McCarthy Asset Management, Inc.
Personalized Wealth Management

June 2015 Monthly Commentary

July 1, 2015

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Stock Market & Portfolio Performance

2nd Qtr & YTD 2015: Stocks were down modestly for the second quarter. For the first half of 2015, the S&P 500 rose slightly while smaller U.S. stocks and international stocks rose. After a rough second quarter, bonds are now down slightly for the first half of the year.

	2nd Qtr	YTD 2015	Description:
Without Dividends:			
S&P 500	-0.2%	0.2%	500 Largest Public U.S. Companies
Russell 2000	0.1%	4.1%	2000 of the smallest U.S. stocks
MSCI EAFE	-0.4%	3.8%	international stock index
U.S. Aggr Bond	-1.7%	-0.1%	index of U.S. bonds
With Dividends, after all fees:			
MAM portfolios	-0.4%	1.1%	non-very conservative MAM portfolios
MAM Conserv	-0.9%	0.1%	portfolios with 50%+ bond allocation

Comment: With the exception of the 2% drop in the S&P 500 on June 29th, stocks have shown little volatility so far this year. That may change with the Fed getting closer to its first rate increase and the financial turmoil in Greece likely to come to a head by mid-July.

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The Greek Debt Crisis

After more than five years, Greece is closer than ever to an exit from the euro. Here is a summary of the most recent events:

- Last week, bailout negotiations broke down between European and Greek leaders over Greece's debt crisis.
- Greek Prime Minister Alexis Tsipras surprised European policy makers on Friday, June 26th, announcing Greece will hold a July 5th national referendum on whether to accept terms demanded by its international creditors. Tsipras is encouraging voters to reject the measure to send a message to its international lenders.
- On Sunday, June 28th, the European Central Bank—meeting in an emergency session—opted not to expand a lifeline of emergency funds that has been sustaining Greek banks while nervous depositors pulled their money out.
- In response, Greece shut down its banking system, ordering lenders to stay closed for six days starting Monday, June 29th, and its central bank moved to impose controls to prevent money from flooding out of the country.

Economic Implications: At this point, it is not clear how the events will play out. While leaving the euro will probably create havoc with Greece's economy, MAM clients care more about the implications for the U.S. and foreign stock markets. A June 26th "Schwab Market Perspective" from Liz Ann Sonders addressed this question. The short answer was "Perhaps not that much". As pointed out in the Perspective, the following are reasons why a potential Greek default may not be a major market event:

1. It's been five years since global growth was as strong and balanced as it appears to be at the midway point of 2015 with all of the world's major economies growing. That means the global economy may be more resilient to shocks, such as a Greek Default.
2. The risk of a financial contagion has been greatly diminished from the threat posed a few years ago. This has been a slow-motion and widely-watched move toward insolvency since 2008, but in particular since 2011. In that time, over 75% of Greece's debt has been moved to the books of government institutions and is no longer held by highly leveraged banks that could cause a financial crisis, or a hedge fund that could cause a market failure.
3. The risk of a spreading panic is unlikely as the European Central Bank (ECB) stands ready to buy the debt.
4. A default and the cut off of central bank liquidity does not automatically mean a Greek exit from the euro. Opinion polls conducted by Greek newspapers reflect an overwhelming majority of Greeks desire to remain in the Eurozone.

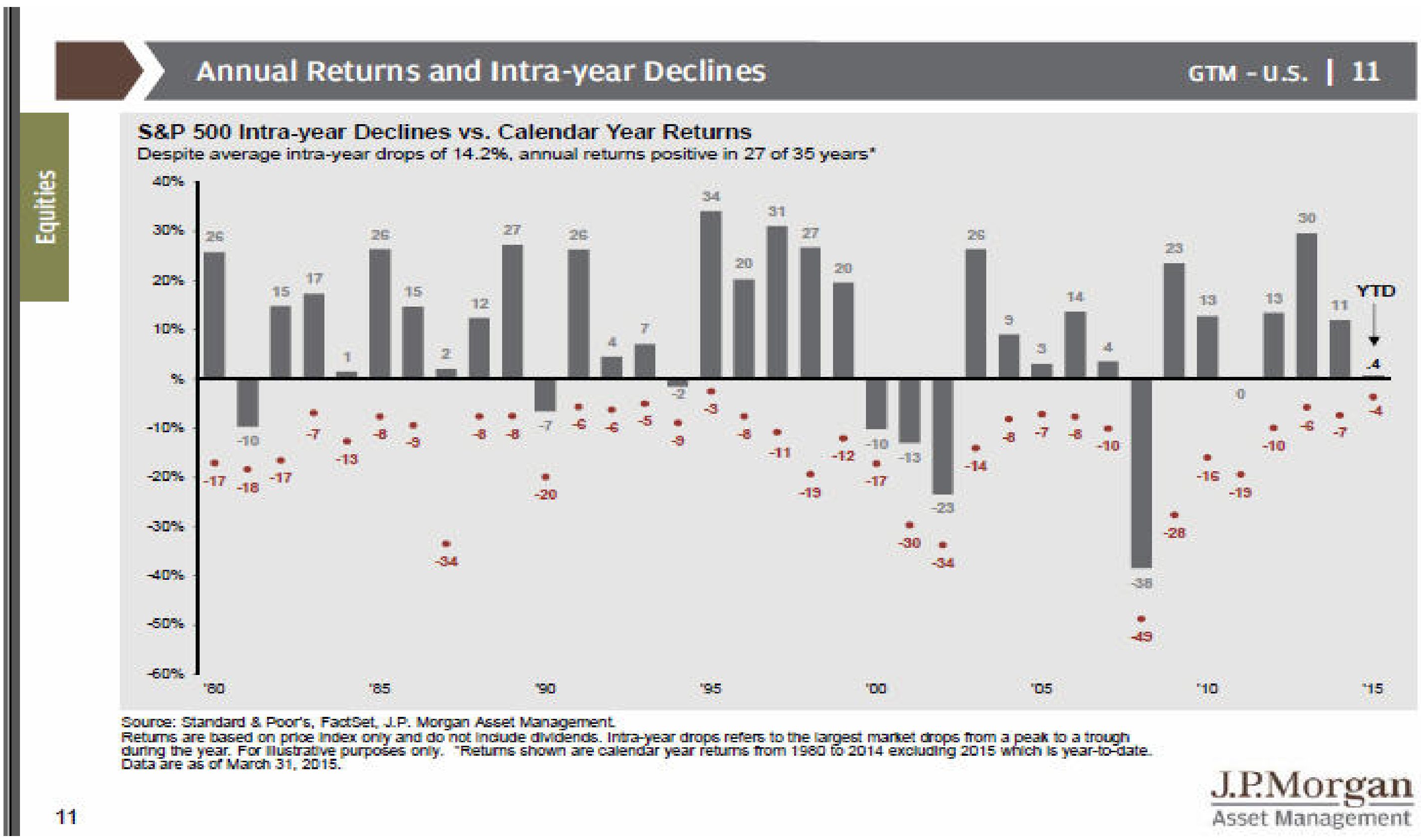
In Summary: The potential default and related withdrawal of ECB support for Greek banks would be painful for Greece and ultimately may lead to elections and a new government. But, the efforts by policy makers over the years have served more effectively to isolate rather than to resolve Greece's problems.

Turbulence Ahead for Stocks? Historical Impact of Fed Interest Rate Increases

We are now in the seventh year of the bull market that started in March of 2009. Although in historical terms, this is an old bull market, we think it still has room to run given the slow-growth economy and still-accommodative Federal Reserve. While we are not currently concerned about a new bear market (which we define as a drop of 20% or more in stock prices) occurring any time soon, a more likely event would be a stock market correction, which we define as a drop of 10%.

The chart below, courtesy of J.P. Morgan, shows the annual return for the S&P 500 since 1980 (in charcoaled grey) along with the maximum drop in the stock market for each year (shown in red). As you can see, even many of the best years (with annual gains in excess of 20%) experienced fairly significant corrections. Since 1980, the average intra-year drop has been 14.2%. Furthermore, 10% corrections occur frequently. Given that it has now been nearly four years since the last 10% correction (April-October of 2011), we are overdue for one.

<u>What could trigger a 10% correction?</u> A 10% correction could result from a Greek exit from the euro (see previous article). Another possible cause could be the first interest rate increase by the Federal Reserve in eight years. Such an increase, which many expect will happen this September, could add to short-term uncertainty for stocks. Historically, though, the stock market has performed well subsequent to initial interest rate increases (see graphs on next page).

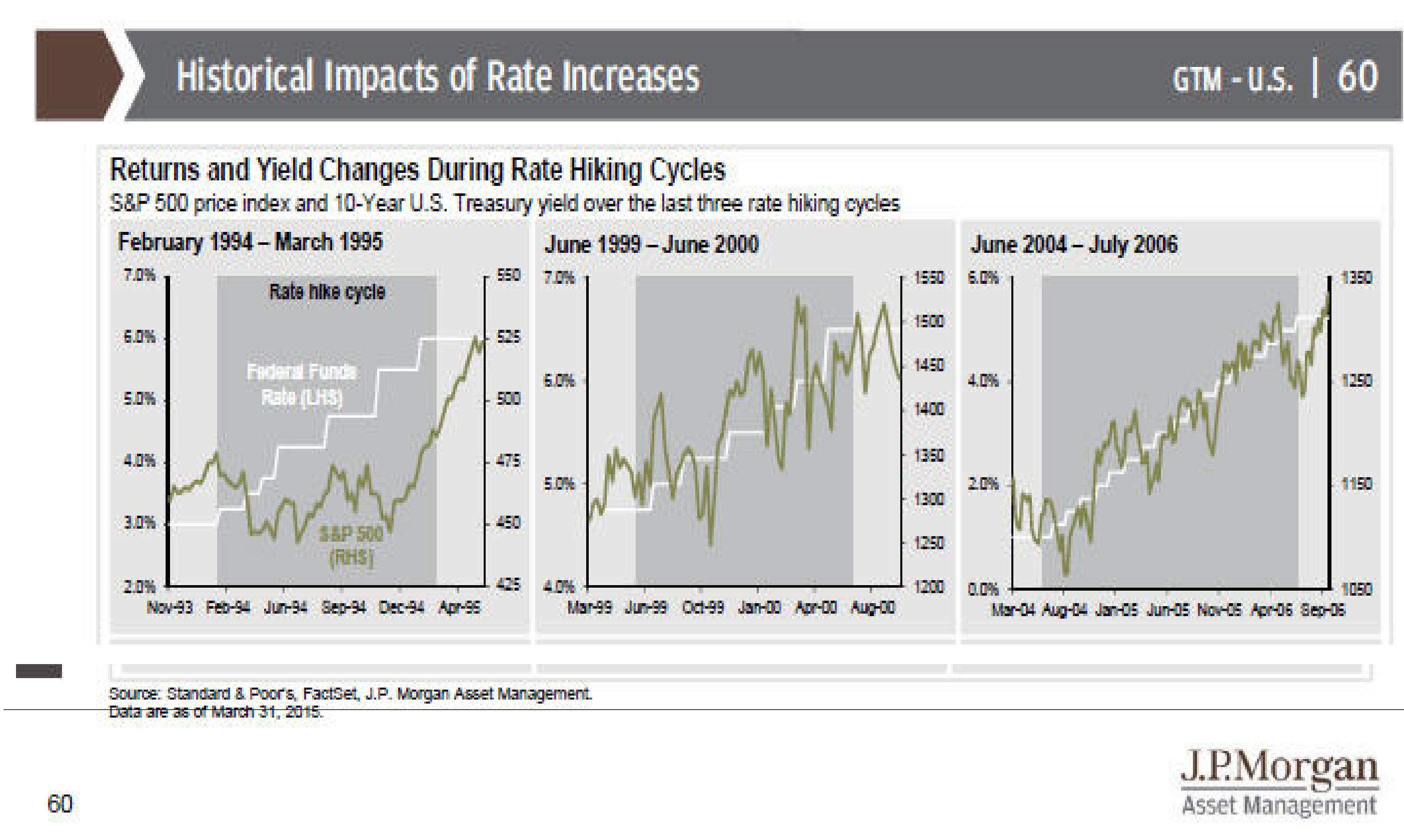


<u>Will MAM try to adjust portfolios in advance of a 10% correction?</u> While corrections of up to 10% are fairly common, they are very difficult to time. MAM does not try to market time to avoid these corrections. If on the other hand, we felt we were at high risk for a new bear market (a drop of 20% of more), we would take defensive action to protect portfolios on the downside.

<u>Should I be concerned about a 10% correction?</u> In a word, "no". As we have said before, corrections are actually healthy in that they lessen speculative pressures which could otherwise cause stock prices to become overly inflated.

Turbulence Ahead for Stocks? Historical Impact of Interest Rate Increases– Con't

<u>Historical Impact of Interest Rate Increases:</u> The J.P. Morgan chart below depicts the performance of the S&P 500 during the last three Fed rate hike cycles. As you can see in the three graphs , while the stock market tended to have an adverse reaction to the initial rate hike, each time it rebounded later in the hike cycle. This puts into perspective the volatility stocks may experience leading up to the first rate hike with an understanding that stocks have historically performed well while the Fed continued to increase rates. This can be attributed to the Fed increasing rates typically when the economy is performing well, which in turn is positive for stocks.



Current Asset Allocation of MAM Portfolios

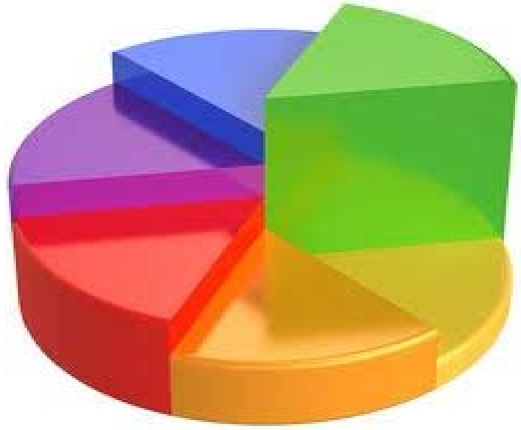
We just finished the semi-annual repositioning of MAM portfolios. Here were the three main purposes of this most recent repositioning:

1. **<u>Add T. Rowe Price Capital Appreciation (PRWCX or PACLX)</u>** to portfolios. T. Rowe Price closed this outstanding fund to new investors in June of 2014. Because MAM clients hold a substantial position in the Fund, T. Rowe Price recently decided to make an exception and allow us to add the Fund to MAM portfolios that do not currently hold it.

2. **<u>Increase International Equity Exposure:</u>** We modestly increased the allocation to international stocks. With U.S. stocks having outperformed foreign stocks for a number of years, we feel foreign stocks represent a better value at this time. Furthermore, there have been a number of recent signs that the European economies are returning to growth.

3. **<u>For Portfolios Providing Regular Distributions</u>**, such as IRA accounts that have required minimum distributions, we like to set aside up to three years of withdrawals in one or more intermediate bond funds. This way once the stock market turns down again, we can cover distributions for up to three years without having to sell any of the equity part of the portfolio. Since the stock market is close to record highs, we replenished this safety bucket for an additional six months of distributions.

Current Asset Allocation of MAM Portfolios– Con't



Current Asset Allocation: MAM portfolios are well diversified among U.S. equities, bonds, alternative assets and foreign equities. While a particular client's asset allocation depends on their Risk Assessment Questionnaire score, their age, and whether they are taking portfolio withdrawals, the typical portfolio is currently invested with an allocation of approximately 55% in U.S. stocks, 15% international stocks, 26% bonds, and 4% alternative assets. I estimate the beta to be approximately 0.71, meaning most portfolios are expected to be 65% to 75% as volatile as the S&P 500.

Here are comments regarding the specific asset classes we are using:

- **U.S. Equity Funds & ETFs:** The largest positions here are the passively managed ETFs Schwab U.S. Dividend Equity and Vanguard Dividend Appreciation and the actively managed mutual funds American AMCAP, FMI Large Cap and Yacktman. With one exception, we don't invest in sector funds as we like to leave it up to the fund manager to decide which sectors to invest in. The lone exception is BlackRock Health Science. With the aging of America, our feeling is that the long-term outlook for the healthcare industry is very positive.

- **Balanced Funds:** We extensively invest in balanced funds, where the fund manager has the latitude to shift the portfolio allocation between stocks and bonds. The favorite funds here are Dodge & Cox Balanced, Income Fund of America, Oakmark Equity Income and T. Rowe Price Capital Appreciation.

- **Bond Funds:** The bond funds used by MAM invest primarily in high-quality corporate, mortgage, high-yield and foreign bonds. There is little exposure to long-term U.S. Treasuries, which we feel are most vulnerable to the threat of rising interest rates. The largest positions here are DoubleLine Total Return, Loomis Sayles Bond and PIMCO Income.

- **International Equities:** The international funds we use most extensively are Capital World Growth & Income, Dodge & Cox International and Matthews Asia Dividend.

- **Alternative Assets:** Currently, the only alternative asset we utilize is a 5% position in Master Limited Partners (via either JP Morgan MLP ETN or Eagle MLP). In the past we have also invested in REITs and Commodity funds, but don't feel that either is attractively priced at this time. In addition, we feel that "managed futures", "long-short funds", and other alternative assets are not appealing given their high cost and poor performance.

Focus on Dividend-Paying Stocks: A major theme in portfolios continues to be investing in mutual funds and ETFs that focus on stocks that pay an increasing dividend. For several reasons, we find this appealing:

- Historically stocks that pay an increasing dividend have outperformed non-dividend-paying stocks.
- In a low-return environment (which we feel we are in), dividends provide a significant part of the portfolio return.
- Dividend-paying stocks tend to be less volatile than non-dividend paying stocks.

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.**
- **Medicare Advisory Program (MAP) - Allen Hamm**
- **The Savvy Life® Classes, Workshops , and One-on-One Consultations**

Reminders/Updates

Are you on course for a financially-comfortable retirement? A Retirement Analysis can be very helpful in answering that. Please let us know if you would like to have us prepare one for you.