

McCarthy Asset Management, Inc.

Registered Investment Advisor

September 1, 2009

Monthly Investment Commentary- August 2009

Stock Market Performance for August: August produced the sixth month of consecutive gains for the stock market. The August 3.4% gain in the S & P 500 resulted in a six-month return of 38.8%, the best six-month gain since the 44.0% gain of September 1938. The recent gains stand in stark contrast to the prior 6-month period ended in February 2009 when the S & P 500 lost 42.7%, the worst 6-month decline since 1932. The net result is that for the last 12 months the S & P 500 has declined 20.4%.

Unadjusted for dividends, for the month of August the S & P 500 rose 3.4%, the NASDAQ climbed 1.5%, the Russell 2000 rose 2.7%, and the international equity index MSCI EAFE jumped 5.2%. Corporate bonds rose for the month as they continued to perform well this year.

MAM August Performance: For the month, MAM portfolios underperformed the S & P 500, with a composite rise of 2.3% (after all fees), versus a rise of 3.6% for the Vanguard Index 500 fund (symbol VFINX) with dividends reinvested. The under performance of MAM portfolios relative to the S & P 500 was primarily due to the bond and Hussman fund allocation. The fully-hedged Hussman fund fell for the month, while the bond funds rose less than the S & P 500.

Year-To-Date Performance: For the first eight months of 2009, unadjusted for dividends, the S & P 500 rose 13.0%, the NASDAQ jumped 27.4%, the Russell 2000 rose 14.5%, and the international equity index MSCI EAFE climbed 21.1%. MAM portfolios slightly underperformed the S & P 500 for these eight months with a rise of 14.7% (after all fees) versus a rise of 15.0% for the Vanguard Index 500 fund with dividends reinvested.

While most of the equity funds used by MAM outperformed the Vanguard S & P 500 for the first eight months of 2009, this was more than offset by the relatively conservative positioning of MAM portfolios. Most portfolios currently have an asset allocation such that they should experience 60% to 75% of the volatility of the S & P 500. While I continue to feel that it is likely the 2009 stock market recovery still has room to run, given the fragile state of the economic recovery, I feel it is prudent to maintain significant downside protection in portfolios.

The remainder of this Monthly Commentary addresses the following:

1. *How to Adjust for the “New Normal”—in 2009 and Beyond*
2. *2009 California Individual Income Tax Increases*

How to Adjust for the “New Normal”—in 2009 and Beyond

Over the last 18 months the economic and financial world has changed dramatically. It is likely these changes will be with us for a long time. As I briefly discussed in my July 2009 Monthly Investment Commentary, my “longer-term assessment is that *we have entered a “new normal”*”

where the fundamental rules of the game have changed. After years of credit and leverage-induced economic growth, the “new normal” will incorporate slower economic growth, lower corporate profit growth, reduced consumption, higher personal savings, and a difficult employment market. *The historical pace of economic growth will face many headwinds including excessive regulation, higher taxation, ballooning deficits, higher interest rates, and a depreciating U.S. dollar.”*

This “new normal” may require many of us to make adjustments in order to achieve our objective of a financially-comfortable retirement. Here are suggested adjustments:

1. *Decrease Expenses and Increase Savings:* Clearly quite a few Americans have done this already as the national savings rate has increased from nearly 0% one year ago to over 5% recently. My advice to clients has always been to try to save at least 10% of their earnings. Studies have shown that if an individual saved 10% of their annual earnings from when they first start working (i.e. early to mid 20’s) and they adequately invest those savings, they should be able to comfortably retire by age 65.

Given the “new normal”, a savings rate greater than 10% may be needed to achieve your retirement goals. For one, I feel that we are in a low rate of return environment as I expect annual stock market returns to average only in the middle to high single digits over the next five to ten years. Furthermore, the massive projected deficits for the Social Security and Medicare systems will likely mean that additional retirement income will be necessary.

2. *The New Retirement Model:* With my parents’ generation, a common goal was to retire at an early age. For many of us, not only is this unrealistic, it may even be undesirable. Today many older-age workers retire from their primary career and embark on a new career. While working during retirement is a financial necessity for some, for others staying active and involved in doing something new is a goal in itself.
3. *Minimize Your Debt:* I have always suggested that the only “good” debt is mortgage debt. All other debt should be avoided and furthermore, a worthy goal is to pay off your mortgage debt by retirement. The reality of the “new normal” is that it is more important than ever to minimize or eliminate non-mortgage debt.
4. *Use the tax law to your benefit:* While the dramatic plunge in the stock market may have caused many Americans to feel disillusioned about funding their 401(k) and other retirement accounts, it is more important than ever to save for retirement. Furthermore, as I expect Federal tax rates will increase by 2011, it will be even more beneficial to invest pre-tax dollars in a retirement plan.
5. *Maintain a flexible investment allocation:* The tried and true “buy and hold” strategy of purchasing investments will no longer be as effective. The extreme volatility of the stock market has shown that in a short period of time stocks can swing back and forth from overvalued to undervalued. These valuation swings can provide an opportunity to benefit from timely asset allocation adjustments. For example:
 - Now I feel is a good time to be somewhat cautious with asset allocation as the six-month surge in stock prices was led by the most risky stocks. I feel the best opportunities in the current market are among the more stable firms with lower debt and higher dividends.

- Eventually rising interest rates and inflation will be a concern. Before that occurs, adjustments should be made to reduce exposure to long-term bonds, and increase exposure to inflation hedges (commodities, REITs and TIPS).
 - Finally, I expect for the U.S. dollar to eventually decline in value. An increased allocation to foreign stocks and bonds can enable portfolios to benefit from a falling U.S. dollar.
6. *Monitor Your Progress Toward a Financially-secure Retirement:* I developed the Net Worth Analysis and Financial Checkup as a way to help guide my clients toward a financial secure retirement. I recommend that we update a client's Net Worth Analysis annually and update their Financial Checkup every few years.

2009 California Individual Income Tax Increases

As part of this summer's California Legislature budget agreement, the following individual income tax increases were voted in retroactively for 2009:

- A 0.25% increase in individual tax rates across the board (i.e. the 1.00% bracket is increased to 1.25%, 2.00% bracket increased to 2.25%, etc.)
- A reduction of the dependent exemption by \$210 per dependent.
- A 0.25% increase in the Alternative Minimum tax rate (from 7.00% to 7.25%)

The rate increases will affect all CA taxpayers and the dependent exemption decreases will affect only those CA taxpayers with dependents. However, because the rate increase applies to all tax brackets, the impact will be greater on those taxpayers in the lower brackets.

The new withholding tables factor in the changes for the tax rate increase only, so taxpayers claiming dependent exemptions credits may still need to reduce the number of allowances they claim on Form DE-4, Employees Withholding Allowance Certificate. (For example the prior DE 4 instructed employees claiming dependents to multiply each dependent by "three". The new form instructs employees to multiply dependents by "one".)

Taxpayers who make quarterly estimated tax payments may want to increase their quarterly payments to adjust for these tax increases, but they are not required to do so because the Franchise Tax Board will not impose an underpayment penalty resulting from these changes for year 2009.

Please email or call if you would like to discuss your specific tax situation or any other financial matter.

Sincerely,

Stephen P. McCarthy, CPA, CFP