

McCarthy Asset Management, Inc.

Registered Investment Advisor

August 1, 2011

Monthly Investment Commentary- July 2011

Stock Market Performance for July: Weak economic reports and the stalemate in Washington over raising the government's debt ceiling contributed to a down month for the stock market for July. Unadjusted for dividends, the S & P 500 fell 2.2%, the NASDAQ slipped 0.6%, the Russell 2000 dropped 3.6%, and the international equity index MSCI EAFE fell 1.7%. Bonds, as represented by the Barclays U.S. Aggregate Index, rose 1.6% for the month.

MAM July Performance: MAM portfolios outperformed the S & P 500 for the month. Excluding the "very conservative" portfolios (which rose 0.2%), MAM portfolios fell 1.1% (after all fees), versus a drop of 2.1% for the Vanguard Index 500 fund (symbol VFINX) with dividends reinvested.

Year-To-Date Performance: For the first seven months of 2011, unadjusted for dividends, the S & P 500 rose 2.8%, the NASDAQ climbed 3.9%, the Russell 2000 rose 1.7%, and the international equity index MSCI EAFE rose 1.3%. Bonds, as represented by the Barclays U.S. Aggregate Index, rose 4.4% for the year-to-date. Excluding the "very conservative" portfolios (which rose 3.6%), MAM portfolios rose 3.3% (after all fees), versus a rise of 3.8% for the Vanguard Index 500 fund (symbol VFINX) with dividends reinvested.

Leaders Agree on U.S. Debt Deal

During the last month the media has increasingly focused on the August 2nd deadline for U.S. policymakers to lift the \$14.3 trillion debt ceiling and avoid a government default. While both Republicans and Democrats in Congress wanted to avoid a default, they had great difficulty in coming to an agreement, particularly whether tax hikes should be included in a plan to cut government spending. On Sunday, July 31st, Congressional leaders and President Obama agreed on a deal. The House of Representatives passed the Bill this evening and the Senate is expected to pass it tomorrow (Tuesday). Here is a summary of the plan that was agreed to:

- The deal would raise the debt ceiling by \$2.4 trillion in two stages, and provide initially for \$917 billion in spending cuts over 10 years.
- A special committee of lawmakers would be charged with finding another \$1.5 trillion in deficit reduction, which could come through a tax overhaul and changes to safety-net programs including Social Security and Medicare.
- If the committee doesn't find at least \$1.2 trillion in savings, or Congress doesn't adopt its proposals, a pre-set array of spending cuts would kick in, including cuts in military spending and Medicare payments to health-care providers.
- The deal leaves the hardest questions unanswered as the details of what programs would be cut is left to congressional committees.

The deal reached yesterday is just a first step on a long and difficult road to restoring the U.S.' fiscal health. While debate will occur during the next 18 months over how the tax code should

be rewritten and what changes will need to be made to entitlement programs such as Social Security and Medicare, U.S. policymakers will probably wait until after the 2012 election before they engage in comprehensive entitlement, tax and other reforms.

Disappointing Economic Reports

The U.S. economy, which has been expanding for two years now, was hit hard earlier this year by shocks. The earthquake in Japan disrupted auto and other production in the U.S. while the Middle East turmoil drove up oil prices. While forecasters expect growth to pick up steam in the second half, we are exiting the first half with several weak economic reports:

- Last Friday the Commerce Department reported that the U.S. gross domestic product (GDP) rose at a meager 1.3% annual rate in the second quarter, well below economists' projected 1.8% growth. A year ago, the economy expanded by 3.8%. Furthermore, the Commerce Department dramatically cut its revised GDP growth measurement for the first quarter to 0.4% from its previously reported 1.9% and cut the growth rate for the fourth quarter of 2010 to 2.3% from its previous 3.1% estimate.
- On July 8th the U.S. Bureau of Labor Statistics reported that nonfarm payroll employment increased only 18,000 for the month of June and the unemployment rate was little changed at 9.2%. Following gains averaging 215,000 per month from February through April, employment has been essentially flat for the past two months while over 14 million Americans are still unable to find work. (Editorial note: Personally, I think U.S. lawmakers should be focusing their efforts on getting unemployed Americans back to work. The reduction in unemployment benefits combined with the taxes paid by the newly employed will help improve our nation's fiscal stability.) The July payroll report is due to be released this Friday.
- Today the Institute of Supply Management reported that the purchasing manager's index (PMI) fell to 50.9 in July from 55.3 in June. This was a big negative surprise as the consensus had been looking for the index to fall to just 54.0. Readings over 50 indicate that U.S. manufacturing is expanding. While the overall index has been above 50 for 24 consecutive months, it is now down sharply from "above 60", which is where it was for four straight months earlier this year.
- The latest read on consumer sentiment from Thomson Reuters/University of Michigan tumbled to 63.8, down from 71.5 in June and below the forecasted level of 72.5. The most recent reading marks the lowest measure since March of 2009. This may actually be a positive contra indicator as, historically, the stock market does well after this indicator reaches a low level. In particular, the previous times consumer sentiment reached its current depths were in 1974, 1979-1980, 1982, 1990, early 2008 and March of 2009. For all but early 2008, these periods proved to be a very favorable time to be invested in the stock market.

Despite these disappointing reports, I remain cautiously optimistic that we should start seeing evidence over the coming months that growth is improving. In particular, I will be looking for improvements in employment growth and manufacturing data.

Stock Market Outlook

I continue to feel that 2011 will be a positive year for the stocks. One reason for this is because corporate earnings continue to be strong. So far about 50% of the S & P 500 companies have reported earnings for the second quarter and the bulk of the reports have been solid with 75% of them reporting better than expected earnings. Relative to these strong earnings, the stock market is reasonably valued.

A second reason is that, historically, the third year of a Presidential cycle (i.e. 2011) is the best of the four years of a President's term. To improve his chance for reelection, President Obama is highly motivated for the U.S. economy's growth to accelerate.

I am also encouraged that two of the market timing services that I respect and monitor continue to be optimistic for 2011. While I am not convinced that anyone can consistently and accurately predict the direction of the stock market, I am open to listening to market timers with a good track record:

- **Lowry's:** In their weekly report issued last Friday, Lowry's said that while stocks have been trading in a fairly narrow range for most of this year, since the June 15th low in the market, signs of improving investor Demand have emerged. Additional confirmation of increased Demand (in particular from another 90% Up Day), would suggest the potential for a breakout from the market's months-long trading range and the start of a new leg up in the bull market.
- **Bob Brinker's Marketimer:** In his July monthly letter, Brinker said that in his view the stock market is in the third year of a cyclical bull market and has further to go in terms of percentage gains and duration. In this report, Brinker updated the latest readings on the five primary causes of a bear market and why none of the causes are currently pointing toward a new bear market.
 - 1) *Tight Money*- The Federal Reserve continues to maintain a highly accommodative monetary policy.
 - 2) *Rising Interest Rates*- Brinker does not expect the Federal Reserve to start raising short-term rates until at least 2012.
 - 3) *High Inflation*- Inflation remains subdued as the principal driver of inflation is wages and salaries. The very soft job market will keep wage inflation very low.
 - 4) *Rapid Growth*- There is no prospect for rapid economic growth anytime soon.
 - 5) *Overvaluation*- Brinker's fair value for the S & P 500 Index based on 2011 corporate earnings is in the low to mid 1400's. This is approximately 10% above the level the S & P 500 index closed at the end of July (i.e. 1292).

Dimensional Fund Advisors

Dimensional Fund Advisors (DFA) is a large money manager and mutual fund company that was founded in 1981. Although the firm manages over \$200 billion in assets, many investors have not heard of them. This is because DFA does not market or offer its funds directly to individual

investors. Instead you must buy them through fee-only financial advisors who have attended the Company's two-day introductory workshop in Santa Monica and been approved by the firm. One of the reasons for this exclusivity is that the firm only wants patient investors that will stay invested for the long-term. They do this by catering only to investors who utilize financial advisors who have been trained by DFA in how to utilize their funds.

Last month, Alexey and I attended the two-day workshop. We were both impressed by the quality of the information provided and the knowledge of the numerous speakers that presented. Dimensional is an academically-based investment firm. It was founded by David G. Booth and Rex Singuefield, both graduates of the University of Chicago Booth School of Business. The Company's board of directors includes Myron Scholes and Robert C. Merton both of whom won the Noble Prize for economics. Most of the presentations at the workshop were very academically-oriented and two of the speakers were famed economists Eugene Fama and Kenneth French, who are also both members of DFA's board of directors and whose research forms the foundation of Dimensional's philosophy. The core philosophy includes these beliefs:

- Passive investing is superior to active investing. Active investing is a "zero sum game" where the return of all active investors is equal to the return of the market minus the fees that active managers charge. It is very difficult to distinguish luck from skill and therefore it is nearly impossible to identify active managers that will consistently beat the market.
- Market timing is futile. As the famous annual DALBAR study shows, the average mutual fund investor dramatically underperforms the stock market averages. For instance for the 20-year period ending in 2009, the average stock fund investor earned a paltry 3.2% annually versus 8.2% for the S & P 500 index. Much of this underperformance can probably be explained by poor market-timing moves by investors (for instance those that cashed out late in 2008 or early in 2009 and missed the subsequent 100% run-up in the market).
- DFA utilizes enhanced indexing to design portfolios and limit trading costs. These enhancements often allow them to slightly outperform index funds. Meanwhile, Dimensional funds have very low operating expenses, well below the expense level of actively managed funds.

Alexey and I attended this conference in order to evaluate DFA's funds for a possible inclusion in MAM portfolios. We were impressed and expect to add DFA funds to the group of institutional mutual funds that we utilize within portfolios.

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