

**Q2 2014 Quarterly Letter  
(also June 2014 Monthly Commentary)**

July 1, 2014

**Stock Market & Portfolio Performance**

**Inside this issue:**

<b>Market &amp; Portfolio Performance</b>	<b>1</b>	<b><u>2nd Qtr &amp; YTD 2014:</u></b> Stocks & bonds posted good gains for second quarter and decent gains for the first half of 2014.
<b>The ClientView Portal– Additional Comments</b>	<b>2</b>	
<b>Economic Update– An Ugly 1st Quarter &amp; Now Higher Inflation</b>	<b>2-3</b>	
<b>IRS Warns of a Pervasive Telephone Scam</b>	<b>3</b>	
<b>Life Lessons from Ryan McCarthy</b>	<b>3-4</b>	
<b>Current Asset Allocation of MAM Portfolios</b>	<b>5-6</b>	
<b>Our Services</b>	<b>7</b>	

	<u>2nd Qtr</u>	<u>YTD 2014</u>	<u>Description:</u>
Without Dividends:			
S&P 500	4.7%	6.1%	500 Largest Public U.S. Companies
NASDAQ	5.0%	5.5%	stocks trading on the Nasdaq
Russell 2000	1.7%	2.5%	2000 of the smallest U.S. stocks
MSCI EAFE	3.0%	3.0%	international stock index
U.S. Aggr Bond	2.0%	3.9%	index of U.S. bonds
With Dividends, after all fees:			
MAM portfolios	4.2%	5.8%	non-very conservative MAM portfolios
MAM Conserv	3.0%	4.8%	portfolios with 50%+ bond allocation

*Comment: Although we continue to feel the current economic environment and Fed policy is conducive to further stock market gains, we are overdue for a short-term market correction.*

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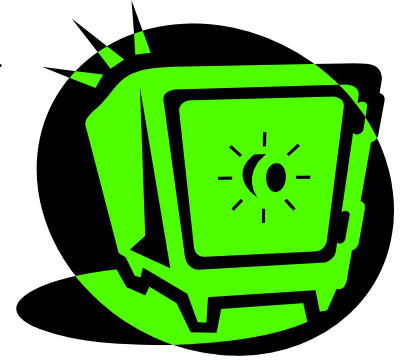
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## The ClientView Portal– Additional Comments

Last month we introduced the ClientView portal (“the portal”) individually to MAM clients via two emails. The first had your username and a link to the portal, along with instructions. The second email was your temporary password. **Please let us know if you need us to resend either of those emails.** As of the end of June, 73 of the 198 clients that were emailed had logged in at least once. So far, the feedback we have received about the portal has been very positive.



An overview of the portal was included with the May 2014 Monthly Commentary.

We now have these additional comments:

- 1) **Daily Updates:** Whereas we updated the old MAM Vault once a week with portfolio positions and prices, we generally will update the ClientView portal each weekday around mid-morning for the prior day’s positions and prices.
- 2) **Monthly & Quarterly Reports:** Within a day or two after month-end and quarter-end, your portal will be uploaded with the most recent Monthly Report and Quarterly Report for your accounts. **Given that you will now have 24/7 online access to your quarterly report, please let us know if you no longer need us to mail you a paper copy.**
- 3) **Securely Sending Us Documents:** You can send us a message and securely attach a document via the “Contact Us” tab at the top of the portal. Any document you attach will show up in your “Document Vault” under the heading “My Uploads”. *If you are not a tax client, I recommend you send Anthony via your portal an electronic copy of your 2013 tax returns. Also, if you don’t see a copy of your estate planning documents in the “Estate Documents” section of the “Document Vault”, please send Marilyn via the portal an electronic copy of your estate planning documents.*
- 4) **Future Additions– Account Beneficiaries:** Over time, we expect to add additional documents to your “Document Vault”. For instance, later this year we plan to verify the beneficiaries listed for your retirement accounts we manage. After you confirm or update this information, we will add it to your “Document Vault”.

## Economic Update– An Ugly 1st Quarter & Now Higher Inflation

**An Ugly 1<sup>st</sup> Quarter of 2014:** On June 25<sup>th</sup> the Commerce Department released its revised estimate of first quarter gross domestic product (GDP) reducing “growth” down to a negative 2.9%. This was a sharp revision from the previous estimate that output fell at an annual rate of 1.0%. It also represented the fastest rate of decline since the 2007-2008 Financial Crisis, and was the largest quarterly drop recorded since the end of World War II that wasn’t part of a recession.

**Future Improvement Expected:** Weather disruptions at home and weak demand abroad were the primary factors causing the severe contraction for the first quarter. Fortunately, many signs since March point toward improving conditions, including reports of growth in consumer spending, and business investment and hiring. Significant job growth is particularly promising as it should boost future consumer spending. Since World War II, there have been 15 other quarters during which GDP contracted by 2.9% or more. Unlike this time, in 14 of those 15 quarters job growth was negative.



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## Econ. Update— An Ugly 1st Quarter & Now Higher— Con't

**Inflation Hits Highest Level in a Year and a Half:** U.S. inflation accelerated in May to its highest level in more than a year and a half—a development that weigh on Federal Reserve officials as they debate when to start raising interest rates. The report from the Commerce Department showed that personal consumption expenditures advanced 1.8% in May from a year earlier. That was the highest level since October 2012 and a sharp pickup from February, when annual inflation stood at just 0.8%.

While the current rate of inflation is reasonable given the Fed's inflation target of 2% and the fact that the annual rate of inflation has averaged 3.0% since 1950, we will monitor future reports to see if inflation continues to accelerate. A little inflation is actually good. In fact, many economists view a pickup in inflation as a sign the economy is gathering steam.

**The Bottom Line:** The U.S. economy stumbled badly in the first quarter while inflation showed signs of picking up in the second quarter. While economists expect growth to return in the second quarter and will accelerate further in the second half of 2014, the risks are rising that any further contractions in the economy or acceleration in the rate of inflation could trigger the long overdue stock market correction.

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## IRS Warns of a Pervasive Telephone Scam

Recently a client received a phone message at home from someone who claimed to be an IRS agent. The caller said my client was being sued by the IRS and might be subject to arrest. Fortunately, my client didn't return the call and instead emailed me. I told him the call was bogus and should be ignored.

I am concerned this may not have been an isolated event. A tax return preparer I know has a client who recently received a similar call. In fact, late last year the IRS released a notice warning consumers of a sophisticated phone scam targeting taxpayers. Victims are told they owe money to the IRS and it must be paid promptly through a pre-loaded debit card or wire transfer. If the victim refuses to cooperate, they are then threatened with arrest, deportation or suspension of a business or driver's license. In many cases, the caller becomes hostile and insulting.

IRS Acting Commissioner Danny Werfel said "The scam has hit taxpayers in nearly every state in the country...Rest assured, we do not and will not ask for credit card numbers over the phone, nor request a pre-paid debit card or wire transfer." Werfel noted that the first IRS contact with taxpayers on a tax issue is likely to occur via mail.

The IRS encourages taxpayers to be vigilant against phone and email scams that use the IRS as a lure. The IRS does not initiate contact with taxpayers by email to request personal or financial information. In addition, recipients should not open any attachments or click on any links contained in the message.

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## Life Lessons from Ryan McCarthy

For those of you who I have not yet had the pleasure of meeting, my name is Ryan McCarthy. I am a junior at the University of Southern California majoring in Business Administration with a concentration in Finance and Accounting. I am one of two kids in my family. My older brother, Kevin, is 24, and I will be celebrating my 21<sup>st</sup> birthday this September. A few weeks ago, I started my summer internship at McCarthy Asset Management. My time here thus far has been fantastic. I am learning skills that will assist me in a plethora of careers. Although I could bore you all with these invaluable experiences and skills I am acquiring here, I would rather pass along three lessons that life has taught me in my mere 20 years on earth.

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# Letter from Ryan McCarthy– Con't

## 1. Sometimes what is meant to be takes a little extra work.

My parents did an incredible job instilling in me the belief that everything happens for a reason. This has helped me endure various struggles throughout my life, including: not making a competitive travel soccer team, receiving a grade below my standard, and most importantly, the passing of family members and friends. Believing that everything happens for a reason is a great way to live life. It allows me to remain optimistic and hopeful in times of despair and sadness.

The college application process can be stressful for many individuals, but I had a dream of attending USC, and never wavered in the slightest bit. In my eyes, the combination of academics, athletics, and the social scene USC offered were unparalleled by any other university in the world. When the admission letters arrived, I was heartbroken beyond words. My college counselor informed me that I had the opportunity to appeal USC's decision, by submitting a one-page letter explaining new information that was not present in my original application. Unfortunately, only about 2% of appeals turn into acceptances. That did not matter to me. I devoted myself to the classroom, earning straight A's both semesters during my senior year, and was named captain of the Volleyball team. Through my dedication and perseverance both in and out of the classroom, I received the greatest email in my life on May 12<sup>th</sup>, 2012. I was accepted into the Marshall School of Business for the fall of my freshman year.

I still believe that everything happens for a reason. Even if appealing did not work, it would have given me comfort knowing that I did everything possible, thus allowing me to fully commit to my second choice of Santa Clara University. However, sometimes what is meant to be takes a little extra work. It is that extra work and the journey of persevering through life's most difficult challenges in which I learned more about myself and grew in ways that I never could have if I was originally accepted into USC. For that, I am very grateful.

## 2. True friendships are rare and should be cherished

Throughout the course of a day, we encounter many people. Some may be friends, acquaintances, or even strangers. Imagine how that number multiplies over a longer period, such as weeks, years, or even a lifetime. Throughout our lives, there are hundreds, even thousands, of individuals that at one point we would call a friend. However, as the years pass and life continues, there are only a couple true friends that are always there. I am fortunate to understand the value of these true friends and I plan on cherishing them, as well as being there for them at all times. My mom's two best friends from her childhood are still two of her best friends. Maintaining close friendships has been a bit more difficult for my dad due to family and work commitments. I hope I am fortunate enough to stay best friends with the people I care about. I will always make sure to be there for them, understanding the value and uniqueness of a relationship with that kind of longevity.

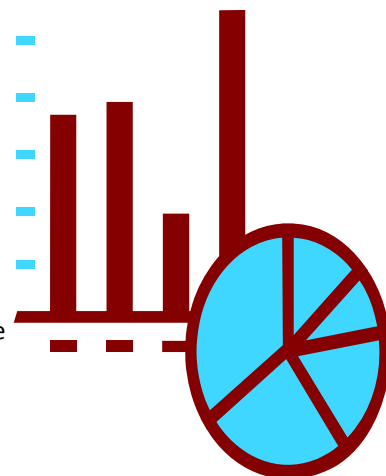
## 3. Life is too short to ever let a day go by without telling the people you love how you feel.

I understand that the saying "life is short" is cliché, but we have all had experiences that made us realize how short life really is. About a year ago, one of my brother's best friends, Aya Nakano, was senselessly murdered outside his car in Oakland because he was the victim of a random "gang initiation". My entire family loved Aya and we will feel the pain of losing him everyday for the rest of our lives. For months I failed to make sense out of this horrific tragedy. I pondered about Aya and what he would tell me if he were still here today. Aya would want me to never let a day pass without telling the people I care about how I feel. He would tell me to do what makes me happy, and if I ever wake up unhappy with my life, to change things immediately. Aya had a unique passion for life that was, and still is, unmatched by anyone I know. I try to emulate his extraordinary outlook and radiant spirit by making the best out of every situation I am in, while hopefully making a positive impact on every life that I encounter. I am able to use this devastating incident as motivation to find happiness in everything I do, as well as treat friends, strangers, and even enemies with both kindness and love. I am grateful to live everyday knowing that Aya is watching from above, with his beautiful and pristine smile.

## Current Asset Allocation of MAM Portfolios

We just finished the semi-annual repositioning of MAM portfolios. Here were the two primary purposes of this repositioning:

- In nearly all portfolios we increased the allocation to Master Limited Partnerships. The letter that was sent to you the day we repositioned your portfolios explained why we are so positive on Master Limited Partnerships. We also plan to write more extensively about them in a future Monthly Commentary.
- For portfolios taking systemic withdrawals, we replenished the “bond safety bucket”. Our strategy is to have three years of portfolio withdrawals in a relatively safe investment. This way, when the stock market drops, we don’t have to sell any equity funds for up to three years, which should provide more than enough time to recover from a bear market.



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 a somewhat conservative asset allocation of approximately 53% in U.S. stocks, 13% international stocks, 28% in bonds, and 6% in alternative assets. I estimate the beta to be between .65 and .70, meaning most portfolios are expected to be 65% to 70% as volatile as the S&P 500. The 12-month yield is 3.2% and the average expense ratio of the mutual funds and ETFs is 0.65.

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 sector to invest in. The lone exception is BlackRock Health Science. With the aging of America, our feeling is that 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. Favorite funds here include Berwyn Income, Dodge & Cox Balanced, Income Fund of America and Oakmark Equity Income.
- **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 two largest positions here are Jeffrey Gundlach’s DoubleLine Total Return and Loomis Sayles Bond.
- **International Equities:** The two international funds we use most extensively are both dividend-focused funds: Capital World Growth & Income and Matthews Asia Dividend. While we feel international equities play a very important role in properly diversifying a portfolio, our allocation to international equities (12% to 15% for most portfolios) is lower than what it was prior to the 2007-2008 Financial Crisis. Our feeling is that currently the U.S. is in better shape economically than most foreign countries. While we feel that emerging and frontier markets offer attractive long-term growth, we currently have little invested there.

## Current Asset Allocation of MAM Portfolios– Con't

- **Alternative Assets:** Currently the only alternative asset is a 6% to 7% position in Master Limited Partnerships. In the past we have also invested in REITs and Commodity funds, but don't feel either of these are attractively priced at this time. In addition, we feel that "managed futures", long-short funds, and other alternative assets funds are not appealing given their high cost and poor performance.
- **Focus on Dividend-Paying Stocks:** A major theme in portfolios has been to invest 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 a dividend have outperformed non-dividend-paying stocks.
  - ◇ In a low-return environment (which we feel we are still in despite 2013's strong stock market gains), dividends provide a significant part of the portfolio return.
  - ◇ Dividend-paying stocks tend to be less volatile than non-dividend paying stocks.

Sincerely,

*Stephen P McCarthy, CPA, CFP®*,

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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

*Please let us know if you would like to have us prepare or update a Net Worth Analysis or Retirement Analysis for you.*



Discover the difference with a  
Registered Investment Advisor.