McCarthy Asset Management, Inc.
*Personalized Wealth Management*

# July 2013 Monthly Commentary

August 1, 2013

## Stock Market & Portfolio Performance

***July 2013:*** U.S. and international stocks performed very well for the month, with most U.S. stock indices closing near all-time highs. The aggregate bond index was slightly positive for the month and still negative for the year-to-date.

| | July 2013 | YTD 2013 | Description: |
|---|---|---|---|
| Without Dividends: | | | |
| S&P 500 | 5.0% | 18.2% | 500 Largest Public U.S. Companies |
| NASDAQ | 6.6% | 20.1% | stocks trading on the Nasdaq |
| Russell 2000 | 6.9% | 23.1% | 2000 of the smallest U.S. stocks |
| MSCI EAFE | 5.2% | 7.5% | international stock index |
| U.S. Aggr Bond | 0.1% | (2.3)% | index of U.S. bonds |
| With Dividends, after all fees: | | | |
| MAM portfolios | 3.3% | 11.5% | non-very conservative MAM portfolios |
| MAM Conserv | 1.3% | 2.5% | very conservative MAM portfolios |

*Comment: Pending approval from each client, we have been modestly shifting 2% to 3% of most portfolios' bond exposure into equities.*

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# Investors Moving Out of Bonds and Into Stocks

**Mutual Fund Flows:** Reversing a multi-year trend, recently mutual fund investors became net sellers of bond funds and net buyers of stock funds. This was primarily in reaction to a sharp drop in bond prices in the latter half of the second quarter. According to Strategic Insight, a mutual fund industry research and business intelligence provider, bond funds had net redemptions of 1.8% of their total assets in June, equal to $59 billion (excluding ETFs). "The high redemptions among bond funds during June should be viewed as an aberration. Historically, stock or bond fund redemptions driven by sharp price corrections have always been limited in magnitude, short in duration (a few days, a few weeks), and non-recurring. Similarly, bond fund flow activity moderated in July and modest bond fund inflows to selected categories would resume in the 2H'13," suggested Avi Nachmany, Strategic Insight's Director of Research. "I also expect further gains in demand for stock funds in 2H'13—adding to the $219 billion invested in stock and balanced funds and ETFs in the 1H'13—as slow but steady economic improvements persist."

**MAM Portfolio Adjustments:** As we discussed in the June Monthly Commentary, fortunately we started to shift part of the bond allocation into equities in January of this year. We did this because as interest rates reached near record lows, we felt confident that stocks would outperform bonds over time (although with greater volatility). Currently, portfolios have approximately a 32% allocation to bonds and cash, down from 42% at the start of 2013. In the June Monthly Commentary, we asked you to contact us if you would be comfortable with a further modest reduction in your bond allocation. Since then we heard from or reached out to nearly half of our clients. The vast majority agreed to have us make this additional adjustment. **If we haven't heard from you, please let us know whether you would be comfortable with us further reducing your bond allocation by an additional 2% to 3% (with the risk being that your portfolios could be a little more volatile).**

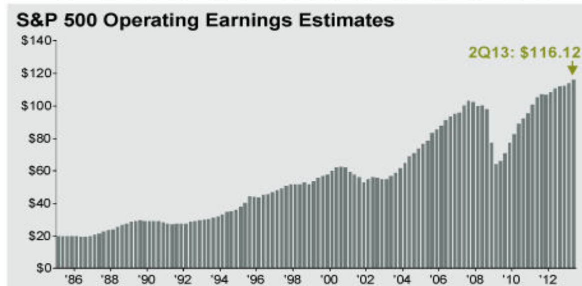
**Our Outlook for Bonds:** After a 2.4% average loss for all bond funds in June (as a result of an overreaction to a June 19th statement from the Federal Reserve after the conclusion of a 2-day meeting), bond prices partially recovered in July. Our outlook for bonds for the remainder of 2013 is for low single-digit returns, as the Fed starts to taper their monthly bond purchases. This assumes that economic growth will pick up modestly and the unemployment rate continues its slow descent.

**Our Outlook for Stocks:** After very strong performance in July, most stock market indices are near record highs. Meanwhile, investors are finally warming up to stocks as they move money away from bonds. In normal times, this would be a cause for concern. Individual investors have historically been like bad party guests—late to arrive and among the last to leave. While we feel that equity returns will likely be muted for the next five to ten years, stocks are still appealing relative to nearly all other alternatives (bonds, cash and alternative assets).

**Shiller Price-Earnings Ratio:** According to certain measures, the stock market currently appears richly priced. For instance, the popular Shiller Price-Earnings ratio, which compares the price of the S&P 500 to its average earnings for the last ten years, is currently at "24", well above the average of "19.1" since 1953 (see chart on the right). According to Robert Shiller, past data suggest that a P/E of "24" would lead to an average annual return in the ensuring 10 years of 2.7% after inflation. While this may seem fairly dismal, this equates to annual returns of 5% to 6% assuming an annual inflation rate of 3.0%, which compares favorably to bonds, cash and most alternative assets.

Furthermore, we are not so sure that the Shiller P/E ratio is as valid today, as earnings for the last 10 years includes a nearly three-year period of very depressed earnings that occurred during the financial crisis. Based on expected corporate earnings for the next 12 months, the stock market appears to be reasonably valued as it currently trades at a forward price-earnings ratio of 14.5, compared with its average of 16.6 since 1999, according to FactSet (see chart on the right).

**Be Prepared for a Stock Market Pullback:** While our outlook for the stock market is modestly positive, the market is still overdue for a correction. So far this year's biggest pullback has been 6%, compared to the average annual pullback of approximately 15% over the past 33 years according to J.P. Morgan. While we don't believe that investors can successfully time these corrections, it is important to be prepared for them so you don't overreact when they do occur.




Source: (Top) Standard & Poor's, FactSet, Robert Shiller Data, J.P. Morgan Asset Management.
Price to Earnings is price divided by consensus analyst estimates of earnings per share for the next 12 months. Price to Book is price divided by book value per share. Data post-1992 include intangibles and are provided by Standard & Poor's. Price to Cash Flow is price divided by consensus analyst estimates of cash flow per share for the next 12 months.

# Real Estate Prices Recovering Rapidly

**Recent Results Very Strong:** Home prices during the first half of 2013 posted their largest gain since the housing boom peaked seven years ago. Nationally, home values rose by 5.8% in June from one year ago, according to Zillow Inc, the real-estate website, the largest gain since 2006. So far this year, prices are up 2.7%, the strongest year-to-date gain in June since 2005.

A separate and widely watched index released this week reported that home prices in 20 major U.S. cities rose by 12.2% in May from one year earlier. The Standard & Poors/Case-Shiller index showed that home prices are now down 24.4% from their 2006 peak, compared with a peak-to-trough decline of 35.1% in March of 2012. Some economists say the Case-Shiller index overstates the magnitude of recent price increases because it includes the impact of foreclosures. Foreclosures, which tend to sell at a discount, made up an unusually high percentage of sales as real estate prices plunged. The Zillow index, by contrast, doesn't include foreclosed properties, minimizing potential volatility from this shift in sales mix (foreclosures now make up a lower proportion of home sales).

**Comments Re Real Estate Prices From Prior Monthly Commentaries:**

Below are comments from the three times since late 2009 that we discussed the state of the housing market in our Monthly Commentaries and Quarterly Letters. While it was clear to us that it would be just a matter of time before real estate prices would start to recover, it was difficult to tell preciously when the recovery would begin.

***September of 2010:*** *"I have often written about the dismal track record of investors' performance resulting from the ill timing of their purchases and sale decisions. This pertains to not only the stock market, but also to bonds, commodities and real estate. A common tendency is for an investor to "chase performance" and purchase an investment after it has had very strong performance…I recently read an interesting comment from Richard E. Band's Profitable Investing. Band wrote that with gold trading at over $1300 an ounce, it now costs 138 ounces of gold to purchase a typical existing home in the United States. Ten years ago, the same house cost 498 ounces of gold. In other words, during the last ten years home prices have dropped 72% relative to the price of gold. Which is the better buy now? While many may now be looking to invest in gold as an inflation hedge, it is clear to me that real estate currently offers better long-term value."*

***March of 2011:*** *"Despite mortgage rates near sixty-year lows and home affordability at the highest level in many years, real estate is still hampered by a glut of foreclosures that are dragging down home prices, high unemployment and tight credit…It has been nearly five years since real estate prices peaked in mid-2006. Since then prices have fallen approximately 30% and are back down to where they were in April of 2002…Like the stock market, I feel it is nearly impossible to time the real estate market to buy at the bottom. For those who are looking to buy their first home or to upgrade to a more expensive home, I think now is a good time to start looking…While a sustained rise in real estate prices may still be a couple of years away, I don't think it is likely that prices will fall much further."*

***January of 2012:*** *"The news regarding housing has been bad for so long (since 2007) that a sustainable recovery in prices may still seem far away…No doubt it will take time to work through the massive foreclosure and short-sale inventory and to get banks to lend again more readily. Still recent data indicates that the housing sector is in the process of turning the corner with the prospect that 2012 could be a better housing year than 2011…"*

# Outlook for Real Estate Prices

While we expect home prices to continue to recover, we also expect it will take many years for prices to return to the over-inflated levels they reached in 2006. Furthermore, we expect the recent sharp recovery in prices will probably moderate for the following three reasons:

Rising mortgage rates: Since mid-May, mortgage rates have jumped nearly 1%, although they still remain attractive. Rising rates are most likely to slow price rises in more expensive markets such as coastal CA.

Potential for more supply: For now, inventories remain tight in the majority of the nation's major housing markets. Currently many of the major markets have a 2.5 to 3.0 month supply on the market, compared to a more typical six-month supply (nationally, at the end of June the supply of existing homes for sale stood at five months). There have been recent signs, though, of an increase in supply as homeowners take advantage of recovering prices.

Decreased demand from investors: In the past couple of years, a historically high percentage of real estate buyers were investors purchasing rental property or planning to resell for a quick profit. These investors were an important source of demand as real estate prices reached their bottom and started to recover. With prices now significantly above their lows, it appears the demand from investors has started to wane.

# Having a Plan for Long Term Care is Crucial
## by Allen Hamm

Notice the emphasis on the word ***Plan*** in that title. Planning for the risk of long-term care is crucial, but the option each family chooses to mitigate the risk is an individual decision.

Most of you are familiar with the issue of long-term care but here's a quick refresher:

Long-term care is defined as needing assistance for at least 3 months, due to a mental or physical disability. It's not covered by Medicare or regular health insurance. The 4 ways to pay for long-term care are to rely on:

- Family
- Welfare
- Your assets
- LTC insurance

Most of our clients are too independent to rely on a family member (at least as a pre-planning option); and virtually none of our clients would qualify for the welfare program. So a discussion about which option is appropriate to pay for care normally boils down to choosing between your assets or LTC insurance (or a combination of these two options).

The LTC insurance industry continues to evolve and part of that evolution includes higher premiums and more difficulty in obtaining the coverage, due to health issues that may have developed prior to applying for insurance. So a nice place to be (or get to as soon as possible) is feeling comfortable relying on your assets. By being in this situation, you're able to avoid paying insurance premiums that will amount to tens of thousands of dollars over your lifetime.

Allen Hamm

Allen Hamm is the author of the book How to Plan For Long-Term Care and the creator of the Smart LTC Planning System. Allen's services are available at no cost to MAM Clients

A good process for discovering whether or not you feel comfortable relying on your assets is to go through an ***LTC Probability Analysis***. This exercise can help you get clarity on how long you might need long-term care, based on your genetic history and your personal health and lifestyle.

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*As you'll remember, we've retained the services of Allen Hamm, author of the book "**How to Plan for Long-Term Care**", to assist our clients in the area of long-term care. He's developed a simple software program that provides you with your individual odds of needing long-term care for less than a year, one to five years, and over five years. Armed with this information, you can better choose your most appropriate option for paying for care.*

*If you would like to set up a phone consultation with Allen to go through this brief analysis (or to assist you with reviewing current LTC insurance that you may own), please let us know. There's no charge to you for these services, because we have Allen on retainer, as a value-added benefit of being our client.*

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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, Workshops , and One-on-One Consultations by best-selling author Melissa Tosetti**

# Reminders

*Although mortgage rates recently spiked, rates are still pretty low. If you have been thinking of refinancing your mortgage and haven't recently done so, we recommend you look into it. We expect mortgage rates to continue to rise over time.*

Discover the difference with a Registered Investment Advisor.