

# *McCarthy Asset Management, Inc.*

Registered Investment Advisor

Re: Fourth Quarter 2009 MAM Letter

January 6, 2010

Dear Client,

What a difference a year makes! At this time last year many thought the whole economic and financial world was falling apart. After experiencing the worst year since 1937 (with a drop of 37% for the S & P 500), stocks prices continued to plummet early in 2009. By early March, the stock market had fallen another 25%. At that point, there was growing sentiment that we might be entering a long period of economic stagnation. Some respected economic forecasters talked about a one-in-five chance of another Great Depression. It was precisely at that point that the coordinated stimulus spending by governments around the world finally had an impact and we began seeing signs of an economic recovery. From the market's bottom on March 9<sup>th</sup> through the end of 2009, global stock markets were up 50% to 65%.

With this report for the quarter ending December 31, 2009, I discuss the performance of the market and MAM portfolios for the quarter and year, as well as my 2010 outlook for the stock market.

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

Stocks rose for the quarter. Unadjusted for dividends, the S & P 500 rose 5.5%, the Nasdaq jumped 6.9%, the Russell 2000 climbed 3.5%, and the international equity index MSCI EAFE rose 3.1%.

**MAM Performance:** Excluding the “very conservative portfolios”, for the quarter, 1% of the MAM portfolios that were invested for the whole 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 4.0% (after MAM fees) versus a gain of 6.0% in the S & P 500 as represented by the performance of the Vanguard Index 500 fund (symbol VFINX) with dividends reinvested.

## **Stock Market & MAM Performance for 2009**

For all of 2009, the S & P 500 rose 23.5%, the Nasdaq jumped 43.9%, the Russell 2000 climbed 25.2%, and the MSCI EAFE International Index rose 27.8%. These returns do not reflect reinvestment of dividends.

**MAM Performance:** Excluding the “very conservative portfolios”, for all of 2009, 21% of the MAM portfolios that were invested for the full 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 23.3% (after MAM fees) versus a gain of 26.5% in the S & P 500 (as represented by the performance of the Vanguard Index 500 fund with dividends reinvested).

**Explanation of MAM performance:** Most MAM portfolios are positioned to experience 60% to 70% of the volatility of the S & P 500. Given this somewhat cautious asset allocation, I am pleased with the 23% average return of MAM portfolios for the year. As I mentioned in last quarter's letter, I

expect the performance of MAM portfolios to lag should the stock market continue to rally sharply. I still think it is prudent to remain defensive with portfolio positioning given the fragile condition of our economy.

**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, 2009, the original \$50,000 had risen to \$77,097, plus \$1,193 of cumulative withdrawals. This represents a cumulative return of 55.6%. During the same time, the S & P 500 (as represented by the Vanguard Index 500) fell 4.0%. For all of 2009, the portfolio rose 26.3%. 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 Outlook**

2009 was a sharp reminder that it's impossible to predict short-term market movements. Last March, just when things looked most dire and investors were most pessimistic, the stock market initiated one of its strongest rebounds ever. If investors can't accurately predict short-term market movements, what can they do? I feel they should focus on two key questions:

1. *First, what do the prospects for economic and profit growth look like in the mid-term—12 to 18 months and beyond?*
2. *Second, to what extent are these prospects for growth accurately reflected in today's prices of stocks and bonds?*

### **Mid-term Prospects for Growth:**

In building portfolios, we start with core assumptions about the environment going forward. Noted British historian Paul Johnson has written that at every given point in time, you can always point to good news and bad news—the only difference is the balance between the two and what gets the media's attention. In early 2000 (at the height of the tech bubble) and in mid-2007 (at the top of the real estate and finance bubble), all we read about was good news—almost no attention was paid to any offsetting concerns. By contrast, during the market bottoms at the end of 2003 and early 2009, all we saw was the bad news—it's as if there were no positives on the horizon. Presently, there are numerous negative and positive factors that may impact the performance of the economy and stock market for 2010.

**The Current Negatives:** Despite the recovery in the global economy and markets since the early part of 2009, the general sentiment and confidence level among people today is still rather negative. Much of that is driven by concerns about our economy, which is still the engine of global growth. And certainly there are lots of things to worry about in the U.S.: stubbornly high unemployment, a housing market that is still depressed, a commercial real estate market that has not hit bottom and ever rising government deficits.

**The Current Positives:** Despite these risks, for at least the mid-term, I believe the positives outweigh the negatives and that the dire predictions about America's decline are overstated. We may not see the rapid growth we've seen in prior economic recoveries, but I expect we will still see solid growth. The positives include:

- **Economy is Rebounding:** Although it has not been officially declared, the recession is over. GDP growth turned positive in the 4<sup>th</sup> quarter of 2009 and is expected to remain positive throughout 2010. The Conference Board's Leading Economic Index (LEI) rose for the

eighth straight month in November, as it registered a gain of 0.9%. The index has risen over 6% over the past seven-months for an annualized rate of ten percent. Historically the LEI has been an accurate predictor of future economic performance.

- Positive Profit Outlook: Currently, the consensus forecast from Wall Street analysts is that companies in the S & P 500 index will earn approximately \$75 a share for 2010 according to Thomson Financial. This would equate to a gain of nearly 26% over 2009.
- Low Interest Rates: Interest rates remain near historical lows and inflation remains almost non-existent. Although the Fed may start raising short-term rates later in 2010, it is likely that any increases will be at a moderate pace.
- Real Estate Not Getting Worse: New housing starts, home sales and home prices may have hit bottom. While there are still risks with a new wave of residential and commercial foreclosures forecast, real estate is no longer expected to remain a drag on economic growth.
- Cash Available: There is still a tremendous amount of cash (approximately \$3 trillion) parked in CDs, money market accounts and savings accounts earning very little. As investor confidence in the stock market returns, I expect a portion of this cash to be invested in stocks, providing an increase in the demand for equities.
- Increase in Dividends: S & P analysts predict that total dividend payouts from S & P 500 companies will rise between 6.1% and 8.9% for 2010. This will partially reverse the estimated 21.4% decline in 2009 and will be the first time since 2007 that the S & P 500 dividend payments have risen.

### Today's Valuation Levels:

*Being right on our mid-term outlook for the economy only helps us if we invest in stocks and bonds at attractive prices.* With regard to bonds, at current ten-year rates of about 3.8%, it is hard to make a case for U.S. Treasury bonds as anything except a safe harbor against another market downturn. The returns on corporate bonds are more interesting, especially toward the bottom of the investment-grade category, which currently yield about 6%.

On the issue of the valuation level of stocks, lots of academics have made a career of studying markets. Of these, I follow two in particular—Robert Shiller at Yale University and Jeremy Siegel at the Wharton School of the University of Pennsylvania.

Shiller believes stocks should be valued based on their average earnings over the past ten years, using what he calls the Cyclically Adjusted Price Earnings ratio (CAPE for short). Employing that measure, at the end of November 2009, Shiller calculated that the U.S. market's multiple was 19.5 times the average earnings for the past ten years. This was near the high end of the normal historical range. Prior to 2008, you have to go back to 1992 to find the last time we saw this multiple consistently below 20-times average ten-year earnings. Throughout the period from 1997 to 2001, this multiple was in the 30s and 40s. No wonder that for the decade ending 12/31/09, equities earned a negative rate of return for the first time on record! The good news is that stocks are now much more reasonably priced than they were ten years ago.

Jeremy Siegel is the best known researcher of long-term returns in the stock market and author of *Stocks for the Long Run*, often cited as one of the all-time ten most influential books on investing. Among his claims to fame is an article in the Wall Street Journal at the peak of the tech mania in early 2000, predicting that sector's collapse. In a December 23, 2009 interview, Prof. Siegel stated

that based on his expectation for a sharp rise in corporate earnings offset by a rise in interest rates, the fair value for the S & P 500 index is 1250. This represents a 12% rise from the S & P 500's close at December 31, 2009. He feels that corporate earnings growth in 2010 will be stronger than anticipated, although they will not reach their prior peak (which occurred in 2007) of the low 90's for trailing 12-month earnings. He does think that earnings growth will hit an all-time high by 2011 or 2012. With \$90 earnings and a 15 price-earnings ratio, a 1350 level for the S & P 500 is reasonable by then (21% above the 12/31/09 close for the S & P 500).

**The “New Normal”:** The bottom line from these two experts is that while stocks are not priced at a bargain level, by historical standards they do offer reasonable value. My personal belief is not quite as optimistic as these two experts. While I do expect that the stock market will continue to recover in 2010, I am more cautious and feel that returns for the next few years are likely to average around 5% to 8% annually. As discussed in my July 2009 Monthly Commentary, I feel we have entered a “new normal” period where the historical pace of economic growth will face many headwinds, including excessive regulation, higher taxation, ballooning government deficits, higher interest rates, and a depreciating U.S. dollar. The upshot of this is that investors should not take on undue risk and should remain flexible to adjust their portfolios in light of changing market conditions. Nonetheless, for investors with diversified portfolios who take a long-term approach, these relatively modest returns will compare favorably to most anything else that can be earned in the current environment.

### **The MAM Approach:**

It is not easy being an investor. The dismal returns provided by the equities for the last ten years were accompanied by tremendous volatility. This volatility caused some investors to become emotional and buy and sell at the wrong time. At MAM we try to make investing easier for our clients by doing the following:

1. **Invest for the Long-Term:** Our basic belief is that the stock market will provide good returns for investors who invest for the long-term. Earning a decent rate of return is very important for many Americans who want to reach their goal of a financially secure retirement. Over the long-term, the volatility of the stock market is reduced dramatically and returns move toward their long-term average of 10% annually.
2. **Stay Invested, Don't Panic:** For investors to earn these long-term returns, they need to stay invested. This can be challenging as investors become emotional: fearful during downturns and euphoric during upturns. When stock prices are depressed, it “feels” better to sell and wait for a better investment environment. This urge to sell was very prevalent during late 2008 and early 2009, as investors fled the stock market in droves. Unfortunately, most of these investors missed the rich returns offered by the initial stage of the market recovery (with stock prices climbing in excess of 50% from March 9<sup>th</sup> through December 31<sup>st</sup>).
3. **Invest Consistent With Your Risk Profile:** MAM portfolios are invested based on clients' risk tolerance and age. Investors who have a more difficult time staying invested during market downturns, have a more conservatively balanced portfolio. While being more conservative will most likely reduce the long-term returns for a client's portfolio, it is more important to stay invested than to be aggressive.
4. **Be Opportunistic:** The stock market is made up of many different asset classes whose prices don't move uniformly up and down. At times some asset classes become overvalued while others become undervalued. This can create an opportunity to add to portfolio returns by overweighting the undervalued asset classes. For instance, although not currently in

portfolios, REITS and commodities provided generous returns when they were undervalued a few years ago. Currently, I feel the best valuation is with large companies that have high barriers to entry in their markets (Morningstar calls these “wide moat” firms). Since the market recovery from last March, the stock prices of these “wide moat” firms have dramatically underperformed those of “no moat” firms. This is typical in the initial stage of a strong market recovery. Another theme currently emphasized in portfolios is investing in stocks that pay a growing dividend. While dividend paying stocks have underperformed non-dividend paying stocks since last March, studies have shown that in the long run, stocks that pay an increasing dividend over time, significantly outperform the overall stock market.<sup>1</sup> This fall, the ETF, Vanguard Dividend Appreciation (VIG) was added to most portfolios to increase the allocation to stocks paying an increasing dividend.

### **Roth IRA Conversions**

As you probably know, effective January 1, 2010 the Roth IRA conversion rules were liberalized. All taxpayers are now eligible to convert their IRA assets to a Roth IRA. Later this month, I plan to write and send an article regarding the pros and cons of doing such a conversion. There are many factors and strategies to consider. For instance, for those with earned income, it may make sense to make a non-deductible IRA contribution, and then convert the IRA to a Roth IRA. Later this month, I will contact those clients who have expressed an interest in doing a conversion to discuss whether it makes sense for them.

### **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 12-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 and Referrals**

As of December 31, 2009, MAM assets under management were over \$90 million, up from \$70 million at the start of the year. Please keep us in mind if you know of anyone who is need of help with managing their investments and other financial affairs. While our minimum amount to manage for new clients is \$350,000, we are willing to be flexible depending on the individual’s situation.

Please call me if you wish to discuss your portfolio(s) or other financial matters.

Very truly yours,

Stephen P. McCarthy, CPA, CFP

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<sup>1</sup> For instance, in an analysis performed by Jeremy Siegel, if an investor had put \$1,000 in a portfolio of the 100 highest-yielding stocks on January 1, 1957, by December 1, 2009, he would have accumulated more than \$450,000 (assuming all dividends were reinvested). That’s a generous annualized return of 12.5%, an average of almost 2.5% per year greater than the return on the S & P 500 index. That same \$1,000 invested in the 100 lowest-yielding stocks returned only 8.8% per year during this same time.