McCarthy Asset Management, Inc.
Personalized Wealth Management

2nd Quarter 2013 Letter
(also June 2013 Monthly Commentary)

July 1, 2013

Stock Market & Portfolio Performance

Inside this issue:

Market & Portfolio Performance	1
Surge in Interest Rates	2
Impact of Raising Rates on the Stock Market	3
Time to Switch from Bonds to Stocks?	3
Finding Money by Melissa Tosetti	4
Our Services	5

2nd Quarter 2013: While U.S. stocks performed well, foreign stocks and bonds did not. For the first six months of 2013, the foreign stock index was up only 2.2% while the U.S. bond index declined 2.4%.

	2nd Qtr 2013	YTD 2013	Description:
Without Dividends:			
S&P 500	2.4%	12.6%	500 Largest Public U.S. Companies
NASDAQ	4.1%	12.7%	stocks trading on the Nasdaq
Russell 2000	2.6%	15.1%	2000 of the smallest U.S. stocks
MSCI EAFE	(2.1)%	2.2%	international stock index
U.S. Aggr Bond	(2.3)%	(2.4)%	index of U.S. bonds
With Dividends, after all fees:			
MAM portfolios	0.6%	8.0%	non-very conservative MAM portfolios
MAM Conserv	(1.3)%	1.1%	very conservative MAM portfolios

Comment: As discussed in this letter, the fear that the Federal Reserve may start to reduce their bond purchases negatively impacted nearly all assets classes in June. As discussed on P. 3, this year we have been shifting part of the bond allocation in portfolios into equities.

Advisor Team

McCarthy Asset Management, Inc.

Three Lagoon Drive Suite # 155
Redwood Shores, CA 94065
USA

STEVE MCCARTHY
CPA, CFP®,
Owner and Principal
650 610-9540 x 303
steve@mamportfolios.com

ALEXEY BULANKOV
CFP®, ChFC, CLU, EA
Financial Planner
Director of Business Development
650 610-9540 x 304
alexey@mamportfolios.com

ANTHONY BERTOLACCI , RTRP
Director of Compliance
Tax Accountant
650 610-9540 x 302
anthony@mamportfolios.com

MARILYN BLANCARTE
Executive Assistant
650 610-9540 x 305
marilyn@mamportfolios.com

Surge in Interest Rates

Longer-term interest rates shot up during the middle of May as bond investors became much more focused on when the Federal Reserve would start "tapering" their bond-purchase stimulus program. As a result, stock and bond prices slumped. In a June 19th press conference following a two-day Federal Open Market Committee (FOMC) meeting, Fed Chairman Ben Bernanke provided markets with a clearer understanding on how the Fed expects to phase out its current quantitative easing (QE) program.

The timetable, while never previously explicitly outlined, should not have been a surprise to most market observers. Nevertheless, Mr. Bernanke's words were met with a sharp selloff across a wide range of financial assets. For investors, it is important to distinguish between logical market reactions and over-reactions while still positioning portfolios for an environment of rising interest rates.

Here are some of the key points from Chairman Bernanke's statement:

- Risks to the outlook for the economy and the labor market had "diminished since last fall". This is significant as the latest version of QE, the Fed's $85 billion-a-month purchases of Treasury and mortgage bonds), was initiated last fall.
- Bernanke outlined the possible path a tapering program could take: If the economy unfolds as the Fed expects—and he emphasized the "if"—it would reduce later this year the size of its bond purchases. He said the plan is to cease QE in mid-2014 if "subsequent data remain broadly aligned with our current expectations" that unemployment will fall to about 7% (it is currently at 7.6%).
- He emphasized that the central bank will be watching the data closely and staying flexible on policy. Even once a "tapering" process has started, it could accelerate, stop or reverse it depending on developments in the economy. The markets seemed to ignore this point. If growth does not improve or if it weakens, the purchase program could be extended or even increased.
- Bernanke repeated his previous vow to keep short-term interest rates near zero "at least" until unemployment falls to 6.5%, and possibly for "several quarters after that". 14 of the 19 FOMC members don't expect to raise short-term interest rates until 2015 at the earliest.

Rise in the Yield on 10-Year U.S. Treasuries: Our feeling is that while there is little doubt the interest rates will be higher over the next couple of years, the market overreacted to the latest statements from the Federal Reserve. In less than two months the yield on U.S. Treasuries surged nearly 1%, from a near-record low of 1.66% on May 1st to 2.59% on June 25th. Why are longer-term interest rates climbing when the Federal Reserve stated that they expect to keep short-term rates near 0% until 2015? A little background will help to explain this. After the Fed reduced the federal funds rate to near 0% in response to the financial crisis a few years ago, they then instituted quantitative easing (QE) as a means of pushing down the rate on longer-term bonds such as the 10-Year U.S. Treasury.

In a recent research report, the Schwab Center for Financial Research said that based on the historical relationship between nominal GDP growth, inflation and Treasury yields, it estimated that long-term interest rates would likely increase by 1.0% to 1.2% as a result of the Fed unwinding QE. Therefore, they estimate that the 10-year Treasury yields could rise toward 3% before the Fed begins to raise short-term rates. Based on this estimate, much of this increase has already happened.

Mortgage Rates: Since early May mortgage rates have spiked sharply. In late June the average rate of a 30-year fixed-rate conforming mortgage jumped to 4.5%, up from 3.4% in early May. 0.5% of this increase occurred the last week of June, the largest weekly increase in mortgage rates in more than 26 years. As a result, there has been a dramatic drop in refinancing activity, which is very sensitive to rate increases. Even with this recent jump, mortgage rates are still low—close to half-century lows. While many economist say the residential real estate market is well-positioned to keep growing, a further significant rise in rates could slow the pace of price and sales gains.

Impact of Rising Rates on The Stock Market

The recent sharp rise in longer-term interest rates due to concerns about the Federal Reserve scaling back its stimulus program has pressured nearly all asset classes:

- The S&P 500 slipped 3.9% during the two-day period ending June 20th.
- Foreign stocks fell even more than U.S. stocks.
- Bond prices fell sharply as the yield on the 10-year Treasury spiked to a 22-month high.
- The price of gold has been in a near free-fall. On June 26th gold closed at $1201, down 10% since June 19th and 27% since the start of 2013.
- What was odd was that the price of nearly all asset classes fell during this time. Typically stock and bond prices have a low correlation to each other (i.e. they don't move in sync) and gold prices have a zero or even negative correlation to stock and bond prices. This indicates to us that markets are acting irrationally.

If this is the beginning of a prolonged period of rising interest rates, what could that mean about the prospects for the stock market? The answer may be, "not bad". Birinyi Associates, a stock research firm, analyzed nine periods since 1962 when the yield on the 10-year Treasury significantly increased over a sustained period of time. They found that *from the start of the rise in rates, the S&P 500 increased a median 0.8% three months later, a median 11.3% six months later and a median 13.8% a year later.*

How can this be? Aren't rising interest rates supposed to hurt stock prices? It appears that *it is not so much the increase in rates that hurts, but the absolute level of rates.* According to a Standard & Poor's study that tracked market performance going back to 1953, U.S. stocks actually posted their best returns when 10-year Treasury yields rose towards 4%. On the other hand, when yields exceeded 6%, stocks started to lose money. "The 'sweet spot' for equity prices appears to be a rising rate environment between 3% and 4%, as a growing economy reduces unemployment while increasing corporate earnings, yet does not trigger growth-slowing efforts by the central bank,", explained Sam Stovall, S&P's chief equity strategist. The 10-year Treasury closed at 2.5% at the end of June (up from 1.7% on May 1st).

Time to Switch from Bonds to Stocks?

<u>We Have Lowered Bond Allocations:</u> Given that our portfolio changes tend to be done in moderate increments, so far this year we have been somewhat aggressive in shifting from bonds into stocks. MAM portfolios have had a relatively large weighting in bonds since the 2008 financial crisis. At the beginning of 2013, in total MAM portfolios had approximately a 42% allocation to bonds. In January of this year we did an unscheduled portfolio repositioning and shifted part of the bond exposure to stocks. We extended this with last month's semi-annual repositioning when we shifted another part of the bond exposure to an exchange traded fund that invests in low-volatility emerging market stocks. As a result of these two moves, in aggregate MAM portfolios currently have approximately a 35% allocation to bonds.

The reason we haven't been even more aggressive in shifting from bonds into equities is that the primary purpose of the bond allocation is to reduce the volatility of portfolios. Given that many MAM clients are at or close to retirement age, it is unlikely that we would lower the aggregate portfolio bond exposure below 25% to 30%, as bonds are an important component for investors who are living off their portfolios. Furthermore, there is always the risk of an external shock such as a geo-political or other event that could cause another significant fall in stock prices. While the volatility of the stocks is reduced over time, our concern is that given the two 50% drops in the stock market since 2000, investors have less of a tolerance for risk these days. Nonetheless, because we do expect that stocks will outperform bonds over the next 5 to 10 years, it is likely that we will continue to reduce the bond allocation in most portfolios as we get closer to 2015, which is when it is likely the Fed will start increasing short-term interest rates.

<u>Would you like to further reduce your bond allocation?</u> ***For those of you who are comfortable with taking on more risk at this time, please let us know. We can then discuss how much of your current bond allocation to shift into equities. Given that the stock market has also fallen in response to the Fed's latest announcement, this may be a good time to increase stock exposure.***

Finding Money
by Melissa Tosetti

Every week I work with individuals and families across the U.S. to "find money". By showing them how to plug financial leaks and streamline their spending we're able to uncover anywhere from $100 - $1,200 a month that can be focused on what's most important to them.

Often, we think we don't have money to put toward retirement or to go on that dream vacation, but in most cases, the money is actually there.

Family of Five in Sacramento
Last year I worked with a family of five in Sacramento whose situation is quite common. They couldn't make it from one paycheck to the next despite taking home six figures.

They were spending $1,500 a month on food, mostly dining out because there were never groceries in the house. The family had no habits or routines around shopping so we focused on creating them. We got the entire family involved each week in building the grocery list based on meals they wanted to cook the following week. Getting the kids involved helped teach them an important money lesson and made sure they couldn't complain about what's for dinner!

Ultimately, we cut their food bill in half and saved them several hours in the week since they no longer had to wait in line for takeout every night or run to the store for one-off items such as laundry detergent. In addition to the $750 saved on food, we also identified another $450 that could be saved each month in other areas. The $1,200 savings was then funneled to their Christmas, Vacation and Emergency Savings Accounts and the bulk of the money was put toward increasing their monthly retirement contribution.

Attorney in Atlanta
I recently worked with an attorney in Atlanta who already had many good money habits in place. She and her husband contribute $1,000 a month for their retirement and still managed to save enough to get to Europe every summer. They came to me for help in finding an additional $1,000 a month to increase their retirement contributions.

By making a few edits to their day-to-day spending, we were able to find the $1,000 plus an additional $245 a month to put toward their Vacation Savings Account giving them even more money for those annual international trips.

Each individual and family has a unique financial situation and the opportunities to streamline or repurpose their spending are equally unique.

Melissa Tosetti

Melissa is the founder of the day-to-day financial education company The Savvy Life and author of the international best-seller Living The Savvy Life.

Melissa's book The Savvy Life" and her one-on-one coaching program, are available to you as a benefit of being a MAM client . Please let us know if you would like to find out more or to set up a meeting with Melissa to discuss how her program can benefit you.

Sincerely,

Stephen P McCarthy, CPA, CFP®,

Alexey Bulankov, CFP®

McCarthy Asset Management, Inc.

Three Lagoon Drive Suite # 155
Redwood Shores, CA 94065
USA

Phone: 650-610-9540
Fax: 610-9541
E-mail: Steve@mamportfolios.com

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

Please let us know if you would like to have us prepare or update a Net Worth Analysis or Retirement Analysis for you.

Discover the difference with a Registered Investment Advisor.