McCarthy Asset Management, Inc.
Personalized Wealth Management

January 2013 Monthly Commentary

February 1, 2013

Stock Market & Portfolio Performance

January 2013: The stock market got off to a great start for 2013 with the S&P 500 having its best January performance since 1997:

	Jan 2013	YTD 2013	Description:
Without Dividends:			
S&P 500	5.0%	5.0%	500 Largest Public U.S. Companies
NASDAQ	4.1%	4.1%	stocks trading on the Nasdaq
Russell 2000	6.2%	6.2%	2000 of the smallest U.S. stocks
MSCI EAFE	5.2%	5.2%	international stock index
U.S. Aggr Bond	(0.7)%	(0.7)%	index of U.S. bonds
With Dividends, after all fees:			
MAM portfolios	3.6%	3.6%	non-very conservative MAM portfolios
MAM Conserv	1.1%	1.1%	very conservative MAM portfolios

Comment: With January's strong performance, it appears that investors have become more bullish given the partial fiscal cliff resolution, continued slow but steady growth in the economy, and a reduced appetite for bonds given the eventual rise in interest rates.

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The Rodney Dangerfield of Bull Markets

Last month USA Today ran an article titled “This Bull Market Gets No Respect”. Since the stock market hit bottom on March 9, 2009, the S&P 500 has risen 121%. The S&P 500 is now within 4% of its October 9, 2007 all-time high of 1565. Despite the sharp rise in the market, investors have given it the same treatment the late Rodney Dangerfield use to quote (“I don’t get no respect”).

As Gene Needles, CEO of American Beacon Funds, was quoted in the USA Today article “Most investors don’t know how strong the market is because they have focused on the short-term volatility. They think the market is down. They’ve been reading all of the dire headlines. The financial crisis. Fiscal cliff. Debt-ceiling debate. Europe. Pick your poison. It hasn’t felt like a bull market. It’s not like in the 1990s when there was a ticker-tape-parade type atmosphere every day on Wall Street.” Here are reasons why some investors are still fearful of stocks:

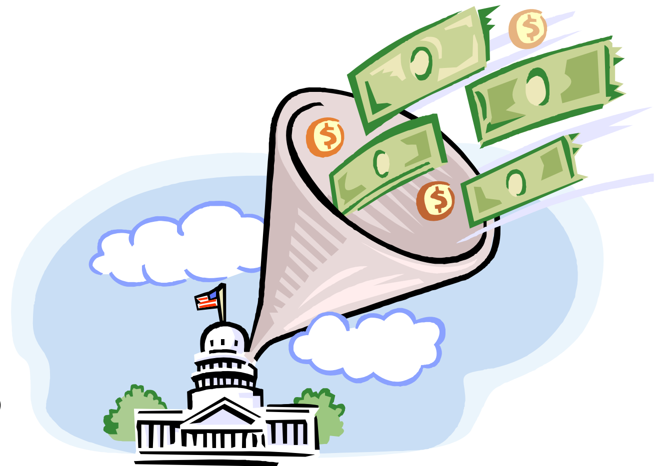
- With the media focused on the negative headlines, the public has been led to believe things are worse than they really are.
- With two 50% drops in the S&P 500 since 2000, some investors are leery of stocks expecting them to fall sharply again.
- The fear (which I think has some credence) is that the economy has been supported in large part by the policies and actions of lawmakers in Congress and central bankers, such as the Federal Reserve and European Central Bank. Some Wall Street bears argue that the stock market gains have been artificially inflated by the stimulus injected into markets by bankers. What is going to happen when the “punch bowl” is removed? I think this is a valid concern, and is partly why we are currently maintaining a significant weighting in bonds in MAM portfolios.

Fund Flows- Starting to Favor Stocks: As discussed in the 4th Quarter MAM letter, the lack of respect for the stock market by individual investors can be seen with how since March of 2009 domestic equity mutual funds experienced nearly $400 billion in net outflows (while bond funds received an even larger net inflow). There are now early signs that investors may finally be getting over their aversion to stocks. A total of $6.8 billion shifted into U.S. stock mutual funds in the first three weeks of 2013, according to mutual-fund tracker Lipper, Inc. That is the biggest inflow since 2001. I feel this shift toward positive inflows into stock funds may be sustainable for some time as there really are currently no good alternatives to the stocks.

Bloomberg Poll: Investors Optimistic on 2013 Stock Prospects: Bloomberg just wrapped up its quarterly survey of global investors. According to the report, investors are the most optimistic on the prospect for stocks relative to other asset classes since 2009, when the survey began. Here are a few of the results:

- 53% of investors polled expect stocks to be the asset class with the highest return in 2013. This is a 17% point jump from the last poll in November.
- 53% consider the US economy to be “improving”.
- Fears of a Greek debt default appear to have faded. 69% still see Greece as likely to default, which is the smallest number since September of 2010.

New Regulations Help Explain the 3.8% Healthcare Surtax



The tax landscape is changing dramatically in 2013. In addition to the new taxes resulting from the fiscal cliff agreement (see 4th quarter letter for more information), the 3.8% Medicare surtax takes effect this year. The tax, which was authorized by the 2010 Affordable Care Act (ObamaCare), is added on to any regular income tax you owe on investment income. At the end of 2012, the IRS issued proposed regulations explaining the rules for the surtax. The new regulations, plus answers to frequently asked questions (FAQ) posted on the IRS website, can help explain the new legislation.

Here are the basis rules: Beginning in 2013, a 3.8% Medicare surtax applies to the lessor of **"net investment income" (NII)** or the amount by which your modified adjusted gross income exceeds:

- $200,000 for single filers
- $250,000 for joint filers

NII is defined to include interest, dividends, capital gains, rents, royalties, nonqualified annuities, income from passive activities, and income from the trading of financial instruments or commodities.

NII does not include most other income including wages, self-employment income, Social Security benefits, tax-exempt interest, operating income from a non-passive business, and distributions from a qualified retirement plan.

To arrive at NII, gross investment income is reduced by deductions that may apply. According to the FAQs on the IRS website, a few examples are investment income expenses, advisory and brokerage fees, expenses related to rental and royalty income, and state and local income taxes related to items included in NII.

Note that for a gain from the sale of a principal residence, only the gain above the exclusion amount ($250,000 for single filers and $500,000 for joint filers) may be subject to the 3.8% additional tax (i.e. depending on the taxpayer's level of modified adjusted gross income).

Sonders Update on Real Estate Recovery

One year ago, in the January 2012 Monthly Commentary, I wrote a piece titled "Real Estate- Has It Hit Bottom?" In the article, I suggested that real estate may finally be taking a turn for the better. I offered to email anyone interested an 11-page article from Liz Ann Sonders, Chief Investment Strategist at Charles Schwab, titled "Rock Bottom: Housing May Have Already Hit It". I respect what Sonders has to say about real estate as she wrote a timely, pessimistic article about housing in 2006 ("Housing: ARMed and Dangerous") just before the start of the housing crash.

Now one year later, it is clear that real estate did hit bottom and a recovery started in early 2012. On January 15, 2013, Sonders wrote a housing update titled "Rehab- An Update on Housing Recovery". *Please let me know if you would like a copy of this 7-page update.* Here are the highlights of the Sonders' update:

- The National Association of Home Builders' Housing Market Index has staged a record- breaking run higher.
- Home prices have been rising and are feeding into real mortgage rates, consumer confidence, household net worth…and pushing fence-sitters off the fence.
- Housing's contribution to job growth could push the unemployment rate down more quickly than many believe.

Q&A

Please let us know if you have any questions you would like us to answer in a future Monthly Commentary. The questions below are ones that we have heard from clients.

Q: Should you reduce my bond exposure given the likelihood that interest rates are going to eventually start rising?

A: Unless you have a pretty conservative risk profile, probably yes at some point. In particular:

- Bonds have performed very well during the last 10 to 15 years. In fact, bonds have outperformed stocks during this timeframe as interest rates declined dramatically (generally bond prices rise when interest rates fall).
- With interest rates now near record lows, bonds are unlikely to produce significant additional capital gains. In fact, once interest rates start to rise, bonds (particularly long-term government bonds) will experience capital losses.
- Furthermore, with rates near record lows, the current yield on bonds is very low, resulting in only modest returns if interest rates don't rise.
- Probably for at least the next year or two, though, it is unlikely for interest rates to rise significantly as the economy is still sluggish and the Federal Reserve has gone on record saying they won't start increasing interest rates until unemployment falls below 6.5% and/or inflation rises above 2.5%.

Relative to cash alternatives (savings accounts & CDs), I feel that bonds are still attractive. **The more important question is whether an investor should shift part of their bond allocation to stocks.** Generally, I think this makes sense to do, particularly into dividend-paying stocks, as long as the investor is comfortable with the greater volatility of investing in stocks. The main reason that MAM portfolios contain a significant allocation to bonds is for the downside protection that bonds will provide should the stock market experience a significant decline. Furthermore, MAM portfolios have little exposure to U.S. government bonds, which are the bonds most vulnerable to capital losses once interest rates start to rise. ***Please let me know if you would like to discuss reducing the bond exposure in your portfolios.***

Q: Given the large run-up in stock prices since March of 2009, does it make sense to invest more in the stocks now?

A: While stock prices have doubled since their March 2009 lows, the S&P 500 has just now gotten back to 1500, which is still below the record close it reached of 1565 on October 9, 2007. Ignoring dividends, the S & P 500 is basically flat with where it was nearly 13 years ago (on March 22, 2000 it closed at 1501).

- Back in 2000, the S&P 500 was trading at a forward price-earnings ratio of around "26", which was nearly double the historical average of around "15". Since then earnings have more than doubled, while the index is back to near the peak it reached in 2000. As a result, currently the forward price-earnings ratio for the S&P 500 is a reasonable "13.5", indicating that the stock market is not overvalued. Furthermore, the current dividend yield on the S&P 500 is 2.3% now, compared to only 1.1% in March 2000.
- As discussed in my 4th quarter 2012 letter, there has been a large outflow out of stock mutual funds the last few years and a very large inflow into bond funds. This is the exact opposite of what happened with the massive flow into stock funds just prior to the stock market peak in early 2000. Given the dismal market timing record of individual investors, these outflows also give me confidence that stocks will outperform bonds for the foreseeable future.
- We are experiencing a "slow growth" economy which is historically a very good environment for the stocks. My feeling remains that stocks will average an annual return of 5% to 8% for the next 5 to 10 years. While this may seem modest compared to the long-term 10% annual returns historically earned by stocks, I think it is still favorable relative to other investment opportunities.

Q&A Continued

Q: If I save 10% of my income every year and retire at 65, what is the likelihood my money will last until age 95?

A: An article in the January issue of Money Magazine asked this question. The answer given was saving 10% will give you a 40% chance of your money lasting until age 95. If you bump your savings up to 15% (ignoring any company match), the likelihood that your funds will last until age 95 increases to 83%. These probabilities are just approximations. The actual results depend on many factors including your level of spending in retirement, the rate of inflation during retirement, and how well your money is invested. For a much more extensive and personalized answer to this question, we recommend you have us prepare a Retirement Analysis for you.

2012 Tax Reporting

Schwab 1099s: As with last year, Charles Schwab plans to mail their 2012 Form 1099-Composite in mid-February. As with the last few years, Schwab is issuing the Form 1099s later to minimize the issuance of corrected Form 1099s. This worked well the last three years as there was not a need to amend previously-filed tax returns for the corrected Form 1099s that were issued later in February.

For those of you who are tax clients, there is no need to wait until you receive your Schwab Form 1099 before providing us with your tax packet. Schwab will be providing us with a copy of the Form 1099 for accounts that we manage. If you have everything else, please provide us with your tax packet.

Cost Basis Reporting: The Form 1099-Composite will include a "Realized Gain or (Loss)" report which should be used to report the realized gains and losses on your 2012 tax returns. The IRS will also be sent a copy of this report. Because the Gain-Loss report is now included in the Form 1099, we will no longer be mailing a full-year Gain-Loss Report to MAM clients that are not tax clients.

Form 1099 Reporting for Schedule C and Schedule E: As in prior years, businesses and rental property owners are required to file Form 1099-Misc for annual payments of $600 or more to unincorporated persons, vendors, subcontractors, independent contractors, and others. **Since 2011, Schedule C (for sole proprietors) and Schedule E (rental property owners) asks whether Form 1099-Misc were required to be filed and whether they were in fact filed.** If you file a Schedule C or Schedule E and you are a tax client, please indicate in the tax organizer (in the section highlighted on Schedule C or Schedule E) whether you filed all required Form 1099s. The penalty for not filing a Form 1099-Misc has been increased to $100 per occurrence.

Sincerely,

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Our Services

McCarthy Asset Management, Inc. (MAM) is an independent, privately owned Registered Investment Advisor firm. We provide clients with the peace of mind that comes from knowing professionals are managing their financial affairs. The services we offer include:

Investment Management Services:

- **MAM creates and manages customized investment portfolios based on each client's investment objectives, timeframe and risk tolerance.**

Financial Planning Services:

- **The Net Worth Analysis (NWA) tracks the accumulation of Invested Assets for pre-retirees and the retention of Invested Assets for retirees. Updated annually.**
- **"Retirement Analysis" a comprehensive analysis of your retirement goals, which produces easy-to-read, interactive working plan, stored in the cloud. Updated as needed for life events.**

Tax Services: Clients have the option of utilizing the income tax services provided through the firm Stephen P. McCarthy, CPA. These services are offered at an hourly rate and may include:

- **Tax Return Preparation**
- **Income Tax Projections**
- **Tax Minimization Ideas**
- **Tax Authority Representation**

Other Services: MAM has retained several outside experts, whose services are available at no cost to our clients:

- **Long Term Care Planning– Allen Hamm of Superior LTC Planning Services, Inc.**
- **The Savvy Life® Classes and Workshops by best –selling author Melis-**

Reminders

ADV Part II: You were provided a copy of our ADV Part II when you became a MAM client. As a Registered Investment Advisor, we file this document with the Securities and Exchange Commission. Along with other items, it contains information regarding our fees and our educational backgrounds. Each year, the SEC requires us to offer clients the opportunity to receive a copy of our most recent ADV Part II. Please let us know if you would like to receive a copy.

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