,000 by the end of the year.

MAM Strategies

Here are my current strategies:

1) **Weighting in technology stocks-** For new clients technology stocks continue to represents between 15 and 22% of the total portfolio. This is comparable to the technology weighting in most existing MAM portfolios. I still am looking forward to increasing the technology exposure further, but I do not expect this to occur any sooner than the fourth quarter of this year.

2) **Large weighting in small & mid-cap stocks-** Small and mid-cap stocks have significantly outperformed large-cap stocks since late 1999. Because small and mid-cap stocks still have a reasonable valuation relative to large cap stocks, I believe that over weighting small and mid-cap stocks will be a good strategy for at least the next year.

3) **Small, undiscovered funds-** I continue to search for small, undiscovered mutual funds. As mentioned in last quarter's letter, during the first quarter I aggregated ten client accounts and made the $50,000 minimum purchase required by the Bogle Small Cap Growth Investor Fund. During the second quarter I purchased the fund for most new accounts and for some existing accounts that had cash to be invested. Over the remainder of the year as I do portfolio rebalancing I will add this fund in most accounts with sufficient cash. I want to establish a position in this fund in portfolios before it is closed to new investors (which Bogle promises to do when assets reach $150 million). I think the fund is a good investment even though Schwab charges transaction fee for purchases (since it is one of the few funds utilized by MAM that is not part of Schwab's one-source program). The fund returned 16.4% during the second quarter.

I am continuing my search for additional small, undiscovered funds. Typically the process is once I find a promising fund, I establish a position in my own account. I then monitor the fund on a daily basis to see how it performs relative to other mutual funds in my account. If I develop enough confidence in the fund, I then start purchasing it in other MAM portfolios. This past quarter I purchased initial positions in three funds and am now monitoring them more closely.

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 have any questions or if you want to discuss your portfolio.

Very truly yours,

Stephen P. McCarthy, CPA