McCarthy Asset Management, Inc.

Registered Investment Advisor

Re: First Quarter 2011 MAM Letter

Tuesday, April 5, 2011

Dear Client,

The stock market was remarkably resilient during the first quarter of 2011 as investors maintained their confidence despite a series of geopolitical and economic crises:

- The world was rocked in January when the president of Tunisia resigned after widespread protests broke out in the North African country. The unrest spread across the region, eventually forcing out long-reigning Egyptian leader Mubarak, igniting a rebellion in Libya and destabilizing several other regimes. The political unrest drove oil prices to a recent new high of $108 per barrel.
- On March 11th Japan was hit by a devastating 9.0 earthquake and Tsunami, causing extensive damage in the northeastern portion of the country and killing over 10,000 people. The earthquake damaged the cooling systems at the Fukushima Nuclear Power Plant leading to a nuclear crisis that is still not resolved.
- In Europe, the sovereign debt fears that dominated the headlines last summer arose again. Credit spreads rose steadily throughout the quarter as worries increased that the European Union framework for bailing out struggling countries would not be robust enough to stave off a crisis. Portugal is the latest country to be at risk of default.
- Meanwhile food and energy inflation recently picked up in the U.S. Rising prices could force the Federal Reserve to tighten monetary policy sooner than it had hoped and short-circuit the recovery.

Despite these events, the stock market staged its best first quarter since 1998. While I feel the stock market is still at risk of a short-term correction, I remain relatively upbeat with my 2011 outlook. With this report for the quarter ending March 31, 2011, I discuss the performance of the market and MAM portfolios for the quarter. This report also includes discussions regarding:

- Positive Employment Reports = Self-Sustaining Economic Growth
- Stock Market Correction- Already Over?
- Real Estate Prices Falling Again- Good Time to Buy?
- A Busy Quarter at McCarthy Asset Management, Inc.

Please see the enclosed for your 3/31/11 investment reports.

Stock Market & MAM Performance for First Quarter

The stock market had a good first quarter of 2011. *Unadjusted for dividends,* the S & P 500 rose 5.4%, the Nasdaq climbed 4.8%, the Russell 2000 jumped 7.6%, and the international equity index MSCI EAFE rose 3.1%. Bonds, as represented by the Barclay's U.S. Aggregate Index, inched up 0.4% for the quarter.

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MAM Portfolio Performance: Excluding the "very conservative" portfolios, the composite return of assets in MAM portfolios was a gain of 3.8% (after MAM fees), versus a gain of 5.9% for the Vanguard Index 500 fund (symbol VFINX) with dividends reinvested. The quarter's composite return for assets in the "very conservative" portfolios was a gain of 2.2%.

Current Positioning of MAM Portfolios: As I have written recently, I expect stocks will out perform bonds for the foreseeable future. In my last Quarterly Letter I asked clients to contact me if they were comfortable taking on a little more volatility with their portfolio(s). Approximately 25% of my clients responded, and I did get a little more aggressive for them. Subsequently, I adjusted most portfolios by shifting a small portion of the bond allocation to equities. I now estimate that the current allocation of most portfolios is such that they should experience 60% to 80% of the volatility of the S & P 500. I feel that this allocation provides a good balance between realizing most of the returns offered by the stock market while providing decent downside protection should stock prices fall.

Oldest Portfolio: The MAM portfolio with the longest track record is a moderately aggressive portfolio that was fully invested on September 13, 1999. As of March 31, 2011, the original $50,000 had risen to $88,854, plus $1,193 of cumulative withdrawals. This represents a cumulative return of 80.1%. During the same time, the S & P 500 (as represented by the Vanguard Index 500 Fund) rose 16.8%. For the quarter ended March 31, 2011, the portfolio rose 3.9%. All returns quoted for this portfolio (and for all MAM portfolios) are net of MAM fees. Also, past performance does not guarantee future results.

Positive Employment Reports = Self-Sustaining Economic Growth

The U.S. economy continued to add jobs at a sustained pace in March, dropping the unemployment rate to the lowest level in two years (8.8%). Last Friday the Labor Department reported that nonfarm payrolls rose by 216,000 last month as the private sector added 230,000 jobs. Since November of 2010 the jobless rate has declined by a full percentage point—the sharpest drop in a generation. Still, it will probably take a few years for the jobless rate to fall back down to the pre-recession level of 5% to 6% as there are still approximately 3.5 million people who would like to work, but can't find a job.

Nonetheless, the news was good as employment growth is necessary for the economic expansion to be self-sustaining. With this stronger job growth, the economy may have grown at a 4% annual rate for the first quarter (compared to the recent upwardly revised growth of 3.1% for the 4th quarter of 2010). Until recently, job creation was the missing ingredient in the "jobless" economic recovery. Manufacturers have created 190,000 jobs in the past year, the most since 1998. The economy's service sector, which employs most of the work force, is expanding at the fastest pace in more than five years. Shoppers are spending more and U.S. exporters are selling more abroad.

Stock Market Correction- Already Over?

In the February 2011 Monthly Investment Commentary, I discussed that the stock market was overdue for a correction. In terms of magnitude I wrote the Lowry's said "given the extent of the overbought condition in the recent rally, investors should probably be prepared for the possibility of a short-term correction in the 7% to 10% range". That just about happened. From February 18th through March 16th, the S & P 500 fell 6.4%. While it seemed the correction had a little further to run, on March 17th prices turned up and the S & P 500 closed March just 1.3% off the February 18th high.

While I was not surprised to see the magnitude of the correction last month, I was surprised by its short one-month duration. A typical characteristic of a market correction is for stock prices to retest their recent lows before embarking on a sustained move upwards. Therefore, I think it is likely that this recent correction has not yet run its course. I don't try to time these short-term market movements. More importantly, I think the overall direction of the stock market is still up, and I continue to feel 2011 will likely be a pretty good year for stocks.

Real Estate Prices Falling Again- Good Time to Buy?

Whether or not you consider your home an investment, real estate is still a big part of many individuals' financial lives. Although home equity levels have dropped substantially amid the housing bust, home ownership remains a significant component of the net worth of many of our clients (although in the Net Worth Analysis we have always excluded the equity in the primary residence from our clients' Invested Assets). The Great Recession was painful for the stock market and the economy. Now, though, the stock market has nearly doubled from its March 2009 lows, the economy has shifted from recovery to expansion with the Gross Domestic Product hitting an all time record level in the fourth quarter of 2010, and most recently, the last few monthly employment reports have shown a large number of new jobs being created. Given all this good news, how is real estate doing? Not so well.

Despite mortgage rates near sixty-year lows and home affordability at the highest level in many years, real estate is still hampered by a glut of foreclosures that are dragging down home prices, high unemployment and tight credit. In fact after a slight recovery in the first half of 2010, housing prices appear to be sliding again. Last week the S & P/Case-Shiller home price index was released for January. The index, which covers 20 major U.S. markets, fell 3.1% year-over-year, representing the sixth consecutive month of declines. Rather than recovering, it appears that prices may be edging closer to a double dip with prices falling to new lows. This dismal report followed other recently-released negative housing market reports. Sales of existing homes were off nearly 10% in February and new home sales declined to their lowest levels in almost 50 years.

It has been nearly five years since real estate prices peaked in mid-2006. Since then prices have fallen approximately 30% and are back down to where they were in April of 2002. According to David Stiff, chief economist at Fiserv Case-Shiller, a "pretty standard time frame" for prices to stabilize after a large correction is five to seven years. In the past, some regions suffered longer than others. For example, Dallas home prices took 12 years to recover after they fell from their peak in mid-1986. This time around, however, the downturn was nation-wide and the mortgage-credit bubble had caused home prices nationally to double from 2000 to 2006, a remarkable rise in less than seven years.

Like the stock market, I feel it is nearly impossible to time the real estate market to buy at the bottom. For those who are looking to buy their first home or to upgrade to a more expensive home, I think now is a good time to start looking. I believe mortgage rates hit bottom late last year. While they are still at very attractive levels, I do expect them to rise over time. Furthermore the recent good employment reports bode well for real estate. While I believe substantial employment growth will be needed for the real estate market to return to health, we may be in the early stages of that employment recovery. Finally, the time to buy is when demand is very low, which is certainly the case now. While a sustained rise in real estate prices may still be a couple of years away, I don't think it is likely that prices will fall much further.

A Busy Quarter at McCarthy Asset Management, Inc.

The first quarter of the year is always very busy for me because of tax season. This season had the added challenge of being the first one in fifteen years of not having the able assistance of the CPA Joe Jefferis. By increasing his work schedule to full time during tax season, Anthony Bertolacci successfully took on much of Joe's workload. While I have worked every day since Super Bowl Sunday, it wasn't much worse than previous tax seasons. In fact, for the first year since I started McCarthy Asset Management twelve years ago, this season the number of tax clients increased from the prior year. I am glad to say that I was able to do this while getting to the gym five to six days per week. While I don't plan to cut back my gym time, I do look forward to soon having my weekends and nights free!

Meanwhile, Marilyn and Alexey have been busy. They both were involved with inputting trades for portfolio repositioning and investing new assets. In addition, they both spent time with their roles for the Peninsula Chapter of the Foundation for Personal Financial Education (FPFE). In fact the first two sets of workshops are already planned for next quarter. Furthermore, Marilyn spent time working on Schwab paperwork for new clients while Alexey worked on the Net Worth Analysis (NWA) for a number of clients. Now that the stock market has recovered most of what it lost in 2008, clients are again interested in seeing where they are at toward achieving a financially-secure retirement.

Assets Under Management and Referrals

As of March 31, 2011, MAM assets under management were over $110 million, up from $103 million at the beginning of 2011. In fact assets under management were the third highest quarter-end on record, not far from the high reached back in 2007. This was a combination of existing clients adding to their investments and a number of new clients that were added. I want to thank those of you who have added to their investments or have referred the services of McCarthy Asset Management, Inc. to their friends and family. I really appreciate this as referrals are our primary source of new clients. While my minimum amount to manage for new clients is $400,000, I am willing to be flexible depending on the individual's situation.

Please call me if you wish to discuss the stock market or your portfolio(s).

Very truly yours,

Stephen P. McCarthy, CPA, CFP

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