McCarthy Asset Management, Inc.

Registered Investment Advisor

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Monthly Investment Commentary- February 2009

Stock Market Performance for February: Just when you hoped it couldn't get much worse, it did. This past month was the second worst February on record for the S & P 500 (1933 was slightly worse). Furthermore, the 18.6% drop in the S & P 500 for the first two months of 2009 is now the worst on record (beating out 1933 when the market fell 17.9% for the first two months). Let's hope the historical comparison to 1933 continues as the good news is that the stock market ended up 46.6% for all of 1933! While I am not predicting that kind of recovery for 2009, the further the market falls, the greater it will eventually recover.

Unadjusted for dividends, for the month of February the S & P 500 fell 11.0%, the NASDAQ dropped 6.6%, the Russell 2000 fell 12.4%, and the international equity index MSCI EAFE dropped 10.5%. Fortunately, bonds rose for the month as they continued their recovery which started in late November of 2008.

MAM February Performance: For the month, MAM portfolios out performed the S & P 500, with a composite loss of 6.2% (after all fees), versus a drop of 10.7% for the Vanguard Index 500 fund (symbol VFINX) with dividends reinvested. The out performance of MAM portfolios relative to the S & P 500 was due in part to three sets of adjustments that were made since last October to increase the downside protection of portfolios.

Year-To-Date Performance: For the first two months of 2009, unadjusted for dividends, the S & P 500 fell 18.6%, the NASDAQ dropped 12.6%, the Russell 2000 fell 22.1%, and the international equity index MSCI EAFE dropped 19.4%. MAM portfolios out performed the S & P 500 for these two months with a composite loss of 10.9% versus a loss of 18.2% for the Vanguard Index 500 fund with dividends reinvested.

MAM portfolios have fallen 60% as much as the S & P 500's for the first two months of 2009. This is primarily due to the current asset allocation of MAM portfolios. Although there is a range depending on the client's risk tolerance score, the composite asset allocation of MAM portfolios is such that MAM portfolios should experience approximately 64% of the volatility of the overall market. *This month I am again asking whether clients would like for me to add at this time further downside protection to their portfolios (see discussion below).*

The remainder of this Monthly Commentary addresses the following:

1. *Economic Update*
2. *American Recovery and Reinvestment Act of 2009*
3. *Housing Bailout Plan*
4. *Stock Market Outlook*
5. *MAM Portfolios: Add Further Downside Protection (Again)?*

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Economic Update: Last week the Commerce Department revised its 4th quarter of 2008 GDP report showing that economic output contracted at a 6.2% annual rate, the lowest pace since the first quarter of 1982. This is a sharp drop from the initial estimate of 3.8% decline for the quarter. Based on the downward revision, economists are now much less optimistic about a rebound starting in 2009. Congress and President Obama have acted quickly to pass the $787 billion economic stimulus bill (The American Recovery and Reinvestment Act of 2009) and have outlined steps for a $275 billion housing bailout plan.

American Recovery and Reinvestment Act of 2009: The bill's provisions that are most likely to impact individuals include:

- Worker Tax Credit: For 2009 and 2010, the bill would provide a refundable tax credit of up to $400 for working individuals and $800 for working families. This tax credit will be calculated at a rate of 6.2% of earned income, and would phase out for taxpayers with adjusted gross income in excess of $75,000 ($150,000 for married couples filing jointly).

- Retiree Payment: Retirees will receive a one-time payment of $250 from the Social Security Administration.

- Deduction for Car Sales Tax: The bill provides all taxpayers with a deduction for State and local sales taxes paid on the purchase of new cars, light truck, recreational vehicles, and motorcycles through 2009. The deduction is subject to a phase-out for taxpayers with adjusted gross income in excess of $125,000 ($250,000 for joint returns).

- Home Buyer Credit: The refundable first-time home buyer credit has been increased to $8000 and no longer has to be repaid to the government for homes purchased after January 1, 2009. The credit phases out for taxpayers with adjusted gross income in excess of $75,000 ($150,000 for married couples). *In addition, CA lawmakers recently approved a $10,000 homebuyer credit for newly constructed, previously unoccupied homes.* The credit is available for one year starting March 1st, or until the $100 million earmarked for it is drawn down. Californians do not need to be first-time home buyers to take advantage of the credit; nor do they have to meet income requirements.

- Premium Subsidies for COBRA Continuation Coverage for Unemployed Workers: The bill provides a 65% subsidy for COBRA continuation premiums for up to 9 months for workers who have been involuntarily terminated. *To qualify for premium assistance, a worker must be involuntarily terminated between September 1, 2008 and December 31, 2009.* The subsidy would terminate upon offer of any new employer-sponsored health care coverage or Medicare eligibility. *Qualifying workers who failed to initially elect COBRA because it was unaffordable, would be given an additional 60 days to elect COBRA and receive the subsidy.* To qualify, individuals' income must be less than $125,000 if single and $250,000 if married.

Housing Bailout Plan: As I have written previously, a critical step to ending the credit crisis and improving the economy is to stop real estate prices from falling further. Nationally, Moody's Economy says that of the nearly 52 million U.S. homeowners with mortgages, about 13.8 million, or nearly 27 percent, currently owe more than their homes are worth. So far the steps that the Federal government has taken to end the slide in real estate prices have been ineffective. In the most significant move to aid homeowners since the housing crisis began, two weeks ago President Obama unveiled a plan to help up to nine million struggling homeowners to refinance or modify their mortgages. The plan, which would cost as much as $200 billion, will

enable as many as five million homeowners who have little equity in their homes—or even who owe slightly more than their homes are worth—to refinance loans through government-controlled mortgage giants Fannie Mae and Freddie Mac. In addition, the government plans to spend $75 billion to encourage lenders to modify loan terms for people at risk of foreclosure or already in foreclosure proceedings. Lenders and the government would jointly lower monthly payments to 31% of homeowners' income. Critics say the new plan offers little help to borrowers whose loan exceeds their property valued by more than 5 percent. While this may be true, if the new Plan can help millions of struggling homeowners, foreclosures should subside which will provide a boost to the real estate market.

Stock Market Outlook: Two questions that I have been hearing recently from clients are "When will the stock market stop falling?" and "How low do you think it will go?" Unfortunately, I can't answer these questions with any confidence. While I continue to feel that tumbling stock prices are setting the stage for a significant recovery, I don't know when it will occur. There are a few stock market research services that I follow who I respect regarding their outlook for the stock market. Their current consensus is that we are not yet at the bottom. My strategy is to cushion portfolios as much as possible during this downturn while still leaving sufficient equity exposure to participate in the recovery.

For many years I have been impressed with sound investment advice provided by Richard Band of "Profitable Investing". In his January issue he laid out three signs to watch for ahead of a genuine market upturn. In his March issue he wrote that two of the three indicators are now flashing "green". Treasury yields are starting to climb from the record lows reached late last year and the stock market's extreme day-to-day volatility has eased. The third gauge, "to keep an eye out for a spark of encouraging news that will jolt the prevailing bearish psychology", has not yet happened. He said President Obama had an opportunity to supply the jolt in February. As it turned out, though, the president couched his arguments for the $787 billion "stimulus" bill entirely in negative terms ("pass it, or we face catastrophe"). Band predicts that we are about to witness a raft of bank seizures by the federal government—perhaps 10 to 15 of the nation's 50 largest banks, and many more small ones. He writes "If the Obama team is smart (as I believe they are), they'll steal a leaf from Franklin D. Roosevelt in 1933 and announce all the seizers at once. The news will shock the world—for a few days. But then stock markets here and abroad will shoot upward as investors realize that the banking crisis is finally on its way to a cure." Band predicts the Dow could rebound 40% to 50% or more within a year.

Richard Bands' latest prediction is intriguing. I have read that compared to the Savings and Loan crisis in the early 1990's, this time the Federal government has been very slow to shut down "failed" financial institutions. One of the lessons from Japan's "lost decade" of the 1990's is that "failed" financial institutions need to be closed down or taken over for the economy to start on a path of sustained recovery.

MAM Portfolios: Add Further Downside Protection (Again)?: As I wrote in last month's commentary, a challenge is helping clients to stay invested for the eventual rebound. In the commentary I discussed undertaking the third portfolio repositioning within five months to protect against a further market drop. My strategy was to reduce U.S. and international equity exposure and invest the proceeds in the conservative Hussman Strategic Growth fund. Normally I make portfolio changes without notifying clients in advance. Given the sharp drop in the market over the previous year, I felt it was important to find out which clients were willing to get more defensive. In early February, I emailed most MAM clients about adding to the Hussman Fund. Approximately 90% of them said to proceed with the move. Fortunately for these clients, Hussman has continued to perform well this year (for the first two months of 2009 it is up 2.3%).

As mentioned above, I estimate that on average MAM portfolios are currently positioned such that they are approximately 64% as volatile as the market. *For some clients, though, it may make sense to reduce this volatility further by reducing U.S. and international equity exposure and adding to Hussman and the bonds funds used by MAM which have also performed well this year.* This would be the clients who are finding it difficult to "hang in there' in what may appear to them to be a market that is destined to keep falling. **Please let me know if you would like me to make these additional adjustments to protect your portfolio(s) against further drops in the market (at a cost of reduced upside during at least the initial upturn in the eventual market recovery). If you send me an email, I will let you know what I estimate to be the current volatility of your portfolio(s) relative to the market. We can then discuss how much you would like me to reduce it further.**

Sincerely,

Stephen P. McCarthy, CPA, CFP