

McCarthy Asset Management, Inc.

Registered Investment Advisor

Wednesday, October 4, 2006

Dear Client,

The stock market showed surprising strength for the third quarter, and most indices are now up for the year. Historically, the third quarter is weak for stocks and September is the weakest month. This September the stock market rose for just the 14th time in the past 36 years. I am hopeful that the positive momentum will last through the fourth quarter of this year.

With this report for the quarter ending September 30, 2006, I discuss the performance of the market and MAM portfolios for the quarter and first nine months of 2006. In addition, I provide comments regarding the economy and my outlook for the stock market. Furthermore, I explain why I recommend clients sign up for eStatements.

Enclosed are four 9/30/06 investment reports:

- *Portfolio Position Analysis*: lists your investments and how each have performed
- *Portfolio Performance Summary*: 3rd 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)

Stock Market & MAM Performance for Third Quarter

The stock market performed well for the third quarter of 2006. The S & P 500 rose 5.2% to 1336, the Nasdaq climbed 4.0% to 2258, and the Russell 2000 rose 0.1% to 726. These returns do not reflect reinvestment of dividends.

The strength of the market this quarter was not as great as indicated by the performance of the S & P 500. In particular, small cap stocks barely rose (as reflected by the 0.1% return for the Russell 2000 small cap index). As reported by MarketWatch, the average diversified U.S. stock fund rose a modest 2% in the quarter. This was the primary reason why only 1% of 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 3.2% (after MAM fees) versus a gain of 5.6% in the S & P 500 as represented by the performance of the Vanguard Index 500 fund (symbol VFINX) with reinvested dividends.

The mid to late 1990's was the last period when large cap stocks led the performance of the market. At the market peak in March of 2000, small cap stocks were inexpensive relative to large cap stocks. This represented a turning point. From 2000 through 2005, small caps significantly outperformed large caps. The large weighting of MAM portfolios in small caps was one of the reasons that MAM portfolios outperformed the S & P 500 each year from 2000 through 2005.

Since late 2004, I have been increasing large-cap U.S. stock exposure and been reducing small cap exposure in anticipation of a new period of large cap out performance. I plan to continue with this shift (with the next portfolio repositioning by year end) if it appears that we have entered another multi-year period when large caps dominate. Even with this repositioning, it will be difficult for MAM portfolios, which are diversified among five asset classes, to outperform the S & P 500 during periods when large cap stocks are the best performing asset class.

The underperformance for the quarter was also attributed to MAM portfolios having a 15% to 30% weighting in bonds. While bonds appreciated, they rose much less than the S & P 500. The purpose of including a bond exposure is to protect against a downturn in the market. During periods of rising stock prices, this diversification will generally reduce portfolio performance.

Best Performers: The eight best performing MAM investments for the quarter were Cohen & Steers REIT (up 9.1%), Oakmark International Small Cap (up 8.5%), Allied Capital (up 7.1%), Oakmark Fund (up 5.6%), Income Fund of America (up 5.6%), Artisan Small Cap Value (up 5.4%), iShares Dow Jones Dividend (up 5.3%), and Capital World Growth & Income (up 5.2%).

Worst Performers: The eight worst performing MAM investments for the quarter were PIMCO Commodity (down 4.9%), Bjurman Micro Cap (down 4.9%), Marsico Focus (up 0.3%), Hussman Strategic Growth (up 0.4%), Century Small Cap (up 0.6%), William Blair Small Cap (up 1.0%), American Growth Fund (up 1.3%), and PIMCO Developing Local (up 1.6%).

Stock Market & MAM Performance for YTD 2006

For the first nine months of 2006, the S & P 500 rose 7.1%, the Nasdaq climbed 2.4% and the Russell 2000 climbed 7.9%. These returns do not reflect reinvestment of dividends.

For the first nine months of 2006, 10% of the MAM portfolios that were in existence for the full nine months out performed the S & P 500. The composite return of assets in MAM portfolios was a gain of 7.1% (after MAM fees) versus a gain of 8.4% 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 September 30, 2006, the original \$50,000 had risen to \$84,626, plus \$1,193 of cumulative withdrawals. This represents a cumulative return of 71.6%. During the same time, the S & P 500 (as represented by the Vanguard Index 500) rose 7.2%. For the quarter ended September 30, 2006, the portfolio rose 3.3%, while for the first nine months of 2006 it rose 6.6%. 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.

Interest Rates, Real Estate and Performance of the Economy

Interest Rates: After seventeen straight interest-rate increases, the Federal Reserve held rates steady at its August and September meetings. The consensus of economists is that unless signs of excessive inflation reappear, the Fed is done raising rates. In fact, some experts predict the Fed will start lowering rates next year.

U.S. Real Estate: The housing sector, which had enjoyed five boom years of record sales and prices, has been slowing sharply this year under the impact of rising mortgage rates and a slowing economy. On September 25th the National Association of Realtors reported that sales of existing homes fell for the fifth consecutive month in August. The weakness in existing home sales followed a report the prior week that construction of new homes and apartments dropped by 6% in August, pushing building activity to the lowest level since early 2003. The slowdown in sales was weighing on home prices, with the median price of an existing home sold in August dropping to \$225,000, 1.7% below the level of August 2005. *It marked the first year-over-year price decline in more than 11 years.*

How deep will the real estate downturn be and how long will it last? Hopefully we will experience nothing like the slump from 1990 to 1992 when CA real estate prices dropped 15% to 20%. Fortunately, mortgage rates have recently dropped. As reported by the Mortgage Bankers Association, the 30-year fixed mortgage rate started 2006 at around 6.0%, rose to 6.8% by June 30th, and recently has fallen back to 6.2%. I am hopeful that the steady performance of the U.S. economy and the recent drop in mortgage rates will soften the slowdown in housing.

U.S. Economy: The U.S. economy grew 2.6% in the second quarter. This was a dramatic drop from the 5.3% inflated rate of growth for the first quarter. Economists estimate that the economy grew 2.5% to 3.0% in the third quarter, and will slow to 2.0% to 2.5% growth in the fourth quarter. The slowdown in the economy is primarily been driven by the slump in housing and the delayed impact of the Fed's 17 interest rate hikes over the last two years. Offsetting the negative impact of the housing slowdown, oil prices have recently dropped from close to \$80 per barrel to around \$60. Also providing a boost to the U.S. economy is the growth of exports due to the world's economy growing at its fastest rate in over thirty years. As long as the current housing slump does not deepen, and inflation does not accelerate causing the Fed to raise interest rates again, I feel the U.S. economy should remain on an upward path.

Outlook for the Stock Market; Return of the Large Caps?

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 September 30, 2006 would represent the thirteenth consecutive quarter of growth in excess of 10%. 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. Assuming that the economy and corporate earnings continue to perform well, I feel optimistic about 2007.

This optimism is echoed by a couple of stock market pundits that I respect and whose services we subscribe to. In his Marketimer report, Bob Brinker has continued to remain positive on his outlook for the U.S. stock market. Brinker's last two major timing calls have been excellent. In January of 2000 he recommended that his subscribers reduce their exposure to equities, two

months prior to the start of the 2000 to 2002 market downturn. His next call was for subscribers to increase equities in March of 2003, which marked the beginning of a major upturn in the market.

The other optimistic prognosticator is Richard Band of Profitable Investing, whose newsletter I have followed for over ten years. While Band is not a market timer like Brinker, he does occasionally make predictions of where he thinks the market is heading. After being fairly cautious for most of this year, in his most recent newsletter he predicted the Dow Jones Industrial Average will rise 37% over the next two years.

On the other hand, Lowry's is a market timing service that feels the stock market may be getting close to a peak. Lowry's has used a proprietary model since 1938 to predict the future direction of the stock market based on its measure of buyer demand and seller supply. In a recent report, it said that since May of this year there has been a sudden change in relative strength away from mid-caps and small-caps and toward big-caps. Such shifts, it says, have often occurred near major market tops. It said that the current market has the classic warning signs of weak demand, reduced volume, lack of market breath (the market strength is not broad based) that have marked the end of previous bull markets. In some of these previous instances, many investors were unaware that the market was close to peaking as the weakness was masked by the highs in the major big-cap price indexes (i.e. the S & P 500).

I feel it is beneficial to gauge the opinion of different respected stock pundits. While it may be confusing when they contradict each other, I find it helps in staying alert for subtle, unexpected changes in the market. In particular, the Lowry's information may be providing an early indication that after six years, this past May there may have been a change in the market leadership to large caps.

Other

eStatements: I highly recommend that clients enroll in eStatements. By enrolling, you elect to stop receiving paper monthly statements. While reducing the amount of mail received, there are other benefits as well. Statements, trade confirmations and tax reports (Form 1099s) are now all available in one location online. In addition, a 7-year archive of these documents is available, to be increased to 10 years by this December. There is no longer a need to save old statements since you can obtain them online. In addition, there is a financial motivation to enroll. Effective October 1, 2006, Schwab is requiring clients to be enrolled in eConfirms and eStatements to qualify for the \$12.95 commission rate (down from \$19.95). (For clients with assets at Schwab of greater than \$1 million, the rate remains \$9.95 whether or not they are signed up for eConfirms or eStatements.) This commission rate applies to individual stocks (like Allied Capital) and exchanged traded funds (like iShares Dow Jones Dividend). *We would like clients to enroll in eStatements to reduce trading costs because I expect to continue to increase the use of exchange traded funds in portfolios.*

In the Risk Assessment Questionnaire, over 70% of clients indicated they would like to enroll in eStatements. Recently, only 30% were signed up. Unfortunately, we cannot enroll clients; it must be done by clients through the Schwab Web site. During the last couple of weeks Marilyn has been calling those who expressed an interest in eStatements to explain how to enroll. **Please call Marilyn if you would like to sign up for eStatements.**

Verification of IRA Beneficiaries: In August we sent out letters to 157 clients providing them with the primary and contingent beneficiary names Schwab has on file for their IRA and other retirement accounts. We asked clients to return the letter and indicate any changes. So far, 102 of our clients responded. If you have not yet responded, please do so.

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 \$4.5 million in net assets so far in 2006, bringing the assets under management to over \$90 million as of September 30, 2006.

I welcome the three new clients that were added this past quarter. Two of the three were referrals from existing clients. I really appreciate your referrals. If you know of someone who may be interested in our investment management services, please let me know and I will send them our newsletter. The minimum amount to manage for new clients is \$500,000. If assets continue to grow at the current rate, I may raise this minimum to \$600,000 effective January 1, 2007.

Please call or email if you wish to set up a meeting, are interested in having us prepare the Net Worth Analysis for you, or have any other items you would like to discuss.

Very truly yours,

Stephen P. McCarthy, CPA, CFP

encl: Investment Reports