McCarthy Asset Management, Inc.
*Personalized Wealth Management*

# 4th Quarter 2012 Letter
## (also Dec 2012 Monthly Commentary)

**January 3, 2013**

## Stock Market & Portfolio Performance

**Inside this issue:**



***4th Qtr & FY 2012:*** The stock market had mixed performance for the 4th quarter while returns for full year 2012 were very good:

| | 4th Qtr | FY 2012 | Description: |
|---|---|---|---|
| Without Dividends: | | | |
| S&P 500 | (1.0)% | 13.4% | 500 Largest Public U.S. Companies |
| NASDAQ | (3.1)% | 15.9% | stocks trading on the Nasdaq |
| Russell 2000 | 1.4% | 14.6% | 2000 of the smallest U.S. stocks |
| MSCI EAFE | 6.2% | 13.6% | international stock index |
| U.S. Aggr Bond | 0.2% | 4.2% | bond index |
| With Dividends, after all fees: | | | |
| MAM portfolios | 1.3% | 11.4% | non-very conservative MAM portfolios |
| MAM Conserv | 1.1% | 9.3% | very conservative MAM portfolios |

*Comments: for the 4th quarter, MAM portfolios performed well relative to the U.S. stock and bonds markets in part due to the strong performance of international stocks*

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# Fiscal Cliff– Relief At Last But Much More Work Ahead

**Relief At Last:** Congress reached a last-minute deal on January 1st to reduce the impact of the fiscal cliff. The new tax Act blocks most of the impending tax increases and postponed for two months the spending cuts. The Act represents the largest tax increase in two decades and was passed over opposition from conservative Republicans in the House who objected that it contained no long-term spending cuts of any significance while raising taxes on upper-income Americans.

Here are the major provisions of the Bill (which are effective for tax year 2013 unless stated otherwise):

- **Payroll taxes to increase**: For 2011 & 2012, employees received a 2% reduction in payroll taxes. For 2013, payroll tax rates will revert to their pre-2011 levels, which should generate approximately $100 billion in additional tax revenue.
- **Tax Rates to Increase for Upper Income**: For most individuals, the legislation permanently extends the lower federal income tax rates that have existed for the last decade (i.e. the "Bush tax cuts"). The top federal income tax rate, however, will increase to 39.6% beginning in 2013 for individuals with income that exceeds $400,000 for single taxpayers and $450,000 for married couples filing joint tax returns.
- **Qualified Dividends & Capital Gains**: The maximum rate for qualified dividends and long-term capital gains will increase to 20% for individuals taxed at the new 39.6% bracket while for all other taxpayers the maximum rate remains at 15%.
- **Alternative Minimum Tax (AMT) Relief Now Permanent**: A permanent AMT patch, adjusted for inflation, will be made retroactive to 2012.
- **Itemized Deduction & Personal Exemption Phase-Out** will be reinstated for single taxpayers with AGI over $250,000 and married taxpayers with income over $300,000.
- **Estate Tax**: The Act makes permanent the $5 million exemption (indexed for inflation) for the estate tax (effectively $10 million for married couples). Taxable estates above this level will be subject to a 40% estate tax (up from 35%).
- There are a series of smaller tax provisions, some of which were l listed in the attachment I emailed with the December Monthly Commentary. Please let us know if you would like another copy of it.

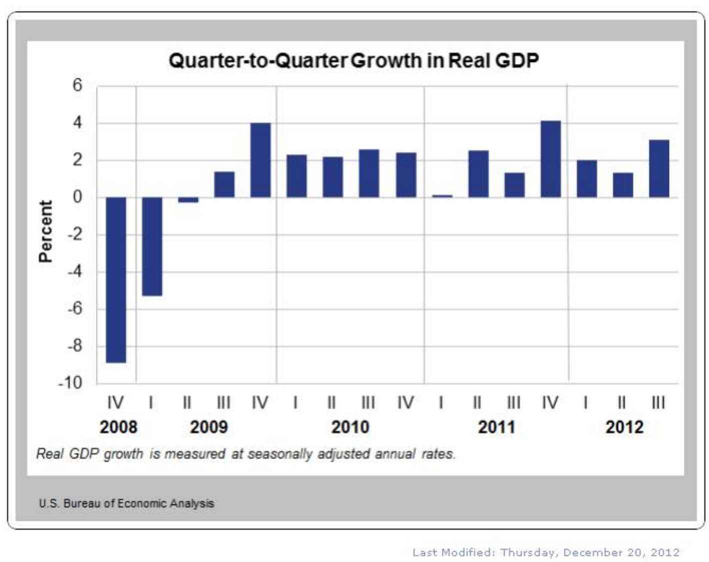
**Much More Work Ahead:** *Much work remains to be done, though, to address longer-term debt and deficit issues which will undoubtedly entail further budget clashes between the Democrats and Republicans:*

- **Automatic Spending Cuts**: The Act postpones for two months the automatic spending cuts that were scheduled to begin.
- **The Debt Ceiling** was not part of the deal, which is important because it will likely need to be raised in February or possibly in March. Republicans may be looking to that debate as an opportunity to move entitlement reform forward and address concerns about the automatic spending cuts.

# 2012 Economic Update

**3rd Quarter 2012 GDP:** The final estimate of third quarter GDP was revised sharply higher to 3.1%, up from an initial estimate of 2.0% and up from the second quarter rate of 1.3%. Stronger trade, increased consumer demand for durable goods (i.e. autos) and health care services, as well as a rebound in government and defense spending also contributed to the higher growth.

**2012 Employment:** November's employment report came in far better than expected, with job growth of 146,000. Overall, the job market has been relatively stable over the last 12 months, adding an average of 161,000 new jobs per month. At that rate, it will still take about another two years to gain back all of the private–sector jobs lost in the recession. The unemployment rate fell to 7.7% from 7.9% in October.



# 2012 Economic Update (Continued)

**2012 Housing:** One of the biggest surprises of 2012 has been the turnaround in the housing market. After several false starts in recent years, a recovery that began in the spring strengthened throughout the summer and fall. Nationally, home prices are on track to notch their first yearly gain since 2006, with an estimated increase of 4% to 5% from 2011. A rising real estate market is important as new home construction is traditionally a large contributor to an economy recovering from a recession. Furthermore, since home equity is such a significant proportion of many Americans' net worth, rising real estate values leads to the "wealth effect" which boosts consumer spending.

The 2013 outlook for housing is positive. November's Builder Sentiment, which tends to be a good predictor of future housing starts and new home sales, is now at its best level since May 2006 and marks the seventh consecutive month of improvement. Significantly, home inventories fell 1.1% in October to 2.14 million units, their lowest since 2006 (and less than 50% of the peak reached in July of 2007).

# 2013 Economic Outlook

The U.S. economy, while certainly not booming, is expected to continue to move forward in 2013. Current estimates are for GDP growth of 2.0% to 2.5% for 2013. Despite the fiscal cliff agreement, the U.S. will experience some degree of fiscal tightening from tax increases and spending cuts. This tightening is essential for the long-term fiscal stability of the U.S. As a result there will be at least some drag on economic growth in 2013. Assuming most other pieces of the fiscal cliff are mitigated or delayed, the following are positive factors that should more than offset negative impact of the fiscal cliff and keep the economy growing:

- *Housing:* The most positive factor is the rebound in the housing market. Housing starts surged to an annual rate of 872,000 in 2012, the highest since the financial crisis. And that's expected to rise to 900,000 in 2013. Historically, housing has accounted for 5% of GDP. Today it's half that as only 300,000 construction jobs have been added since the markets bottom in January of 2011 compared to 2.2 million construction jobs lost during the housing bust and recession. More of those construction jobs are expected to return in 2013.
- *Jobs Are Coming Back:* While hiring is far from robust, the unemployment rate has been steadily declining and job growth has been averaging over 150,000 per month for the last 18 months. The U.S. has now replaced more than half of the jobs lost during the recession. While businesses are in good shape to hire again, many are waiting for more certainty relative to the fiscal cliff.

**Home Sales and Housing Starts**


Sources: US Census Bureau, Factset, ING Investment Management

- *Consumer Debt is Shrinking:* The balance sheets of American families has improved since the recession ended. Consumers have been paying down their installment debt, and that, combined with low borrowing rates for mortgages and autos, has eased payment burdens significantly.
- *Booming Oil & Gas Production:* As I discussed at length in the Third Quarter 2012 MAM Letter, the U.S. is experiencing a long-term boom in energy production that could be a "game changer" for the U.S. Over the next 10 to 20 years the U.S. has the potential of reaching energy independence, millions of energy-related jobs could be created, and U.S. exports could experience a surge due to very low natural gas prices that would give U.S. manufacturers an edge over foreign competitors.
- *Federal Reserve is Very Accommodating:* The Federal Reserve continues to do everything in its power to foster economic growth. Most recently, the Fed replaced the expiring "Operation Twist" with additional monthly purchases of $45 billion long-term Treasury securities and $40 billion of mortgage-backed securities. In addition, the Fed announced that it doesn't expect to start raising interest rates as long as inflation stays below 2.5% and the unemployment rate above 6.5%.

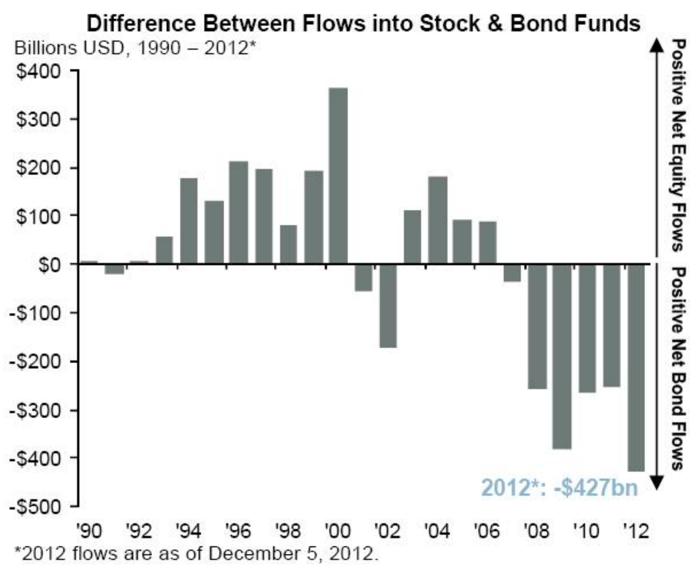
# Bad Market Timing: Investors Have Been Selling Stocks & Buying Bonds

**<u>Dismal Performance of Individual Investors:</u>** Each year, the research firm DALBAR publishes their *Quantitative Analysis of Investor Behavior* (QAIB) and the results have consistently shown that individual investors are their own worst enemies. The QAIB examines the real returns earned by investors in equity mutual funds, bond mutual funds, and asset allocation mutual funds:

- Over the past twenty years, the average equity mutual fund investor has under-performed the S&P 500 Index by an annualized 4.3% per year. The S&P 500 returned an average of 7.81% for the 20-year period through 2011, while the average equity fund investor generated only a 3.49% annual return.
- Investors in bond funds have done even worse. Compared to the Barclays Aggregate Bond Index which has a trailing 20-year annualized return of 6.5% per year, the average investor in a bond fund gained an annualized return of only 0.94% per year over this same period (or an underperformance of 5.56% per year).

The majority of individual investors' underperformance can be blamed on bad timing decisions. As I have written about before, investors invariably get out of the market after a decline and jump back in after a rally. In other words, they buy high and sell low as their emotions cloud their investment-making decisions. A successful strategy is to observe what most investors are doing, and do the opposite! So what did investors do in 2012?:

**<u>Investors Sell Equities and Buy Bonds:</u>** Consistently throughout 2012 individual investors sold equity mutual funds and bought bond funds. I believe this happened because many investors are still fearful of stocks, having experienced two sharp downturns (in 2000-2002 and 2008). Furthermore, over the last 15 years bonds outperformed stocks while experiencing much lower volatility. Because of this superior performance, bonds "feel" like a better investment than stocks. While historically stocks have outperformed bonds, it is easy to see why bonds have been the better investment since 1999. Back in 1999, at the peak of the dotcom boom, stocks were extremely overvalued with the price-earnings ratio for the S&P 500 stocks at 30 (compared to "15" historically). Meanwhile since 1999, bonds have benefited from a dramatic drop in interest rates.




Sources: ICI, J.P. Morgan Asset Management. Data are as of 12/19/12.

What is important is which will be the better investment for the foreseeable future? Unlike 1999, stocks are now reasonably valued with the S&P 500 trading at a price-earnings ratio of "14" while bonds provide little value with interest rates near record lows. Despite this, many investors have been irrationally selling stocks and buying bonds. Through November of 2012, investors have pulled nearly $115 billion out of actively managed U.S. stock funds (surpassing the record $108 billion that flowed out of them during all of 2008). Meanwhile, flows into bond funds is estimated to exceed $350 billion for 2012.

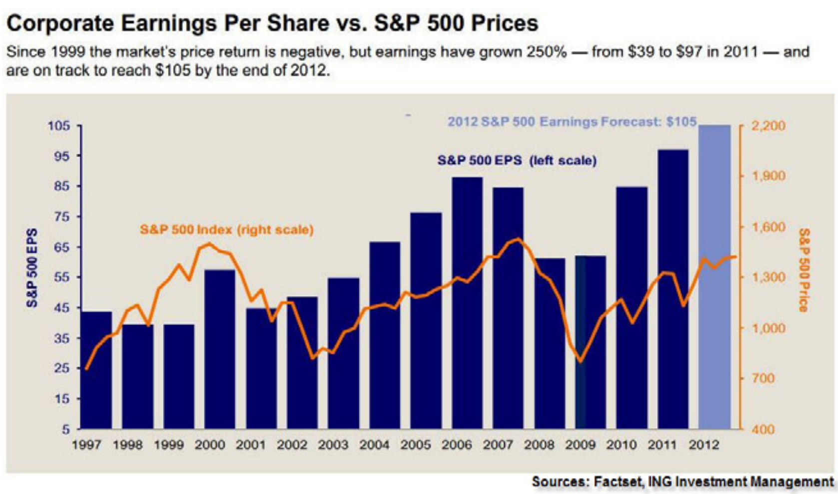
**<u>Historical Flows Into Stock & Bond Funds:</u>** The chart above shows the difference between flows into stock & bond funds since 1990. Investors poured money into stock funds throughout most of the 1990s, with the peak occurring in 1999-2000 just as the stock market reached extreme valuations. Since 2007, though, investors have consistently and dramatically shifted out of stock and into bonds (and missed the 100%+ rebound in stock prices since the March, 2009 low). My feeling is they are again exhibiting very poor market timing that will result in future DALBAR QAIB reports showing that stock and bond investors continue to underperform the stock and bond indexes.

# 2013 Stock Market Outlook

**Cautiously Optimistic**: If you were told one year ago that the U.S. economy in 2012 was going to be sluggish, investors would remain fearful of stocks, Europe would enter a minor recession, and the U.S. fiscal cliff would remain unresolved at year-end, you probably would have thought that 2012 would have been a tough year for the stock market. There is truth to the adage that the "market likes to climb a wall of worry" as while there was plenty to worry about during 2012, stocks performed well. Little has changed in regards to these worries as we start 2013. The stock market, though, is reasonably valued relative to earnings and investors remain skeptical. While we are cautious and maintain significant downside protection in portfolios, I see these reasons for optimism:

- **Where Else Invest?**: While many investors' sentiment toward stocks remains relatively negative, this skepticism gives me optimism. Investors should slowly begin to recognize that stocks could continue to move higher while the meager returns on cash investments and the historically low yields on many fixed income investments become more unattractive (particularly relative to dividend-paying stocks). With the massive amount of cash on the sidelines, a gradual improvement in sentiment could contribute to another strong run in stock prices. According to a recent article written by Liz Ann Sonders, Chief Investment Strategist at Charles Schwab, the amount of cash on the sidelines (relative to at–risk funds) is at the highest level since World War II. Sonders is bullish because of this risk aversion as this excess cash could fuel demand for stocks as the economy strengthens.

- **Continued Slow Economic Growth:** Given the partial resolution to the fiscal cliff, the U.S. economy is expected to grow slowly in 2013 due to the rebound in housing and a host of other factors (see page 3). A "Goldilocks Economy" ("not too hot and not too cold") historically has provided a good environment for stocks. This is in contrast to a booming economy, which typically is a challenging environment as the Federal Reserve raises interest rates to keep inflation from getting out-of-hand.




- **Corporate Earnings:** As can be seen in the chart to the right, At just over $100, earnings per share for the S&P 500 companies are now double what they were at the peak of the market in 2000 (when investors were selling bonds and buying stocks!). Analysts project that earnings will continue to grow in 2013 to an estimated $105 per share.

- **Positive Impact of Dividends:** Historically, dividends have accounted for a significant percentage of the return from investing in stocks. Whether or not the tax rate on dividends increases due to the expiration of the Bush tax cuts, I expect dividends to account for a rising portion of returns. Through mid-December, 287 firms in the S&P 500 either lifted or initiated payouts. While the dividend yield for the S&P 500 is currently just over 2%, the percentage of corporate income paid out in dividends is just 28%, leaving plenty of room for growth. For full year 2012, it is estimated that S&P 500 companies paid out regular cash dividends of $281 billion, which is 17% higher than 2011 and 13% above the previous record in 2008. Dividend-paying stocks has been a major theme in MAM portfolios for the last few years. In addition to Vanguard Dividend Appreciation (VIG) and Matthews Asia Dividend (MAPIX), which have been in portfolios for two to three years, Schwab U.S. Dividend Equity was recently added to most portfolios.

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.

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 several outside experts, whose services are available at no cost to our clients:

- Long Term Care Planning– Allen Hamm of Superior LTC Planning Services, Inc.
- The Savvy Life® Classes and Workshops by best –selling author Melissa Tosetti


## Reminders

1) 4th Quarter Federal & California Estimated Payments are due January 15, 2013.

2) ADV Part II: You were provided a copy of our ADV Part II when you became a MAM client. As a Registered Investment Advisor, we file this document with the Securities and Exchange Commission. Along with other items, it contains information regarding our fees and our educational backgrounds. Each year, the SEC requires us to offer clients the opportunity to receive a copy of our most recent ADV Part II. Please let us know if you would like to receive a copy.

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