

# ***McCarthy Asset Management, Inc.***

Registered Investment Advisor

June 1, 2010

## **Monthly Investment Commentary- May 2010**

**Stock Market Performance for May:** This past month the stock market experienced its sharpest correction in over a year. Unadjusted for dividends, the S & P 500 fell 8.3%, the NASDAQ dropped 8.3%, the Russell 2000 fell 7.7%, and the international equity index MSCI EAFE dropped 12.1%. Bonds fell modestly and REITs fell nearly 6% for the month.

**MAM May Performance:** MAM portfolios out performed the S & P 500 for May. Excluding the “very conservative portfolios” (which fell 1.4%), MAM portfolios declined 5.5% (after all fees), versus a drop of 8.0% for the Vanguard Index 500 Fund (symbol VFINX) with dividends reinvested. MAM portfolios experienced only 69% of the S & P 500’s drop due to the downside protection provided by the bond allocation.

**Year-To-Date Performance:** For the first five months of 2010, unadjusted for dividends, the S & P 500 fell 2.3%, the NASDAQ dropped 0.5%, the Russell 2000 rose 5.8%, and the international equity index MSCI EAFE plunged 13.7%. Excluding the “very conservative portfolios” (which rose 1.8%), MAM portfolios fell 1.5% (after all fees), the same as the 1.5% drop in the Vanguard Index 500 fund with dividends reinvested. For MAM portfolios, the double digit drop in foreign stocks offset the downside protection of the bond allocation.

## **Is This The Start of a New Bear Market?**

Since peaking on April 23<sup>rd</sup>, the S & P 500 has fallen 10.5%. A drop of this magnitude officially qualifies as a market correction. The big question is, “have we entered a new bear market or is this just a temporary correction?” The market turbulence in recent weeks is certainly unsettling and I expect stocks will continue to struggle for the foreseeable future. Eventually, though, I think it is likely for stocks to start rising again once investors realize that Europe’s economies will not implode and the United States won’t get infected by the contagion. For the following reasons, I think it is unlikely we have entered into a new bear market:

- 1. Global Economies in Recovery:* In the late 2007 to early 2009 bear market, the U.S. and global economies were mired in the worst recession since the Great Depression. In contrast, currently the U.S. and most global economies have been in recovery for three quarters. The Organization for Economic Cooperation and Development (OECD), a watchdog for 31 of the world’s most developed economies, recently raised its forecasts for economic growth in its member countries to 2.7% this year, up from its forecast of 1.9% last November. This growth is expected to continue through at least 2011.
- 2. U.S. Economy Continues to Recover:* The U.S. economy continues to recover as indicated by consistent increases in consumer confidence. Furthermore, job growth has finally returned. Last month the U.S. Labor Department reported that employers added 290,000 jobs in April, the fastest pace in four years. The Jobs Report for May will be released this Friday. It is expected to show a further increase in job growth.

3. *Concerted International Response to the Greece Crisis:* Policymakers in Europe have quickly introduced measures to address the fiscal crisis in Greece. The International Monetary Fund and Greece's euro-zone partners have promised a rescue package of \$110 billion euros, while Greece, Spain, Portugal and Italy recently passed austerity bills to reduce their fiscal deficits. While I expect that Greece's economy will continue to struggle, I think it is unlikely it will derail the global economic recovery.
4. *Interest Rates to Remain Low:* A silver lining to the Greek crisis is the low inflation rate and the fragile financial markets are likely to keep the Federal Reserve from raising interest rates anytime soon. In fact, with the recent economic uncertainty (and the prospects of the upcoming November elections), the Fed may hold off raising interest rates until 2011. An extended period of near record low interest rates is a positive for both the U.S. economy and the stock market.
5. *Corporate Earnings Strong; Stock Market Reasonably Valued:* First quarter 2010 earnings for companies in the S & P 500 came in very strong with a near record number of companies reporting earnings in excess of expectations. Analysts now project that full-year 2010 earnings for the S & P 500 companies to be \$81.72 per share (up from a 2010 estimate of \$78.05 as of March quarter end). Based on May's month end close of 1089 for the S & P 500 Index, this represents a reasonable price-earnings ratio of 13.3 based on 2010 expected earnings. This price-earnings ratio is all the more reasonable given the current very low interest rate environment.

### **Questions and Answers**

Some questions that clients may be wondering about given the recent downturn:

1. *Given the Recent Drop in the Stock Market, Shouldn't I Get More Defensive Now?* If this is the start of a new bear market, then yes, there is still time to get more defensive. As discussed above, though, I believe that most likely this is just a market correction that will run its course. More importantly, I believe it is too hard to try to time portfolio adjustments for stock market corrections. Recently updated statistics reported by DALBAR indicate how poorly individual investors do with their market timing decisions. For the 20-year period ending December 31, 2009, equity mutual fund investors averaged a 3.17% annual return, compared to the 8.20% return for the S & P 500. Finally, as indicated by MAM portfolios experiencing only 69% of May's drop in the S & P 500 index, the current bond allocation does provide decent downside protection for portfolios.
2. *Why Don't I Reduce the Allocation to Foreign Equities?* Foreign equities are down nearly 14% this year versus a 2.3% drop in the S & P 500. While European stocks and the euro are likely to continue to struggle, there are reasons for optimism. For one, fiscal coordination is rapidly improving in the euro zone, addressing one of the area's key deficiencies. Second, European equities are attractively valued. For instance, European stocks trade with an average dividend yield of 3.3%, versus 1.9% for U.S. stocks. Finally, the sharp drop in the euro (down 14% relative to the U.S. dollar since the start of 2010) will benefit many European companies as Europe is highly integrated with global trade. In fact, 41% of Europe's gross domestic product is attributable to exports, as compared to only 11.3% in the U.S. and 12.8% in Japan. For instance, Germany, whose

export market is 30% larger than that of the U.S., is the largest net exporter in the world. A weaker euro will make European exports more competitive. The potential benefit of a falling euro was highlighted by a recent JP Morgan study which showed that since the mid 1970s European equities have outperformed U.S. equities when the euro (and the pre-euro equivalent) was declining.

3. *Is Now a Good Time to Get More Aggressive?* Why this may prove to be the case, my most important job in managing portfolios is to protect on the downside. For now, I think it is prudent to retain the downside protection of the bond allocation to protect against a further drop in the stock market.

### **Featured Investment- Vanguard Dividend Appreciation (VIG)**

From time to time, I use the Monthly Commentary to profile an investment used in MAM portfolios. Since I am particularly excited about the prospects for stocks paying an increasing dividend, this month I am profiling the Vanguard Dividend Appreciation Fund. VIG was first added to MAM portfolios in the November 2009 portfolio repositioning. It is an exchange-traded fund that holds a diversified portfolio of high-quality U.S. large-cap stocks. The custom index used for this fund demands that companies increase their dividends for ten consecutive years just to make the cut. It then imposes further tests for liquidity and financial strength to narrow the U.S. equity universe down to an exclusive list of nearly 200 names across a variety of sectors and industries. The familiar names that top this ETF's portfolio are stalwarts such as Procter & Gamble, International Business Machines, ExxonMobil and McDonalds. The portfolio has more than 90% of its assets in companies that Morningstar analysts have assigned a wide or narrow moat (i.e. greater protection from competition) and an incredible 85% of assets in companies with low or medium uncertainty. These statistics beat out nearly every nonsector ETF in the Morningstar database.

I was attracted to the Fund because, historically, stocks that pay an increasing dividend have outperformed the overall stock market with less volatility. This Fund is an inexpensive way to own such stocks as its annual expense ratio is only 0.24%. The Fund showed its high quality and low beta through 2008 and 2009. It lost "only" 26% in 2008, compared to 37% for the S & P 500. However, in the "junk company" rally of 2009, VIG returned only 19% versus a 29% for the U.S. market as a whole. Fortunately, this means that companies in the Fund are still reasonably valued. For the first five months of 2010, VIG was down 0.8% compared to a drop of 1.5% in the Vanguard Index 500 Fund.

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