McCarthy Asset Management, Inc.
*Personalized Wealth Management*

# December 2018 Monthly Commentary/Q4 Qtr Letter

January 2, 2019

## Stock Market & Portfolio Performance

***Fourth Quarter 2018:*** U.S. and international stocks experienced a very difficult quarter. As a result, full-year returns for 2018 were negative. Bonds provided a safe-haven, posting positive returns for the fourth quarter, which offset their losses from earlier in the year.

| | 4th 2018 | YTD 2018 | Description: |
|---|---|---|---|
| Without Dividends: | | | |
| S&P 500 | -14.0% | -6.2% | 500 Largest Public U.S. Companies |
| Russell 2000 | -20.5% | -12.2% | 2000 of the smallest U.S. stocks |
| MSCI EAFE | -12.9% | -16.1% | international stock index |
| U.S. Aggr Bond | 1.6% | 0.0% | index of U.S. bonds |
| With Dividends, after all fees: | | | |
| MAM portfolios | -9.3% | -4.7% | non-very conservative MAM portfolios |
| MAM Conserv | -6.2% | -3.6% | portfolios with 50%+ bond allocation |

*The returns showed above are unaudited. Past performance is not indicative of future results. Returns for McCarthy Asset Management Portfolios ("MAM Portfolios") are net of management fees and transaction costs, and reflect the reinvestment of dividends. Results represent a composite of clients using a similar investment strategy, individual results will vary.*

*Returns for the indices are provided solely as a general indication of current market conditions. MAM Portfolios are not invested in a style substantially similar to any index. Indices do not reflect the deduction of management fees or transaction costs or the reinvestment of dividends. Performance for the indices would be lower if these costs were reflected.*

**Inside this issue:**



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# Stock Market Selloff– Where's the Bottom?


**It is rare, but this past quarter, stocks experienced a sharp selloff without a recession.** In most cases, bear markets and steep declines occur in conjunction with a recession. But that's not the case today with the economy performing well and stocks dropping sharply. There have been a few similar events in the past:

- In 1987, a combination of factors, compounded by computer-generated selling, led to Black Monday, that resulted in a 34% decline in stock prices in a little over three months.
- In 1998, stocks fell 19% in two months during the Asian currency crisis.
- Most recently, in 2016, there was a 13% decline over three months due to slowing growth in Asia and falling oil prices.

None of these drops occurred during a recession and they each proved to be temporary events. Unless we have a significant decline in economic fundamentals, we don't expect a prolonged drop in stock prices either.

**What is causing this most recent selloff?** We believe the primary culprits are:

1) Increasing concerns about a slowing economy and a possible near-term recession.
2) Fear that the Federal Reserve will raise interest rates too much.
3) Repercussions from the trade dispute between the U.S. and China.

**When will stock prices start to recover?** What is often seen when sharp corrections reach a bottom is investor capitulation, which is when investors "bail out" of the market due to emotional selling. Extreme investor sentiment is a measure of capitulation. The latest weekly survey from the American Association of Individual Investors (AAII) showed those with a bullish outlook was at 31.5%, compared to a historical average of 38.5%, while those with a bearish outlook soared to 50.3%, compared to a historical average of 30.5%. Generally, the stock market performs best after the AAII survey reports a high percentage with a bearish outlook and low percentage with a positive outlook. We don't think this latest reading is showing extreme negative sentiment. It may take a further drop in prices for that to occur.

**Performance of the Economy:** Most of the underlying fundamentals of the economy continue to be positive, as the risk of a global recession is relatively low in 2019 and even lower for the U.S. In particular, solid consumer spending, business investment and government spending should drive continued growth in the U.S. economy. Economists are projecting gross domestic product (GDP) growth of 2.00% to 2.75% for 2019.

**Market Valuation:** The selloff has caused stock prices to become undervalued. The S&P 500 is now trading at about 14.7 times expected 2019 earnings of $170 per share, below the average of 16.2 times over the past 50 years. Excluding the 'FANG' group of stocks (Facebook, Amazon, Netflix, and Google-parent Alphabet, plus Microsoft), the remaining 495 stocks in the S&P 500 are priced at less than 12.8 times expected 2019 earnings.

**MAM Action:** We moderately reduced equity allocations and increased bond allocations in the October portfolio repositioning. Furthermore, we replenished the "3-year withdrawal bucket" for portfolios generating regular withdrawals. At least at this point, we don't expect to take any action in response to the selloff due to our belief that it is temporary. Please let us know if you would like to discuss your portfolios.

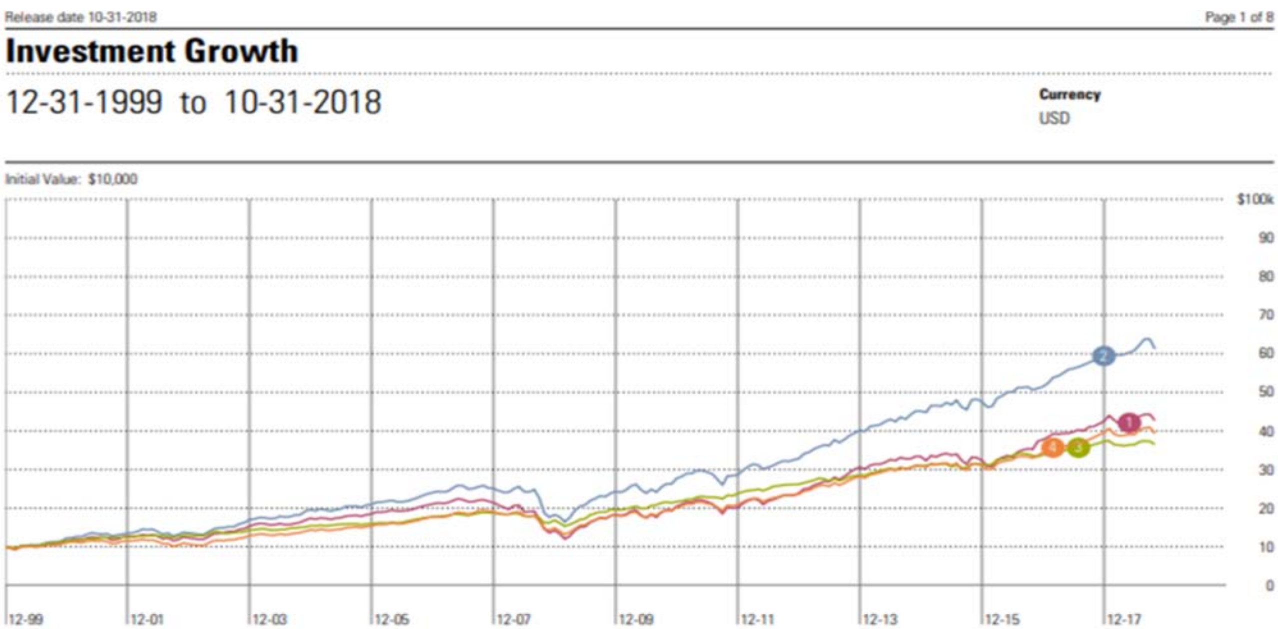
# Fund Profile– T. Rowe Price Capital Appreciation

In November, Ira Carnahan, who is one of six investment analysts for the T. Rowe Price Capital Appreciation Fund (symbol PRWCX), made an office visit with Lauree and me. We appreciated the opportunity hearing from an insider from the largest holding in most MAM portfolios.

**The basic goal of the Fund is to deliver over a full market cycle S&P 500-like or better returns, while taking substantially less risk than the S&P 500.** As can be seen below, the Fund has a tremendous track record. In 2008, we started adding it in some portfolios. In 2014, the Fund closed to new investors to keep assets at a manageable level. Fortunately, in 2015, T. Rowe Price granted an exception to MAM to allow us to add it to new portfolios. Since then it has become our largest holding.

**<u>Performance:</u>** The Fund has been remarkably successful since David Giroux became the manager in June of 2006. It outpaced all of its peers in the "50% to 70%" equity allocation category from his June 2006 start through September 2018. It also outperformed more than 94% of those peers on a risk-adjusted basis. The Fund has also been remarkably consistent; it outpaced its typical peer in each calendar year since 2008, placing in the 14th percentile on average. For the 4th quarter of 2018, the Fund slipped 6.3%, compared to the S&P 500's drop of 13.5%.

The Morningstar chart below shows the performance of the Fund (shown in blue) relative to three other excellent moderate allocation funds (Dodge & Cox Balanced, Vanguard Wellington and Vanguard Wellesley) from 12/31/99 through 10/31/18:




| Investment | Cumulative Return % | Annualized Return % | Amount at End of Period $ |
|---|---|---|---|
| 1 Dodge & Cox Balanced (USD, DODBX) | 326.70 | 8.01 | 42,669.60 |
| 2 T. Rowe Price Capital Appreciation (USD, PRWCX) | 511.85 | 10.10 | 61,184.89 |
| 3 Vanguard Wellesley® Income Inv (USD, VWINX) | 264.40 | 7.11 | 36,440.28 |
| 4 Vanguard Wellington™ Inv (USD, VWELX) | 292.58 | 7.53 | 39,258.15 |

***Performance Disclosure***

*The performance data quoted represents past performance and does not guarantee future results. The investment return and principal value of an investment will fluctuate; thus an investor's shares, when redeemed, may be worth more or less than their original cost. Current performance may be lower or higher than return data quoted herein. For performance data current to the most recent month-end, please visit http://advisor.morningstar.com/familyinfo.asp.*

# Fund Profile– T. Rowe Price Capital Appreciation– Con't

**Process:** Giroux has taken advantage of the Fund's flexibility over time, shifting the equity allocation in the range of 55% to 72% of assets. He's often taken a contrarian stance, increasing risk after market downturns, such as in 2008, and become more cautious during periods of strength, such as in the last couple of years. This flexibility to adjust the asset allocation is a major advantage that it has over index and balanced funds, such as those with Vanguard, which maintain a rigid asset allocation.

As explained in our meeting with Ira, currently the Fund has a 61% equity exposure. The actual beta of the Fund is even lower, though, due to the use of investment in lower-beta stocks and calls written against some of the portfolio holdings. Factoring this in, Ira estimates that currently the fund has an S&P 500 equity equivalent allocation of only 54%.

**Operating Expenses:** The investor share class (which can be purchased and sold for no transaction fee) has a 0.71% expense ratio, which is 0.16% cheaper than the median for similarly sold peers.

**How Has It Performed So Well?** Well-timed asset allocation changes have certainly helped, such as getting more defensive in 2006 and more aggressive in 2009. Ira said that good individual stock selection, however, has accounted for the bulk of the outperformance. As written in the most recent Morningstar report on the Fund, the equity portfolio has beaten the S&P 500 during Giroux's tenure by a substantial margin. More specifically, Ira said that Giroux's hit rate, which he defined as the percentage of the stocks in the portfolio that outperformed their sectors, is an outstanding 80-85%. Typically, a good portfolio manager would have a hit rate of more like 55%.

**MAM Thoughts:** We have been very impressed with the performance of the Fund and feel fortunate that we are able to add this closed fund to portfolios. Furthermore, we take comfort that Giroux has shifted the portfolio to a conservative allocation given that we are likely in the latter stages of this bull market .

# Bob Brinker's Review of the Five Causes of a Bear Market

Bob Brinker is a well-known financial advisor and radio personality. For 32 years (ending this past October), he hosted the nationally-syndicated financial radio show Moneytalk. Brinker still produces a monthly newsletter "Bob Brinker's Marketimer," which we subscribe to. Brinker made an excellent market call in January of 2000 when he advised investors to shift into cash. The dot.com market crash started just three months later. In the December 4th issue of Marketimer, Brinker reviewed the current status of five causes of a bear market. Here is a summary of what he wrote:

1. **Tight Money:** The Federal Reserve has been gradually raising the federal funds rate since 2015. He expects another 0.25% raise in its December meeting (the Fed announced the raise on December 19th). For now, Brinker views the Fed's monetary policy as sufficiently accommodating.
2. **Rising Rate:** Sharply rising interest rates have been a cause of previous bear markets. One of the key indicators of an on-coming recession is the shape of the yield curve. He will continue to monitor all of his pre-recession indicators, including the yield curve inversion indicator, for signs of deterioration.
3. **High Inflation:** The Consumer Price Index (CPI) has risen 2.5% over the past year, and the core CPI, which excludes the volatile food and energy sectors, has gained 2.1%. These are moderate inflation levels that are within the Fed's targets.

# Bob Brinker's Review of the Five Causes of a Bear Market– cont'd

4. **Rapid Growth:** Rapid economic growth can lead to a bear market because the Federal Reserve often raises interest rates to prevent the growth from triggering high inflation. Brinker defines rapid growth as a rate of real gross domestic product (GDP) above the historical average of 3% to 3.5%. Brinker expects real GDP growth of close to 3% for 2018 (boosted by the 2018 tax cuts), and a slowing rate of growth in 2019 within a range of 2.0% to 2.6%.

5. **Overvaluation:** Brinker feels stocks are now undervalued. He currently estimates that operating earnings for the S&P 500 Index will be $170 for 2019. Based on a price-earnings ratio of 17 to 18 times earnings, the S&P 500 has the potential to trade into the 3,000-3,100 range by year-end 2019. This would result in 20% to 25% appreciation from the December 31, 2018 close of 2507 in the S&P 500.

**Brinker's Current Recommendation:** In late November, Brinker upgraded his market outlook to "attractive for purchase." While he was at least a little early with this call given the sharp December drop in the market, it will still be a good call if the S&P 500 can get close to his 3000-3100 target by year-end 2019. While we don't try to make short-term market calls, I find Brinker's Marketimer newsletter is one of a few good sources we use to get a gauge on longer-term movements in the stock market.

Sincerely,

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MAM


# Our Services

**McCarthy Asset Management, Inc. (MAM) is an independent, privately owned Registered Investment Advisor firm. We provide clients with the peace of mind that comes from knowing professionals are managing their financial affairs. The services we offer include:**

**Investment Management Services:**

- **MAM creates and manages customized investment portfolios based on each client's investment objectives, timeframe and risk tolerance.**

**Financial Planning Services:**

- **The Net Worth Analysis (NWA) tracks the accumulation of Invested Assets for pre-retirees and the retention of Invested Assets for retirees. Updated annually.**
- **"Retirement Analysis" a comprehensive analysis of your retirement goals, which produces easy-to-read, interactive working plan, stored in the cloud. Updated as needed for life events.**
- **Social Security Planning is an analysis of the best strategy for when and how to start claiming Social Security benefits.**

**Tax Services: Clients have the option of utilizing the income tax services provided through the firm Stephen P. McCarthy, CPA. These services are offered at an hourly rate and may include:**

- **Tax Return Preparation**
- **Income Tax Projections**
- **Tax Minimization Ideas**
- **Tax Authority Representation**

**Other Services: MAM has retained outside experts, whose services are available at no cost to our clients:**

- **Long Term Care Planning– Allen Hamm of Superior LTC Planning Services, Inc.**
- **Medicare Advisory Program (MAP) - Eileen Hamm**

# Reminders/Updates

1) **Estimated Tax Payments**: 4th Quarter 2018 Federal & State Estimated Payments are due January 15, 2019.

2) **ADV Part II**: You were provided a copy of our ADV Part II when you became a MAM client. As a Registered Investment Advisor, we file this this document annually with the Securities and Exchange Commission. Along with other items, it contains information regarding our fees, experience and educational back-grounds. Each year, the SEC requires us to offer clients the oppor-tunity to receive a copy of our most recent ADV Part II. Please let us know if you would like to receive a copy

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