

McCarthy Asset Management, Inc.

Registered Investment Advisor

Re: Third Quarter 2009 MAM Letter

October 5, 2009

Dear Client,

For the second consecutive quarter, the stock market (as represented by the S & P 500) generated a 15% quarterly gain. The S & P 500's 32.5% return over the last six months is the best since the first two quarters of 1975. I believe much of this gain was because the stock market had fallen too much and that the worst recession since the 1930's was coming to an end. Looking forward, while I think there is a good chance that stocks will continue to recover, I expect the gains will be much more moderate as the economy struggles to regain its footing.

With this report for the quarter ending September 30th, 2009, I discuss the third quarter and year-to-date performance of the market and MAM portfolios. I also summarize some of the financial events that occurred over the last twelve months and provide my economic outlook. I also touch on a few miscellaneous topics including another great opportunity to refinance a mortgage due to the recent dip in mortgage rates, efforts by the State of California to collect use tax from businesses and the announcement that we are redesigning our MAM Web site.

Enclosed are four 9/30/09 investment reports:

- *Portfolio Position Analysis*: lists your investments and how each have performed
- *Portfolio Comparative Performance Review*: portfolio performance by year and cumulatively since inception
- *Portfolio Performance Summary*: 3rd quarter and YTD 2009 portfolio rates of return
- *Realized Gains and Losses*: YTD 2009 investment realized gains and losses (included only for taxable accounts)

Stock Market & MAM Performance for Third Quarter

Stocks rose sharply for the quarter. Unadjusted for dividends, the S & P 500 rose 15.0%, the Nasdaq climbed 15.6%, the Russell 2000 jumped 18.9%, and the international equity index MSCI EAFE climbed 18.8%.

MAM Performance: Excluding the "very conservative portfolios", for the quarter, 1% of the MAM portfolios that were in existence for the quarter had performance that equaled or exceeded that of the S & P 500. The composite return of assets in MAM portfolios was a gain of 11.8% (after MAM fees) versus a gain of 15.6% in the S & P 500 as represented by the performance of the Vanguard Index 500 fund (symbol VFINX) with dividends reinvested.

Stock Market & MAM Performance for YTD 2009

For the first nine months of 2009, the S & P 500 rose 17.0%, the Nasdaq jumped 34.6%, the Russell 2000 climbed 21.0%, and the MSCI EAFE International Index rose 25.5%. These returns do not reflect reinvestment of dividends.

MAM Performance: Excluding the “very conservative portfolios”, for the first nine months of 2009, 59% of the MAM portfolios that were in existence for the whole period had performance that equaled or exceeded that of the S & P 500. The composite return of assets in MAM portfolios was a gain of 18.7% (after MAM fees) versus a gain of 19.3% in the S & P 500 (as represented by the performance of the Vanguard Index 500 fund with dividends reinvested).

Explanation of MAM performance: Most MAM portfolios continue to be positioned to experience 60% to 70% of the volatility of the S & P 500. Given this somewhat cautious asset allocation, I am pleased that nearly 60% of portfolios slightly outperformed the S & P 500 so far this year. As I mentioned in last quarter’s letter, I expect the performance of MAM portfolios to lag should the stock market continue to rally sharply. I still think it is prudent to remain defensive with portfolio positioning given the fragile condition of our economy.

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 September 30, 2009, the original \$50,000 had risen to \$73,815, plus \$1,193 of cumulative withdrawals. This represents a cumulative return of 50.0%. During the same time, the S & P 500 (as represented by the Vanguard Index 500) fell 9.4%. For the first nine months of 2009, the portfolio rose 20.9%. All returns quoted for this portfolio (and for all MAM portfolios) are net of MAM fees. Also, past performance is not necessarily an indicator of future performance.

Review of the Last 12 Months:

To put the current stock market environment in perspective, I think it is enlightening to review what has occurred during the last 12 months:

- On September 29th, 2008 the stock market experienced its worst one-day percentage loss (the S & P 500 fell 8.8%) in 21 years in reaction to the U.S. House of Representative’s failure to pass the Troubled Asset Relief Program (TARP). The measure, which was intended to stem further economic woes by stabilizing the financial sector, did subsequently pass early the following month.
- After dropping 20% for the first nine months of 2008, the stock market plunged further in October and November of 2008, driven by the failure of Lehman Brothers and AIG. For the full year, the S & P 500 had its worst year (down 37%) since 1937.
- Per the February 2009 MAM Monthly Commentary: “Just when you hoped it couldn’t get much worse, it did. This past month was the second worst February on record for the S & P 500 (1933 was slightly worse). Furthermore, the 18.6% drop for the first two months of 2009 is now the worst on record (beating out 1933 when the market fell 17.9% for the first two months). Let’s hope the historical comparison to 1933 continues as the good news is that the stock market ended up 46.6% for all of 1933! While I am not predicting that kind of recovery for 2009, the further the market falls, the greater it will eventually recover.”

- The Federal government passed the TARP in October of 2008 and followed up in February of 2009 with an \$800 billion stimulus package. The Federal Reserve was even more aggressive cutting short-term interest rates from 5.25% to a range of zero to 0.25% (where they still remain) and in March of 2009 launched a \$1.2 trillion effort to lower rates on mortgages and other consumer debt.
- Starting with March 2009, the S & P 500 recorded seven straight months of gains, with the cumulative result being a 43.8% gain. This occurred as it became clear that measures taken by the Federal government and Federal Reserve were enabling our economy to recover from the worst U.S. recession since the 1930s.

Economic Outlook:

The U.S. economy has started to grow again. After a 1% drop in gross domestic product (GDP) for the 2nd quarter of 2009, economists predict that GDP grew at a 3% annual rate for the 3rd quarter, the fastest quarterly growth in two years. The consensus is that GDP growth will slow to a 2.5% rate in the fourth quarter, because part of the third quarter was driven by the temporary government programs (cash-for-clunkers and tax credit for first-time home buyers) that “borrowed” growth from future quarters. Furthermore, demand still looks anemic outside of these artificially stimulated sectors. But the economy is still expected to grow as money is cheap, export demand is growing, inventories are lean (and need to be restocked) and fiscal stimulus will start helping.

The big question now is: Is the recovery sustainable, or is this just a temporary bounce fueled by a few one-shot government programs? The debate will not be settled anytime soon, but several underlying forces make a strong case that the upturn is durable. The key force at work is the sheer volume of fiscal and monetary policy. Its support of demand this year and next dwarfs any such effort in the downturns since World War II. To date, most of the fiscal stimulus has been targeted toward consumers. However, much of the stimulus from infrastructure spending and other government outlays are only now working its way into the economy. Housing should also be a positive. Already, the housing component of GDP is set to add to growth this past quarter for the first time in 3½ years. Furthermore, the upturn is global, with Asia, the Americas, and Europe all set to grow simultaneously. A synchronized recovery will boost the volume of world trade, which will especially benefit U.S. exporters.

Of course, consumers will be essential to a lasting recovery, and their help will require stronger labor markets. With the official unemployment rate closing in on 10%, we seem a long way from where job growth will be sufficient to support a sustainable recovery. In the last two Monthly Commentaries, I have written about the “New Normal”. After years of credit and leveraged-induced economic growth, the “New Normal” will incorporate slower economic growth, reduced consumption, higher personal savings, and a difficult employment market. As a result, I expect that returns from stocks, real estate, and commodities will be lower than their historical averages. My August 2009 Monthly Commentary provided a list of six adjustments to make in order to achieve the objective of a financially-comfortable retirement in light of the reality of the “New Normal”.

Miscellaneous Items

Mortgage Rates- Another Great Opportunity to Refinance: On October 1st Freddie Mac reported that for the most recent week, rates on 30-year home loans dropped below 5% for the first time in four months. Borrowers may want to consider the Federal Reserve’s announcement last

week that it is slowing down a program intended to lower mortgage rates and boost the housing market. Analysts say that while mortgage rates should remain low for now, they could eventually move higher, and homeowners who want to refinance mortgages shouldn't delay.

Roth IRA Conversions: Currently only taxpayers with adjusted gross income of \$100,000 or less are eligible to convert a traditional IRA to a Roth IRA. This is a compelling opportunity for anyone with very low or negative taxable income for 2009. Until early next year, though, high-income taxpayers have been precluded from converting to a Roth IRA. That changes in 2010 when new Roth conversion rules take effect, eliminating the income restriction. In addition, a special tax rule allows taxpayers who convert a traditional IRA to a Roth in 2010 to report half the resulting income on their 2011 federal income tax return and half on their 2012 return. I plan to discuss the opportunity for 2010 Roth IRA conversions further in future MAM updates.

Use Tax Letters Arriving: It will come as no surprise that the State of California is desperately looking for ways to raise revenue. Until now, CA has not had much success in collecting use tax (do you report and pay your fair share?). A recent CA law change will help in collecting use tax from CA businesses.

What is use tax? Use tax is a substitute for sales tax. All states which have a sales tax also impose a use tax. Use taxes are imposed to minimize unfair competition between sales made in-state and those made out-of-state. The use tax rate is the same as the sales tax rate. Use tax applies when sales tax has not been charged. Purchases made over the internet and out-of-state are the most common type of transactions subject to use tax.

Recently the BOE started sending letters to businesses with at least \$100,000 in business gross receipts who are not already registered with the BOE and do not hold a seller's permit. This means *all* businesses, regardless of business type must register. Businesses that receive the letter must complete the contact info and mail it to the BOE. (If the taxpayers do not respond to the letter, the BOE will register them automatically.) The BOE will then register the business and send them an account number and log-in information so that they can e-file their returns. The 2009 returns are due April 15, 2010. Taxpayers who did not report use tax for 2007 and 2008 must file returns to report and pay that tax. Sadly, the use tax reporting will now become another cost of operating a business in California.

Development of New MAM Web Site: Last month we started working with Advisor Products, the largest developer of Web sites to Investment Advisors, to redesign the MAM Web site. The targeted completion date is October 31, 2009. The new Web site will retain the same features of the existing Web site. In addition, it will offer new features including:

- Portfolio Performance reports can be loaded to the client's private, secure vault on the Web site.
- Clients will have the ability to load other documents to this vault (wills, trust documents, tax returns, etc.).
- The Web site will be regularly updated with financial planning articles; an eNewsletter will be sent to clients providing a link to the articles.
- Links will be provided from the Web site to log into Schwab and other pertinent financial Web sites.

I will keep you posted as the delivery date of the new MAM Web site gets closer.

Assets Under Management and Referrals

Assets Under Management: As of September 30, 2009, MAM assets under management were approximately \$85 million, up from \$70 million at the start of the year. Please keep us in mind if you know of anyone who is need of help with managing their investments and other financial affairs. While our minimum amount to manage for new clients is \$300,000, we are 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

Encl: Investment Reports