

McCarthy Asset Management, Inc.

Registered Investment Advisor

Thursday, January 3, 2008

Dear Client,

With the exception of small cap stocks, for 2007 the stock market posted positive returns for the fifth consecutive year. Unlike the previous four years, though, volatility returned and the gains were modest. As we start 2008, the economy faces recessionary risks from the fallout of the subprime lending crisis. There are a number of positives, though, that may allow the 5-year bull market to continue. 2008 promises to be an interesting year.

With this report for the quarter ending December 31, 2007, I discuss the performance of the market and MAM portfolios for the quarter and year, as well as my outlook for the economy and the stock market. In addition, I discuss the current positioning of MAM portfolios.

Enclosed are five 12/31/07 investment reports:

- *Portfolio Position Analysis*: lists your investments and how each have performed
- *Portfolio Comparative Performance Review*: portfolio performance by year and cumulatively since inception
- *Portfolio Performance Summary*: 4th quarter and full year 2007 portfolio rates of return
- *Position Performance Summary*: We provide this report annually. It provides a detailed portfolio analysis by position for full year 2007.
- *Realized Gains and Losses*: full year 2007 investment realized gains and losses (included only for taxable accounts)

Stock Market & MAM Performance for Fourth Quarter

The stock market performed poorly for the fourth quarter of 2007. The S & P 500 fell 3.9% to 1468, the Nasdaq dropped 1.9% to 2652, and the Russell 2000 fell 4.8% to 766. These returns do not reflect reinvestment of dividends.

In General: For the quarter, 91% 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 loss of 2.8% (after MAM fees) versus a loss of 3.4% in the S & P 500 as represented by the performance of the Vanguard Index 500 fund (symbol VFINX) with dividends reinvested.

Best Performers: The eight best performing MAM investments for the quarter were PIMCO Commodity (up 9.2%), Blackrock Health Science (up 4.5%), PIMCO Developing Local (bonds)

(up 2.9%), Columbia Marsico 21st Century (up 1.5%), Artisan International Small Cap (up 1.5%), Loomis Sayles Bond (up 1.2%), Capital World Growth & Income (up 0.3%), and Dodge & Cox International Stock (down 0.6%).

Worst Performers: The eight worst performing MAM investments for the quarter were Allied Capital Corp (down 24.5%), Oakmark Select (down 12.9%), Oakmark International Small Cap (down 9.6%), William Blair Small Cap (down 8.2%), Artisan Small Cap Value (down 6.3%), Cambiar Opportunity (down 5.5%), Income Fund of America (down 3.3%), and Schwab S & P 500 (down 3.3%).

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, 2007, the original \$50,000 had risen to \$94,251, plus \$1,193 of cumulative withdrawals. This represents a cumulative return of 90.9%. During the same time, the S & P 500 (as represented by the Vanguard Index 500) rose 20.6%. For the quarter ended December 31, 2007, the portfolio fell 3.0%, while for all of 2007 it rose 3.5%. 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 2007

Full year results for 2007 were mixed. *Unadjusted for the reinvestment of dividends*, the S & P 500 rose 3.5%, the Nasdaq Composite climbed 9.8%, and the Russell 2000 fell 2.7%. For all of 2007, 12% 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 3.7% (after MAM fees) versus a gain of 5.4% in the Vanguard Index 500 (symbol VFINX) with reinvested dividends.

While MAM portfolios have significantly outperformed the S & P 500 since MAM started in 1999, I am disappointed that the portfolios underperformed for 2007. I attribute the underperformance to a couple of factors. Over half of the 1.7% underperformance was due to the sharp drop in the price of Allied Capital (see “Portfolio Positioning” below for further discussion). A second factor was that for the first time in eight years, small company stocks underperformed large company stocks (i.e. the Russell 2000 fell 2.7%). While the small cap exposure in MAM portfolios has been dramatically reduced during the last three years, the diversification of portfolios is such that they will never have as much large cap exposure as the S & P 500.

Performance of the Economy

U.S. Economy: As represented by the Gross Domestic Product (GDP), the U.S. economy showed increasing growth for the first three quarters of 2007. After anemic first quarter growth of 0.6%, growth accelerated to 3.8% in the second quarter and 4.9% in the third quarter. Due to the impact of the credit crisis, economists expect growth slowed to 1.5% in the final quarter of 2007, and that it could slow to 0.5% or less in the first quarter of 2008.

In its most recent survey of U.S. economists in December, the Wall Street Journal found that economists now estimate the chance of a recession at 38%. A recession is defined as two

consecutive quarters of negative GDP growth. The main cause of the slowing U.S. economy is the worst real estate downturn in decades. Nationally, home foreclosures hit a record high in the third quarter of 2007, and home prices are falling in most markets. Experts do not expect real estate to start to recover until at least 2009.

Will the U.S. economy manage to avoid a recession? While housing represents a relatively small 5% of the economy, consumer spending represents 70% of the economy. The key to avoiding a recession will be how well consumer spending holds up. The most important determinant of consumer spending is employment. As long as employment growth remains decent, the U.S. may likely avoid a recession in 2008.

The Federal Reserve is expected to do its best to keep the U.S. economy growing. Since August, the Fed has reduced the Federal Funds rate three times, by a total of 1%. The benefit of these cuts are still to be felt, as there is typically a six to nine month lag before Fed interest rate changes impact the economy. I expect that the Fed will continue to aggressively cut rates if dictated by the economic data. These cuts will probably occur in the first half of the year, as the Fed will prefer to avoid cutting rates too close to the November Presidential election.

Outlook for the Stock Market

As I said last month in my November 2007 Monthly Commentary, I am probably less confident in my “cautiously optimistic” outlook for the stock market than at any time in the last four years. I expect that the real estate downturn and the fallout from the subprime lending crisis to continue to have a negative impact. As listed in the November 2007 Monthly Commentary, there are a number of factors, though, that should be beneficial to the economy and stock market:

1. **Strong Global Economic Growth:** While global economic growth may slow in 2008 from this year's 4% to 5% growth, the expected strength in the global economy should continue to provide a strong boost to U.S. exports. Furthermore, 15% to 30% of MAM portfolios are invested in international equities, which should benefit from the strong global growth.
2. **Worldwide Inflation Remains Low:** Despite soaring energy and other commodity prices, the forces of global competition continue to place powerful downward pressure on prices. Within the U.S., core CPI inflation has been in a steady decline, now running at 2.2% annually, down from its peak of 2.9% in September 2006. Inflation remaining muted is very important, as it will allow room for the Federal Reserve to continue to cut interest rates if needed.
3. **Stock Market Reasonably Valued:** Based on current earnings estimates, the S & P 500 is currently trading at approximately 14.5 times 2008 earnings. This is very reasonable. Furthermore, factoring in the current low level of interest rates, stocks prices appear to be almost cheap. While corporate earnings growth has been slowing (and was negative during the third quarter) strong foreign operations should continue to boost U.S. corporate earnings.
4. **Potential further Federal Reserve Interest Rate Cut(s):** Assuming inflation remains muted, the Fed appears ready to help the U.S. avoid a recession in the upcoming Presidential election year.

For long-term success it is critical for investors to not allow their emotions to impact their investment decisions (to avoid the tendency to sell when the market is depressed and buy when it is high). *Assuming their portfolios are invested consistent with their risk tolerance*, investors should be able to maintain a long-term perspective. *If you feel you cannot ride out a 10% or 20% market drop, adjustments should be made now to make your portfolio more conservative. Please let me know if you want to discuss this further.*

Current Portfolio Positioning

MAM portfolios are repositioned twice per year. The most recent was completed in November. Portfolio repositioning is done based on my outlook for the performance of various asset classes, and factor in each client's risk tolerance, as determined by the score from their Risk Tolerance Questionnaire. The following is a discussion of the current asset allocation of MAM portfolios:

1. **U.S. Equities (35% to 50% of most portfolios):** Here is what I wrote in 4th quarter of 2006 report: "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."

For 2007, large caps significantly outperformed small caps. With the most recent repositioning, dedicated small cap funds have been eliminated in many portfolios. MAM portfolios still have exposure to small and mid-cap stocks, though, as some of the MAM mutual funds have flexible mandates that allow them to invest in companies of all sizes.

In addition to increasing large cap exposure, growth stock exposure was increased this year while value stock exposure was reduced. For instance, in November iShares Dow Jones Select Dividend was replaced by iShares Russell 1000 Growth Index (symbol IWF).

2. **Bonds (15% to 30% 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. For the second consecutive year in 2007, this cost was a detractor from performance as bonds returned less than stocks. For 2008, though, this bond exposure should be beneficial if the economy does enter a recession.
3. **International Equities (15% to 30%):** The international equity exposure provided a significant benefit to MAM portfolios in 2007. I continue to like international equities because I feel many foreign markets provide a better investment opportunity than the U.S. market and investing in foreign equities reduces the volatility of an equity portfolio. During the most recent repositioning, in most portfolios a small position was established in American Funds New World, a diversified emerging market fund. In the past, I have avoided investing in emerging market funds because of their high risk. I am more comfortable with New World, though, as it invests 50% of its assets in companies located in developed markets (i.e. generally European countries) that have significant operations in emerging markets.

A risk to this foreign stock exposure would be if the U.S. dollar strengthens in 2008. After dropping sharply in 2007, some experts are predicting the dollar will rebound in 2008. I don't try to speculate on foreign currency changes. Instead I am attracted to foreign equities because of the positive outlook for the growth in the world economy.

4. **Alternative Assets (4% to 7%):** MAM portfolios invest in alternative assets with the goal of reducing the volatility of the portfolios without sacrificing returns. For 2007, this goal was not achieved as the strong performance of PIMCO Commodity was not sufficient to offset the dismal performance of Allied Capital Corp (symbol ALD). As the largest business development company in America, ALD invests debt and equity in mid-size American companies. My initial attraction to ALD was for its excellent long-term performance, high dividend yield, and relatively low correlation to the stock market. ALD has paid a consistent, generally rising quarterly dividend since 1963. Like other business development companies, ALD stock price has probably dropped due to the subprime lending crisis (even though it lends and invests in companies rather than lends to homeowners). The dividend (with a current yield of 12%) appears to be safe. While I don't plan to add to the ALD position, I expect that it will provide a boost to 2008 MAM portfolio performance.

The position in the alternative asset fund Cohen & Steers REIT was fully eliminated during 2007. This proved to be a very profitable investment since its initial purchase in the Summer of 2000. Back in 2000 I was attracted to REITs high dividend yield (in excess of 6%) and low correlation to the stock market. The tripling of REIT prices since then has caused their yield to drop to less than 3%. Although REITs had negative performance for year 2007, I will probably not reinvest in them until their yield rises further.

Other

Net Worth Analysis: Since October of 2005, we have prepared a Net Worth Analysis for over 100 clients and updated the Analysis for 55 clients. Billy will continue to send the update questionnaires to those whose 1-year anniversary comes up. My goal is to annually update the Net Worth Analysis in order to help clients track the growth in their invested assets. Growing invested assets is a critical step in securing a financially comfortable retirement.

Retirement Planning Software: As discussed in the November 2007 Monthly Commentary, we are in the process of evaluating three financial planning packages which are commonly used in the financial planning industry. During 2008, my goal is to select one of the packages to expand on the financial analysis we currently provide with the Net Worth Analysis. Areas that can be addressed include retirement planning, education funding, insurance planning (life, disability, and long-term care), and estate planning. My experience with comprehensive financial planning packages is that they can be cumbersome. They require many hours of input and generate voluminous reports that can be overwhelming for clients to comprehend. My goal is to choose a package that can be efficiently utilized, tailored to individual clients, and generate succinct, easy to understand reports so that we can cost effectively expand our financial planning services.

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, 2007, MAM assets under management were in excess of \$110 million, up from \$100 million at the start of the year. For 2007, existing and new clients added approximately \$4.5 million in net assets to their managed accounts.

I really appreciate the referrals that some of you have made, as that is my primary source of new clients. While my minimum amount to manage for new clients remains at \$600,000, I am willing to be flexible depending on the individual's situation.

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

Very truly yours,

Stephen P. McCarthy, CPA, CFP

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