

McCarthy Asset Management, Inc.

Registered Investment Advisor

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Monthly Investment Commentary- August 2011

Stock Market Performance for August: Wow, what a difficult month! The final results don't reflect how bad it could have been. Unadjusted for dividends, the S & P 500 fell 5.7%, the NASDAQ dropped 6.4%, the Russell 2000 fell 8.8%, and the international equity index MSCI EAFE dropped 9.3%. Bonds, as represented by the Barclays U.S. Aggregate Index, rose 1.5% for the month. Results could have been much worse, though, as the S & P 500 rose nearly 9% the later half of the month.

MAM August Performance: MAM portfolios outperformed the S & P 500 for the month. Excluding the "very conservative" portfolios (which fell 1.5%), MAM portfolios fell 3.4% (after all fees), versus a drop of 5.5% for the Vanguard Index 500 fund (symbol VFINX) with dividends reinvested.

Year-To-Date Performance: For the first eight months of 2011, unadjusted for dividends, the S & P 500 fell 3.1%, the NASDAQ slipped 2.8%, the Russell 2000 dropped 7.3%, and the international equity index MSCI EAFE fell 8.1%. Bonds, as represented by the Barclays U.S. Aggregate Index, rose 5.9% for the year-to-date. Excluding the "very conservative" portfolios (which rose 1.9%), MAM portfolios slipped 0.2% (after all fees), versus a drop of 1.9% for the Vanguard Index 500 fund (symbol VFINX) with dividends reinvested.

Return of Market Volatility

Stock market volatility increased dramatically in August. The S & P 500 moved by more than 1% for 14 out of the 23 trading days. The second week of August was of near historical volatility. For 4 of the 5 days of the week of August 8th the S & P 500 moved over 4% (two up and two down). VIX is a popular measure of the stock market's volatility. The VIX closed June at a modest 16.52 (while the S & P 500 closed at 1292). The VIX jumped 53% in July to close at 25.25 as the S & P 500 fell 2.1% for the month. The fear index then spiked to 48.00 on August 8th, the day the index lost a devilish 6.66%, dropping the S & P 500 to 1119, which was the low for the month. The VIX index has not been that high since it closed at 49.68 on March 9, 2009. This good news is that March 9, 2009 was the Bear market low (the S & P 500 was at 677). Now if we could only be so lucky with the recent spike in the VIX. From August 8th through the end of the month the S & P 500 recovered 8.9% while the VIX dropped to 31.71 (note the historical average for the VIX is 20.38).

Comments from Federal Reserve Chairman Ben Bernanke

Last week the Federal Reserve met in Jackson Hole, Wyoming. After a similar meeting one year ago, the Fed introduced a program termed "Quantitative Easing 2", which was credited with being a significant contributor to last year's stock market recovery. Last Friday, Fed Chairman

Bernanke made a widely-anticipated address where he made a number of comments regarding the Fed's view of the current state of the economy. Based on the sharp rise in the stock market that day, investors responded well to his comments. I have attached to this Monthly Commentary excerpts from the speech. Here are some of the key points that he made:

- (At least at this point) The Fed is not planning to introduce another bond-buying program ("Quantitative Easing 3").
- Based on revised statistics, it is clear the recovery from the financial crisis has been weaker than previously measured and, in fact, the economy has still not recovered to where it was prior to the crisis.
- Growth in the second half of 2011 is expected to improve over the first half due to the waning influence of the run-up in commodity prices and the Japanese disaster.
- Bernanke's longer-term outlook for the U.S. economy is more optimistic. He stated reasons for his longer-term optimism including how the U.S. has become more competitive internationally.

Suggestions for How to Weather a Volatile Stock Market

Don't Panic, Stick With Your Long-Term Investment Plan: In a report last week, Liz Ann Sonders, Chief Investment Strategist at Charles Schwab & Co., said it well: *"It can be difficult to be an investor during times such as this as emotions are running high. However, fear, panic, (or greed) are not solid pillars of a successful investment strategy. In fact, historically when volatility spiked and investor confidence sank, as we have seen recently, the following year was quite positive for equities. Times like this test whether your investment plan is one that you're actually comfortable with for the longer term. We continue to believe that investors who sell due to fear and panic will ultimately end up with a less successful result than those who stick with a well-thought out long-term plan. That of course requires discipline around diversification and regular rebalancing. There is always another potential crisis around the corner, as well as a possible positive surprise and trying to time the market in the short term can be a fool's errand."*

Ignore the Sensational Economic News Headlines: Although the risk is higher than normal, I believe the U.S. economy is probably not headed toward a double-dip recession. In a normal environment, the probability of a recession is about 15%, while currently I guess the probability is closer to 30% (which is consistent with the current consensus forecast of economists).

That is not to say that the sensationalist financial headline writers won't continue to suggest otherwise. For example, CNBC.com recently ran a widely-read story with the headline "Chance of Recession Is as High as 80%," which cited data from Bank of America Merrill Lynch that *"a plunge in recent economic data puts the probability of a double-dip recession above 80%".* The actual Merrill Lynch report stated *"We urge caution regarding forecasts of another recession. While we concede the risks are rising—we now see a 40% chance of a contraction over the next 12 months—a recession is not baked in the cake. If the economy can avoid shocks, we would expect a modest bounce in growth into the end of the year..."*

Include Sufficient "Downside Protection" for Your Portfolio: It is important for investors to be comfortable with the volatility of their portfolios. While focusing on long-term results can help in this regard, it is also easier to "hang in" during difficult times if their portfolios contain sufficient downside protection. The trade-off, of course, is that their portfolios will generally

not keep pace with the market when it is rising. Most MAM portfolios are currently invested with an asset allocation that should cause them to experience only 60% to 70% of the stock market's volatility. In fact, the decline in most portfolios was at the lower end of this range during the sharp market sell-off in early August.

Reaction of Clients: During the early August turmoil, I emailed two market updates to clients. Most of the responses I received were clients asking if we should take advantage of the selloff by getting a little more aggressive. In most cases I suggested we hold off until it becomes clearer that we are only going through a market correction (as opposed to a new bear market). Since then the market has recovered more than half of its losses. I am still not looking to get more aggressive at this time as I would not be surprised to see the market test its August lows.

Stock Market Outlook: Short-Term Caution, But Reasons for Longer-Term Optimism

While I am not currently looking to get more aggressive with portfolio positioning, I am also not looking to get more conservative. I was pleased by the downside protection portfolios provided in the early August selloff. Furthermore, while I realize there are challenges ahead (see below regarding risks of U.S. economy falling into a recession, European countries defaulting on their debt, and the U.S. not addressing its rising deficits), I also see positives:

- Despite some negative economic data during recent weeks—second quarter growth in GDP, manufacturing numbers in July, and consumer confidence—other indicators suggest a brightening outlook. Consumer spending, which makes up 70% of the economy surged in July while payrolls, unemployment claims, auto sales, the money supply, and new home construction all showed signs of improvement.
- Mortgage rates are at record lows, housing affordability is near record high, and oil prices have tumbled in the past five months, all of which should benefit U.S. household's bottom line.
- Monetary policy remains extremely accommodative.
- Negative effects from Japan's disaster are abating.
- Economic growth is continuing in most parts of the developing world, including China, Asia, Latin America and the Middle East.
- After the recent drop, the S & P 500 is trading at 11 times 2011 earnings estimates and providing a 2.1% dividend yield in comparison with a 2.3% yield on 10-year Treasury bonds. In particular, I continue to feel that dividend-paying stocks are a compelling long-term investment relative to nearly any of the alternatives (bonds, savings accounts, etc.).

Concerns I Will Be Monitoring

During the next few months I will be monitoring the following areas that are my greatest concerns:

1. Future Economic Reports- I am looking for signs that economic growth will show a slight improvement in the second half of 2011 relative to the first half. In particular, I will be looking at the monthly reports for Jobs and Consumer Spending.
2. "Super" Committee- As required by the Budget Control Act of 2011, which was passed in early August with only hours before the U.S. could have defaulted on its debt, Congress formed a "Super Committee" that is charged with proposing and approving \$1.5 trillion in spending cuts and/or revenue increases by November 23rd. Congress will

then have until December 23rd to approve in an up-or-down vote the Plan proposed by the Committee. The Super Committee is made up of six Democrats and six Republicans (6 from the Senate and 6 from the House). Failure of the Super Committee to come up with a Plan or for Congress to approve it will trigger \$1.5 trillion in automatic across-the-board spending cuts, with some exceptions for programs such as Social Security and unemployment insurance. Hopefully, our leaders will set aside their political differences and work together to achieve this task. The fallout from not doing so could lead to more turmoil for the stock market later this year.

3. **Eurozone Debt Problems-** The actions taken so far by the European Central Bank (ECB) appear to have only delayed the day when Greece will default on its debts. The greater concern is whether larger countries such as Italy and Spain also default on their debts, resulting in potentially catastrophic losses for European banks.

What I Would Like to See the U.S. Do in the Long-Term

1. **Reduce unemployment-** The government should primarily be focused on finding ways to increase employment in America. Helping more Americans get back to work will do wonders for reducing our fiscal deficits. One suggestion is for a tax holiday for multi-national firms that shift their massive foreign cash holdings to America to expand operations, invest in research and development, and hire new employees. Also, incentives should be provided to small businesses (which are the main driver of U.S. employment growth) to form, expand and hire workers.
2. **Reduce the national debt-** To avoid becoming like Greece, we need to at least stabilize the increase in national debt relative to the growth in the GDP. See “3” through “5” below.
3. **Get entitlements under control-** The dramatic projected deficits of Medicare and Social Security need to be addressed, or the aging of the U.S. population will result in the costs of these programs to spiral out-of-control.
4. **Simplify the tax code-** Congress missed an opportunity during the debt ceiling debate to address simplification of the tax code. This would probably entail eliminating or reducing many of the tax incentives and reducing tax brackets. The Super Committee now has an opportunity to make this happen.
5. **Shift in federal spending from “nation building” toward education and energy independence-** Currently we spend a massive amount of money in “nation-building” in Iraq and Afghanistan. If a significant portion of this money could be shifted to education and investing in green technology and fuel efficiency, America would have a more competitive work force and an economy that could become energy independent.

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

Sincerely,

Stephen P. McCarthy, CPA, CFP®