McCarthy Asset Management, Inc.
*Personalized Wealth Management*

# Q3 2014 Quarterly Letter
# (also September 2014 Monthly Commentary)

October 1, 2014

**Inside this issue:**



## Stock Market & Portfolio Performance

***3rd Qtr & YTD 2014:*** While Large-Cap U.S. stocks rose modestly for the third quarter, U.S. small & mid-cap and foreign stocks fell sharply

| | 3rd Qtr | YTD 2014 | Description: |
|---|---|---|---|
| Without Dividends: | | | |
| S&P 500 | 0.6% | 6.7% | 500 Largest Public U.S. Companies |
| NASDAQ | 1.9% | 7.6% | stocks trading on the Nasdaq |
| Russell 2000 | -7.3% | -5.3% | 2000 of the smallest U.S. stocks |
| MSCI EAFE | -6.4% | -3.6% | international stock index |
| U.S. Aggr Bond | 0.2% | 4.1% | index of U.S. bonds |
| With Dividends, after all fees: | | | |
| MAM portfolios | -0.6% | 5.2% | non-very conservative MAM portfolios |
| MAM Conserv | -0.6% | 4.3% | portfolios with 50%+ bond allocation |

*Comment: As discussed on P.2 of this report, the recent positive performance of Large-Cap U.S. stocks may be masking a short-term market correction.*

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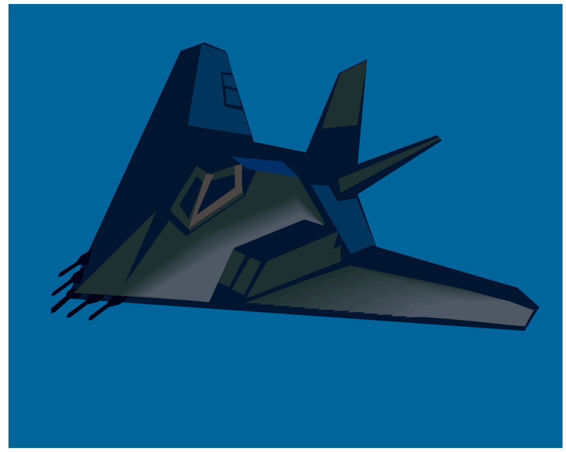
## A Stealth Market Correction?

While large-capitalization U.S. stocks have performed well so far in 2014 (the S&P 500 was up 6.7% for the first nine months of 2014 and up 0.6% for the third quarter), small and mid-cap U.S. stocks and international stocks have struggled.  For instance, the Russell 3000, which is an index of small U.S. stocks, was down 7.3% for the first nine months of 2014 and down 5.0% for the third quarter.  Meanwhile, the EAFE  international stock index was down 6.5% for the first nine months and 3.7% for the quarter.



Could this be a stealth market correction?  We are certainly due for one as it has now been nearly three years since the S&P 500 index has fallen 10%.  Such market corrections can be healthy as they keep investors from becoming too exuberant about rising stock prices.  As I have said many times before, we don't try to "time" market corrections as they are too difficult to predict.  I echo the sentiment of Peter Lynch, manager of the Fidelity Magellan Fund during its heyday, when he said, "Far more money has been lost by investors preparing for corrections, or trying to anticipate corrections, than has been lost in corrections themselves" (BusinessWeek, September 2014).  Time will tell if a market correction is finally at hand.

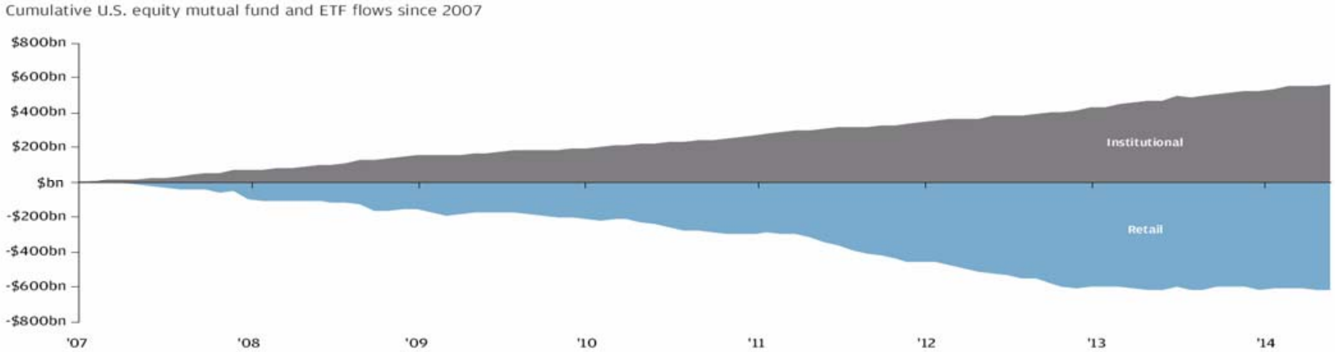
## Longer-Term Outlook for the Stock Market

Much of this article on the long-termer outlook for stocks is based on the JP Morgan report "The Sentimental Investor-Staying Disciplined in a Skeptical Market".  The report is attached to the email sent with this Monthly Commentary.  The JP Morgan report made the following points:

1) Despite a U.S. business cycle that is now in its sixth year of expansion, many remain skeptical about investing in the stock market.  Such skepticism is a sign of a healthy market, as investors tend to be under-invested in stocks when they are skeptical.

The graph below shows the cumulative U.S. equity mutual fund and ETF flows since 2007 (i.e. purchases net of redemptions).  The dark gray shows that while institutions have consistently added to their U.S. equity investments since 2007, the blue shows that retail ("individual investors") have been consistently reducing their equity exposure.

EXHIBIT 7: RETAIL FLOWS TO U.S. EQUITIES SINCE THE FINANCIAL CRISIS REFLECT BEHAVIORAL BIASES
Cumulative U.S. equity mutual fund and ETF flows since 2007




Source: ICI, J.P. Morgan Asset Management. For illustrative purposes only. Data are as of 8/31/2014.

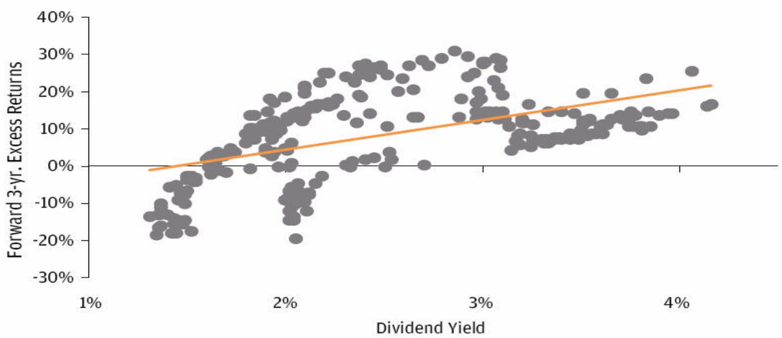
# Longer-Term Outlook for the Stock Market– Con't

2) Historically, investing when the market dividend yield and term spread are high has resulted in strong returns over long horizons. The current levels of these measures suggest that the expected return for stocks is still attractive.

a) The **<u>Dividend Yield</u>** is one of the better indicators for forecasting future stock market returns. The higher the yield, the greater the expected stock market returns. The J.P. Morgan graph to the left shows the historical "forward 3-year excess returns" for the stock market based on the S&P 500's dividend yield.

**EXHIBIT 1: THE MARKET DIVIDEND YIELD AND SUBSEQUENT RETURNS ARE CORRELATED**

S&P 500 Dividend Yield and forward 3-yr. excess returns




Source: Standard & Poor's, J.P. Morgan Asset Management. For illustrative purposes only. Data are as of 8/31/2014.

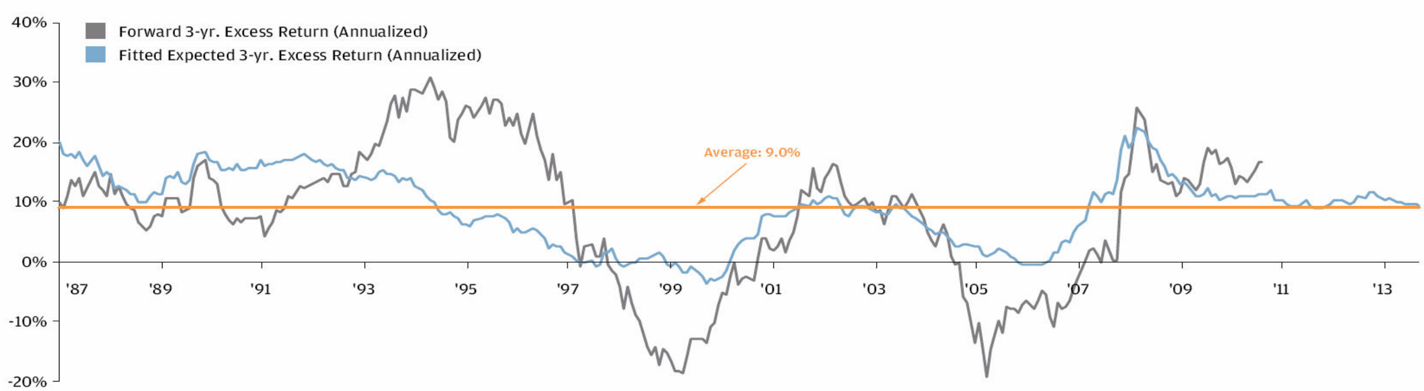
While the current yield of the S&P 500 is a modest 1.9%, corporate profit and dividend growth for the S&P 500 companies is projected to remain strong for at least the next couple of years. Furthermore, the payout ratio (the percentage of earnings paid out as dividends) is currently in the low 30's, compared to periods prior to the 1990's when it was 40% to 60%. The low payout ratio combined with strong profit growth should provide companies the ability to generously increase their dividends for the foreseeable future.

b) The **<u>Term Spread</u>**, or the steepness of the yield curve, is also a good indicator of future stock market returns. When long-term rates are high relative to short-term rates, the yield curve is steep. The higher the term spread, the higher the projected return for the stock market. The term spread is highest during recessions (when the Federal Reserve reduces short-term interest rates) and falls as the cycle progresses. Eventually, as the business cycle reaches its end (i.e. the Federal Reserve stops raising short-term rates), the yield curve flattens, which results in a low term spread. Currently, the term spread is approximately 4%, which is above its average since 1987 of 3.2%. The term spread, though, is expected to drop once the Fed starts raising short-term interest rates next year.

Putting it all together, as shown on the chart below, the current market dividend yield and term spread suggests a slightly higher than normal long-run return for stocks. The JP Morgan report indicates an attractive 9.3% on an annualized basis (compared to a long-term average of 9.0%). While this would be wonderful for investors, my personal belief is that we are in a low return environment with my guesstimate of annual stock market returns of 4% to 7% for the foreseeable future. My estimate is based on the current dividend yield for the S&P 500 (1.9%) plus average annual growth in the profit of S&P 500 companies (3% to 5%). Even with my subdued expectations, stocks still remain attractive relative to most any other investment alternative.

**EXHIBIT 3: LONG-RUN EXPECTED RETURN FOR THE STOCK MARKET IS STILL ATTRACTIVE**

Expected 3-yr. excess returns on the S&P 500 based on Dividend Yield and Term Spread




Source: Federal Reserve, Standard & Poor's, J.P. Morgan Asset Management. For illustrative purposes only. Data are as of 8/31/2014.

# The Importance of Updating Your Estate Planning Documents (Written by Marina Modlin of Modlin Legal Services, Inc.)

You probably feel your estate planning affairs are in order – after all, you visited an attorney back in the 90s, and not much has changed since. However, estate planning gets out of date. Here are a few reasons why your plan might be not as good as it could be:

## 1) Changes in Law

### a) Subtrust Funding and the Estate Tax Exemption

- Estate planning documents may be out of date because of changes in law. The biggest changes in law we have seen have to do with subtrusts, the federal estate tax exemption, and a new concept called "portability".

- The federal estate tax is assessed onto all decedents' estates larger than the exemption amount in the year of death. In the 90s, the exemption was under $1 million. While rising steadily in the 21st century, the exemption did not reach $2 million per person until 2006.

- Because of the low exemption amount, many Silicon Valley estates were potentially or actually taxable. Thus, most estate planning attorneys drafted complex trust instruments which allowed the surviving spouse to postpone the payment of the estate tax until after his or her death by mandating the funding of various subtrusts (often referred to as "A", "B" and "C" Trusts or Survivor's and Bypass Trusts).

⇒ It's very important to review your existing trust in light of the size of your estate and the current exemption amount ($5.34 million per person). Because of the change in the exemption amount, most estates are no longer taxable, and the old documents are no longer needed. Furthermore, due to "portability", in many cases there may no longer be a need to fund a Bypass Trust (which some older Trust documents may mandate).

### b) Health Care Directives

The Health Insurance Portability and Accountability Act (HIPAA) was passed on August 21, 1996, and various related regulations have been enacted and implemented in the late 90s and early 2000s. For our purposes, one of the main consequences of HIPAA was the restriction of sharing confidential medical information with anyone, except the patient herself. A 3rd party needs a health care directive, signed by the patient before she lost capacity, containing an authorization to share the confidential medical information with the named 3rd party.

⇒ It's important to update your estate planning documents because older Advance Health Care Directives simply may not have the language required to bypass the HIPAA restrictions and authorize medical professionals to share your confidential medical information with anyone but you. What this means is should you become incapacitated, your loved ones could run into extreme difficulty trying to manage your health care on your behalf.

# The Importance of Updating Your Estate Planning Documents (Written by Marina Modlin of Modlin Legal Services, Inc.)– Con't

**2) Changes in Fact**

Other reasons to revisit your old estate planning documents have to do with changes in fact – changes in your personal life. For example, since you put the original plan in place:

- Have the people you named as successor trustees gotten ill, too old, passed away, or simply moved away?
- Do you still like your distribution scheme?
- Have you gotten married or divorced?
- Has the size of your estate changed substantially?

⇒ These and other questions will help you do a preliminary assessment on whether your existing estate plan is out of date because of changes in fact.

**3) Not Properly Funding Your Trust(s)**

The third reason to revisit your estate planning is to make sure your trust is properly funded. Clients frequently email me letting me know that they just purchased a rental property, but forgot to title it to the trust. Or, they take real estate out of the trust during the refinancing process, and forget to put it back it.

Typically, it costs $300 per property to transfer it into the existing trust. That's if the client is alive. If the client doesn't get around to transferring it until after his/her death, then it costs about $3,000, as the family needs to petition the court to transfer the property. The choice is clear.

In conclusion, it's important to revisit your estate plan every 5-10 years, or sooner if major life changes occur. Please feel free to email marina@modlinlegal.com should you have any questions.

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 hour-ly 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 avail-able 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 show you how to access the information that is available on your MAM portal.*

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