

McCarthy Asset Management, Inc.

Registered Investment Advisor

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Monthly Investment Commentary- October 2010

Stock Market Performance for October: Historically October has been a scary month for the stock market. This proved not to be the case this year as stocks continued their hot streak that started in September. For October, unadjusted for dividends, the S & P 500 rose 3.7%, the NASDAQ climbed 5.8%, the Russell 2000 rose 4.0% and the international equity index MSCI EAFE climbed 3.6%. Bonds rose modestly and REITs rose sharply for the month.

MAM October Performance: As expected for a period of good market returns, MAM portfolios lagged the S & P 500 for the month. Excluding the “very conservative portfolios” (which rose 0.8%), MAM portfolios rose 2.2% (after all fees), versus a rise of 3.8% for the Vanguard Index 500 Fund (symbol VFINX) with dividends reinvested.

Year-To-Date Performance: After two consecutive very good months, the stock market is now solidly up for the year. For the first ten months of 2010, unadjusted for dividends, the S & P 500 rose 6.1%, the NASDAQ climbed 10.5%, the Russell 2000 rose 12.5%, and the international equity index MSCI EAFE rose 5.5%. Excluding the “very conservative portfolios” (which rose 7.4%), MAM portfolios rose 7.0% (after all fees), versus a rise of 7.7% for the Vanguard Index 500 fund with dividends reinvested.

Topics Discussed: The following are the topics discussed in this Monthly Commentary:

1. Slow Economic Growth, Fed Action, Strong Corporate Earnings
2. Fourth Quarter Portfolio Repositioning- Do You Want to Talk First?
3. Last Great Chance to Refinance a Mortgage?
4. Should You Do a Roth IRA Conversion?
5. “Ten Retirement Lessons from the Smartest People I Know”

Slow Economic Growth, Fed Action, Strong Corporate Earnings

- ***GDP for 3rd Quarter of 2010:*** Last Friday the initial estimate of Gross Domestic Product (GDP) for the third quarter of 2010 was released. In the report the Commerce Department said the economy expanded at a 2.0% annual rate, a slight improvement from the feeble 1.7% growth in the April to June quarter. Consumers helped boost last quarter’s economic growth with a 2.6% increase in spending. This was better than the second quarter’s 2.2% growth rate and marked the biggest quarterly increase in consumer spending since a 4.1% gain at the end of 2006 before the recession hit.

While it was good to see another quarter of economic growth, the subpar 2.0% pace was too slow to generate the hiring needed to reduce unemployment. Economists currently estimate GDP growth will be 2.4% for the fourth quarter. For all of 2010, the economy is now expected to grow 2.6%. While growth is good, one rule of thumb is that the

economy would need to expand by 5% for a full year to reduce the jobless rate (currently at 9.6%) down by 1%.

- *Disappointing Case-Shiller August Home Price Report:* The housing market continues to struggle. According to the most recent S & P/Case-Shiller U.S. National Home Price survey, home prices rose a less-than-expected 1.7% in August on a year-over-year basis. The weaker growth came as the federal homebuyer tax credit program ended. Compared to the prior month, home prices in the 20-city index fell 0.2% in August from July. Nationally home prices are now down about 28% since peaking in 2006. For the housing market to return to health and for home prices to start a sustainable rise, household formation needs to turn positive again. The key to sustainable household formation is adequate employment growth of at least 100,000 to 125,000 jobs per month. Clearly, we are not there yet.
- *Fed- New Round of Quantitative Easing:* This week the Federal Reserve is expected to embark on a new round of bond buying to lower long-term interest rates in the hope of spurring more borrowing and spending. At best, economists believe this latest effort by the Fed's is likely to provide only a modest boost to economic growth that won't be sufficient to significantly drive down unemployment.
- *Strong Corporate Earnings:* A very solid third-quarter earnings season provided a boost to the stock market for October. As of last Thursday, nearly half the companies in the S & P 500 index have reported third-quarter earnings, and the results once again look impressive. According to Thomson Reuters, 81% of the reporting companies have delivered results that are better than expected. If the season ends this way, it will be the highest proportion since 1994. Overall earnings are on track to rise 28% from a year ago, the fourth gain in a row after nine prior quarters of decline.

While the very strong third quarter earnings season has helped the stock market, investors are still cautious. Looking forward to 2011, analysts are calling for more subdued growth rates of 11.6%, 10%, and 13.3% in the first, second and third quarters according to Thomson Reuters. Nonetheless, based on the current level of the S & P 500, continued corporate earnings growth throughout 2011 would indicate that the stock market is still reasonably valued.

Fourth Quarter Portfolio Repositioning- Do You Want to Talk First?

Typically I reposition MAM portfolios twice per year. Since we last did this in April and May, I am planning to do the next repositioning later this quarter. Here are some current thoughts regarding what I am planning to do:

- *Purchase of the DoubleLine Total Return Fund:* Jeffrey Gundlach is the former manager of the outstanding TCW Total Return Fund mortgage bond fund. Early this year he formed DoubleLine Funds and brought over his mortgage bond team from TCW. His DoubleLine Total Return Fund is off to a very fast start both in terms of performance and growth in assets. While I have already added the Fund to portfolios with cash, I plan to add it to nearly all portfolios with this next repositioning.

- *Purchase of Matthews Asia Dividend Investor Fund:* While I have discussed this Fund in recent Monthly Commentaries, I will now be adding it to most portfolios for the first time. Since its launch in 2006, the Fund has beaten its peer group (the MSCI Pacific Index) by double digits each year. The two managers of the Fund (who have managed it since its inception) search for firms with stable cash flows, strong balance sheets, and solid franchises. They also want Asian firms that have increased their dividends and are committed to doing so in the future. The current yield on the Fund is 3.3%.
- *Sale of Funds:* To free up cash to fund the new purchases, I plan to sell all or a portion of Growth Fund of America and/or Selected American in most portfolios. These two large-cap U.S. funds have performed just comparable to the S & P 500 during the last few years. To provide the capital to purchase the DoubleLine bond fund, I plan to sell a portion of bond funds currently in the portfolios.
- *Increase Risk Profile by Shifting Bonds to Stocks?* I estimate that most MAM portfolios are currently positioned to have 60% to 70% of the volatility of the S & P 500. While that has not held back performance much this year as most of the bond funds used by MAM have performed well, I believe this is likely to change by next year:
 - I feel that the slow growth, low-interest rate environment we are in is positive for the stocks. With investors able to earn so little on their savings, stocks (particularly dividend-paying stocks) are an appealing option.
 - As I discussed in the 3rd quarter 2010 letter, 2011 will be the third year of President Obama's 4-year presidential term. Historically, the third year of a presidential term is the best for stock market performance. In fact, the S & P 500 index has been positive on a total return basis during the last 17 "presidential 3rd years". The likely take-over of the Republicans of the House of Representatives in tomorrow's election is probably another positive for the stock market for 2011.
 - While bonds have out performed stocks for the last ten years, I expect the opposite will be true for the next ten years. One of the reasons I feel this way is that unlike the last ten years when bonds benefited from declining interest rates, I expect that rates will eventually start to rise (perhaps by late 2011 or early 2012).

My inclination is that now would be a good time to start shifting part of the bond allocation to equities. My hesitation in doing so is that the current allocation to bonds provides significant downside protection for portfolios. This was proven to be the case this summer when the stock market stumbled. For instance, in August MAM portfolios fell 1.9% while the S & P 500 fell 4.5%. Furthermore, I believe many MAM clients still want to be cautious given the dismal performance of the stock market over the last ten years (with two drops of over 50% in the S & P 500) and the continued sluggishness in the economic recovery.

One of the significant challenges of being a money manager is managing clients' emotions. As I have discussed many times, the average mutual fund investor has consistently underperformed the stock market. As a money manager, one of my jobs is to not let my clients' emotions impact their investment decisions. This means that after a strong market run (such as 1999) I should be more conservative with the asset allocation

than what clients want. It was easy for investors to take on undue risk then with the incredible stock market performance of the late 1990's, although doing so proved to be harmful. Now the opposite may be true. As indicated by mutual fund flows, for over the last twelve months investors have been reducing their stock exposure and purchasing bonds at a record pace. Most likely, they should probably be doing the opposite right now.

Unfortunately, my crystal ball of future stock market performance (particularly short-term) remains a little cloudy. While I am feeling more optimistic about 2011, nothing is assured. Risks remain and there are a number of possible negative events (expiration of Bush tax cuts, terrorist attack, double-dip recession). One of my investment rules is "to be as aggressive with managing a client's portfolio(s) as they can handle in a market downturn". Since I can't accurately predict short-term movements in the stock market (nor can anyone), I only want to get more aggressive for those clients who can weather any possible short-term dips. While most of my clients defer to my judgment in making portfolio positioning adjustments, I know there are still some clients who are very concerned about the risks in today's environment, while there are others who feel more optimistic than me. **To guide me in determining the changes to make to your portfolios, please let me know if you would like to have a discussion regarding your portfolio(s) before I do the repositioning. We can either meet in person or have a phone conversation.**

Last Great Chance to Refinance?

I feel like the boy who cried wolf. In my February 2010 Monthly Commentary I included a section with this same title. At the time, many experts felt that mortgage rates were going to start climbing because the Federal Reserve had just stopped purchasing bonds. While rates did initially climb, they fell to new lows this summer as the economic recovery sputtered.

Mortgage rates continue to be close to record lows. According to Fremont Bank's website (www.fremontbank.com), as of today their current rates for a "no-cost" refinance of a conforming first mortgage (i.e. up to \$417,000) are 4.625% for a 30-year fixed and 3.99% for a 15-year fixed. Since I expect rates will be substantially higher in a few years, if you expect to own your home for at least five years from now, it may make sense to incur costs to obtain an even lower rate. According to Wells Fargo's website (www.wellsfargo.com/mortgage/rates), their current rates for a conforming loan with costs are 4.25% for a 30-year fixed and 3.75% for a 15-year fixed. Three more comments:

- As mentioned above, the Federal Reserve is expected to start purchasing bonds again. It is possible that this effort could have a short-term impact of further lowering mortgage rates.
- According to an October 28th Wall Street Journal article, the Mortgage Bankers Association predicts rates on a 30-year fixed rate loan will average 4.4% in the fourth quarter of 2010, increasing to a 4.7% average in the first quarter of 2011, and climb to 5.1% by the end of next year. The one caveat mentioned in the article is this assumes there will be no "blockbuster" announcement related to quantitative easing from this week's Federal Reserve meeting.

- A fallout from the credit crisis is that obtaining a new mortgage is now a much more time-consuming and extensive process. Furthermore, due to the sharp drop in real estate prices, many homeowners are not able to take advantage of the near-record low mortgage rates. If you are finding it difficult to refinance, you may want to check with a mortgage broker who works with more than one lender. Please let me know if you need a referral.

Should You Do a Roth IRA Conversion?

I want to remind you that effective January 1, 2010 the Roth IRA conversion rules were liberalized. All taxpayers are now eligible to convert their IRA assets to a Roth IRA. Earlier this year I emailed a letter to clients providing an overview of the Roth IRA conversion rules, the advantages of doing a conversion, when a conversion does not make sense, and some suggestions and recommendations. Please read the letter if you would like to know more about whether a Roth IRA conversion is appropriate for you. Then if you would like to discuss this further, please send me an email or give me a call.

Ten Retirement Lessons from the Smartest People I Know

Attached is a pdf of a 3-page article entitled “Ten Retirement Lessons from the Smartest People I Know” written by Paul Merriman. I obtained this article from Advisor Perspective, which provides me with a number of financial articles on a daily basis. This easy-to-read article was one of my favorites as it provides simple, sane advice which I feel is applicable to my clients. Among the lessons:

- Happiness in later life is not a direct function of how much money somebody has.
- Wealth comes from choices people make, not chances they take.
- The quality of your life is shaped by the quality of the people in your life.
- Smart people do not wait around for “real life” to start.

Sincerely,

Stephen P. McCarthy, CPA, CFP

Encl: “Ten Retirement Lessons from the Smartest People I Know”