McCarthy Asset Management, Inc.

Registered Investment Advisor

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Monthly Investment Commentary- April 2010

Stock Market Performance for April: The stock market's recovery continued in April as, unadjusted for dividends, the S & P 500 rose 1.5%, the NASDAQ climbed 2.6%, the Russell 2000 rose 5.6%, and the international equity index MSCI EAFE dropped 2.1%. Bonds rose modestly and REITs sharply for the month.

MAM April Performance: MAM portfolios under performed the S & P 500 for April. Excluding the "very conservative portfolios" (which rose modestly), MAM portfolios rose 0.9% (after all fees), versus a rise of 1.6% for the Vanguard Index 500 fund (symbol VFINX) with dividends reinvested.

Year-To-Date Performance: For the first four months of 2010, unadjusted for dividends, the S & P 500 rose 6.4%, the NASDAQ climbed 8.5%, the Russell 2000 jumped 14.6%, and the international equity index MSCI EAFE dropped 1.9%. Excluding the "very conservative portfolios" (which rose 3.3%), MAM portfolios under performed the S & P 500 with a rise of 4.2% (after all fees) versus a rise of 7.0% for the Vanguard Index 500 fund with dividends reinvested. The under performance of MAM portfolios relative to the S & P 500 was primarily due to the impact of bonds rising less than equities (i.e. the "cost" of downside protection) and the decline in international equities (i.e. the "cost" of diversification).

Portfolio Repositioning

We completed portfolio repositioning in late April. The changes included:

- Despite the negative impact of international equities on portfolio performance so far this year, we generally made only a modest reduction in the international equity allocation because I feel that longer term the best growth will be outside of the U.S. and that eventually the U.S. dollar will start declining again.
- We significantly reduced the allocation to the Hussman Strategic Growth Fund. The Fund has performed poorly this year as manager John Hussman remains bearish in his outlook for the stock market.
- A small position in REITs was reestablished, as I think real estate will start to recover, and the current dividend yield on REITs is attractive.
- Thornberg Investment Income Fund was added due to its focuses on high dividend-paying stocks.
- A position in either Fairholme or Yacktman was added to most portfolios. These large-cap U.S. equity funds are run by managers with a track record of being very good stock pickers.
- Templeton Global Bond Fund was added to most portfolios as a way to benefit from the decline in the U.S. dollar relative to stronger currencies. The Fund invests extensively in countries that have a strong currency (i.e. the Asian countries).

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Economic Update- The Recovery Continues

A rebound in consumer spending and strong business spending gave the economy a solid boost for the first quarter of 2010. Last Friday the Commerce Department released its initial estimate of the 1st quarter gross domestic product, reporting that the economy grew at a solid 3.2% pace. This marked the third straight quarterly gain as the United States heals from the longest and deepest recession since the 1930's. Still growth was slightly weaker than expected and significantly weaker than the fourth quarter of last year, when the economy grew at 5.6%.

The first-quarter growth was powered by consumer spending. For the quarter, consumers increased their spending at a 3.6% pace, the strongest showing since early 2007—before the economy tipped into a recession. This was a big improvement from the fourth quarter when consumer spending grew at a lackluster 1.6% pace. Looking ahead, analysts believe it will be challenging for consumers to significantly further increase their spending given the very high level of unemployment (9.7%).

While the recovery in the economy during the last three quarters has been very welcome, the rebound has been modest relative to prior periods when the economy was recovering from a sharp slowdown. Continued solid but modest growth, though, may be an ideal environment for stocks to continue to appreciate. A sharp bounce back in the economy could spark inflationary fears, resulting in the Federal Reserve raising interest rates. In the announcement issued after its meeting last week, the Federal Reserve maintained its commitment to keep interest rates near zero for now to support the recovery.

Corporate Earnings Strong

First-quarter earnings season is now about one-third over, and so far the news has been very positive. Roughly a third of companies in the S & P 500 index have reported results, with 83% of them having beat Wall Street's consensus per-share profit estimates, according to numbers from Strategas Research Partners. Historically, the normal "beat expectations" ratio is 61%. Furthermore, on average, the earnings surprises have been big—21% more than the consensus estimate. Continued strong earnings reports could help propel stocks higher.

Stock Market- Setting Up For Another Plunge?

Probably Not, According to Lowry's: The powerful, nearly 80% stock market surge which started March 9th, 2009 has been a rise of historic proportions. According to Lowry's, from the March 9, 2009 low, the stock market rally has shown the largest gains of any rally over the same time span since at least 1960. Furthermore, the major market indexes have rallied virtually without pause since the mid-February 2010 market bottom, with the S & P 500 suffering no pullbacks of more than two days while gaining 13%. Given this strength, some investors may be wondering whether the market could be setting up for another crash. In a recent commentary, Lowry's points out that, historically, signs of increasingly selective buying have provided one of the most reliable indications of an approaching market top. This selective buying is typically displayed through the deterioration in the "advance-decline line" (i.e. number of stocks advancing less the number of stocks declining) and in a fewer number of stocks hitting new 52-week highs. Currently, none of the warning signs of a major market top are evident. All of the advance-decline lines followed by Lowry's have recently recorded new highs as has the number of stocks hitting new highs.

A Correction Could Be Healthy: While I continue to feel cautiously optimistic in my outlook for the stock market, a temporary correction could be healthy. A stock market that rises without pause may attract speculative investors. A 5% to 10% correction can be helpful in purging the speculative excesses out of the market, and setting the stage for a renewed advance. While I am not predicting such a correction, I would not be discouraged to see one. It doesn't appear, though, that stock market has become too speculative:

- The most recent sentiment survey by the American Association of Individual Investors still shows there are nearly as many investors (34.2%) who are bearish as there are those who are bullish (38.1%). Historically the percentage that is bullish is 9% higher than the percentage that is bearish.

- More significantly, since last year's market bottom, investors have pulled $24.6 billion out of mutual funds focused on U.S. equities. Over the same time, they've invested $455.6 billion into bond funds. This is the opposite of what investors were doing during 1999, just before the 2000 stock market peak, when they poured nearly $200 billion into equity funds and withdrew $4 billion out of bond funds. Given the dismal market-timing track record of individual investors, I will become concerned once I see individual investors making large, consistent inflows into U.S. equities.

Why Do Good Investors Make Poor Decisions?

Why do investors with losing investments fixate on "getting back to even" before they sell? What makes investors buy at the top of the market? The field of behavioral finance asserts that investors' personalities, as well as the way information is presented, influences investment decisions and market outcomes. Studies have shown repeated patterns of investors making irrational and inconsistent decisions, especially when faced with uncertainty. Here are a few common investor behaviors—"loss aversion", "over emphasis of the recent past" and "anchoring".

Loss Aversion: The "loss aversion" bias describes the fact that individuals feel the pain of loss more severely than they feel the joy of gain. Studies have shown that while individuals may not be willing to take on additional risk for a prospective gain, they may take on additional risk to avoid a potential loss. In terms of investing, loss aversion can cause investors to:

- Sell winning investments too soon, trying to capture a gain before experiencing any potential loss.
- Hold losing investments too long to avoid realizing the loss.
- Take on more risk than they would under normal circumstances to make up for losses.

Over Emphasis on the Recent Past: Some investors are prone to overly emphasize the recent past and to allow their emotions to influence their investment decisions. These actions can be very detrimental to investment results.

- To some the late 1990's was the dawn of a new era when the internet boom was going to allow the economy to grow at an unprecedented rate without the interruption of recessions. Stock prices nearly doubled during this timeframe, as the price-earnings ratio of large-cap growth companies skyrocketed. Some investors became greedy and loaded up on technology stocks to take advantage of the "opportunity". This bubble ended badly as overly aggressive investors were painfully burned.

- The opposite took place just over a year ago. The financial crisis and the worst recession since the Great Depression caused the stock market to plunge nearly 60% between late 2007 and early 2009. Some investors panicked. They saw little hope for improvement in the economy and were very fearful of further stock market losses. They did the seemly rational thing of liquidating their stocks to wait for a better environment to reinvest. This caused them to miss out on the early, most significant part of the gains of the ensuing rally.

How costly is the impact of irrational behavior on individuals' investment performance? In its famous study, DALBAR, Inc. compared the average return from 1989 to 2008 of investors in domestic equity mutual funds versus the S & P 500 index. *Sadly, the average mutual fund investor experienced an annualized return of only 1.87%, compared to 8.35% for the S & P 500.* This study supports the findings that *loss aversion* and *over emphasis of the recent past* often results in investors buying high and selling low.

Anchoring: Anchoring is the tendency to use an idea or fact as a reference point for future decisions, even though the reference point has no bearing on future judgments or decisions. An example of this would be an investor who purchased a home in 2000 for $400,000. At the peak of the housing market in 2007, the home had appreciated to $1 million. Ready to sell the home in 2010, the homeowner learns the current value is $700,000. If this investor became anchored on the market high value of $1 million, he may view the current value as a $300,000 loss, while he actually has a $400,000 gain from the original purchase. The same can happen with the stock market. Anchored investors may focus on the value of their portfolio as of November of 2007 (the market high) as the benchmark for future returns. It is not rational to become anchored on the highest value that an investment reached. What is rational is to focus on the outlook for a given investment relative to other investment alternatives.

How can investors protect against their human emotions clouding their investment decisions? Here are some suggestions:

- Hire an investment professional like MAM, Inc. to manage your investments. An investment professional should make rational investment decisions based on the relative outlook for different investment alternatives.
- Try not to time the market. Investing gradually takes away the challenge of determining the best time to buy.
- Diversify your investments among stocks, bonds, international equities and alternative investments.
- Realize that it is unrealistic to expect that you can buy at the low and sell at the high.
- Give your investments the gift of time to appreciate. A longer timeframe also reduces the volatility of a diversified portfolio.

Please call or email me if you have any questions or would like to discuss your portfolio(s) or any other financial matters.

Sincerely,

Stephen P. McCarthy, CPA, CFP