

Q4 2014 Quarterly Letter (also December 2014 Monthly Commentary)

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Stock Market & Portfolio Performance

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4th Qtr & Full Year 2014: While large-cap U.S. stocks and bonds performed well in 2014, small-cap U.S. stocks lagged and foreign stocks fell.

	4th Qtr	FY 2014	Description:
Without Dividends:			
S&P 500	4.4%	11.4%	500 Largest Public U.S. Companies
NASDAQ	5.4%	13.4%	stocks trading on the Nasdaq
Russell 2000	9.0%	3.5%	2000 of the smallest U.S. stocks
MSCI EAFE	-3.9%	-7.4%	international stock index
U.S. Aggr Bond	1.8%	6.0%	index of U.S. bonds
With Dividends, after all fees:			
MAM portfolios	1.6%	6.9%	non-very conservative MAM portfolios
MAM Conserv	0.1%	4.5%	portfolios with 50%+ bond allocation

Comment: Although stocks are no longer cheap, and we expect greater volatility, our 2015 outlook is moderately positive given the strength in the U.S. economy. Bonds may struggle, though, as the Fed Reserve is expected to start raising short-term interest rates by mid-year.

Advisor Team

McCarthy Asset Management, Inc.

Three Lagoon Drive Suite # 155
Redwood Shores, CA 94065
USA



STEVE MCCARTHY
CPA, CFP®,
Owner and Principal
650 610-9540 x 303
steve@mamportfolios.com



Lauree Murphy, CFP®, EA
Financial Planner
Tax Specialist
650 610-9540 x 304
lauree@mamportfolios.com

ANTHONY BERTOLACCI ,
RTRP
Director of Compliance
Tax Accountant
650 610-9540 x 302
anthony@mamportfolios.com

MARILYN BLANCARTE
Executive Assistant
650 610-9540 x 305
marilyn@mamportfolios.com

Does Diversification Still Work?

While most professional advisors and money managers utilize diversified portfolios of various asset classes, the fact is that most diversified portfolios have lagged large-cap U.S. stocks during the dramatic stock market recovery that began in March 2009. As a result, some investors may think investing solely in the S&P 500 is the best path to investment success. While being only invested in large U.S. stocks has worked during the most recent time period, staying diversified has paid off over time, and chasing recent performance is generally not a good course of action. Additionally, being overly concentrated in one asset class can be risky, particularly when that asset class has been the best performing for a number of years.



The out-performance of large cap U.S. stocks was particularly pronounced in 2014, with large-cap U.S. stocks having their best performance relative to small cap U.S. stocks since 1998. For the year, excluding dividends, the S&P 500 was up 11.4%, the Russell 2000 index of small stocks was up 3.5%, the EAFE index was down 7.4%, and the U.S. Aggregate Bond index was up 6.0%. Therefore, excluding dividends, a portfolio of 35% S&P 500, 15% Russell 2000, 30% bonds, and 20% international equities rose just 4.8% in 2014, compared to the S&P 500's rise of 11.4%.

Why Own International Stocks?



Historically, globally diversified portfolios have outperformed domestic-only ones for the same level of risk. But today some investors may question whether to invest internationally, given that the U.S. stock market has outperformed most foreign markets over the last several years. This out-performance is due to the U.S. economy having been in better shape than most foreign economies. Nonetheless, it still makes sense to diversify a portfolio internationally because:

- Foreign stocks are relatively cheap compared to U.S. stocks.
- Foreign stocks pay a higher dividend yield than U.S. stocks.

For instance, the Vanguard Developed Markets ETF (VEA) has a 3.5% yield, compared to the Vanguard S&P 500 ETF (VOO), which has a 1.8% yield.

Importance of Current Account: A November 25, 2014 report from Charles Schwab, titled "Will International Stocks Outperform in 2015?", discussed a subtle change that may start providing a boost to foreign stocks. The report explained that changes in the U.S. current account could indicate that the relative performance of international stocks may start improving. The "current account" is "a measure of trade and investment flows in and out of the U.S.". Historically, the trend in the current account has had significant implications for investors:

- U.S. stocks outperformed international stocks when the U.S. current account improved as a percentage of GDP.
- International stocks outperformed U.S. stocks when the U.S. current account decreased as a share of GDP.

Why Own International Stocks– Con't

Importantly, the current account tends to lead relative market performance by about three quarters. While past performance is not a guarantee of future results, the “current account” indicator has performed consistently in a variety of economic environments over the past 42 years. The only exception was the period in the second half of the 1990s. During this period, the U.S. current account deteriorated, yet U.S. stocks, led by technology stocks as the internet bubble inflated, outperformed international stocks.

The latest data on the U.S. current account depicts that it has flattened out after improving significantly in recent years. While the dramatic decrease in U.S. oil imports has been quite a positive, the U.S. trade balance in other goods has rapidly deteriorated. As a result, the current account could start falling. The key to that direction in 2015 may be the U.S. dollar, which has climbed 10% since the end of the second quarter of 2014, and is now close to a four-year high. The dollar's recent rise could hurt the trade balance, since it makes foreign goods cheaper for U.S. buyers and U.S. goods more expensive for foreign buyers.

Investment Implications: Most MAM portfolios have a 10% to 16% allocation to international equities. While this is lower than it had been several years ago, we will consider increasing the international allocation later in 2015 depending on trend in the U.S. current account.

Preparing for a Rise in Interest Rates

After seven years with the federal funds rate near zero, the Federal Reserve is expected to start raising the federal funds rate by the middle of 2015. Fed Chair Janet Yellen has stated that the interest-rate increases will depend on a variety of economic factors, but she has repeatedly mentioned the primary two as inflation and the labor market.

While inflation is expected to remain subdued for the foreseeable future (particularly now with the dramatic recent drop in oil prices), the labor market continues to improve. For the most recent month, November, the Labor Department estimated a net increase of 321,000 in jobs (well above the 230,000 that was expected), the highest single month since January 2012. This follows several months of strong data.

So how rapidly are interest rates expected to climb? Historically, the Fed tightened, and bond yields rose, most often because inflation threatened to erupt. But, in recent decades inflation has been much more stable, and lately has been below the Fed's 2% target. Therefore, the Fed rate increases are expected to be muted, with economists currently predicting a federal funds rate of 1% to 1.5% by the end of 2015.

Impact on Bond Prices: A rising interest-rate climate causes bond prices to fall (all else being equal). Duration is a measure of interest rate sensitivity. Funds with shorter durations will typically be less sensitive to increases in interest rates. However, funds with shorter durations typically have lower yields. Offsetting the price impact of rising rates, higher interest rates can boost interest payments as new bonds are purchased in a bond fund, helping to buffer the decline in bond prices.

The primary purpose of a bond fund allocation in portfolios is to provide downside protection for when the stock market is falling. We lowered the bond allocation in the average MAM portfolio from 40% at the beginning of 2013 to 30% at the end of 2013. The current bond allocation is approximately 28%. For the bond allocation, our strategy is to primarily invest in intermediate bond funds where the manager has the flexibility to adjust the fund's average duration and move into parts of the bond market less sensitive to rising rates.



Preparing for a Rise in Interest Rates– Con't

Impact on Stock Prices: As previously discussed in our Second Quarter 2013 Letter, rising interest rates are not necessarily bad for stock prices. Birinyi Associate, a stock research firm, analyzed nine periods since 1962 when the yield on the 10-year Treasury increased over a sustained period of time. It found that from the start of the rise in rates, the S&P 500 increased a median 0.8% three months later, 11.3% six months later, and 13.8% one year later.

How can this be? Aren't rising interest rates supposed to hurt stock prices? It appears that *it is not so much the increase in rates that hurts, but the absolute level of rates*. According to a Standard & Poor's study that tracked market performance going back to 1953, U.S. stocks actually posted their best returns when 10-year Treasury yields rose towards 4%. On the other hand, when yields exceeded 6%, stocks started to lose money. "The 'sweet spot' for equity prices appears to be a rising rate environment between 3% and 4%, as a growing economy reduces unemployment while increasing corporate earnings, yet does not trigger growth-slowing efforts by the central bank", explained Sam Stovall, S&P's chief equity strategist. The 10-year Treasury closed 2014 at 2.17%.

How Are You Situated for Retirement? Time For a Retirement Analysis?

Whether you are currently retired, or still working and saving for retirement, it is good to see if you are on course for a financially-secure retirement. Studies have shown that many Americans are woefully unprepared financially for retirement. The free service we provide to MAM clients is the preparation of a "Retirement Analysis". Unless you are one of our clients who are not at risk of outliving their money, we highly recommend you have us prepare one for you. To do so, we utilize the MoneyGuide Pro software that incorporates Monte Carlo analysis into the calculations.



Since Lauree Murphy started working at MAM, Inc. last May, she has prepared a Retirement Analysis for 27 clients. This is the most we have prepared since we first introduced the service a few years ago. A Retirement Analysis is useful for:

- **Those Still Working:** It is very helpful in determining whether individuals are on-course for a financially-comfortable retirement. If they are not, we come up with recommendations such as increasing savings, working longer, etc.
- **Those Looking To Make a Major Financial Decision:** It is very useful for those who are about to make a major financial decision, including: retiring, changing to a less lucrative job or career, purchasing a significantly more expensive home, etc.
- **Those who are Already Retired:** It is helpful in determining how much money they can spend while minimizing the risk of outliving their money.

This past summer, we added the capability for clients to view their completed Retirement Analysis from their MAM portal. This allows them to make changes to certain assumptions in the Analysis (retirement age, annual spending in retirement, etc.) and quickly see the projected impact. The ability to change assumptions and see the results is very empowering for clients.

How Are You Situated for Retirement? Time For a Retirement Analysis?– Con't

Here is what one client recently said about his completed Retirement Analysis, “This was simply amazing and super valuable in giving us a good view into current status, actions we can take and decisions pending as we get closer...The beauty of the analysis is that it gives concrete steps to accomplish and achieve our goals.”

To prepare a Retirement Analysis for a client we need:

- MAM to prepare a recent Net Worth Analysis. (which lists the client’s assets & liabilities)
- Clients to complete a Retirement Analysis workbook where they estimate their spending in retirement

If we have not already completed one for you, please contact us if you would like to have us prepare a Retirement Analysis for you.

Assets Under Management and Referrals

As of December 31, 2014, MAM assets under management were in excess of \$170 million, up from \$150 million at the beginning of 2014. For the year, we received the most new clients since the early years of MAM. Thank you for being a client, and thank you to those who added to their investments or referred us to their friends and family. We really appreciate referrals as they are our primary source of new clients. While our minimum amount to manage for new clients is \$500,000, we are able to be flexible depending on the individual’s situation.

Sincerely,

Steve P McCarthy, CPA, CFP®

McCarthy Asset Management, Inc.

Three Lagoon Drive Suite # 155
Redwood Shores, CA 94065
USA

Phone: 650-610-9540
Fax: 610-9541
E-mail: Steve@mamportfolios.com



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 2014 Federal & State Estimated Payments are due January 15, 2015.
- 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 annually 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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