# *McCarthy Asset Management, Inc.*

Registered Investment Advisor

Re: Fourth Quarter 2010 MAM Letter

January 4, 2011

Dear Client,

Thanks to a very strong 4th quarter, the stock market posted good returns for 2010. Combined with outstanding 2009 performance, the stock market has made up much of the losses it experienced during the 2008 Financial Crisis. With numerous signs that the economic recovery is gathering steam, the outlook for further gains in 2011 is positive.

While I was cautiously optimistic throughout 2010, the one major concern I had has now been addressed. As I wrote one year ago, "I am wary of the impact of the pending expiration of the Bush tax cuts. Raising taxes at a time when the economy is so weak would not be prudent. At a minimum, I think it is very important that these cuts be extended for one or two years for at least the middle class." In a surprising display of bipartisanship, last month President Obama reached an agreement with Congressional Republicans to extend the Bush tax cuts for everyone for two years. Despite fierce opposition from some Democrats, Congress passed and President Obama signed the **Tax Relief, Unemployment Insurance Reauthorization and Job Creation Act of 2010 ("The 2010 Tax Relief Act").** See pages 3 and 4 for a summary of the new law.

With this report for the quarter ending December 31, 2010, I discuss the performance of the market and MAM portfolios for the quarter and year. This report also includes:

- Introduction of Alexey Bulankov and Anthony Bertolacci
- Summary of the 2010 Tax Relief Act
- Outlook for U.S. Economy
- Stock Market Outlook
- Most Recent Portfolio Repositioning- Further Focus on Dividend-Paying Stocks

Please see the enclosed for your 12/31/10 investment reports.

## Stock Market & MAM Performance for Fourth Quarter

The stock market had a very strong fourth quarter of 2010. *Unadjusted for dividends,* the S & P 500 rose 10.3%, the Nasdaq climbed 12.0%, the Russell 2000 jumped 16.0%, and the international equity index MSCI EAFE rose 6.2%. Bonds rose modestly while REITs and commodities rose sharply for the quarter. Excluding the "very conservative" portfolios, the composite return of assets in MAM portfolios was a rise of 5.8% (after MAM fees), versus a rise of 10.7% 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 1.0%.

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## Stock Market & MAM Performance for 2010

For all of 2010, unadjusted for dividends, the S & P 500 rose 12.8%, the Nasdaq climbed 16.9%, the Russell 2000 jumped 25.4%, and the international equity index MSCI EAFE inched up 4.9%. Bonds, REITs and commodities all rose for the year. Excluding the "very conservative" portfolios, the composite return of assets in MAM portfolios was a rise of 10.7% (after fees), versus a rise of 14.9% for the Vanguard Index 500 Fund (symbol VFINX) with dividends reinvested. The 2010 composite return for assets in the "very conservative" portfolios was a gain of 7.7%.

**Explanation of MAM performance:** MAM portfolios under performed the S & P 500 for the quarter and the year for two reasons:

1. **Bond Allocation:** The poor performance of bonds in the later part of 2010 hurt the performance of portfolios relative to the all-stock S & P 500 Index. During November and December interest rates rose and bond prices weakened as investors became more confident that the economic recovery was strengthening. Bond prices fell further after the passage of the stimulus-loaded 2010 Tax Relief Act.

   Determining the proper bond allocation is a challenging issue because while bonds have outperformed equities for the last twenty years, *I think it is very likely that for the foreseeable future stocks will outperform bonds due to rising interest rates and inflation.* Bonds do play an important role, though, as they cushion portfolios during periods when the stock market declines. In particular, the lower volatility provided by bonds makes it easier for clients to stay invested for the long term. Due to the significant bond allocation, most MAM portfolios are currently positioned to experience 60% to 75% of the volatility of the S & P 500.

   In the December portfolio repositioning, we reduced the allocation to those parts of the bond market that are most vulnerable to rising interest rates (i.e. Treasuries and high-duration bonds). Despite taking these steps, if as I expect the stock market continues to recover in 2011, MAM portfolios are likely to under perform the S & P 500 due to their significant bond allocation. **If you are comfortable with taking on more volatility with your portfolio, please call or email and we can discuss whether I should shift part of your bond allocation to stocks.** I am hesitant to adjust all portfolios to a more aggressive allocation because I feel many clients are still concerned about another possible downturn in the stock market.

2. **International Equity Allocation:** The poor performance of international equities also hurt the relative performance of MAM portfolios. As indicated above, for 2010 the international MSCI EAFE index rose only 4.9% for all of 2010, compared to the 12.8% rise in the S & P 500. While I wouldn't be surprised to see the U.S. dollar rise and the U.S. stock markets outperform many foreign markets for 2011, my longer-term outlook is that the U.S. dollar will fall and many foreign markets will outperform the U.S. As such I think it makes sense to maintain a significant weighting in portfolios to international equities.

**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 December 31, 2010, the original $50,000 had risen to $85,500, plus $1,193 of cumulative withdrawals. This represents a cumulative return of 73.4%. During the same time, the S & P 500 (as represented by the Vanguard Index 500 Fund) rose 10.4%. For the quarter ended December 31, 2010, the portfolio rose 4.4%. All returns quoted for this portfolio (and for all MAM portfolios) are net of MAM fees. Also, past performance does not guarantee future results.

## Introduction of Alexey Bulankov and Anthony Bertolacci

As discussed in the November 2010 Monthly Commentary, after six years at MAM, Billy Alhorn has resigned to take a position at Franklin Funds, his original employer. I have taken Billy's resignation as an opportunity to rearrange and expand Billy's job duties and replace him with two employees. The first is Anthony Bertolacci, who has worked for my tax practice for the last twenty tax seasons. Anthony has been hired by MAM to take on the role of Director of Compliance. In addition, Anthony will assist with portfolio trading and assorted other tasks.

I am excited to announce that Alexey Bulankov has been hired as Financial Planner and Director of Business Development. Alexey was one of several very strong candidates that I interviewed, and I feel very fortunate to have found him. Although Alexey is only thirty-two years old, he has over a decade of experience in the financial service industry. For the last six years, he worked at the Schwab San Mateo branch managing portfolios for individuals. Prior to Schwab he worked at Citigroup and Merrill Lynch. Alexey obtained a BA degree in Economics from San Francisco State University and is a Certified Financial Planner and holds his Chartered Financial Consultant and Chartered Life Underwriter designations from the American College. He is currently a level II candidate in the Chartered Financial Analyst (CFA) program.

Adding Alexey and Anthony to the MAM team (which includes Marilyn Blancarte) adds depth and breadth to the services we provide. In particular, we plan to expand our comprehensive financial planning services. In addition, I expect Alexey to play a key role in educational workshops that we will be offering at various corporations later this year. I hope to have more to report on our effort in this area in the January 2011 Monthly Commentary.

## 2010 Tax Relief Act

On December 17, 2010, the President signed the **Tax Relief, Unemployment Insurance Reauthorization and Job Creation Act of 2010**. The following are the highlights of the new tax law as they affect individual taxpayers (business provisions are not covered here):

1. **Two-year extension of all current tax rates through 2012:** The current income tax rates will be retained for two years (2011 and 2012), with a top marginal rate of 35% on ordinary income and 15% on qualified dividends and long-term capital gains.

2. **AMT Patch:** A two-year AMT "patch" for 2010 and 2011 will keep the AMT exemption near current levels and allow personal credits to offset AMT. Without the patch, an estimated 21 million additional taxpayers would have subject to AMT in 2010.

3. **A 13-month Extension of Unemployment Insurance**

4. **Estate Tax:** The Act makes several major changes to the federal estate tax for tax years 2011 and 2012 including increasing the estate tax exemption amount to $5 million per person. The top estate and gift tax rate for these years will be 35%. Unless Congress acts again, the estate tax rate will revert to a top rate of 55% with a $1 million exemption beginning in 2013. Another change in the law is that for 2011 and 2012, when one spouse dies, any unused portion for that spouse's estate tax exemption amount may be transferred to the surviving spouse.

5. **One-Year Employee Payroll Tax Cut:** Employees and self-employed individuals will receive a reduction of two percentage points in Social Security payroll tax in 2011, bringing the rate down from 6.2% to 4.2% for employees, and from 12.4% to 10.4% for the self-employed.

6. **Extension of "tax extenders" for 2010 and 2011,** including:

   - Tax-free distributions of up to $100,000 from IRAs for charitable purposes
   - Above-the-line deduction for qualified tuition and related expenses
   - Expanded Coverdell Accounts and definition of education expenses
   - American Opportunity Tax Credit for tuition expenses of up to $2,500
   - Deduction for state and local general sales taxes (in lieu of state income taxes)
   - 30% credit for energy-efficiency improvements to the home; the new law reduces the maximum credit to $500 (down from $1500) and there are further restrictions
   - Exclusion of qualified small business capital gains

## Outlook for the U.S. Economy

Recent economic reports point toward an accelerating recovery for the U.S. economy. Even long-time bears are getting more upbeat. For instance, Goldman Sachs chief U.S. economist Jan Hatzius has lifted his 2011 forecast for GDP growth to 3.4% from 2% due to a spate of stronger-than-expected economic statistics and the significant stimulus that is expected to result from the 2010 Tax Relief Act. Similarly, the normally pessimistic Mohamed A. El-Erian, chief executive officer of PIMCO (and originator of the term "the new normal"), says the stimulus should help the U.S. expand by 3% to 3.5% in the fourth quarter of 2011 year over year. El-Erian previously predicted growth of 2% to 2.5%. Even the jobless rate, which is a lagging economic indicator, should start to improve. Some economists now predict the U.S. economy will generate two to three million jobs in 2011 and the unemployment rate will drift down to 9% by year-end (versus an average of 9.6% during 2010).

## Stock Market Outlook

I am optimistic that the stock market recovery will continue in 2011. Here are several reasons for my optimism:

- **Improving Economy:** As discussed above, the recovery in the U.S. economy is expected to accelerate in 2011, with a substantial improvement in hiring. As the economy improves, investors are likely to become more confident about investing in equities.

- **Inexpensive Valuations:** Operating earnings for companies in the S & P 500 are projected to grow from $84 for 2010 to $94 in 2011. Based on the 12/31/10 S & P 500 close of 1258, the index trades at 13.5 times 2011 estimated earnings. This compares with a median price-earnings ratio of 16.4 since 1956, according to data compiled by Bloomberg.

- **Stocks Are Attractively Priced Relative To Bonds:** The S & P 500 earnings yield, or annual profit dividend by share price, was 6.45% on December 13th. That was 3.13 % more than the payouts on 10-year Treasuries and about 2.4% more than the average interest on U.S. corporate bonds as measured by Barclays. After a two-year outflow out of equities and into bonds, recently investors started selling bonds and moving back into equities. I expect this trend will continue throughout 2011.

- **Corporations Are Loaded With Cash:** Nonfinancial U.S. companies held $1.93 trillion in cash and other liquid assets at the end of September, up from $1.8 trillion at the end of June. At this level cash accounted for 7.4% of the companies' total assets, a 51-year high. Record cash levels mean companies can increase mergers, acquisitions, and share repurchases, all of which are bullish for equities.

- **Money Market Accounts and CDs Yield Next to Nothing:** Dividend-paying stocks look particularly attractive relative to the unappealing alternatives.

- **3rd Year of Presidential Cycle:** Historically, by a wide margin the 3rd year of a presidential cycle (i.e. 2011) is the best of the four years. Since 1926 large company stocks have averaged an annual gain of 19.2% during the 3rd year. In fact, the S & P 500 index has been positive on a total return basis during the last 17 'presidential 3rd years'.

## Most Recent Portfolio Repositioning- Further Focus on Dividend-Paying Stocks

In December we repositioned portfolios. As mentioned above, one of the purposes of this was to reduce the exposure to bonds that I feel are most vulnerable to rising interest rates (i.e. U.S. Treasuries and high-duration bonds). In addition, we added another dividend fund, Matthews Asia Dividend, which invests in Asian dividend-paying stocks and currently pays a yield of 3%. Focusing on dividend-paying stocks is a theme that we have emphasized since late 2009. At that time we added to portfolios Vanguard Dividend Appreciation, an ETF that focuses on stocks which pay an increasing dividend. Last spring we added Thornburg Investment Income, a mutual fund which focuses on global stocks and bonds, and sports a yield of 6%.

As I have discussed in prior reports, historically dividend-paying stocks have out performed stocks that don't pay a dividend. In fact, nearly half of the 10% annual return for equities was due to dividends. My long-term outlook is that we will remain in a low return environment, with the stock market providing on average a 5% to 7% annual return. With a current dividend yield of 2% for companies in the S & P 500, dividends may not seem particularly appealing. There are a number of blue-chip companies, however, that pay dividends yielding 4% to 5%. Furthermore, many companies have the ability to increase their dividends and in fact, started to do so in 2010. Bill Nygren of Oakmark Fund recently pointed out that the most under analyzed statistic today is the 'S & P 500 earnings ratio retention ratio'. That ratio computes the percentage of earnings that are being held by companies instead of being paid out in dividends. Through much of history, about half of earnings were paid in dividends and about half were retained in order to invest for growth. Currently companies are paying out only 25% of their earnings and retaining 75%. The 2010 Tax Relief Act which extends the tax favorable treatment of qualified dividends for two more years will provide more incentive for companies to boost their payouts.

## ADV Part II

When you became a MAM client, we provided you with a copy of my ADV Part II. As a Registered Investment Advisor (RIA), MAM, Inc. files this 12-page document with the Securities and Exchange Commission each year. Along with other items, it contains information regarding our fees and my educational background. Each year, I am required to offer clients the opportunity to receive a copy of my most recent ADV Part II. Please let me know if you would like a copy.

## Assets Under Management and Referrals

As of December 31, 2010, MAM assets under management were over $103 million, up from $90 million at the beginning of 2010. 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. 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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