

# *McCarthy Asset Management, Inc.*

Registered Investment Advisor

Re: Third Quarter 2008 MAM Letter

Thursday, October 2, 2008

Dear Client

The stock market experienced a difficult quarter, climaxed last Monday (September 29<sup>th</sup>) with the worst one-day percentage drop for the S & P 500 (8.8%) in 21 years. The sharp drop was triggered when the House of Representatives narrowly defeated the financial bailout bill. With this report for the quarter ending September 30<sup>th</sup>, 2008, I discuss the second quarter and year-to-date performance of the market and MAM portfolios. I also discuss the significance of the bailout bill, my outlook for the stock market, and recommendations for how investors should respond. I also explain why anyone interested in refinancing a jumbo mortgage of up to \$729,750 may want to act quickly.

Enclosed are four 9/30/08 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*: 3<sup>rd</sup> quarter and YTD 2008 portfolio rates of return
- *Realized Gains and Losses*: YTD 2008 investment realized gains and losses (included only for taxable accounts)

## **Stock Market & MAM Performance for Third Quarter**

Stocks fell sharply for the quarter. The S & P 500 fell 8.9%, the Nasdaq dropped 9.2%, and the Russell 2000 fell 1.5%. International equity markets fared much worse than the U.S. markets. The MSCI EAFE international index fell 21.1% for the quarter. These returns do not reflect reinvestment of dividends.

**MAM Performance:** For the quarter, 1.6% 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 12.9% (after MAM fees) versus a loss of 8.4% in the S & P 500 as represented by the performance of the Vanguard Index 500 fund (symbol VFINX) with dividends reinvested.

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**Explanation of MAM under performance:** The 4.5% under performance of MAM portfolios relative to the S & P 500 for the quarter was due to the sharp drop in international equities. As indicated above, the international equity index MSCI EAFE fell 21.1% (versus a drop of 8.9% for the S & P 500). The dramatic drop in the prices of oil and other commodities also hurt, as the PIMCO Commodity fund fell 32.7%. While bonds did provide some cushion on the downside, the bond funds also fell for the quarter.

As I explained in the August Monthly Commentary, for the long-term I favor foreign stocks over U.S. stocks for the following reasons:

- Foreign economic growth will exceed U.S. economic growth
- Foreign stocks are cheap relative to U.S. stocks
- Foreign stocks have higher dividend yields than U.S. stocks

I also feel that over time, the U.S. dollar will fall as the U.S. struggles with rising deficits due to massive shortfalls from the Social Security and Medicare systems. The performance of foreign stocks was significantly hurt by the recent spike in the U.S. dollar (up 11.8% relative to the euro for the quarter), which rose as the price of oil fell sharply.

### **Stock Market & MAM Performance for YTD 2008**

For the first nine months of 2008, the S & P 500 fell 20.7%, the Nasdaq dropped 21.5%, the Russell 2000 fell 11.3%, and the MSCI EAFE International Index fell 31.1%. These returns do not reflect reinvestment of dividends.

For the first nine months of 2008, 30% of the MAM portfolios that were in existence for the whole period had performance that equaled or exceeded that of the S & P 500. The composite return of assets in MAM portfolios was a loss of 19.8% (after MAM fees) versus a loss of 19.3% in the S & P 500 (as represented by the performance of the Vanguard Index 500 fund with dividends reinvested).

**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 September 30, 2008, the original \$50,000 had risen to \$75,177, plus \$1,193 of cumulative withdrawals. This represents a cumulative return of 52.7%. During the same time, the S & P 500 (as represented by the Vanguard Index 500) fell 2.8%. For the quarter ended September 30, 2008, the portfolio fell 13.2%. 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.

### **Government Bailout Bill**

On Monday, September 29<sup>th</sup>, the stock market experienced its worst percentage loss in 21 years (the S & P 500 fell 8.8%) in reaction to the U.S. House of Representative's failure to pass the Troubled Asset Relief Program (TARP) that was sponsored by the Bush Administration and supported by the Congressional Republican and Democratic leadership. Most market participants had expected the plan to pass and, following its defeat, stocks plummeted quickly. The measure was intended to stem further economic woes by stabilizing the financial sector.

The main provision of the bill would allow the U.S. Treasury to allocate up to \$700 billion to buy troubled mortgage-backed securities and other assets from U.S. financial institutions. These securities would be held by the government, with the government collecting the revenue generated by the assets until the crisis subsided and a secondary market for these assets re-emerged. Purchases of distressed mortgages and other illiquid securities would bolster bank balance sheets, easing restrictions on credit. Also, with Fannie Mae and Freddie Mac set to significantly increase their

purchases of prime mortgages, mortgage rates should slip lower. All of this would add support to home demand and could help prices to start to recover by next year.

The plan was unpopular with the American public, whose objections ranged from anger over CEO pay to the perception that billions of dollars in taxpayer money would be used to bail out the wealthy. Others were deeply concerned with the government intervention in the free market. This is a misunderstanding by the public, as the plan is effectively an asset swap whereby the government is creating a market for these unmarketable and illiquid securities where a previous market did not exist. The government would likely buy these difficult-to-value securities from banks at what should be a deep discount, reducing the end-cost of the program substantially. According to some, the government (and taxpayers) could potentially turn a profit on this deal. In any event, the program should cost significantly less than the full \$700 billion that is proposed to be allocated.

I think it is likely that a bailout bill in some form will be passed. In fact on October 1<sup>st</sup> the Senate easily passed (by a margin of 74 to 25) a similar version of the TARP Bill. The House is expected to vote on the measure on Friday, October 3<sup>rd</sup>. If an acceptable and reasonable deal is approved, a level of doubt will be removed around the U.S. economy and banks should be able to sell toxic assets. Although the eventual cost to taxpayers is currently unknown, this should restore confidence in banks and enable the free flow of cash in a currently paralyzed credit environment.

**Economic Outlook:** One of the big surprises this year has been the resilience of the U.S. economy and corporate earnings in the face of escalating credit problems. Over the past several weeks, however, the extreme market turmoil, the freezing of bank activity and the shutdown of mortgage credit have placed a tremendous strain on the U.S. economy. As indicated by nine consecutive months of negative employment growth, the U.S. economy had already been weak. I think that recent events are likely to tip the United States into a recession lasting into early to mid-2009. This is not necessarily a negative for the stock market outlook, because historically stock prices start to recover once a recession is underway. In addition, current market levels seem to have already priced in an economic slowdown. The S & P 500 is now down nearly 30% from its peak, with many indexes down a lot more. Furthermore, if the U.S. economy slows significantly, the Federal Reserve may move to further lower the federal funds rate.

**Stock Market Outlook:** The recent broad sell-off in equity markets are signs of capitulation on the part of many investors. Risk tolerance has moved to extremely low levels as we have seen a large degree of high-volume selling. Over the short term, these tend to be signals that the market is due for a rally. Volatility measures also point to the possibility of some sort of short-term climb in equity prices. On September 29<sup>th</sup> the VIX Index (the CBOE Volatility Index- a measure of stock market volatility) rose into the upper 40s, a place it has only been four other times in its history—during the Asian financial crisis of the late 1990s, the Long-Term Capital Management fallout, the 9/11 terrorist attacks, and the WorldCom bankruptcy filings. Following these previous

VIX spikes, the S & P 500 climbed an average of 15% three months later. Over the longer term, whether such a rally would have durability would depend on several factors including the narrowing of credit spreads (the yield difference between Treasury securities and other fixed income assets), concerted global monetary policy moves that indicate central bankers around the world are willing to step in to help stabilize the system, and ongoing capital raising and continued consolidation in the financial sector.

**What should investors do?** Sitting tight when your investments are falling can feel dreadful; we all dislike the price of investing in times like this. But is it important to avoid emotional decision-

making at all costs. Selling into weakness and turmoil is rarely a sound strategy and requires two nearly perfect decisions: when to get out and when to get back in. Remember that locking in losses by selling assets when prices are depressed creates the challenge of when you should be re-entering the markets and potentially missing out on potential upswings. Extreme declines almost always lead to extreme advances.

The market has already fallen because the stock market is a gauge of the future. The current relevant question is what happens a year or two from now? In my opinion, given the extremes we have been experiencing recently and the incredible pessimism in the system, the more likely scenario is a far better market outlook over the next few years.

All decisions about your investments should be made from the perspective relative to your personal situation. As long as you do not need to withdraw from your investments for at least a couple of years, you should be able to weather this downturn. A more difficult situation is if you are currently drawing off your investments to supplement your income. As a general rule, for these clients I maintain the equivalent of one to three years of withdrawals in a short-term bond fund so that investments do not need to be liquidated when prices are depressed. For those investors who are still funding their investments, the current downturn will probably represent an opportunity to make new purchases at very attractive prices.

### **Miscellaneous Items**

**Opportunity to Refinance Certain Jumbo Mortgages:** As I discussed in last quarter's letter, I expect mortgage rates to be higher in the future (i.e. rising Federal deficits will drive mortgage rates higher). I suggested obtaining a 15-year or 30-year fixed rate loan. For some of you there may be some urgency in this recommendation. A mortgage broker recently pointed out that the temporary increase to the conforming loan amounts is set to expire this December 31<sup>st</sup>. In certain high-cost areas (the Bay Area) the conforming loan amount has been temporarily increased to \$729,750. *If the temporary increase is not extended*, the conforming maximum will then drop to \$417,000.

*This could be a big deal if you are looking to refinance a mortgage between \$417,000 and \$729,750. Per Wells Fargo's Web site ([www.wellsfargo.com/mortgage/rates/](http://www.wellsfargo.com/mortgage/rates/)), as of October 2<sup>nd</sup>, the rate on a 30-year fixed rate conforming loan was 6.000%, while the rate on a 30-year fixed rate jumbo loan was 9.125%. That's an increase of 3.125%! The mortgage broker recommended that anyone looking to do such a refinance, do so soon because some lenders may cut-off those loans well before the end of the year. For instance he said Chase just announced that all*

temporary-limit loans must be closed in their pipeline by December 1<sup>st</sup>. Please contact me if you want to discuss this further.

**Financial Checkup:** Since May, we have generated a Financial Checkup for fourteen clients (eight of them just this past month). While the Financial Checkup requires some work on our clients' part to fill out the questionnaire, and a fair amount of work for us to create the document, I think it is well worth the effort. We are now sending out the Financial Checkup questionnaire in conjunction with the questionnaire for the annual update to the client's Net Worth Analysis. When you receive your questionnaire, please take the time to complete it.

**Assets Under Management:** As of September 30, 2008, MAM assets under management were approximately \$90 million, down from \$104 million at the start of the year.

**Referrals:** I really appreciate the referrals that some of you have made, as that is my primary source of new clients. You may know of other investors who need assistance because of the uncertainty created by the tremendous financial turmoil and sharp drop in the stock market. This may be particularly true for investors who don't use an investment advisor. Furthermore, the historical turmoil in the financial industry has led to the recent bankruptcy of Bear Sterns and Lehman Brothers, the near bankruptcy of AIG and Wachovia, and the takeover of Merrill Lynch by Bank of America. Investors who use these brokerage firms may also be unsure of what to do.

Please refer McCarthy Asset Management if you know of someone who has expressed interest in an investment advisor. I would be happy to talk to them and send out our newsletter. In light of the drop in equity prices, I have reduced my minimum amount to manage for new clients to \$500,000. As always, the minimum is also flexible depending on the individual's circumstances.

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