McCarthy Asset Management, Inc.

Registered Investment Advisor

Re: Third Quarter 2011 MAM Letter

Tuesday, October 4, 2011

Dear Client,

For the third quarter of 2011, the stock market experienced its worst three months since 2008. I expect the stock market to remain turbulent for the foreseeable future due to the risks of the U.S. slipping back into a recession and the potential fallout of the sovereign debt crisis in Europe. In this letter, I will discuss both reasons for my short-term concern as well as the potential for the stock market to recover from these relatively depressed levels. This letter also discusses:

- The New Format for Reporting that is Being Introduced this Quarter
- Economic Outlook- Is a Double-Dip Recession Likely?
- Explanation of the European Debt Crisis
- Stock Market Outlook
- Mortgage Rates at Historical Lows

Stock Market & MAM Performance for Third Quarter

Unadjusted for dividends, the S & P 500 fell 14.4%, the Nasdaq dropped 12.9%, the Russell 2000 plunged 22.1%, and the international equity index MSCI EAFE dropped 19.6%. Bonds, as represented by the Barclays U.S. Aggregate Index, rose 3.8% for the quarter.

MAM Portfolio Performance: Excluding the "very conservative" portfolios, the composite return of assets in MAM portfolios was a loss of 10.3% (after MAM fees) versus a drop of 13.9% 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 loss of 4.1%.

Stock Market & MAM Performance for YTD 2011

For the first nine months of 2011, unadjusted for dividends, the S & P 500 fell 10.0%, the Nasdaq dropped 9.0%, the Russell 2000 fell 17.8%, and the international equity index MSCI EAFE dropped 17.2%. Bonds, as represented by the Barclays U.S. Aggregate Index, rose 6.7% for the nine months.

MAM Portfolio Performance: Excluding the "very conservative" portfolios, the composite return of assets in MAM portfolios was a loss of 6.2% (after fees) versus a loss of 8.8% 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 loss of 1.0%.

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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, 2011, the original $50,000 had risen to $80,455, plus $1,193 of cumulative withdrawals. This represents a cumulative return of 63.3%. During the same time, the S & P 500 (as represented by the Vanguard Index 500 Fund) rose 0.7%. For the quarter ended September 30, 2011, the portfolio fell 10.2% and for the first nine months of 2011 it fell 5.9%. All returns quoted for this portfolio (and for all MAM portfolios) are net of MAM fees. Also, past performance does not guarantee future results.

New Format for Quarterly Reports

We recently purchased the "Enhanced Reporting Module" from Schwab Performance Technology. I am excited to introduce this new reporting format with this quarter's reports. Here are some comments:

- Visually the reports are more appealing as they are in color and include graphs.

- **Consolidated Portfolio Returns:** Consolidated portfolio returns (combining all your managed accounts) are reported for the current quarter, 2011 year-to-date, last three years, last five years, and since inception on the Portfolio Overview and Performance Summary pages.

- **Individual Portfolio Returns:** Individual portfolio returns are reported for the current quarter, 2011 year-to-date, last three years, last five years, and since inception on the Account Performance Summary.

- **Time Weighted Rate of Return (TWR):** All performance reports reflect the TWR for portfolios, which are the returns not adjusted for deposits and withdrawals. TWR is useful for comparing the performance of the investments we have selected for you to that of a market index, such as the S & P 500. In the past, MAM quarterly reports showed the Internal Rate of Return (IRR) for portfolios, which provides the measure of the growth of a portfolio adjusted for the timing of deposits and withdrawals. Effective with this quarterly reporting we are switching to TWR for three reasons. First, we have always used TWR to report quarterly, consolidated MAM performance. Second, most investment advisors use TWR to report results to their clients. And third, currently the Account Performance Summary can only display TWR.

- **No Reporting of Index Returns:** As in the past, none of the reports reflect the performance of an index such as the S & P 500. This is because we have not been able to find a data service that will provide returns for the S & P 500 with dividends. I think it would be deceptive to report the returns for the S & P 500 without dividends as that would understate the annual performance of the index by approximately 2%. Please see page one (above) for the quarterly and year-to-date performance of various indices (including the Vanguard Index 500 Fund with dividends reinvested).

- **Asset Allocation:** The asset allocation for your account(s) is provided in graphic and tabular form in the upper left on the Portfolio Overview and the individual positions by account are shown by asset class on the Portfolio Holdings page.

- **Portfolio Value vs Cumulative Net Investment** is displayed in graphic form on the lower left of the Portfolio Overview page.

Please call or email Alexey (Alexey@mamportfolios.com) or myself if you would like to have us further explain the new format of your reports. Also, I am interested in receiving your feedback regarding this new reporting. Please email me at Steve@mamportfolios.com. Currently a number of our clients receive their quarterly reporting via email. Please let us know if you would like to switch from receiving a paper copy via the U.S. mail to receiving an electronic copy via email.

Economic Outlook- Is a Double-Dip Recession Likely?

The two main fears which drove the stock market lower this past quarter were the fear that the U.S. is slipping back into a recession and the continued sovereign debt turmoil in Europe. I will discuss the former in this section and the later in the next section of this letter.

Clearly the risks of the U.S. falling back into a recession have increased over the last couple of months. This was made clear on September 30th when Economic Cycle Research Institute (ECRI) announced that the weakness in the leading economic indicators had become so pervasive that the ECRI now predicts a recession is unavoidable. The ECRI is an independent institute that publishes weekly the widely followed U.S. Leading Economic Indicators. In their 9/30 report, co-founder Lakshman Achuthan said that while "the jury was still out in late August", the further weakening in the leading economic indicators in September led them to this conclusion. Given the ECRI's past record of accurately predicting recessions, their prediction should not be ignored.

While clearly the risks are rising, I am still not convinced that a recession for the U.S. is imminent. Most economists are still predicting the U.S. economy will avoid a recession, although the growth will be very tepid. Most of the recent economic reports have been somewhat positive:

- The most recent Weekly Jobless Claims report showed first-time claims for unemployment benefits dropped to 391,000, down from 428,000 the prior week. Reports of new weekly jobless claims below 400,000 are an indicator of economic growth.
- Last week the final report for second quarter GDP showed that the economy grew at a 1.3% rate, up from 1.0% previously estimated.
- On October 3rd, auto makers reported double-digit gains in U.S. auto sales for the month of September. General Motors sales chief Don Johnson said the September auto sales and other recent economic data "all point to a slow growth scenario but not a double dip." For the month, GM's sales rose 20%, Ford's sales rose 9% and Chrysler's rose 27%.
- Also on October 3rd, the Institute for Supply Management reported that the U.S. manufacturing sector continued to modestly expand for the month of September.
- One major negative report was the August Jobs report which showed no job growth. This Friday the September Job's report will be released. Currently, economists are looking for job growth of 50,000 to 100,000 for the month.

In a recent report, Robert Johnson, Director of Economic Analysis for Morningstar, did a good job in summarizing the current state of the economy when he wrote "The economy is not booming, but it isn't falling back into the abyss. The U.S. economy is likely to remain mixed in the months ahead, with jobs and manufacturing data staying anemic at best. While sovereign debt fears, the U.S. debt ceiling crisis, and a volatile stock market are certainly weighing on consumer attitudes (as measured by major consumer confidence surveys), the other half of the consumer brain seems relatively committed to spending more cash, especially in stores."

Explanation of the European Debt Crisis

Probably the most significant concern of investors these days is whether European policymakers can contain the European sovereign debt crisis. While European countries have roughly the same amount of government debt as a percentage of GDP as the United States, the problem is the distribution of this debt. Germany has a lower, sustainable debt level, while some peripheral European countries (Greece, Portugal, Ireland, Spain and Italy) have rapidly rising, unsustainable debt levels.

- Historically, when a country was at risk of defaulting on its debts (e.g. Brazil, Argentina, etc.), there was a simple solution. The country would sharply devalue their currency to make their exports more competitive and their imports more expensive.
- The problem with Europe's Economic and Monetary Union (EMU) is that participating countries don't have the benefit of an independent currency and monetary policy. This means that for the high-debt countries to stay competitive, they must implement structural reform. Yet, significant fiscal austerity and reform may prove so challenging that a few of the most leveraged ones, like Greece, may have to restructure (i.e. default on their debts) and leave the Euro in order to restore competitiveness and reduce their debts to a sustainable level.
- The problem is that many European banks have large exposure to European sovereign debts. The fear is that if Greece and other at-risk countries default on their debts, some of these banks could potentially experience a Lehman Brothers-type crisis.
- This European sovereign debt crisis is happening at a time when global economic growth is already slowing.

In a recent report, Mark Kiesel, Managing Director at PIMCO funds (the largest bond manager in the world) listed several actions that should be taken to restore confidence in the European markets:

1. Policy makers should make clear which European sovereigns will be backed unconditionally through explicit guarantees and assist those sovereigns whose debt will ultimately be restructured (i.e. perhaps Greece and Portugal).
2. While many European peripheral countries will likely need to embrace significant budget cuts and challenging austerity measures, policy leaders should balance higher taxes and spending cuts with pro-growth structural reform which promotes privatization and allows workers to remain productive and employed longer given the need to increase retirement ages.
3. One or more of the highest debt European peripheral countries (i.e. Greece and Portugal?) deemed too insolvent may have to exit the EMU and Euro currency in order to restore debt sustainability and competitiveness.
4. The ECB should ease monetary policy and stand more aggressively behind solvent European sovereigns by acting decisively as a lender of last resort.

I think it is all but inevitable that Greece will default on its debts. The financial markets may actually welcome such a default if:

- It is presented as a "structured default" where the Greek government bonds will be restructured (i.e. their face value is reduced by some percentage).
- Simultaneous with the default announcement, a plan should be unveiled to recapitalize (i.e. add equity) to the most important banks throughout the euro zone.
- There should also be an announcement of a coordinated program among central banks, the International Monetary Fund (IMF), and sovereign wealth funds worldwide to support the government bond markets of the remaining countries in the European Union (EU).

Stock Market Outlook

With the stock market close to a year's low on September 30th, clearly there is a very high risk for the market to fall further in the short-term. There is no accurate way to determine how far the market may fall because the drop may now be driven by irrational selling from investors who are panicking. While this may present an opportunity for long-term investors, I don't plan to get more aggressive at this time due to the uncertainty of the European situation. On the other hand, please contact me if you are having a difficult time weathering this market turmoil. We can discuss whether to take steps to add further downside protection to your portfolio(s).

Impact of a U.S. Recession: I am less concerned about the impact of the U.S. falling back into a recession. Whether this happens may be only a technicality. If we do avoid one, growth is expected to be very anemic, while if we don't, the recession is likely to be mild. In contrast to 2007 and 2008 when the U.S. experienced the greatest recession since the Great Depression, the U.S. financial system is much better capitalized, the housing market is no longer significantly overvalued, and there is some demand in the cyclical parts of the economy.

Furthermore, even if the U.S. does go into another recession, the impact on the stock market may not be that significant. The 16% drop in the S & P 500 since July 7th is close to the drops experienced in prior mild recessions. According to a recent report from LPL Financial, based on their analysis of past earnings cycles, a recession level for the S & P 500 Index is about 1120, which is only 1% below where the S & P 500 closed at on September 30th. Furthermore, historically, the stock market has often bottomed before the recession was even declared.

Reasons for Longer-Term Optimism:

1. Record Corporate Earnings: Through the second quarter of 2011, there have been ten consecutive quarters of earnings increases, and the last seven have been at a double-digit year-over-year rate. Analysts currently project companies in the S & P 500 to deliver operating earnings of about $99 per share in 2011. That's well above the record $91.47 that was achieved in the 12 months that ended June 2007 and represents a 16% increase from the 2010 figure.

2. Corporations are Cash-Rich: In a recent report, Michael Rawson, CFA, an ETF analyst with Morningstar pointed out that companies in the S & P 500 now have approximately $290 per share in cash, compared with about $100 per share 10 years ago. Based on the 9/30/11 closing price for the S & P 500 index, cash currently represents 26% of the value of the index.

3. Investor Sentiment is Very Bearish: As reflected in recent American Association of Individual Surveys, investor sentiment is very negative, which historically is bullish for the future direction of stock prices. Equity mutual funds have suffered huge net liquidations for months. Negative sentiment looks similar to the spring of 2009, right before the start of a huge two-year rally.

4. American Consumers Continue to Deleverage: U.S. households have made good progress in getting their finances in order. The Household Debt Service Ratio dropped to 11.1% at the end of June after being as high as 14% in late 2007. This is the ratio of how much of the average family's gross income is dedicated to debt service. Note that this ratio was below 11% back in 1982 and 1992, which were the beginning of extended periods of prosperity. While the Americans have made steady progress in deleveraging, unfortunately the process is only just beginning for the public sector.

5. Stocks May Be Undervalued: Morningstar in their September 27th report "Our Outlook for the Market" wrote that at the close of the third quarter of 2011, the market-capitalization-weighted average price/fair-value ratio of stocks under Morningstar coverage stood at an undervalued 78%. This means that of the thousands of stocks followed by Morningstar analysts, on average they were trading at a 22% discount to Morningstar's estimate of fair value. This is in sharp contrast to Morningstar's previous quarter's outlook (issued June 29, 2011) when they felt that the stock market looked fairly valued and was trading at neither a discount nor a premium.

6. Warren Buffett's Berkshire Hathaway Inc. (BRK.A) announced on September 26th that the company is authorized to repurchase stock for the first time in four decades. At the time of the announcement Berkshire's stock was priced at less than 1.1 times book value. That level is 29% below Berkshire's average of 1.55 since 2000. Furthermore, Buffett said his company spent more to buy stocks on August 8th than any time this year. These moves are encouraging given Warren Buffett's record as one of the most astute investors ever.

Mortgage Rates at Historical Lows

Last week mortgage rates fell to historical new lows for a fourth consecutive week. Freddie Mac reported the average on a 30-year fixed mortgage fell to 4.01%. That's the lowest rate since Freddie Mac began keeping records in 1971. The last time long-term rates were lower was in 1951, when most long-term loans lasted just 20 or 25 years. For those who can afford the quicker repayment, the average on a 15-year fixed mortgage dropped to 3.28%. Rates on mortgages could fall further after the Federal Reserve announced two weeks ago that it will take further action to try to lower long-term rates.

Unfortunately many homeowners who purchased in the last five to seven years don't have sufficient equity to qualify for a new loan. This is not the case with most MAM clients. If you have not refinanced in the last year or two, I recommend you check to see if doing so would be worthwhile. Please call or email if you would like to discuss your situation. For those who do a refinance, I recommend you pay off the new loan at least as quickly as you have been paying off the current loan. In terms of a specific lender, I have had many clients do a no-cost refinance with Fremont Bank (www.fremontbank.com). Rates are now so low, though, that it may make sense to pay refinance costs to obtain an even lower rate. Please let me know if you would like the referral of a mortgage broker.

Assets Under Management and Referrals

As of September 30, 2011, MAM assets under management were over $105 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 our primary source of new clients. While our minimum amount to manage for new clients is $500,000, 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®

Encl: Investment Reports