McCarthy Asset Management, Inc.

Registered Investment Advisor

Thursday, January 4, 2007

Dear Client,

The market ended a great year with a great quarter. 2006 was the fourth consecutive year of positive returns for the market. Hopefully, this momentum will carry through 2007.

With this report for the quarter ending December 31, 2006, I discuss the performance of the market and MAM portfolios for the quarter and year, as well as my outlook for the economy, interest rates, and the stock market. In addition, I discuss the current positioning of MAM portfolios.

Enclosed are five 12/31/06 investment reports:

- *Portfolio Position Analysis*: lists your investments and how each have performed
- *Portfolio Performance Summary*: 4th quarter and full year 2006 portfolio rates of return
- *Portfolio Comparative Performance Review*: portfolio performance by year and cumulatively since inception
- *Position Performance Summary*: We provide this report annually. It provides a detailed portfolio analysis by position for full year 2006.
- *Realized Gains and Losses*: full year 2006 investment realized gains and losses (included only for taxable accounts)

Stock Market & MAM Performance for Fourth Quarter

The stock market performed very well for the fourth quarter of 2006. The S & P 500 rose 6.1% to 1418, the Nasdaq climbed 7.0% to 2415, and the Russell 2000 rose 8.5% to 788. These returns do not reflect reinvestment of dividends.

In General: For the quarter, 90% 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 7.0% (after MAM fees) versus a gain of 6.7% in the S & P 500 as represented by the performance of the Vanguard Index 500 fund (symbol VFINX) with dividends reinvested.

3 Lagoon Dr, Suite 155, Redwood Shores, CA 94065, (650) 610-9540 Fax (650) 610-9541
email: steve@mamportfolios.com Web site: mamportfolios.com

Best Performers: The eight best performing MAM investments for the quarter were Artisan International Small Cap (up 15.9%), Oakmark International Small Cap (up 11.9%), Dodge & Cox International (11.4%), Cohen & Steers REIT (9.8%), Causeway International (9.7%), Capital World Growth & Income (9.1%), Allied Capital (9.0%), and Marsico Focus (8.8%).

Worst Performers: The eight worst performing MAM investments for the quarter were Hussman Strategic Growth (up 0.2%), PIMCO Total Return Bond (up 0.8%), Nuveen High Yield Municipal Bond (up 2.3%), PIMCO Commodity (up 2.4%), Loomis Sayles Bond (up 2.8%), Calamos Growth & Income (up 4.8%), Dodge & Cox Balanced (up 4.9%), and American Amcap (up 5.3%).

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 December 31, 2006, the original $50,000 had risen to $91,070, plus $1,193 of cumulative withdrawals. This represents a cumulative return of 84.6%. During the same time, the S & P 500 (as represented by the Vanguard Index 500) rose 14.4%. For the quarter ended December 31, 2006, the portfolio rose 7.6%, while for all of 2006 it rose 14.7%. 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.

Stock Market & MAM Performance for 2006

Full year results for 2006 were excellent. *Unadjusted for the reinvestment of dividends,* the S & P 500 rose 13.6%, the Nasdaq Composite climbed 9.5%, and the Russell 2000 rose 17.1%. For all of 2006, 24% of MAM portfolios that were in existence for the whole year had performance that equaled or exceeded that of the S & P 500. The composite return of assets in MAM portfolios was a gain of 14.6% (after MAM fees) versus a gain of 15.6% in the Vanguard Index 500 (symbol VFINX) with reinvested dividends.

For each of the years 2000 through 2005, the composite return of MAM portfolios (after all fees) exceeded the performance of the Vanguard Index 500 fund. 2006 represents the first year in seven that MAM portfolios underperformed the S & P 500. What were the causes? The first is that the S & P 500 was a stronger competitor in 2006. As quoted in the Wall Street Journal on December 29, 2006, through December 27th only 19% of all actively managed funds in U.S. diversified-stock-fund category beat the S & P 500 for 2006. A more significant reason was the impact of bonds. Most MAM portfolios have a 15% to 30% weighting in bond funds. While bond funds appreciated for 2006, they rose much less that the S & P 500.

Performance of the Economy, Real Estate and Interest Rates

U.S. Economy: As represented by the Gross Domestic Product (GDP), the U.S. economy has slowed rapidly this year. After a first-quarter spurt of 5.6%, growth slowed to 2.6% in the second quarter, and 2.0% in the third quarter. Economists expect growth slowed further in the fourth quarter to an annual rate of approximately 1.5%. A slump in the housing market was the principal cause of the slowdown. In addition, the delayed impact of the Fed's 17 interest rate increases was also responsible for the deceleration.

Assuming the housing slowdown does not worsen, most economists expect modest increases in growth throughout 2007. For instance, U.S. Trust currently projects quarterly GDP figures of 1.4%, 2.6%, 2.7%, and 3.1% for each of the consecutive quarters for 2007.

The good news with this economic slowdown is that inflationary pressures have lessened. After rising 3.4% for 2005, the consumer price index (CPI) is estimated to have risen 3.2% for 2006. While this is still well-above the 2% rate targeted by the Federal Reserve, U.S. Trust estimates that the CPI will drop to 1.7% for 2007.

U.S. Real Estate: The sharp slowdown in the housing sector is the main reason for the slowing U.S. economy. In the third quarter the decline in home building and residential investment shaved more than one percentage point off the annual rate of economic growth. Many economists expect a similar reduction in the fourth quarter.

Despite some continued uncertainty, economists view the recent housing data as an early indication that the worst of the housing market's downturn may be over. For instance, on December 29th the National Association of Realtors said sales of existing homes in November increased 0.6% from October. Sales have now increased in back-to-back months for the first time in more than one year. A recent pickup in new-home sales also points to stabilizing demand. The Commerce Department reported on January 2nd that new-home sales rose 3.4% in November. While that pace is down more than 15% from a year earlier, it has held fairly steady in recent months.

An important gauge of the health of the U.S. residential sector is the "inventories of unsold homes". The most recently reported figure is for November, with a 7.3-month supply, up from a five-month supply a year earlier. This suggests that builders will continue to cut production until supply is better aligned with demand. In the meantime, large inventories will continue to put downward pressure on prices.

Interest Rates: The slowing economy and lessening inflation may bode well for interest rates. After seventeen straight interest-rate increases, the Federal Reserve has held rates steady since August. The consensus of economists is that the Fed will start to reduce rates by the middle of 2007. The Federal Funds rate increased from 4.25% on December 31, 2005 to 5.25% on December 31, 2006. In a recent poll by the Wall Street Journal, sixty economists predicted that the Federal Funds rate will fall to 4.75% by year-end 2007 (while the prime rate will fall from 8.25% to 7.75%).

Outlook for the Stock Market

Corporate earnings growth for the last four years has been incredible. Corporate profits, as measured by the Commerce Department, have risen more than 12% a year since 2002 (about double the historical average of 6%). In the third quarter of 2006, profit growth was running at an annualized rate of 16%. But the consensus forecast of economists polled by The Wall Street Journal calls for those gains to slow to the single digits for 2007 and 2008, with pretax profits rising about 6%.

The rapid increase in earnings the last four years is why stocks are reasonably priced despite four years of rising stock prices. Companies in the S & P 500 currently trade for about 16 times earnings, which is comparable to its long-term average (and down from 30 in 2000).

A slowing economy could be good news for investors, assuming a recession is avoided and the Federal Reserve starts to cut interest rates. History has shown that the market cheers when the Fed starts cutting rates. For example, in a similar slowdown in the middle of an economic expansion in the mid 1990s, stocks surged after the Fed cut interest rates, despite slowing growth in corporate earnings. A combination of moderating inflation, falling interest rates, and a soft economic landing are normally a recipe for expanding price-earnings ratios. If so, the stock market gains in 2007 could exceed 10%, even if profits rise only 6% or so.

Another bullish element for stock investors is the presidential cycle. Since 1960, every third year in a president's term has been a positive year for the markets (12 consecutive times), with only one failing to post double-digit gains.

There are risks, though. The housing slump could worsen, resulting in reduced consumer spending and possibly a recession. Or inflation could remain above the Fed's target, resulting in one or more additional interest rate increases. And the crisis in Iraq and the nuclear ambitions of Iran, raise questions about oil supplies and geopolitical stability.

In summary, assuming that the housing slump does not worsen, and that the Federal Reserve starts to lower interest rates during 2007, I remain cautiously optimistic for the stock market.

Current Portfolio Positioning

MAM portfolios are repositioned at least twice per year. The most recent was completed in December. Portfolio repositioning is done in light of each client's risk tolerance, as determined by the score from the Risk Tolerance Questionnaire that clients completed this past year. Before I discuss the current asset allocation of portfolios, I would like to comment on what I mean by "repositioning".

Many investment advisors refer to "rebalancing" a portfolio. By this they mean buying and selling various positions to return a portfolio back in line with certain target allocations (for example 70% U.S. equities, 20% bonds, 10% international, etc.). This is a beneficial strategy to the extent that the assets sold had become overvalued and the assets purchased undervalued. The repositioning I do is similar to this, with a very important difference. My target portfolios (which vary depending on a client's risk tolerance) change over time, sometimes dramatically. Portfolios evolve based on the changing dynamics of the stock market. For instance, MAM portfolios had a very significant weighting in small cap stocks relative to large cap stocks during much of the period 2000 through 2004. In the last two years, though, much of this small cap exposure has now been shifted back to large cap. In addition, proactive portfolio changes are made to invest in attractive areas. An example of this was the 2006 addition of Allied Capital to portfolios, as a way to gain exposure to the private equity market.

The following is a discussion of the current asset allocation of MAM portfolios:

1. ***U.S. Equities (40% to 55% of most portfolios):*** For each of the last seven years, small cap stocks outperformed large cap stocks. Historically, this is a long period of out performance. In 2005 and 2006, I dramatically decreased small cap exposure and increased large cap. I feel that large caps are once again poised to outperform small caps. One reason for this is that large caps are trading at a discount relative to small caps. In addition, historically, large cap stocks outperform when the economy slows down.

   Another theme that I have emphasized for the last couple of years is overweighting higher-dividend paying stocks (i.e. through the exchange traded fund iShares Dow Jones Select Dividends).

2. ***Bonds (15% to 25% of most portfolios):*** The main purpose of investing in bond funds is to provide downside protection in case equities start to decline again. The cost of this protection is that MAM portfolios could under perform the S & P 500 if the market continues to rise. This cost was a significant detractor from performance as bonds returned much less than stocks in 2006.

   The bond exposure is diversified among convertible (Calamos Growth & Income), foreign (PIMCO Developing Local Markets and Loomis Sayles Bond), high quality (PIMCO Total Return and Yieldquest Total Return), high yield (Loomis Sayles Bond), and municipal bonds (Nuveen High Yield Municipal).

3. ***International Equities (16% to 25%):*** The international equity exposure provided a significant benefit to MAM portfolios in 2006. I continue to like international equities because (1) I feel many foreign markets provide a better investment opportunity than the U.S. market (2) investing in foreign equities reduces the volatility of an equity portfolio and (3) investing in foreign equities provides a hedge against a further drop in the U.S. dollar. Unlike in most previous years, for 2007 the growth in the world economy is expected to out pace the growth in the U.S. economy.

4. ***Alternative Assets (10% to 12%):*** MAM portfolios invest in alternative assets to reduce the volatility of the portfolios without sacrificing returns. For 2006, alternative assets provided a mixed impact to performance as the strong performance of Cohen & Steers REIT was offset by the weak performance of PIMCO Commodity and Hussman Strategic Growth.

   A new alternative asset for 2006, Allied Capital, is the first individual stock purchased for portfolios. Allied Capital is the nation's largest business development company, which provides loans and equity investments to private companies. The stock has performed extremely well since its initial public offering in 1960. It has paid an increasing dividend since 1963, offering a current yield of 8%. With a 3% weighting in most portfolios, the stock has performed very well since being purchased in the Summer of 2006.

Other

Net Worth Analysis: Since October of 2005, we have prepared a Net Worth analysis for 76 clients. Billy has already sent update questionnaires to those clients whose Analysis were completed in late 2005. Billy will continue to send the update questionnaires to those whose 1-year anniversary comes up. My plan is for us to annually update the Net Worth Analysis to help clients track the growth in their invested assets. As I have said in the past, growing invested assets is a critical step in securing a financially comfortable retirement.

eStatements: We made a concerted effort during 2006 to assist clients in enrolling in eStatements. I highly recommend eStatements for clients with internet access. In addition to reducing the cost that Schwab charges for the trading of individual stocks and exchange traded funds, eStatements is a space saver and organizer. There is no longer a need to save monthly statements, because Schwab now provides online access to statements for the last ten years. The challenge for us has been that we cannot enroll clients; clients need to take action themselves. Nonetheless, we have been successful in getting clients to enroll approximately 65% of accounts managed by MAM (up from 30% at the end of September). If you are still receive a monthly statement in the mail, you are not yet enrolled. If you would like to enroll, please contact Billy or Marilyn for assistance.

ADV Part II: When you became a MAM client, I provided you with a copy of my ADV Part II. As a Registered Investment Advisor (RIA), I file this 10-page document with the Securities and Exchange Commission each year. Along with other items, it contains information regarding my fees and educational background. Each year, I am required to offer clients the opportunity to receive a copy of my most recent ADV Part II. Please let me know if you would like a copy.

Assets Under Management

As of December 31, 2006, MAM assets under management were in excess of $100 million, up from $80 million at the start of the year. For 2006, existing and new clients added approximately $7 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
Privacy Disclosure Statement