McCarthy Asset Management, Inc.
Personalized Wealth Management

Q4 2013 Quarterly Letter
(also Dec 2013 Monthly Commentary)

January 2, 2014

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Stock Market & Portfolio Performance

4th Qtr & FY 2013: The U.S. stock market performed very well for 2013 with the S&P 500 having its best year since 1997. With the exception of emerging market firms, foreign stocks had a pretty good year. Bonds, though, had their worst performance in many years, suffering modest losses for the year. The big loser for 2013, which fortunately was not in MAM portfolios, was gold which suffered a drop of nearly 30% for its worst performance since 1981.

	4th Qtr	FY 2013	Description:
Without Dividends:			
S&P 500	9.9%	29.6%	500 Largest Public U.S. Companies
NASDAQ	10.8%	38.3%	stocks trading on the Nasdaq
Russell 2000	8.4%	37.0%	2000 of the smallest U.S. stocks
MSCI EAFE	5.4%	19.4%	international stock index
U.S. Aggr Bond	(0.1)%	(2.0)%	index of U.S. bonds
With Dividends, after all fees:			
MAM portfolios	5.7%	19.3%	non-very conservative MAM portfolios
MAM Conserv	3.6%	7.9%	portfolios with 50%+ bond allocation

Comment: Despite 2013 strong gains, we feel that the slowly improving U.S. economy along with an accommodating Federal Reserve continues to provide a good environment for stocks.

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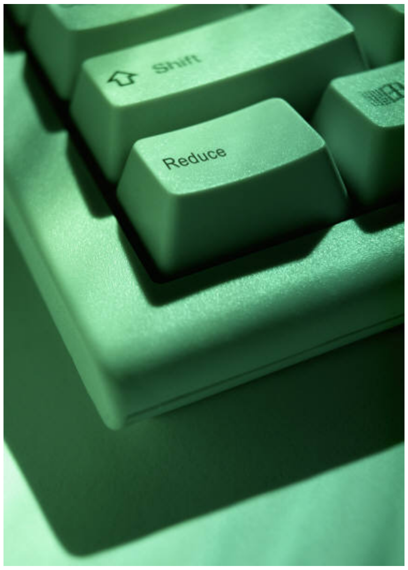
Fed Starts Tapering– Finally

On December 18th the Federal Reserve announced plans to trim its aggressive bond-buying program by reducing its monthly asset purchases by $10 billion, lowering them to $75 billion. The move, which marks a historical turning point for the largest monetary policy experiment ever, was taken due to better prospects for the economy and labor market. The stock market responded with strong gains the day of the Fed's announcement. More reductions are expected "in measured steps" at future meetings assuming the economy lives up to the Fed's expectations of continued growth.



Outlook for Short-Term Interest Rates: The Fed tempered its long-awaited tapering announcement by suggesting its key interest rate (the Federal Funds rate) would stay lower for even longer than previously promised. In particular, the Fed said regarding its policy toward short-term interest rates: "*It will now likely be appropriate to maintain the current target range for the federal funds rate well past the time that the unemployed rate declines below 6 ½ percent, especially if inflation continues to run below the Committee's longer run 2% goal."*

The vast majority of the Fed officials think that rate increases in 2015 will be modest and that the benchmark fed funds rate will remain below 1% by the end of that year. The majority also expects the fed funds rate to remain below 2% in 2016. These low rate expectations persist even though the Fed sees the unemployment rate falling below 6.5% next year. **The indication that short-term rates will stay very low for a longer period of time is a positive for the stock market**. With CD and saving rates now expected to stay very low for longer, it is likely that investors will continue to move assets from low-yielding savings accounts into the stock market.

Congressional Budget Removes Threat of Government Shutdown

For the first time in what seems like ages, Congress has passed and the President has signed a government spending plan without the antics of midnight negotiations to prevent an imminent government shutdown. The two-year bipartisan budget deal reached by Congressional negotiators effectively takes the threat of another government shutdown off the table for 2014 and most of 2015—well after the next November's mid-term elections.

The agreement, which falls short of the grand bargain that Obama and congressional Republicans once aspired to, provides $63 billion in sequester relief over the two years, split evenly between defense and non-defense programs. The next round of sequester cuts were scheduled to hit in January. The deal has only a modest effect on the long-term budget deficit, reducing it by an estimated $20 billion to $23 billion.

Debt Limit Battle Looms In the Spring: The agreement does not address the debt ceiling. Under the October agreement, the debt ceiling has been suspended until February 7th, at which time the Treasury Department will have the ability to use its "extraordinary measures" for a period of several weeks to ensure the U.S. does not default on its debt. Unless further bipartisan work can be accomplished, it is possible both sides will regress back to political dysfunction with the Republicans insisting they want concessions before raising the debt limit and Obama insisting he won't negotiate. In the end, though, we have no doubt that an agreement will be reached and a government default will be avoided.

2014 Stock Market Outlook

After a great year for equity markets in 2013, it is natural to feel that 2014 could be a subpar year. Our feeling is that while the stock market is well overdue for a short-term pullback, we are relatively optimistic in our outlook for 2014. Some of the positives include:

- Economic Growth: Most economists expect a sustained pickup in U.S. GDP growth for 2014 to around 3% driven by continued gains from housing, increased consumer spending, a rebound in business investment, and the positive impact of the expanding U.S. energy boom. Furthermore, the sharp decline in federal spending in 2013 is likely to slow sharply in 2014. Finally, global GDP growth is expected to accelerate. The International Monetary Fund (IMF) is forecasting global growth of 3.6% in 2014, an improvement over estimated growth of 2.9% for 2013.

- Federal Reserve Remains Very Accommodating: Despite its recent announcement to begin tapering its monthly bond purchases, the Fed has made it clear that it will remain very accommodating with maintaining short-term interest rates very low into at least 2015.

- Improved Federal Deficit: During the last couple of years, economic growth, sequester cuts and tax increases have helped to reduce the federal budget deficit from 10% to 4% of GDP. While we continue to feel that serious entitlement reform is needed to address long-term federal budget deficits, for at least the next year or two the budget deficit as a percent of GDP is expected to continue to decline.

- Recession Not on the Horizon: While the stock market has experienced a dramatic recovery since hitting its lows in March of 2009, the U.S. economy is still in the early stages of the business cycle. Business cycles do not die from old age but rather from over-expansion and inflation. Most cyclical sectors such as consumer durables and business fixed investment have not recovered to their normal post-recession share of GDP or made a full recovery.

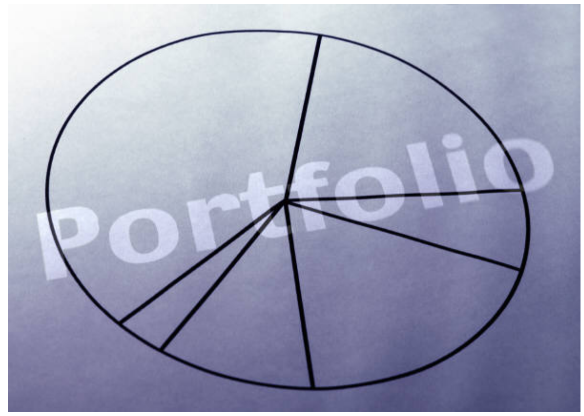
- The Market is Not in a Bubble: In our November 2013 Market Commentary, we discussed why we think the stock market is not in a bubble. Stocks in the S&P 500 are trading at 15 times earnings estimates for 2014, a reasonable valuation considering an environment with very low interest rates.

- Historically Stocks Do Well After a Strong Year: Since 1945, there have been 21 years that the S&P 500 gained more than 20%, according to historical data compiled by S&P Capital IQ. In the following year, the S&P 500 recorded an average increase of 10%, versus an average price gain of 8.7% for all years since WWII.

- Diversification and Active Management: With the exception of bonds, emerging market stocks, and commodity funds, 2013 was a very good year for nearly all other asset classes, due in large part to the easy-money policies of the world's central banks. Asset classes such as large & small U.S. equities and foreign stocks moved largely in-sync and posted double-digit returns with little volatility. 2013 was also a year when many active managers underperformed their respective benchmarks, adding fuel to the index-vs-active management debate. At MAM we believe that diversification and active management add value in part by protecting investors against excessive losses in market pullbacks, so we continue to broadly diversify our portfolios across asset classes while looking for talented managers who are poised to outperform their respective benchmarks through skill and active selection

Current Asset Allocation of MAM Portfolios

MAM portfolios are well diversified among U.S. equities, bonds, alternative assets and foreign equities. Here are a few comments regarding how portfolios are currently positioned:



- **<u>Shift from Bonds to Stocks</u>**: While the asset allocation for a specific client depends on their risk tolerance score and other factors, the average MAM portfolio has approximately 54% in U.S. equities, 30% in bonds & cash, 3% in alternative assets and 12% in foreign equities. The big change made in 2013 was a reduction in the bond allocation from approximately 40% at the beginning of 2013 down to 30% by the end of the year. The most aggressive portfolios currently have approximately 15% allocated to bonds & cash.

- **<u>Increase in ETFs</u>**: Exchange-traded funds and exchange-traded notes make up 20% to 25% of most portfolios, up from 10% to 15% at the start of 2012. We expect to continue to gradually shift more of the portfolio allocation to ETFs given their benefits of low operating expenses and tax efficiency.

- **<u>Focus on Dividend-Paying Stocks</u>**: For the last four years, a major theme has been to invest in mutual funds and ETFs that focus on dividend-paying stocks. For several reasons we find dividend-paying stocks appealing, particularly those that have a history of increasing their dividends:
  - ◊ 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.

- **<u>Specific Market Sectors</u>**: Generally, we don't focus on which market sectors to invest in, such as technology, financials, and consumer spending. Currently, the only sectors we are specifically emphasizing are health care and energy master limited partnerships (which are benefiting from the U.S. oil & gas boom). Beyond that, we leave it up to the mutual fund manager as to which sectors to invest in (or in the case of passively-managed ETFs, to gain broad exposure to many sectors).

Fund Profile– FMI Large Cap

FMI Large Cap (symbol FMIHX) is currently the largest position in MAM portfolios. We first started using this mutual fund in 2007. It primarily invests in large companies (both in the U.S. and internationally). Here are some highlights about the Fund:

FMI Funds

Advised by Fiduciary Management, Inc.
www.fmifunds.com

- **Performance:** Since its December 2001 inception through March of this year, it earned an 8.1% annualized gain, outpacing the S&P 500 Index and the large-cap blend category average by 3.2% and 3.9% per year, respectively, with less volatility. It's been consistent, too, landing in the top 25% of its peer group in more than three fourths of all rolling three-year periods since its inception.

- **Investment Approach:** Lead manager Pat English (who is chief investment officer of Fiduciary Management Inc. and has managed the Fund since its inception) and his team look for strong and durable businesses trading at reasonable valuations. Using a contrarian mindset, they look to buy stocks whose prices are depressed and sell them after their prices have recovered. The managers run a concentrated portfolio of approximately 30 stocks, keeping a watch list of attractive companies they can buy when their prices dip.

- **Buy & Hold:** The managers are patient investors. Annual portfolio turnover is relatively low at 21%, implying a typical holding period of nearly five years, compared to 72% annual turnover for its typical large-blend peers.

- **Bear Market Performance:** The Fund's showing during past bear markets has played a large part in boosting its long-term record. For instance, it lost significantly less money than the vast majority of its peers during 2008's downturn when its 27% loss, while tough in absolute terms, was among the best performance in the large-blend category, and more than 10% better than its average peer and the S&P 500 Index. The ability to weather a storm stems from a disciplined process, although in turn, the fund has modestly lagged in strong rallies, such as 2013 when it rose 30.5%, 1.9% less than the S&P 500. Over time, as evidenced by the fund's stellar long-term track record, it is a worthy trade-off.

- **Fees:** While the Fund isn't the cheapest around, it is moderately priced. Its 0.96% annual expense ratio is a little below the category's median of 0.99%.

- **Closed To Most New Investors:** On June 30, 2013 management closed the Fund to most new investors to keep assets at a manageable level. This is a good sign of a fund company that places its investors' interest first. Fortunately we are still able to add the Fund to new portfolios because we already own it in MAM 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.**
- **Medicare Advisory Program (MAP) - Allen Hamm**
- **The Savvy Life® Classes, Workshops , and One-on-One Consultations**

Reminders

1) **Estimated Tax Payments**: 4th Quarter 2013 Federal & State Estimated Payments are due January 15, 2014.

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 this document with the Securities and Exchange Commission. Along with other items, it contains information regarding our fees, experience and 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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