McCarthy Asset Management, Inc.

Registered Investment Advisor

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Monthly Investment Commentary- April 2012

Stock Market Performance for April: After a very strong 6-month run, stocks pulled back modestly in April. Unadjusted for dividends, the S&P 500 slipped 0.7%, the NASDAQ fell 1.5%, the Russell 2000 dropped 1.6%, and the international equity index MSCI EAFE fell 2.4%. Bonds, as represented by the Barclays U.S. Aggregate Index, rose 1.1% for the month.

MAM April Performance: MAM portfolios slightly outperformed the S & P 500 for the month. Excluding the "very conservative" portfolios (which rose 0.3%), MAM portfolios fell 0.3% (after all fees), versus a fall of 0.6% for the Vanguard Index 500 fund (symbol VFINX) with dividends reinvested. In contrast to the first quarter, during April MAM portfolios benefited from good performance from the alternative asset and bond funds.

Year-To-Date Performance: For the first four months of 2012, unadjusted for dividends, the S&P 500 rose 11.2%, the NASDAQ climbed 16.9%, the Russell 2000 rose 10.3%, and the international equity index MSCI EAFE climbed 7.3%. Bonds, as represented by the Barclays U.S. Aggregate Index, rose 1.4% for the year-to-date. Excluding the "very conservative" portfolios (which rose 4.3%), MAM portfolios rose 6.8% (after all fees), versus a rise of 11.8% for the Vanguard Index 500 fund (symbol VFINX) with dividends reinvested.

Slowing Economic Growth; Good 1st Quarter Earnings; Dividends Keep Growing

1st Quarter GDP Report: Last week the Commerce Department reported that the U.S. economy grew at a rate of 2.2% in the first quarter of 2012, down from 3% at the end of 2011. The deceleration reflected sharp cutbacks in government spending and weaker business investment. The report did reveal a few areas of strength. Consumer spending, which accounts for about 70% of the economy, accelerated in the first quarter with 2.9% growth, and the moribund housing sector also showed signs of improvement.

Moderate growth can provide a good environment for the stock market. As long as inflation remains subdued, the Federal Reserve is likely to keep interest rates at near record low levels. This moderate growth should be sustainable if monthly employment growth averages close to 200,000, which in turn should support modest growth in consumer spending.

1st Quarter Corporate Earnings: With over 50% of the companies in the S & P 500 reporting so far, over 70% of them have beaten expectations and earnings growth is nearly 7% compared to the first quarter of 2011. Significantly, most of the earnings growth has been driven by sales growth of nearly 6%. Howard Silverblatt, Senior Index Analyst at Standard and Poors currently projects aggregate 1st quarter earnings for the S & P 500 companies to come in at $24.44. This would represent the third best in history, with the 3rd quarter of 2011 ($25.29) the highest and the 2nd quarter of 2011 ($24.86) coming in second.

Bob Brinker wrote in his Marketimer report which was released today that he is maintaining his S & P 500 operating earnings estimate for 2012 of $103. "This estimate is within the context of

3 Lagoon Dr, Suite 155, Redwood Shores, CA 94065, (650) 610-9540 Fax (650) 610-9541;
e-mail: steve@mamportfolios.com Web site: mamportfolios.com

a slow to moderate pace of real gross domestic product (GDP) growth this year within a range of 1.5% to 2.5%." Due to the uncertainty related to the European sovereign debt crisis, he is using a conservative price-earnings ratio view of 14.5 to 15 times operating earnings. This brings his S&P 500 target into the upper-1400s to lower-1500s within the next twelve months (compared to the S&P 500's close at 1398 on April 30th).

Dividends Keep Growing: Companies that pay a growing dividend has been a very important theme in MAM portfolios for the last couple of years. As discussed in previous Monthly Commentaries and Quarterly Letters, historically over 50% of the return from investing in the stock market has come from dividends. Dividend payouts are rising and the total dollar amount paid by the S&P 500 companies could reach a record high this year. In a report released today, Howard Silverblatt said 8 companies initiated a dividend so far this year (including Apple Inc, which is now the 3rd largest dividend payer behind Exxon and A T &T), bringing the total number of S&P 500 companies paying a dividend to 401, the highest level since January 2000. Furthermore, Silverblatt projects that dividends will total $279 billion this year, compared to $241 billion paid in 2011, and the $248 billion record paid in 2008.

While the current dividend yield on the S&P 500 companies is a modest 2%, there is plenty of room for additional growth. The payout ratio, or the percentage of earnings paid out as dividends, is currently near a record low of 27%. Historically, payout ratios have averaged more than 50% while the average dividend yield was over 4%. With corporations holding record levels of cash and corporate profits near all-time highs, I expect that the recent rapid growth in dividends will continue.

Social Security System- Reasons For Concern

I would like to thank Alexey Bulankov for writing this piece about Social Security.

Social Security benefits are a critical source of income for many retirees. Currently 26% of retirees depend on Social Security as their only source of income. Unfortunately, without changes the current System is not sustainable. On Monday, April 23rd, the annual Social Security Trustees report was released by the Board of Trustees. The Report contained some alarming facts about the state of the Social Security System. The Trustees expect that by 2021 taxes and interest will fall short of the annual benefit payments, at which point the government will be required to " tap the principal" and that by 2033 the assets of the Fund will be fully exhausted. The shortfall is largely a function of the changing demographics (aging population), increased life expectancies and decreased growth in the economy.

The root of the problem is that the number of retirees is growing much faster than the number of workers supporting them through payroll tax. The eldest of the 77 million American baby boomers became eligible for social security four years ago and every day for the next 20 years 10,000 baby-boomers will turn 65. Back in 1965, the ratio of workers-to-retirees was 4 to 1. By 2010 it dropped to 2.8 to 1 and by 2035 it is projected to be 2 to 1.

By 2035, the annual costs of the program will increase to 6.4% of the Gross Domestic Product, more than the military budget. According to the same report, "*both Medicare and Social Security cannot sustain projected long-run program costs under the currently scheduled financing, and the legislative modifications are necessary to avoid disruptive consequences for beneficiaries and taxpayers*".

If no changes are made, by 2033 the principal will be fully spent and revenues will be sufficient to pay only about 75% of the promised benefits. All the political issues aside, the deficit can be eliminated only by putting more money into the pot or by reducing benefits. In order to keep the Fund solvent, the Report recommends that the lawmakers:

- raise the combined payroll tax from the current rate of 12.4% to new rate of 15%
- reduce scheduled payments by 16.2%
- adopt some combinations of these approaches or
- find alternative sources of revenue

The picture becomes even cloudier when the political implications are considered. Fixing Social Security requires some very unpopular measures such as benefit cuts and tax hikes that few lawmakers are willing to touch. But the options become fewer as time passes and the longer the legislators ignore the problem, the less time the public will have to prepare and the more painful the transition will be.

While a hike in taxes appears likely, the deficit is too large to be balanced by raising taxes only on the rich. To bring the system into balance without a drastic tax hike, benefit cuts of 25% or more are needed. Some legislators have proposed changing the benefits options in favor of low-income beneficiaries. <u>If passed, such measures will essentially make the system a need-based one.</u>

Furthermore, Congressional unwillingness to fix Social Security has the strongest impact on the young. While the gradual demise of the Social Security System is unsettling to current retirees, the most corrosive impact is on younger employees, most of whom have simply written the system off because they do not believe it will be there for them in their retirement years. Andrew Biggs, the former deputy commissioner of the Social Security Administration warned that the result of procrastination by the legislators <u>could result in a "two-tiered" system, as heavier cuts will fall on young Americans</u>.

Whether the system becomes a need-based one or experiences a big reduction in benefits, more of your retirement income will need to come from pensions and your invested assets. What can you do about it? Here are some questions for you to consider:

- How do you know if you are on track for a financially secure retirement?
- How much do you need to save?
- What is the rate of return that you need to generate on your investments?
- How much risk can you really afford to take?
- What happens if the market slides again?
- When should you begin receiving your Social Security Benefits?

At MAM we have the necessary tools and expertise to help you answer these questions. Through the annual update of your **Net Worth Analysis** and the more detailed **Retirement Analysis,** we can help you plan. These services are free to exiting clients and are yet another benefit of working with MAM. Please contact us if you are interested in getting started. If you are interested in learning more about the basics of Social Security and the strategies for maximizing your benefits, contact us for the details of a **webinar** which we will be offering in May and/or June.

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®