

McCarthy Asset Management, Inc.

Registered Investment Advisor

Wednesday, July 5, 2006

Dear Client,

The stock market stumbled this past quarter. In particular, between May 5th and June 13th, the S & P 500 fell 7.7%. A turnaround late in the quarter, however, allowed the S & P 500 to recover most of the loss. Other indices were not as fortunate. With this report for the quarter ending June 30, 2006, I discuss the first quarter and year-to-date market and MAM portfolio performance, as well as my outlook for the economy and the stock market. In addition, I discuss the status of several projects that we are currently working on.

Enclosed are four 6/30/06 investment reports:

- *Portfolio Position Analysis*: lists each investment in the portfolio
- *Portfolio Performance Summary*: 2nd quarter and YTD 2006 portfolio rate of return
- *Portfolio Comparative Performance Review*: portfolio performance by year and cumulatively since inception
- *Realized Gains and Losses*: YTD 2006 investment realized gains and losses (included only for taxable accounts which had sales).

Stock Market & MAM Performance for Second Quarter

The stock market performed poorly for the second quarter of 2006. The S & P 500 fell 1.9% to 1270, the Nasdaq dropped 7.2% to 2172, and the Russell 2000 fell 5.2% to 725. These returns do not reflect reinvestment of dividends.

For the quarter, 44% 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 loss of 1.5% (after MAM fees) equal to the loss of 1.5% in the S & P 500 as represented by the performance of the Vanguard Index 500 fund (symbol VFINX) with reinvested dividends.

I am actually pleased with the most recent quarterly MAM portfolio performance relative to the S & P 500. MAM portfolios performed comparably in a quarter when the best performing part of the market was large cap U.S. stocks (i.e. the S & P 500). As noted above, the Nasdaq and Russell 2000 dropped 7.2% and 5.2%, respectively. In addition, international equities and bonds were mixed, while REITs fell.

Best Performers: The eight best performing MAM mutual funds for the quarter were PIMCO Commodity (up 5.1%), Causeway International (up 1.8%), Income Fund of America (up 1.8%), iShares Dow Jones (up 1.5%), Dodge & Cox Intl Stock (up 1.2%), Hussman Strategic Growth (up 1.2%), Nuveen High Yield Muni (up 0.9%), and PIMCO Developing Local (up 0.7%).

Worst Performers: The eight worst performing MAM mutual funds for the quarter were North Track PSE Technology (down 10.4%), Bjurman Micro Cap (down 7.4%), William Blair Small Cap (down 5.5%), Century Small Cap (down 5.2%), Artisan Intl Small Cap (down 4.6%), Marsico Focus (down 4.6%), Cohen & Steers REIT (down 3.8%), and Artisan Small Cap Value (down 3.8%).

Stock Market & MAM Performance for YTD 2006

For the first six months of 2006, the S & P 500 rose 1.8%, the Nasdaq fell 1.5% and the Russell 2000 climbed 7.7%. These returns do not reflect reinvestment of dividends.

For the first six months of 2006, 97% of the MAM portfolios that were in existence for the full six months out performed the S & P 500. The composite return of assets in MAM portfolios was a gain of 3.8% (after MAM fees) versus a gain of 2.6% in the S & P 500 as represented by the performance of the Vanguard Index 500 fund (symbol VFINX) with reinvested dividends.

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 June 30, 2006, the original \$50,000 had risen to \$81,906, plus \$1,193 of cumulative withdrawals. This represents a cumulative return of 66.2%. During the same time, the S & P 500 (as represented by the Vanguard Index 500) rose 1.5%. For the quarter ended June 30, 2006, the portfolio fell 2.0%, while for the first six months of 2006 it rose 3.2%. 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: On June 29th, for the 17th time in the past 17 meetings, the Federal Reserve announced a 0.25% increase in its target interest rate. The federal funds rate, which directly impacts short-term interest rates such as the prime rate, is now at 5.25%, the highest level in more than five years. While the quarter-point hike was a foregone conclusion on Wall Street, in the statement accompanying the announcement of the rate increase, the Fed raised hopes that its two-year campaign to raise rates may be coming to an end. Wall Street cheered the news with a rise of 215 points in the Dow Jones industrial average on the day of the Fed announcement, the biggest one-day point gain in more than three years (the S & P 500 rose 2.2% for the day).

If the Fed were to continue to increase rates, the concern is that the economic recovery would end, possibly leading to a recession. While the Fed is well aware of the risks of going too far with its interest rate hikes, it is striving to prevent a rise in inflation. The Fed indicated that “the extent and timing” of any additional rate increases is dependent upon upcoming reports about inflation and the economy.

Some economists feel the Fed may have already gone too far. For instance, U.S. Trust, in its Economics Quarterly Outlook for the Summer of 2006, states that worries about inflation seem overdone. The most significant factor causing the recent spike in “core” Consumer Price Inflation (which excludes the volatile food and energy sectors) was the impact of rents. Rents typically rise when the home-buying market weakens, which we are experiencing now. In the report, U.S. Trust predicted that by early 2007 the Fed will start reducing the Federal Funds rate. By the end of 2007, it predicts the rate will fall to 4.0%, down from its current 5.25% level.

Performance of the Economy: Recent economic reports show that U.S. industrial production and factory use have stumbled a bit, while retail spending has moderated, and the leading indicators—which provide a sense of the future course of the economy—are now off somewhat. Economists expect that rising interest rates and a slowing housing market will reduce U.S. gross domestic product growth to about 3% during the quarter ending June 30th. Furthermore, many economists hope that growth will stabilize in the 2.5% to 3.0% range over the next 12 to 18 months. It is hoped that this moderate growth will be sufficient to allow corporate profits to continue to grow while dampening the demand for high-priced commodities and other materials, thereby reducing inflationary pressure.

Meanwhile the world’s economy is growing at its fastest rate in over thirty years. With the Japanese economic recovery broadening to the consumer sector, European growth recovering from its recession lows, and Asian production continuing to ramp up, the world’s economic engine is firing on all cylinders. China and India, accounting for one-third of the world’s population, are expanding at twice the global average. The economic expansion is the most broad-based in history, with virtually every region (except Europe) forecast to grow by over 3%.

Corporate Profits and Outlook for the Stock Market

Next week the market will turn its attention to the release of corporate quarterly earnings reports. Growth for the last three years has been very impressive. If earnings come in as projected, the quarter ending June 30, 2006 would represent the twelfth consecutive quarter of growth in excess of 10% (versus 6% for the long-term average annual growth rate in U.S. corporate earnings). Although this string of double digit quarterly earnings growth is expected to end this year, analysts still project that profit growth will be in the high single digits for all of 2006.

This double-digit profit growth has been accompanied by modest returns in the stock market for the last 2 ½ years. As a result, relative to current earnings, stocks are the cheapest they have been in years. *As long as the economy and corporate earnings continue to grow, I am cautiously optimistic that the market will produce moderately positive returns for 2006.* This is consistent with what I have stated for the last few years: we are in a moderate return environment with average annual returns of 5% to 7%. Longer-term, I am still concerned about our huge foreign trade deficit and the risk to a dramatic drop in the value of the U.S. dollar. I am factoring these concerns into the asset allocation of portfolios with a large allocation to foreign equities.

Current Projects:

The following is an update on projects we are working on this year:

1. *New Risk Assessment Questionnaire (RAQ):* In May we created and mailed a new questionnaire to measure our clients' tolerance for portfolio risk. So far we have received back completed RAQs from 110 clients. Each possible question in the RAQ has a number of points assigned. As we receive back a client's completed RAQ, we score it, and respond with a letter comparing the client's score to the firm's average. Currently, the average RAQ score is 55, with a range from -34 to a high of 102. Each time I reposition the client's portfolio(s), I factor in the client's RAQ score and year of birth. *If you have not yet completed and returned your Risk Assessment Questionnaire, please do so ASAP.*
2. *Portfolio Repositioning:* In June we repositioned portfolios for those clients who have returned their Risk Assessment Questionnaire. I plan to complete the repositioning for the remaining clients during July. Generally twice per year I reposition most MAM portfolios. Typically this occurs in June/July and November/December. I feel portfolio positioning has been a significant contributor to MAM's very positive performance relative to the S & P 500 in the six and half years of MAM's existence. In particular, the stock market is constantly changing. Certain asset classes become overvalued, while others become undervalued. A portfolio needs to evolve to stay ahead of the market.
3. *Client Meetings:* A major goal for 2006 is to meet with many clients. During May and June I conducted 37 client meetings. Once the quarterly reporting and portfolio repositioning is completed (by the latter part of July), I plan to start conducting meetings again. Topics covered include a multi-year review of account performance, comments regarding the Net Worth Analysis, a discussion regarding alternative assets, as well as any items the client would like to address. Please contact me if you are interested in scheduling a meeting. For clients that live out of the area, we can conduct a meeting via a telephone and internet connection.
4. *Net Worth Analysis:* The Net Worth Analysis is a tool to help determine whether a client is on track in saving for a financially comfortable retirement. The Analysis is an Excel spreadsheet in which we list a client's assets and liabilities and total their "Invested Assets". Included is a 5-year projection of the assets and liabilities and total Invested Assets based on stated assumptions. We obtain the information needed for the spreadsheet from a 2-page questionnaire that we send out. So far we have completed the Analysis for 53 clients, with 7 more in process. Please contact us if you would like to have a Net Worth Analysis prepared.
5. *eStatements:* eStatements is Schwab's term for the electronic delivery of monthly statements. We have been encouraging clients to sign up for eStatements, to reduce the amount of mail they receive from Schwab and to reduce the commission that Schwab charges for the trading of individual stocks and exchange traded funds. To sign up for eStatements, you log on to your account(s) via Schwab.com or SchwabAlliance.com. If you do not have a user id and password, please call the Schwab Alliance Service team at 1-800-515-2157, extension 3. In addition, the Schwab team can walk you through the "sign up" process. As always, please call Billy, Marilyn, or myself if you need help navigating the Schwab Web site to sign up for eStatements.

Wealth Manager Ranking: I was pleased to see that McCarthy Asset Management, Inc. made it into Wealth Manager Magazine's 6th Annual listing of the top 500 U.S. wealth managers. The ranking is based on the average size of clients' managed assets. As listed in the July/August 2006 issue of Wealth Manager Magazine, MAM, Inc. was listed 408th based on an average asset size of \$471,515. The ranking is based only on those managers that responded to a questionnaire sent out by Wealth Manager Magazine.

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 \$2.5 million in net assets during the first six of 2006, bringing the MAM assets under management to over \$85 million as of June 30, 2006.

I continue to welcome 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