

McCarthy Asset Management, Inc.

Registered Investment Advisor

March 1, 2011

Monthly Investment Commentary- February 2011

Stock Market Performance for February: Despite seismic political upheaval in the Middle East, February was a good month for investors and 2011 is off to the best first two months (up 5.5% for the S & P 500) since 1998. For the month, unadjusted for dividends, the S & P 500 rose 3.3%, the NASDAQ climbed 3.0%, the Russell 2000 rose 5.4%, and the international equity index MSCI EAFE climbed 3.1%. Bonds, as represented by the Barclay's Global Aggregate Index, rose 0.3% for the month.

MAM February Performance: MAM portfolios underperformed the S & P 500 for the month. Excluding the "very conservative" portfolios (which rose 1.2%), MAM portfolios rose 2.2% (after all fees), versus a rise of 3.4% for the Vanguard Index 500 fund (symbol VFINX) with dividends reinvested. Although the bond funds used by MAM beat the performance of the Barclay's Global Aggregate Bond Index, they still held back the performance of the portfolios relative to the all-equity S & P 500 Index.

Year-To-Date Performance: For the first two months of 2011, unadjusted for dividends, the S & P 500 rose 5.5%, the NASDAQ climbed 4.9%, the Russell 2000 rose 5.1%, and the international equity index MSCI EAFE climbed 5.5%. Bonds, as represented by the Barclay's Global Aggregate Index, rose 0.5% for the year-to-date. Excluding the "very conservative" portfolios (which rose 1.7%), MAM portfolios rose 3.2% (after all fees), versus a rise of 5.9% for the Vanguard Index 500 fund (symbol VFINX) with dividends reinvested.

The Economy- Two Keys Are Job Growth and Oil Prices

As mentioned in last month's Commentary, the economy returned to the expansion mode last quarter as the nation's total output increased to the highest level since the end of 2007, when the Great Recession started. Although last quarter's Gross Domestic Product report was recently revised downward to 2.8% growth, this year growth is expected to accelerate. Recent reports that support this growth thesis include the Institute for Supply Management reporting that U.S. manufacturing increased for the 16th consecutive month and the Thomson Reuters/University of Michigan consumer-sentiment index which rose in February to its highest level in three years. Two important items that I will monitor to help determine the strength of this economic expansion are:

- **Job Growth:** This Friday the U.S. Department of Labor will release the February Jobs Report. The monthly employment report has now taken on much more significance as we have moved past the early stages of the economic recovery. Now employment growth is needed to sustain the economic expansion. The consensus forecast is for growth of 172,000 jobs versus January's measly 36,000 (which was depressed due to poor weather). Strong employment reports from several regional purchasing managing surveys, falling initial unemployment claims, better weather, and anecdotal evidence from companies suggest that a gain of 172,000 new jobs may be realistic.

- **Oil Prices:** With growing civil unrest in the Middle East and North Africa, it appears that the political framework of authoritarian regimes that dominated the region for the last several decades is unraveling. We first saw this in Tunisia, followed by Egypt, and uprisings and protests have since spread throughout the region, most notably in Libya. As a member of OPEC, Libya produces 1.5 million barrels of oil a day. As a result, oil prices have reached their highest level since fall of 2008. Bank Credit Analyst (BCA) estimates that every \$10 increase in the price of oil shaves economic growth by 0.1-0.2%. With the price of oil reaching \$100 per barrel last week, the recent surge in prices is not yet a significant threat to the economy.

It is impossible to predict the outcome from geopolitical unrest, but outside of larger-scale conflicts, the most likely scenario is that oil-supply disruptions will be short-term in nature. In fact, despite spiking spot-oil prices, the message from the futures market is that this is a short-term phenomenon, with long-term prices below current levels. In addition, the Saudi Arabian government has said that it can step in and fill the void left by the supply disruption in Libya, which accounts for only 2% of global oil output.

My main concern is the risk of the political unrest spreading to Saudi Arabia, the world's largest oil producer. King Abdullah is a popular figure there and a new \$36 billion package of social benefits may keep unrest at bay. Still, the risk remains of an uprising by the Shiite Muslim minority, which constitutes 75% of the population in the eastern province, the home to key oil fields. A major disruption in Saudi Arabian oil output could have a disastrous impact, causing oil prices to spike to over \$200 per barrel.

Stock Market- Due for a Correction?

While I remain relatively upbeat with my 2011 outlook for the stock market, a short-term correction is long overdue. According to Bob Doll, Chief Equity Strategist at BlackRock, until last week the U.S. stock market had gone 107 days before experiencing a peak-to-trough decline of 3.5%, which represents a new record. During the last three months the S & P 500 has climbed 12% and since last July 1st it is up over 29%. In fact, since the March of 2009 low, the small cap Russell 2000 and the Nasdaq have more than doubled.

Investors have been warming up to stocks. Throughout most of 2010, investors continually shifted out of stocks and into bonds. That trend recently reversed. The latest fund data from the Investment Company Institute showed a net \$5.2 billion flowed into domestic equity funds in the week ended February 16th, the sixth straight week of inflows. Clearly the mood of equity investors has improved considerably in recent months.

While I think stock prices are still reasonably priced relative to corporate earnings, a stock market correction may be needed. As Lowry's wrote in its most recent weekly report, "Each phase of a bull market creates excesses as buying enthusiasm becomes somewhat overdone, pushing prices too far, too fast. Then, a period of short term market weakness becomes necessary to correct the excesses. Once the excesses have been wrung out of the market, then new bargains emerge and the next leg of the bull market will be ready to resume." In terms of a possible correction, Lowry's says "...given the extent of the overbought condition in the recent rally, investors should probably be prepared for the possibility of a short term correction in the 7% to 10% range".

Net Worth Analysis- Time for an Update?

Since being hired in December, Alexey has been busy preparing updates to the Net Worth Analysis (NWA) for clients. I have been pleased to see the renewed interest clients have shown in having their NWA updated, as I think this is a great way to track your progress in saving for a financially-secure retirement. While we have prepared a NWA for over 100 MAM clients, some clients have not had theirs updated since the 2008 stock market and real estate crash. For some this is probably because they don't like to see their net worth decline. Now that the stock market has climbed back close to where it was at the start of 2008, clients are more interested in finding out where they are. **If you are interested in having us update your NWA or creating your initial one, please let me know and I will ask Alexey to send you a questionnaire.**

Investment Spotlight: Vanguard Dividend Appreciation (VIG)

Included with this month's Commentary is a recent Morningstar analysis of the exchange traded fund Vanguard Dividend Appreciation (symbol VIG). I first added VIG to portfolios in November of 2009. It is one of my favorite equity funds and now represents one of the largest positions in most MAM portfolios. Here are some reasons why I really like it:

- The fund holds a diversified portfolio of high-quality U.S. large-cap equities that have a history of increasing dividends. For a company to be considered for the fund, it must have increased its dividend for 10 consecutive years and it must pass balance sheet and profitability screens to make sure the company is in good financial shape and has the ability to increase future dividends. Per research conducted by Ned Davis, stocks with at least five years of dividend growth significantly outperformed the S & P 500 during the period 1972 through 2008. Companies with at least five-year dividend-growth generated average yearly gains of 8.9%, compared to 6.2% for the S & P 500.
- While there are other exchange traded funds that do pure dividend screens, VIG stands out because almost all of the portfolio companies are classified by Morningstar as "wide-moat" or "narrow moat" companies. "Moat" refers to the extent to which a company has built a "barrier to entry" to competition. Having this "sustainable competitive advantage" should enable VIG's companies to increase their dividends.
- The stock market rally since March 2009 has been led by speculative companies. This is not unusual as typically coming out of a recession the more leveraged, higher risk firms perform the best initially. As the stock market rally matures, historically, performance shifts to the higher quality companies.
- The beta for this fund is .83, meaning that it has been 83% as volatile as the S & P 500. While that has meant the fund often lags in bull markets, it falls less when the stock market is dropping. More importantly, as indicated above by the Ned Davis research, I expect this fund to outperform the S & P 500 over time.

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