

McCarthy Asset Management, Inc.

Registered Investment Advisor

September 1, 2010

Monthly Investment Commentary- August 2010

Stock Market Performance for August: August proved to be a cruel month on Wall Street as stocks experienced their worst August since 2001. Unadjusted for dividends, the S & P 500 fell 4.7%, the NASDAQ dropped 6.2%, the Russell 2000 fell 7.5% and the international equity index MSCI EAFE slipped 3.3%. Bonds rose and REITs fell modestly for the month.

MAM August Performance: As expected for a period of weak market returns, MAM portfolios outperformed the S & P 500 for the month. Excluding the “very conservative portfolios” (which rose 0.5%), MAM portfolios fell 1.9% (after all fees), versus a drop of 4.5% for the Vanguard Index 500 Fund (symbol VFINX) with dividends reinvested.

Year-To-Date Performance: With the poor August performance, the stock market is back in the red for the year-to-date as fears mount of a faltering economic recovery. For the first eight months of 2010, unadjusted for dividends, the S & P 500 fell 5.9%, the NASDAQ dropped 6.8%, the Russell 2000 slipped 3.7%, and the international equity index MSCI EAFE plunged 9.8%. Excluding the “very conservative portfolios” (which rose 4.6%), MAM portfolios fell 1.2% (after all fees), versus a drop of 4.7% for the Vanguard Index 500 fund with dividends reinvested.

Year-to-date, MAM portfolios have outperformed the S & P 500 as the good performance from bond and balanced funds more than offset the relatively sharp decline in foreign equities. I am satisfied with the fairly conservative positioning of MAM portfolios. Although I still feel the stock market has a good chance to recover in the fourth quarter, I don't want to get more aggressive unless there are clear signs that the economy has reached a point of a sustainable recovery. More specifically, I would like to see more significant growth in the U.S. job market. Furthermore, I remain concerned that the pending expiration of the Bush tax cuts could have negative implications next year on our fragile economy.

Topics Discussed: The following are the topics discussed in this Monthly Commentary:

1. Economic Update- Slowing Growth
2. Vanguard's Long-Term Outlook
3. Q & A- Answers to Clients' Questions
4. September Webinar Regarding Long-Term Care
5. Review Your Home Insurance

Economic Update- Slowing Growth

Most of the recent economic reports have been disappointing:

- The estimate of Gross Domestic Product (GDP) growth for the second quarter of 2010 was reduced to 1.6% down from the initial estimate of 2.4%. GDP growth will need to increase to at least 2.5% to 3.0% to generate sufficient jobs to bring down the near 10% national unemployment rate.
- A 25.5% decline in existing home sales was impacted by the expiration of an \$8,000 Federal tax credit for new home purchases. This decline together with a corresponding rise in the inventory of unsold homes raise fears that another decline in housing prices could be on the horizon (after prices had stabilized this past year).
- The July jobs report was disappointing as for the second consecutive month the U.S. economy has shed jobs as the government continued to unload census workers. More importantly, hiring by businesses was weak, as private employers added only 71,000 jobs in July. Businesses have now added jobs in every month so far this year, a total of 630,000 positions. This is an anemic average of 90,000 a month. There needs to be an overall gain of about 150,000 jobs per month just to keep pace with population growth.

The good news is that historically it is common for the U.S. economy to experience a “soft patch” at this stage in an economic recovery. Furthermore, in recent testimony before Congress, Federal Reserve Chairmen Ben Bernanke made it clear that if needed the Fed is ready to apply additional stimulative measures to the U.S. economy. Despite these recent disappointing economic numbers, I continue to feel that it is unlikely that the U.S. economy will experience a double-dip recession.

Vanguard’s Economic and Capital Markets Outlook

Unlike the last decade, there’s a good chance investors will experience positive equity returns over the next decade, according to a recent capital markets outlook issued by Vanguard. The 18-page report dives into everything from inflation expectations over the next decade to expected returns from emerging-markets stocks. This is the first time Vanguard has issued this type of report, and they expect to update it annually. *Please let me know if you would like me to email you a PDF copy of the report.*

Vanguard cautions that its forecasts are long-term in nature and include a wide range of possible outcomes. Here are some key points:

- Chances of a double-dip recession are about 20%.
- 3% inflation should be expected over the long term.
- Long-run median returns for most fixed-income investments should be below current yields (due to the impact of rising interest rates).
- The long-term median return for global equity markets is near historical averages, given current market valuations and the projected equity risk premium. Specifically, there is about a 65% chance the S & P 500 will return between 4% and 16% annually over the next decade.

Q & A- Answers to MAM Clients’ Questions

I frequently receive questions from clients. While some of the questions are specific to the individual asking it, others are more general and may pertain to many others. The following are answers to two questions that I have recently received:

Question 1: It will be hard for us to sustain another hit should the stock market fall 50% again as we're still exposed to substantial volatility and getting older! Any thoughts on this?

My response:

- MAM portfolios are not invested as aggressively as the overall stock market. Currently I estimate that most MAM portfolios have an asset allocation such that they should experience 60% to 70% of the volatility of the overall stock market. This is reflected in the modest decline in MAM portfolios so far this year relative to the 4.7% decline in the S & P 500.
- While bonds have outperformed stocks for the last ten years, for the next ten years I expect stocks to outperform bonds. While I am not confident that stocks will provide a return equal to their long-term average of 10% annual returns, I do expect returns to average 5% to 7% annually during this time. (Note that for any given year the return will likely be higher or lower than this range.) Meanwhile, since interest rates will eventually start to rise, bonds will not perform as well as they have in the last ten years.
- Trying to time the stock market is incredibly difficult. While I agree that it feels like the stock market has gotten riskier since the concerns have grown about a slowing economy, the stock market tends to turn when it is least expected. It seemed that no one was optimistic in March of 2009 when the stock market hit bottom, and then went on to surge 70% over the next twelve months. Current investor pessimism is reflected in the continued outflow out of equity funds and into bond funds. Furthermore, the most recent weekly Bull/Bear survey from the American Association of Individual Investors (AAII) saw the smallest number of bulls (20.7%) in the latest week ended August 26th since the fateful week ended March 5, 2009. All of this negative investor sentiment is very bullish for the stock market.
- Probably the most important advice: I don't want to be any more aggressive with a client's portfolio(s) than what they can handle if the stock market were to fall further. If you are very concerned about the risk to your portfolio(s), let's talk.

Question 2: What would you say if I say let's move everything to bonds or a similar conservative profile?

My response: I can understand why a client may feel this way. As indicated above, for the first eight months of 2010 the "very conservative portfolios" appreciated 4.6% while all other MAM portfolios fell 1.2%. The "very conservative portfolios", which contain an 85% to 90% allocation to bond funds, were designed as an alternative to low-yielding savings accounts and CDs. So far, no clients have had me convert their diversified portfolio into a "very conservative portfolio". In the long run I expect these bond-heavy portfolios to underperform the more diversified MAM-managed portfolios. These very conservative portfolios are more appropriate for conservative money such as a client's emergency cash fund.

Note: Please send me any questions you would like to have me answer in a future Monthly Commentary.

September Webinar Regarding Long-Term Care

Long-term care is an important issue that many of us may face some day. Also, we may have parents or other elderly relatives that have had to deal with it. Like other parts of retirement planning, this should be addressed through long-term planning. As discussed in an email that I sent last week, I am excited to announce that I have entered into an engagement (through payment of a retainer fee) with Superior LTC Planning Services, Inc. to provide long-term care planning services to clients. As part of the service, Superior LTC will create and annually update a Long-Term Plan at no cost to MAM clients. To provide you with more information about this new service, Allen Hamm, founder of Superior LTC, and I will hold a Webinar for clients on September 22nd at 7 pm. Details of how to log in or call in to the Webinar were provided in the email.

Review Your Home Insurance

One financial planning area that I have not addressed in a while in the Monthly Commentary is home insurance. This is an area that most of us have probably given little thought to. I recommend that you review your policy and make sure you have adequate coverage. To provide you with some items to consider, attached to this Monthly Commentary email is a 3-page article from Kiplinger's Personal Finance entitled "Upgrade Your Home Insurance". Here are some excerpts from the article:

- According to Marshall & Swift, which provides building cost data to the insurance industry, nearly two-thirds of U.S. homeowners are underinsured by an average of 18%.
- Without adequate coverage, you may not have sufficient insurance to rebuild your home and replace its contents in the event of a fire or other disaster.
- Conduct a home inventory. The article recommends that you use the Insurance Information Institutes free online tool at www.knowyourstuff.org to take an inventory and store it (along with photos) online. You should also print the report and store it in a fireproof safe or bank safe-deposit box.
- To keep the cost of your policy down, take the biggest deductible that you can afford. According to the article, raising your deductible from \$500 to \$1,000 could save you up to 25% on your premiums.
- I highly recommend that clients obtain an umbrella policy to raise the liability limits on their auto and home policies to \$1 million or more. These policies are reasonably priced. Per my agent at Farmers, for a homeowner with two cars, the current annual cost of a \$1 million policy is \$228.
- Not addressed in the article was a risk relevant to California homeowners—earthquake insurance. I have mixed feelings about earthquake insurance. These policies are very expensive and the deductible is extremely high. Nonetheless, undoubtedly it is just a matter of time before we experience another major quake. If major earthquake damage to your home would be financially devastating, you should consider purchasing a policy.

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

Encl: Upgrade Your Home Insurance