

June Monthly Commentary/Q2 2018 Quarterly Letter

July 2, 2018

Stock Market & Portfolio Performance

Second Quarter 2018: U.S. stocks posted good returns, while international stocks fell for the quarter. Bonds slipped further as interest rates continued to edge up.

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| | 2nd Qtr | YTD 2018 | Description: |
|---------------------------------|---------|----------|--------------------------------------|
| Without Dividends: | | | |
| S&P 500 | 2.9% | 1.7% | 500 Largest Public U.S. Companies |
| Russell 2000 | 7.5% | 7.0% | 2000 of the smallest U.S. stocks |
| MSCI EAFE | -2.3% | -4.5% | international stock index |
| U.S. Aggr Bond | -0.2% | -1.6% | index of U.S. bonds |
| With Dividends, after all fees: | | | |
| MAM portfolios | 1.4% | 0.9% | non-very conservative MAM portfolios |
| MAM Conserv | 0.5% | 0.0% | 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.

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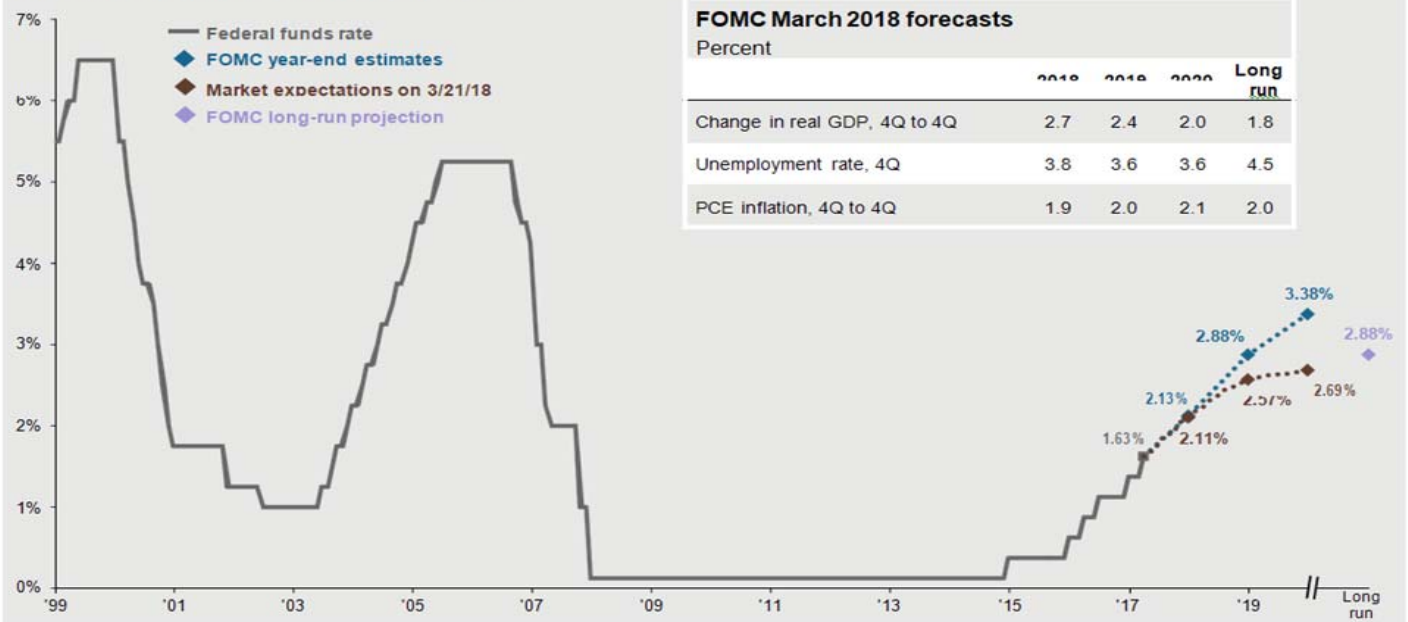
As expected, on June 13th, the Federal Open Market Committee (FOMC) raised the target range for the federal funds rate by 25 basis points, to a range of 1.75% to 2.0%. This marks the second rate hike this year and the seventh since the tightening cycle began in December 2015. The FOMC also indicated that it expects two additional hikes later this year. The graph below from J.P. Morgan displays the historical Federal funds rate since 1999 along with the projected rate for the next couple of years.

The Fed and interest rates

GTM - U.S. | 32

Federal funds rate expectations

FOMC and market expectations for the fed funds rate



Source: FactSet, Federal Reserve, Bloomberg, J.P. Morgan Asset Management. Market expectations are the federal funds rates priced into the fed futures market as of the date of the March 2018 FOMC meeting. *Guide to the Markets - U.S.* Data are as of March 31, 2018.

J.P.Morgan
Asset Management

The federal funds rate is an overnight bank-to-bank lending rate that the Fed uses to implement monetary policy. When the Federal wants to tap the brakes on economic growth, it raises the federal funds rate, making it more expensive for banks to borrow from each other. Because it's a short-term rate, any changes tend to have the strongest impact on short-term instruments, such as deposit accounts, money market funds, Treasury bills, short-term bonds and short-term bond funds. Intermediate and long-term bonds (including mortgages) may be less affected by an increase in the federal funds rate.

In response to falling unemployment and inflation edging toward its 2% target, the Fed is likely to continue to raise short-term interest rates over the next couple of years. However, the FOMC's long-term views still suggest that growth and inflation will remain at moderate levels.

Stock markets typically rise during the earlier stages of rate-tightening cycles. Recently, the yield curve has been flattening as short-term rates have been rising faster than long-term rates. Stocks have historically performed well in such conditions—and in some cases have continued to do so even after the yield curve has inverted (i.e. when short-term rates are higher than long-term rates).

It's typically when monetary policy becomes overly restrictive that a recession grows more likely and stocks suffer. In any case, recessions have historically come after the Federal finished hiking rates, not during a rate-hiking cycle. The period immediately before the recession arrives—starting up to six months prior—has tended to be the worst for the U.S. stock market in terms of returns. But we aren't there yet as the economy is not yet showing signs of overheating.

IRS Rules on After-Tax 401(k) Rollover to Roth IRA

Making pretax contributions to a 401(k) retirement plan has been a great way to save for retirement for millions of employees. More recently, employers have been adding a Roth 401(k) as an option to their retirement plans. Our feeling is that it probably is best to fund a Roth 401(k) when an employee's tax brackets are relatively low and switch to contributing pretax dollars to a traditional 401(k) when their tax brackets are higher.



401(k) Contribution Rules: For 2018, employees can contribute up to \$18,500 to a traditional or Roth 401(k). For those over age 50, an additional \$6,000 can be contributed. But employees can sock away a lot more retirement cash if their company plan offers an after-tax option with their traditional 401(k). For 2018, up to \$55,000 can be contributed between pre-tax and after-tax dollars (\$61,000 for those over age 50). This total includes any employer matching contributions.

After-tax contributions to a traditional 401(k): For employers that provide the option, these are non-deductible contributions above the \$18,500/\$24,500 limit for the traditional or Roth 401(k). A 2014 IRS ruling ([IRS Notice 2014-54](#)), makes it easier to convert these after-tax contributions directly to a Roth IRA when the employee retires or leaves the company. This is a great way to contribute a significant amount of money to a Roth IRA.

Tax Benefits of a Roth IRA: As a reminder, here are the very significant tax benefits of having assets in a Roth IRA account:

- All appreciation in a Roth IRA account is tax-free for qualified withdrawals.
- Unlike with a traditional IRA, there are no required minimum distributions starting at age 70 ½ for a Roth IRA.
- A Roth IRA held in an estate can be rolled over by a beneficiary into an Inherited Roth IRA. While there are required minimum distributions for an Inherited Roth IRA based on the life expectancy of the owner of the Inherited Roth IRA, this strategy can add decades to the tax-free growth of Roth IRA assets.

2014 IRS Ruling: Prior to 2015, there were no clear rules about how an ex-employee could roll over their after-tax 401(k) contributions into a Roth IRA. With the 2014 ruling, effective January 1, 2015, the after-tax money in a traditional 401(k) can be rolled over directly into a Roth IRA. In doing so, the entire 401(k) account will need to be distributed with the after-tax money going into a Roth IRA and the pre-tax money going into a IRA Rollover.

Does Your Employer Allow for After-Tax Contributions? Not all employers allow for after-tax contributions to their 401(k). According to benefits consultant Aon Hewitt, about half of plans allow after-tax contributions. I recommend finding out if yours does. If they don't, request for them to add that option as it will provide an attractive benefit for potential employees, providing another great way to save for retirement.

“Beat the Crowd” by Ken Fisher

Ken Fisher, founder of Fisher Investments, is a prolific financial author. He has written a financial column for Forbes for over twenty years and has written a number of investment-related books. In 2015, he published his latest book “Beat the Crowd (How you can Out-Invest the Herd by Thinking Differently)”. I found it to be an interesting read. Fisher can be very outspoken in his financial beliefs. While I didn't agree with all of his statements (such as “government deficits don't matter”), I did find the book to provide the following good financial lessons:

The Great Humiliator (TGH): “The stock market’s goal is to humiliate as many people as possible as often as possible for as long as possible...No approach works all the time, including assuming the crowd is wrong. The market usually doesn’t do what everyone expects, but there are always exceptions...Markets often let the crowd look right temporarily, before turning on them. Folks who believed the Eurozone crisis would end the bull market in 2011 looked awfully right that October, when world stocks were at the bottom of a deep correction. But stocks bounced and the bull carried on in 2012, 2013 and beyond, shrugging off history’s largest sovereign default in Greece along the way....Just as the crowd is sometimes right, true contrarians are sometimes wrong. Everyone is wrong sometimes! The goal is simply being right more often than wrong, as opposed to looking right at first but ultimately being wrong more often than not.”

Why Most Investors Are Mostly Wrong Most of the Time: “It isn’t because they’re uninformed. It isn’t because they lack smarts. Very well-read, bright people who pay close attention to the market often make pretty bad investing decisions! There is usually one simple reason for this: They inadvertently get sucked into the consensus view.”

The First Rule of True Contrarianism: “Here is the fundamental feature of true contrarianism. If you don’t remember anything from the next nine chapters, remember this: If most believe something will happen in the markets, the contrarian simply believes something else will happen...Note, I didn’t say the opposite happens. Just something different. Today’s (market) prices (reflect) what the crowds commonly conceive.”

Simplicity: “One of contrarians’ biggest strengths—and advantages—is their ability to filter out the noise and keep things simple. Simplicity is power. One, it’s usually right. Two, it keeps you sane.”

The Magical Indicator: “There is a simple, quick way to see if economies are heading up or down over a meaningful timeframe—the next several months out. What is it? The Leading Economic Index, better known as LEI. It’s simple and usually magical...The current series has 10 variables and The Conference Board has computed it back all the way to 1959...It’s a wonderfully accurate read of the economy’s future direction. Not its short-term wibbles and wobbles—the broader, longer-term trend. LEI trends usually precede reality by several months. No recession in the last 55 years has occurred during a rising LEI trend—they all started after LEI had fallen for some time.”

Not in the Next 30 Months: “If whatever big, bad, terrible thing the media warns about won’t happen materially in the next approximate 30 months, it doesn’t matter for stocks. Even if the terrible horrible prediction ends up true eventually, way down the road! Stocks don’t look that far ahead...The “not in the next 30 months” test is a top trick. You can apply it to pretty much every long-term issue that headlines hype as America or the world’s eventual socioeconomic downfall...If doom isn’t likely within the next 30 months, markets won’t worry about it today, and neither should you. This simple trick helps tune out a cacophony of frightful noise.” An example of this is:

- Retiring Baby Boomers: “For over a decade now, folks have obsessed over the Baby Boomers. What happens when they all retire? Who will be left to buy stocks?...Boomers’ retirement won’t move markets. It will play out too slowly—over an entire generation!—and nothing about it is a surprise.”

In Summary: I found Fisher’s book to be insightful and interesting. My three biggest takeaways from it are:

- Keep things simple.
- To get a good indication of the direction of the economy, focus on the trend of the Leading Economic Index (LEI).
- Don’t worry about events or risks not likely to occur in the next 30 months.

Sincerely,

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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

*Are you on course for a financially-comfortable retirement? A **Retirement Analysis** can be very helpful in answering that. Please let us know if you would like to have us prepare one for you.*



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