McCarthy Asset Management, Inc.
Personalized Wealth Management

March 2022 Monthly Commentary (1st Quarter Letter)

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Stock Market & Portfolio Performance

First Quarter2022: U.S. and international stocks fell due to concerns about Russia's invasion of Ukraine and the Federal Reserve initiating the first in a series of interest rate increases. Bond prices fell nearly as much as stocks due to the fear that the Fed will be more aggressive than previously expected in raising interest rates.

	Mar 2022	YTD 2022	Description:
Without Dividends:			
S&P 500	3.6%	-5.0%	500 Largest Public U.S. Companies
Russell 2000	1.1%	-7.8%	2000 of the smallest U.S. stocks
MSCI EAFE	0.1%	-6.6%	international stock index
U.S. Aggr Bond	-2.8%	-5.9%	index of U.S. bonds
With Dividends, after all fees:			
MAM portfolios	1.3%	-5.3%	non-very conservative MAM portfolios
MAM Consrv	0.5%	-4.5%	portfolios with 45%+ bond allocation

The returns showed above are unaudited. Past performance is not indicative of future results. Returns for McCarthy Asset Management Portfolios ("MAM Portfolios") are net of management fees and transaction costs, and reflect the reinvestment of dividends. Results represent a composite of clients using a similar investment strategy, individual results will vary.

Returns for the indices are provided solely as a general indication of current market conditions. MAM Portfolios are not invested in a style substantially similar to any index. Indices do not reflect the deduction of management fees or transaction costs or the reinvestment of dividends. Performance for the indices would be lower if these costs were reflected.

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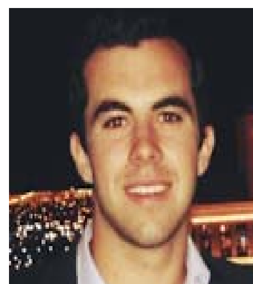

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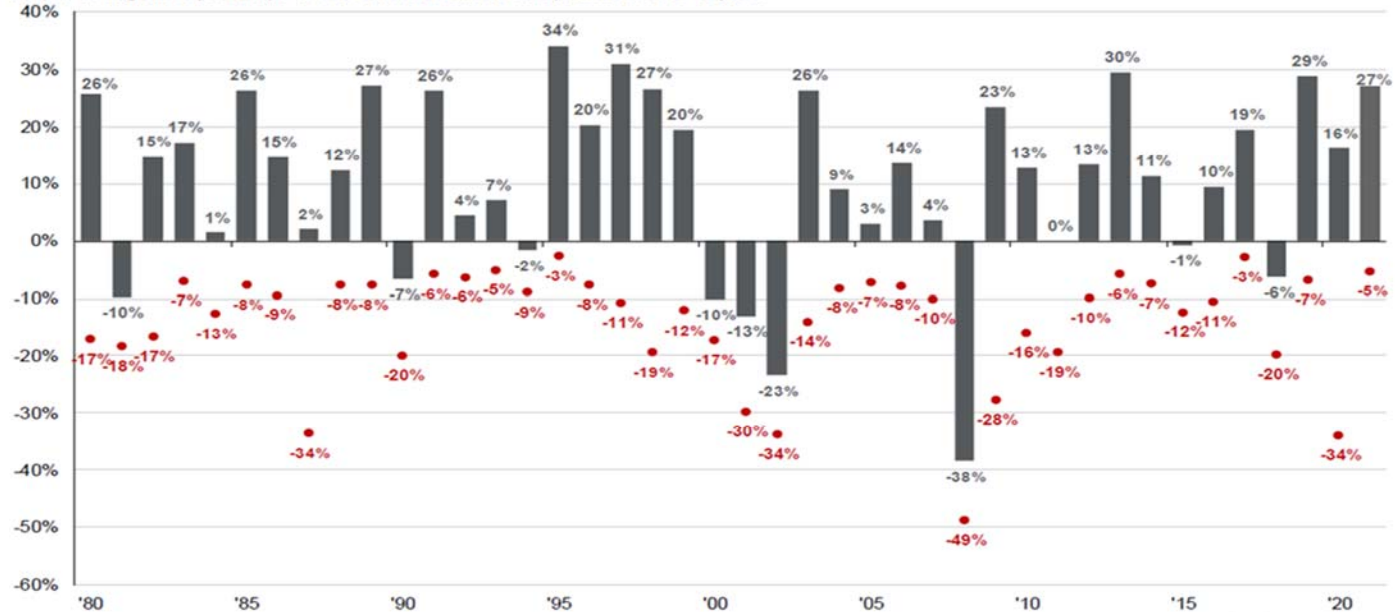
Stock Market Update

Since reaching record highs earlier this year, stock prices have fallen, with small -company stocks and technology shares faring the worst. The market has endured waves of volatility, as investors try to balance strong corporate fundamentals against the fear of monetary tightening by the Federal Reserve and the economic impact of Russia's invasion of Ukraine.

Frequency of Stock Market Corrections: During the first couple of weeks after the invasion, stock prices sold off world-wide. Since then, stock prices have been very volatile. I have been very impressed with the patience of MAM clients during this sell-off. As I have said many times before, it is the nature of the stock market to experience frequent short-term corrections. We don't try to time these market movements, as we feel it is nearly impossible to do so. We continue to anticipate a volatile stock market over the next few months until the terrible situation in Ukraine will hopefully come to a peaceful resolution.

The following chart from J.P. Morgan does a great job illustrating the frequency of stock market corrections (shown in red). As indicated in the chart, "despite average intra-year drops of 14%, annual returns were positive in 32 of the last 42 years". This chart has not been updated for the 2022 market correction:



Rather than trying to time short-term movements in stock prices, we focus on likely longer-term movements. For this, we monitor the performance of the U.S. economy. A significant, sustained drop in stock prices is unlikely to occur outside of the U.S. experiencing an economic recession. For at least the next year or two, we feel the U.S. economy will perform well and the start of the next U.S. recession is not yet on the horizon.

Stock Market Update– Con't

What About Rising Gasoline Prices? As expected, energy prices have risen sharply since Russia's invasion into Ukraine. What is the risk of this causing a slowdown in U.S. economic growth?

- We feel the economy's solid underlying momentum will help protect against the impact of rising fuel prices.
- U.S. consumer spending on gasoline is unevenly distributed, with low-income households bearing the biggest brunt of higher gasoline prices.
- Mid-to-upper income households, which drive the bulk of U.S. consumption, have smaller gasoline burdens, and a larger buffer of excess savings, which will limit the negative economic impact.

Rising Interest Rates: On March 16th, the Federal Reserve announced the highly-anticipated, first increase in its benchmark federal-funds rate. The Fed raised it by a quarter percentage point to a range of between 0.25% and 0.5%. The statement also signaled that the Fed could soon announce and implement a plan to shrink its $9 trillion asset portfolio.

According to an average estimate of 16 Fed officials, the expectation is for the federal-funds rate to rise to at least 1.875% by the end of this year, climb to around 2.75% by the end of 2023, and remain at that level in 2024. This implies a total of seven quarter-percentage point increases this year and another three or four next year. As mentioned in last month's Commentary, stocks often fall when bond yields rise suddenly, but usually bounce back as long as yields do not move into economically restrictive territory. The current projection of Fed officials is for rates to remain below the level that historically could trigger a recession. Of course, this is all subject to change if inflation remains elevated for longer than the Fed currently anticipates.

Bond Market Selloff: The normally sleepy bond market is seeing some of its worst losses in years as the markets reset their expectations for how quickly the Fed will raise interest rates. For instance, the Vanguard Total Bond Market Index Fund (VBMFX) is down 6.0% this year. For comparison, the worst year in history for VBMFX was a 2.7% decline in 1994.

Mortgage Rates: Incidentally, in mid-March, mortgage rates rose above 4% for the first time since 2019. At the beginning of this year, the average rate on America's most popular home loan was 3.22%. It hit a record low of 2.65% in January 2021 and spent more than half the year under 3%.

MAM Portfolios: As we wrote in last month's Commentary, at this point, we don't plan to make any portfolio adjustments as a result of Russia's invasion of Ukraine or the Fed raising short-term interest rates. While market volatility is likely to remain heightened for the foreseeable future, we are focused on the bigger picture. For us, that means monitoring the performance of the U.S. economy and corporate earnings. At least at this point, we expect another solid year for both.

Sustainable Withdrawal Rate - Is 3.3% the New 4%?
By Ryan McCarthy

When it comes to determining what is a sustainable withdrawal rate, many researchers are questioning whether the traditional 4% rule can continue to be relied upon. Before we can evaluate the factors impacting this, as well as consider potential courses of action, we must first determine what a sustainable withdrawal rate means.

A sustainable withdrawal rate is *the percentage of your invested assets that you can spend each year without running out of money before reaching the end of your life*. The "4% sustainable withdrawal rule" was first introduced in a 1994 study by William P. Bengen, in which he stated that for a portfolio comprised of 50% stocks and 50% intermediate-term treasuries, a 4% annual withdrawal rate is sustainable for a minimum 30 years. The rule states:

Sustainable Withdrawal Rate - Is 3.3% the New 4%? By Ryan McCarthy– Con't

Withdrawing 4% of your portfolio in the first year of retirement and then withdrawing the same amount adjusted for inflation each year thereafter will result in a high probability of your retirement savings lasting 30 years or more.

The sustainable withdrawal rate was last written in the March 2018 MAM Monthly Commentary. However, now that many analysts have been speculating the traditional 4% rule may need refinement, we believe it is a good time to revisit this important concept. A report released in November of 2021 from Morningstar stated that retirees should spend no more than 3.3% of their income in their first year of retirement if they want to make their money last 30 years. Two of most significant risks to the traditional 4% rule are:

1. **Low-Yield Environment:** Bond yields are currently as low as they have been in any environment in the last 70 years. This could prove problematic to the 4% rule, as Morningstar Investment Management's 30-year inflation-adjusted return for investment-grade bonds is -0.11%.

2. **Above-Average Stock Valuations:** While there are a number of ways to value the S&P 500, the price/earnings ratio is the industry standard and most common. The price/earnings ratio measures the price investors pay for a dollar of corporate earnings. Using recently reported earnings, at the beginning of 2022, the S&P 500's P/E ratio was calculated at 23.88, which was significantly higher than the 17.35 average over the past 20 years. Morningstar Investment Management's 30-year inflation-adjusted return forecast for U.S. large-cap stocks is 2.74%.

While the low-yield environment and above-average stock valuations are the two most impactful drivers behind the new 3.3% sustainable withdrawal rate estimates, it is also important to understand potential courses of action to mitigate the impact of a lower return environment. Examples of actions pre-retirees and retirees could take to offset a potential lower sustainable withdrawal rate include:

- **Working Longer:** This is often the most impactful option. Reducing the number of years in which you need to make your money last in retirement has a significant financial benefit. However, it is often the least desired option as well.

- **Delaying Social Security:** By waiting longer to start collecting, you increase your monthly benefit, which then reduces the needed withdrawal amount. The biggest financial risk in retirement is living a long life and outliving your money. Delaying Social Security until age 70 helps offset this risk, known as "longevity risk."

- **Withdrawing From Accounts in a Tax Efficient Manner:** While this a strategy that should always be implemented, in a period of lower returns, minimizing taxes will be especially beneficial.

Devising a Sustainable Withdrawal Program – The optimal solution is understanding that there isn't one single solution, but rather an array of steps to collectively take.

- **Understanding Sequence Risk:** The sequence of returns throughout a retirement period matter. The first few years of retirement are critical to the overall success of the sustainable withdrawal program. For example, individuals who retired in late 2000 or 2007, retired right before the onset of a major bear market. This caused the withdrawals during those early bear market years to have a significantly larger negative impact on the overall health of the portfolio. The most impactful ways to offset sequence risk are creating a 3-year bucket and employing variable withdrawal systems.

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- **Creating a 3-Year Bucket:** For clients who are receiving periodic distribution from their portfolios, we typically set aside 3 years' worth of withdrawals in a conservative bond fund. As long as stock prices are not depressed, we replenish this conservative fund at least every six months when we reposition portfolios. The benefit of using this technique is that when a bear market starts and stock prices drop precipitously, we do not need to sell any equities for at least three years to cover portfolio withdrawals. Given that the duration of the average bear market since the Great Depression has been 18 months, we should have enough held in the conservative bond fund to allow the rest of the portfolio to recover as the market correct runs its course.

- **Employing Variable Withdrawal Systems:** Taking less of a withdrawal in down markets and more in good ones can significantly enlarge both starting and total lifetime withdrawals. Additionally, reducing expenses during a market downturn also reduces the amount of distribution needed from your portfolio(s).

Portfolio Specific Actions to Counter a Lower Return Environment – When evaluating the 30-year inflation-adjusted return forecast for investment grade bonds and U.S. large-cap stocks, the value of diversification and alternative assets grows significantly.

- **Diversifying Your Portfolio:** Most of the research related to sustainable withdrawal rates has been based on a portfolio made up of only stocks and bonds. Adding alternative assets to a portfolio can improve the risk-adjusted returns. When Bengen added a third asset class, small-company U.S. stocks, he raised the acceptable withdrawal rate to 4.5%. Additionally alternative assets like real estate provide significant portfolio value due to their lack of correlation with stocks and bonds.

- **Increasing International Stocks and International Bonds Exposure:** Adding international stocks and international bonds adds diversification to a portfolio. Additionally, international stocks have lagged U.S. stocks significantly over the last 13 years (i.e., since the end of the Financial Crisis). At some point, this trend will reverse and international stocks will have a period of outperformance.

- **Adding More Equities, Especially Dividend-Paying Stocks:** As individuals go through retirement and their life expectancies become shorter, it makes sense to reduce equity exposure and be more conservative with their retirement portfolios. However, for those with a 15-year or longer life expectancy, portfolio growth is critical so that future-year distributions can be increased for inflation. Additionally, dividend-paying equities can provide significant value in a portfolio during retirement.

In Summary: We are likely entering a lower return environment for the foreseeable future. We believe that factoring in the steps we take in managing portfolios, along with the recommendations above, our clients will be well positioned to enjoy a financially-secure retirement even if 3.3% is the new 4%.

Sincerely,

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Our Services

McCarthy Asset Management, Inc. (MAM) is an independent, privately owned Registered Investment Advisor firm. We provide clients with the peace of mind that comes from knowing professionals are managing their financial affairs. The services we offer include:

Investment Management Services:

- **MAM creates and manages customized investment portfolios based on each client's investment objectives, timeframe and risk tolerance.**

Financial Planning Services:

- **The Net Worth Analysis (NWA) tracks the accumulation of Invested Assets for pre-retirees and the retention of Invested Assets for retirees. Updated annually.**
- **"Retirement Analysis" a comprehensive analysis of your retirement goals, which produces easy-to-read, interactive working plan, stored in the cloud. Updated as needed for life events.**
- **Social Security Planning is an analysis of the best strategy for when and how to start claiming Social Security benefits.**

Tax Services: Clients have the option of utilizing the income tax services provided through the firm Stephen P. McCarthy, CPA. These services are offered at an hourly rate and may include:

- **Tax Return Preparation**
- **Income Tax Projections**
- **Tax Minimization Ideas**
- **Tax Authority Representation**

Other Services: MAM has retained outside experts, whose services are available at no cost to our clients:

- **Long Term Care Planning– Allen Hamm of Superior LTC Planning Services, Inc.**
- **Medicare Advisory Program (MAP) - Eileen Hamm**

Reminders/Updates

Tax Reminders:

- April 18th is the deadline for filing 2021 individual income tax returns and making 2021 IRA, SEP-IRA, and Roth IRA contributions.
- It is also the deadline for first quarter 2022 Federal and State estimated payments.
- April 10th is the deadline for California property tax payments for the first half of 2022.

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