

McCarthy Asset Management, Inc.

Registered Investment Advisor

Re: Second Quarter 2010 MAM Letter

Tuesday, July 6, 2010

Dear Client,

The stock market stumbled badly in the second quarter as the economic recovery from the Great Recession slowed sharply. While the short-term risk of a further drop is high, I don't think we have entered into a new bear market. With this report for the quarter ending June 30, 2010, I discuss the performance of the market and MAM portfolios for the quarter and first six months of 2010. In addition, in my mid-year economic update/outlook, I discuss the likelihood of the U.S. economy experiencing a double-dip recession. In my stock market outlook, I explain factors that may impact the performance for the remainder of this year. Finally, I comment on four interesting sessions that Billy and I recently attended at this year's Financial Planning Association NorCal Conference.

Stock Market & MAM Performance for Second Quarter

The stock market had its first down quarter since the first quarter of 2009. *Unadjusted for dividends*, the S & P 500 fell 11.8%, the Nasdaq dropped 12.1%, the Russell 2000 fell 10.3%, and the international equity index MSCI EAFE dropped 13.7%. Bonds rose and REITs fell modestly for the quarter.

MAM Portfolio Performance: For the quarter, 99% of MAM portfolios that were invested for the whole quarter had performance that equaled or exceeded that of the S & P 500. Excluding the "very conservative" portfolios, the composite return of assets in MAM portfolios was a loss of 6.6% (after MAM fees), versus a loss of 11.5% for the Vanguard Index 500 Fund (symbol VFINX) with dividends reinvested. The quarter's composite return for assets in the "very conservative" portfolios was a gain of 0.1%.

Stock Market & MAM Performance for YTD 2010

For the first six months of 2010, unadjusted for dividends, the S & P 500 fell 7.6%, the Nasdaq dropped 7.0%, the Russell 2000 slipped 2.5%, and the international equity index MSCI EAFE plunged 15.4%. Bonds and REITs rose modestly for the first six months of 2010.

MAM Portfolio Performance: For the first six months of 2010, 99% of MAM portfolios that were in existence for the whole period had performance that equaled or exceeded that of the S & P 500. Excluding the "very conservative" portfolios, the composite return of assets in MAM portfolios was a loss of 3.5% (after fees), versus a loss of 6.7% for the Vanguard Index 500 Fund (symbol VFINX) with dividends reinvested. The year-to-date composite return for assets in the "very conservative" portfolios was a gain of 2.3%.

Explanation of MAM out performance: Most MAM portfolios are currently positioned to experience 60% to 70% of the volatility of the S & P 500. While most portfolios lagged the S & P 500 during the strong first quarter, the downside protection provided by the bond and Hussman Fund allocation helped cushioned portfolios during the rough second quarter. Despite the stock market having become more reasonably valued, I think it is prudent to remain defensive with portfolio positioning given the recent weakening of the economic recovery. In fact, if we get further signs that the economic recovery is stalling, I may become even more defensive.

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 June 30, 2010, the original \$50,000 had risen to \$74,055, plus \$1,193 of cumulative withdrawals. This represents a cumulative return of 50.5%. During the same time, the S & P 500 (as represented by the Vanguard Index 500 Fund) fell 10.4%. For the quarter ended June 30, 2010, the portfolio fell 6.9%. All returns quoted for this portfolio (and for all MAM portfolios) are net of MAM fees. Also, past performance does not guarantee future results.

Mid-Year Economic Outlook

How Far We Have Come: In the U.S., we are now about twelve months into the economic recovery from the worst recession since the Great Depression. Over that time, real gross domestic product (GDP) growth has been close to 4%, equity market gains have been double digit, the Case-Shiller Home Price Index has advanced modestly throughout much of the country, and employment levels have improved for six months. From the perspective of where things stood one year ago, none of this would have seemed likely. Over the next year, most economists expect economic growth to slow as fiscal and monetary stimulus is removed. Nonetheless, growth is projected to be positive based on modest improvements in employment and consumer spending and solid corporate profits. Outside of the United States, growth is expected to remain strong in emerging markets while some European economies will struggle given their sovereign debt issues.

Is a Double-Dip Recession Likely? During the last two months, investors have become increasingly concerned about the impact of the European sovereign debt crisis on U.S. growth prospects. This has resulted in a two-month drop in stock prices and investor fears of a double-dip recession in the U.S. However, history strongly suggests that U.S. double-dips are exceptionally rare. In fact, according to the historical records, there have been only three episodes in U.S. business cycle history (starting in 1854) when the economy lapsed back into recession within a year of the previous recession ending. According to the National Bureau of Economic Research (NBER), the official arbiter of business cycles, there have been 33 recessions dating back to 1854, when records began. The first two double-dip recessions occurred in the early 1900s (1913 and 1920). *There were actually no double dips in the 1930s Great Depression and there has been only one in the last sixty years.*

The last double-dip recession occurred in the early 1980s in circumstances that were much different than today. In March 1980, President Carter imposed credit controls that were designed to put a brake on excessive money and credit creation, which was pushing inflation toward 15%. The ensuing credit crunch caused the economy to slip into a sharp but brief recession; it lasted only six months because credit controls were lifted in July 1980. The economy then grew for another 12 months at which point Federal Reserve Chairman Paul Volcker, with strong encouragement from newly elected President Reagan, dramatically tightened monetary policy to induce a recession to “break the back of inflation”. The strategy worked and the double digit inflation from the 1970’s was history.

In summary, double-dip recessions are very rare in the U.S. History suggests that the economy should grow for at least a couple of years before the possible onset of another recession. It is clear, though, that we are experiencing a pullback in the growth momentum of the recovery which started one year ago. Furthermore, there are a number of risks facing the U.S. economy, including the European debt crisis, a sharp increase in tax rates starting in 2011, and the risks of regulatory reform.

Stock Market Outlook

In my letter last quarter, I wrote that while I was cautiously optimistic for 2010, I wouldn't be surprised to see a modest pullback in the stock market during the next month or two. As it turned out, the market has pulled back over 10% and is now down for the year. Some are concerned that the market could be headed for another plunge similar to what occurred in 2008. For at least another couple of months, I expect that the stock market will continue to struggle until the economy regains strength. The following are some key indicators that I will monitor to help refine my stock market outlook and to determine whether any portfolio adjustments are warranted:

- **Job Growth:** A key determinate of the strength of the economic recovery will be U.S. employment market growth. On Friday, July 2nd, the Labor Department released the June Jobs Report. The report showed that the private sector added just 83,000 jobs for the month, which was the second straight month of lackluster hiring by American businesses. While it was good to see another positive month of growth, it is estimated the U.S. economy needs 200,000 new jobs per month to bring down the unemployment rate. I will continue to monitor the monthly jobs report and other important indicators to see if the U.S. economy could slip into one of those rare double-dip recessions. If this appears to be the case, then I expect to further increase the downside protection in portfolios. On the other hand, if job growth accelerates, the economic recovery will become more self-sustaining. This would likely lead to an upturn in stock market prices.
- **Corporate Earnings Growth:** Based on current analysts' estimates, earnings for S & P 500 companies are projected to rise 32% in 2010 and 17% in 2011, the largest two-year advance since the period ended in 1995. The S & P 500 index is now trading at 13.1 times forecasted 2010 earnings and 11.5 times forecasted 2011 earnings. This compares to a long-term average of about 15. While these earnings estimates may be revised downward to reflect the recent slowdown, the stock market appears to be reasonably valued at current levels.
- **Interest Rates:** There continues to be a tremendous amount of cash held in very low yielding savings accounts, money market accounts and certificates of deposits. With the Federal Reserve expected to leave interest rates at current levels until at least 2011, some of this cash may represent an additional source of demand for stocks. Many high quality large U.S. stocks are trading with a dividend yield of 3% or more. Assuming that qualified dividends continue to be favorably taxed in 2011, I believe investors will become more attracted to the benefit of investing in high quality companies that pay an increasing dividend over time. As long as interest rates remain very low, stocks are more likely to regain favor with investors.

2010 FPA NorCal Conference

Each year I look forward to attending the Financial Planning Association NorCal Conference. This year, over 600 CFPs attended the two-day conference held at the Palace Hotel in San Francisco. What follows is a brief discussion of four sessions that I found particularly interesting:

1. Re-Assessing Your Allocation to Asia: This session was led by Robert Horrocks, Chief Investment Officer and Portfolio Manager at the Matthews Funds. San Francisco-based Matthews Funds is solely focused on investing in Asia. Bob presented a compelling case on the merits of investing in Asian companies. In particular, the dramatic growth in the middle class in the Asian countries will enable them to experience among the highest growth rates in the world for at least the next ten to twenty years. Furthermore, given that nearly all Asian countries have trade surpluses, their currencies may provide a safe haven for U.S. investors. This is important as my long-term outlook on the U.S. dollar is negative due to long-term fiscal challenges that our country will face. I am particularly intrigued by the Matthews Asia Dividend Fund. The Fund has a tremendous track record since its 2006 launch, and it currently offers a dividend yield of over 4%.
2. Expanding the Framework of Safe Withdrawal Rates: This session was provided by Michael Kitces, Director of Research at the Pinnacle Advisory Group and publisher of The Kitces Report. Michael is an expert in the study of “safe withdrawal rates” for retirees or what percentage of a retiree’s portfolio can be withdrawn annually without the retiree running out of money. His session addressed the question “Given the historical returns of the markets, how high of a withdrawal rate would have survived any historical market scenario?” He also discussed the optimal portfolio asset allocation to survive the volatility. Furthermore, he showed how dynamic asset allocation, where the portfolio allocation is adjusted based on the relative values of the various asset classes, can be used to increase the safe withdrawal rate. I found this session to be not only interesting but very applicable to retirement planning for many MAM clients.
3. What’s Next For The Global Economy and the Dollar? This session was led by Axel Merk, Founder and President of Merk Investments, LLC. Merk Mutual Funds specializes in mutual funds that focus on currency investing. Axel was more negative on his outlook for the US economy than he is for Europe. He feels that eventually the U.S. dollar will fall relative to Asian and other currencies.
4. Multi-Generation Planning: Rod Zech, the dynamic CEO of the Heritage Institute led this session. According to Rod, 90% of wealthy families fail to keep their families and fortunes together for more than three generations—and that has been true for centuries. The Heritage Institute engages in the research, development, application and reality of increasing the 10% that succeed. The two biggest reasons why families fail is unprepared heirs and lack of communication and trust. Successful families share the following common characteristics: 1) meet regularly and have fun together 2) good communication and trust 3) know their family story 4) actively mentor the successive generations 5) celebrate shared values/accepting of differences 6) understand that wealth is more than about money. Rod stated that for “baby boomers” it was ten times more important to pass or receive the family story and life lessons than financial assets or real estate.

I found Rod's presentation very fascinating. While the cost to hire the Heritage Institute to facilitate a family implementing their strategies is prohibitive for most, Rod has written a book ("Beating the Midas Curse") that discusses many of the principles. I have ordered the book and look forward to reading it.

Assets Under Management and Referrals

As of June 30, 2010, MAM assets under management were just over \$90 million, comparable to what they were at the beginning of 2010. I want to thank those of you who have added to their investments or have referred the services of McCarthy Asset Management, Inc. to their friends and family. I really appreciate this as referrals are my primary source of new clients. While my minimum amount to manage for new clients is \$350,000, 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