McCarthy Asset Management, Inc.

Registered Investment Advisor

Re: Second Quarter 2011 MAM Letter

Tuesday, July 5, 2011

Dear Client,

Despite mixed results for the stock market for the second quarter, the first six months of 2011 represents the first time in four years the market is up for the first two quarters of the year. Although the current market correction may run a little longer, I continue to expect a positive second half of the year. With this report for the quarter ending June 30, 2011, I discuss the performance of the market and MAM portfolios for the quarter and the first six months of 2011. This report also includes discussions regarding:

- Mid-year Economic and Stock Market Update
- Real Estate: Initial Signs of a Recovery, Especially in Silicon Valley
- Misc. Topics: Updating IRA Beneficiaries and Signing Up for eDelivery
- Comments Regarding This Year's Financial Planning Association NorCal Conference.

Stock Market & MAM Performance for Second Quarter

After a strong 4-day run at the end of June, the stock market recovered to post mixed results for the quarter. *Unadjusted for dividends,* the S & P 500 fell 0.4%, the Nasdaq dropped 0.3%, the Russell 2000 slipped 2.0%, and the international equity index MSCI EAFE rose 0.3%. Bonds, as represented by the Barclays U.S. Aggregate Index, rose 2.3% for the quarter.

MAM Portfolio Performance: Excluding the "very conservative" portfolios, the composite return of assets in MAM portfolios was a gain of 0.6% (after MAM fees), versus a gain of 0.1% 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 1.2%.

Stock Market & MAM Performance for YTD 2011

For the first six months of 2011, unadjusted for dividends, the S & P 500 rose 5.0%, the Nasdaq climbed 4.5%, the Russell 2000 rose 5.6%, and the international equity index MSCI EAFE rose 3.0%. Bonds, as represented by the Barclays U.S. Aggregate Index, rose 2.7% for the six months.

MAM Portfolio Performance: Excluding the "very conservative" portfolios, the composite return of assets in MAM portfolios was a gain of 4.5% (after fees), versus a gain of 6.0% for the Vanguard Index 500 Fund (symbol VFINX) with dividends reinvested. The year-to-date composite return for assets in the "very conservative" portfolios was a gain of 3.4%.

Current Portfolio Positioning: Although I expect stocks to outperform bonds once the current market correction runs its course, I am somewhat cautious with the asset allocation of MAM portfolios. I

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estimate that the current allocation of most portfolios is such that they should experience 60% to 75% of the volatility of the S & P 500. While this downside protection caused portfolios to lag the S & P 500 in the first quarter, it was beneficial in the second quarter when the stock market posted mixed results.

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 June 30, 2011, the original $50,000 had risen to $89,607, plus $1,193 of cumulative withdrawals. This represents a cumulative return of 81.6%. During the same time, the S & P 500 (as represented by the Vanguard Index 500 Fund) rose 16.9%. For the quarter ended June 30, 2011, the portfolio rose 0.9% and for the first six months of 2011 it rose 4.8% All returns quoted for this portfolio (and for all MAM portfolios) are net of MAM fees. Also, past performance does not guarantee future results.

Mid-Year Economic and Stock Market Outlook

Recent Economic Numbers Have Been Disappointing: Most of the economic reports released in June were disappointing, indicating that the economy has hit a soft patch. For instance, the May employment report showed paltry growth of only 54,000 new jobs versus expectations of 180,000 and prior months' gains of 244,000 for April and 221,000 for March. The slowdown has been attributed to a combination of factors including manufacturing delays resulting from the disaster in Japan and a spike in the price of oil resulting in a sharp increase in gasoline prices.

Economic growth for the first half of 2011 was disappointing. For the first quarter gross domestic product (GDP) growth increased at an annual rate of only 1.9%, down from 3.1% growth for the fourth quarter of 2010. GDP estimates for the 2nd quarter aren't much better. The average growth forecast of economic surveyed by The Associated Press is 2.3%. The economy has to grow 3% per year just to hold the unemployment rate steady while annual growth of about 5% is needed to lower the unemployment rate by a full percentage point. The unemployment rate is currently a very high 9.1%.

Stock Market Correction- Already Over? Primarily as a result of fears of a slowing economy and renewed worries about the Greek debt crisis, the S & P 500 fell 7.3% from the end of April until June 15th. With this quarterly letter I planned to write about how I thought the recent economic slowdown and stock market stumble were temporary. That discussion became less relevant with the release last week of two positive reports that indicated the U.S. manufacturing sector returned to brisk expansion in June. As a result, stocks experienced their best week since the start of the bull market two years ago, recovering most of the losses experienced in the last seven weeks.

Despite last week's surge in stock prices, I am not convinced that the recent correction is over. Much will depend on when economic growth returns to a healthier level and employment gains accelerate such that the unemployment rate starts falling again. I am not overly concerned about the slowing economy as the recent weakness can be explained by temporary factors. These pressures appear to be reversing, which should provide a boost to second half growth. In particular, Japanese industrial production is bouncing back sharply and reduced inventories in the supply chain for technology and automotive companies are likely to be replenished over the summer, contributing to economic growth while oil prices have given back most of their recent gains.

The Federal Reserve appears to agree with this assessment of the resumption of a stronger growth. During their most recent meeting they said "The unemployment rate remains elevated; however, the Committee expects the pace of recovery to pick up over coming quarters and the unemployment rate to resume its gradual decline…" Furthermore the Fed said they will remain accommodative: "The Committee continues to anticipate that economic conditions—including low rates of resource utilization and a subdued outlook for inflation over the medium term—are likely to warrant exceptional low levels for the federal funds rate for an extended period."

Stock Market Outlook- Reasons for Cautious Optimism: Factors that could help propel a further recovery in the stock market include the fact that monetary policy remains extremely accommodative (see the Fed statement above), corporate profits are strong, inflation is low, the labor market is slowly improving (despite the lackluster hiring for May), and inflation may be near its peak in China—wholesale food prices have declined 10% from the recent peak—suggesting interest rate hikes in China and elsewhere may soon abate. Furthermore, both business and consumer loan demand are growing and the money supply is rising as well—two factors that were not evident last year and which suggest that financial conditions have come a long way since the 2007-2009 credit crisis. Together, all of these factors should help the economy continue to grow, albeit at a pace less than that typically associated with economic recovery.

Real Estate- Initial Signs of Recovery, Especially in Silicon Valley

One part of the economy that has continued to lag has been residential real estate prices. In fact, after a slight uptick in prices last year due to a since-expired Federal tax credit for first-time home buyers, prices experienced a double-dip, falling to new lows this year. Eventually real estate prices will hit bottom and then start to recover. Last week provided the first positive signs of the better times ahead. The S & P 500/Case-Shiller gauge of home prices in 20 major cities showed a monthly gain in April—its first such increase since July of 2010. Prices were up 0.7% in April when compared to March according to the report. While the report doesn't mean that housing is on the mend, it does indicate that the past year's slide in housing prices could be easing.

Locally, the news is even better. In a recent report the Santa Clara County's assessor said property values are starting to rebound, primarily in Palo Alto, Mountain View, Los Altos and Los Altos Hills. Assessor Larry Stone reported last week that the county's 2011-12 assessment roll, which provides a snapshot of the value of all properties in the county as of January 1, 2011, grew from $296 billion the previous year to $299 billion, or an increase of 0.9 percent. Stone said "Even though it's a modest increase in property assessments, the trend is encouraging. I think I can say without hesitation that we've finally hit bottom."

The real estate market in Palo Alto, in fact, really appears to be heating up. In a recent Dreyfus Properties report provided by Realtor Susan Tanner, "Palo Alto continues its meteoric charge and shows no sign of stopping. Inventory dropped 20% from May numbers last year while sales rose 6% and under contract sales were up a staggering 60%. Days supply of inventory has gone from 81 days in May 2010 to 27 days for this May." According to DataQuick, the median price of single-family houses sold in Palo Alto, home of Facebook Inc., climbed 20% in May from a year earlier. According to Ken Rosen, Chairman of the U.C. Berkley's Fisher Center for Real Estate and Urban Economics (and my favorite professor at U.C. Berkeley), developing social network companies such as Linked-In—which doubled the first day of trading—and an expected offering from Facebook will fuel a boom in some Silicon Valley cities into 2013. Rosen said "It's just the beginning of the story and I suspect we'll see an explosion in the next couple of years."

Misc Topics

1. **Updating Beneficiaries:** We maintain an Excel spreadsheet which includes the primary and contingent beneficiaries for the tax-deferred accounts we manage for clients. Last month Marilyn sent a letter to those clients who we feel may want to update their beneficiary information. *In case we didn't send you a letter, please let Marilyn know (Marilyn@mamportfolios.com) if you would like to make any changes or verify what Schwab is showing for your account(s).*

2. **Schwab eDelivery:** Most of our clients are signed up for eDelivery of trade confirmations and Schwab statements. This is a secure and efficient way to receive information from Schwab. For instance, while the eConfirms are delivered via email, they do not contain the client's full account number. As for the monthly statements, clients receive an email notifying them their statements are available. They can then access up to ten years of statements by logging on to Schwab's website. Signing up for eDelivery results in a dramatic reduction in the volume of mail clients receive from Schwab. In addition, Schwab provides a financial incentive to clients who are signed up for eDelivery as they pay a commission of $8.95 for the purchase or sale of individual stocks and exchange traded funds, versus $19.95 for those clients not signed up who have household assets of less than $1 million.

   This quarter Marilyn will send an email to certain clients who are not signed up for eDelivery or electronic delivery of shareholder communication. She will ask whether they would like to have her initiate the process to sign them up for eDelivery.

2011 FPA NorCal Conference

Last month I attended the Financial Planning Association's Northern California annual conference. This year over 650 CFP professionals attended the two-day conference held at the Palace Hotel in San Francisco. What follows is a brief discussion of four sessions and keynote speeches that I found particularly interesting:

1. Keynote Speech by Neel Kashkari: Kashkari currently is a managing director at PIMCO Funds. Before joining PIMCO in 2009, he was the Assistant Secretary of the Treasury and was picked by Henry Paulson to oversee the $700-billion Troubled Assets Relief Program (TARP). Kashkari provided an insider's view of the 2008 meltdown. In addition, his comments focused on the growing pressure that entitlements (i.e. Medicare and Social Security) will put on the government that, if left unchecked, could lead to serious fiscal problems for the U.S. Here are some of his comments:

   - The traditional patterns of indebtedness are being reversed—emerging economies (China, India, etc.) are healthy while the developed countries (U.S., Japan, much of Europe) are overleveraged. Developing economies will lead global growth so get more comfortable investing outside of the U.S.
   - Is the U.S. destined to be like Japan (who has experienced almost 20 years of no growth)? Unlike Japan, the U.S. working age population is still growing. Kashkari recommends for the U.S. to focus on education, basic research, infrastructure and high skill immigration. Also we need to give the private sector confidence—fundamental tax reform, minimize regulatory uncertainty and control deficits.

- Our political system is much better at fixing problems after they occur than it is at taking steps to prevent them. He was surprised at how quickly Congress passed TARP late in 2008 during the depths of the financial crisis.
- In terms of solving the long-term U.S. fiscal problems, everything has to be on the table (spending cuts, tax/revenue increases). Means testing and increasing the retirement age are a couple of strategies to manage the entitlement-driven crisis. The Social Security changes, though, will probably only impact future retirees, so basically we'll make our children pay.
- An eventual default for Greece is inevitable. Their economy has more debt than can be outgrown or sustained. The key is how to do it in a manner that doesn't trigger contagion or Euro crisis.
- When asked about what will be the next bubble his response was "look at the valuations of some of the social media companies".

2. <u>Keynote Speech by Michael Lewis:</u> In his 2010 best seller, *The Big Short*, Lewis begins with a crucial question, "Who understood the risk inherent in the assumption of ever-rising real estate prices, a risk compounded daily by the creation of those arcane, artificial securities loosely based on piles of doubtful mortgages?" Lewis' other best sellers include *Liar's Poker, The Blind Side* and *Moneyball*. Here are some of his comments:

    - Lewis said the financial crisis was all about incentives. Perverse incentives led Wall Street to ignore clear risks in subprime lending. Those who called out the risks were fired. He said "it's amazing what people won't see when you pay and incentivize them not to see it".
    - If Lewis could "play God", to help prevent a future financial crisis he would break up the major financial institutions into smaller entities that the government would allow to fail and forbid them from trading in securities they advise on.
    - Europe is probably where the next crisis will start. It could be Greece defaulting on its debts, which could start a domino effect.

3. <u>Savvy Social Security Planning for Couples:</u> This session was led by Elaine Floyd, CFP® an expert in Social Security planning. Floyd explained various strategies that couples could use to maximum their benefits:

    - The traditional method is where the wife, who has a low earnings history, receives one-half of her husband's benefit. For the wife to file for benefits, the husband must first file for his.
    - The nontraditional method is where the spousal benefits are not limited to the low-earning spouse. It takes advantage of little-known rules and generates additional income to the couple while one or both are delaying benefits. One version of this is for the high-earning husband to claim his spousal benefit at age 66 (his wife must have filed for her own benefit). At age 70, he then switches to his own benefit.
    - Other strategies discussed included how to maximum survivor benefits and benefits for divorced women and men.
    - Floyd's firm sells a package to financial advisors that includes two books on Social Security planning and 5 proprietary calculators to run client scenarios. MAM has ordered the package to use with clients.

4. Use of Alternatives at Mosaic Financial Partners: David Cowles, CPA, CFP® of Mosaic Financial Partners led this session. Mosaic is a Bay Area financial planning firm managing $450 million for 210 clients. Currently Mosaic allocates 20% of portfolios to alternative investments. This is roughly allocated 3% in each of 7 areas: Commodities, Emerging Market Debt, Energy MLPs, Arbitrage, Emerging Currency, Managed Futures, and Timber REITs. The appeal of investing in alternative assets is to obtain equity-like returns with investments that have a low correlation to the stock market. Currently most MAM portfolios have a 2.5% to 3.0% allocation to PIMCO Commodity (which is the same fund that Mosaic uses for Commodity exposure). In addition, most MAM portfolios include Templeton Global Bond, which invests in emerging market bonds. I am going to start tracking the JP Morgan Alerian MLP Index ETN, which is the fund Mosaic uses for energy MLPs.

Assets Under Management, Referrals and Increase in Minimum for New Clients

As of June 30, 2011, MAM assets under management were over $113 million, up from $103 million at the beginning of 2011. 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 my primary source of new clients. Effective this quarter, I am increasing the amount the minimum amount to manage for new clients to $500,000 (although 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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