# *McCarthy Asset Management, Inc.*

Registered Investment Advisor

June 1, 2007

## Monthly Investment Commentary- May 2007

***Stock Market Performance for May:*** The stock market turned in another very good month. Unadjusted for dividends, the S & P 500 rose 3.3%, the NASDAQ climbed 3.1%, while the Russell 2000 rose 3.9%. Foreign equities rose less than U.S. equities, REITs rose modestly, while bonds and commodities fell.

***MAM Performance:*** For the month, MAM portfolios under performed the S & P 500, with a composite rise of 2.5% (after all fees), versus a rise of 3.5% for the Vanguard Index 500 fund (symbol VFINX) with dividends reinvested.

The five best performing MAM investments for May were Allied Capital Corp (up 9.7%), Artisan International Small Cap (up 4.8%), Oakmark Select (up 4.7%), William Blair Small Cap (up 4.1%), and American Growth Fund (up 3.9%).

The five worst performing MAM investments for May were PIMCO Commodity (down 1.9%), Hussman Strategic Growth (down 1.8%), PIMCO Total Return Bond (down 1.4%), Nuveen High Yield Municipal Bond (down 0.4%), and Oakmark International Small Cap (up 0.2%).

The 1% underperformance of MAM portfolios relative to the S & P 500 was due to poor performance of the bond funds and alternative asset funds (PIMCO Commodity, Hussman Strategic Growth and Cohen & Steers REIT). In the most recent portfolio repositioning (see below) Hussman Strategic Growth is being completely sold in all but the most conservative portfolios while Cohen & Steers is being substantially sold in all portfolios. Bonds funds will continue to be a drag on portfolio performance should the stock market continue its strong run. The proportion of bonds in a portfolio is dependent upon a client's score from their Risk Assessment Questionnaire. More conservative portfolios have a greater allocation to bond funds. The purpose of the bond exposure is to protect portfolio performance in a stock market downturn.

**Year-To-Date Performance:** For the first five months of 2007, unadjusted for dividends, the S & P 500 rose 7.9%, the Nasdaq climbed 7.8%, and the Russell 2000 rose 7.6%. MAM portfolios under performed the S & P 500 for these five months, with a composite return of 6.5% (after all fees), versus a gain of 8.7% for the Vanguard Index 500 fund (symbol VFINX) with dividends reinvested.

**Portfolio Repositioning:** As of May 31st, we have completed portfolio repositioning for 80% of our clients. We will complete the process by the middle of next week. On the day we reposition a client's portfolio(s), we send a 2-page letter of explanation, an Excel spreadsheet showing the current asset allocation for each portfolio, and Morningstar reports for two new funds being purchased in most portfolios (Columbia Marsico 21st Century and BlackRock Health Science Opportunities).

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The main purpose of this repositioning is to increase U.S. large cap exposure and reduce small cap exposure. By nature, I am a contrarian. I prefer to sell what has done the best and purchase what has done the worst. Per a recent article in the Wall Street Journal, from March of 2000 through April 30, 2007, the cumulative return for large U.S. stocks was 11.1%, for small U.S. stocks: 65.2%, and for REITs: 331.6%. There are signs that performance is finally shifting back to large cap stocks. Since March 30, 2007, the S & P 500 (i.e. large-cap stocks) rose 7.7%, while the Russell 2000 (i.e. small cap stocks) rose 3.9%. Given the incredible performance of REITs during the last six years, I feel that it is time to sell most or all of the remaining position in the Cohen & Steers REIT Fund.

A lesser theme in the latest repositioning is to sell a small portion of the small and mid-cap international funds. While I still am very fond of international investing, the continued outstanding performance of international equities has caused the international exposure in portfolios to become greater than my target.

**Slowing Economy to Speed Up?:** On May 31st the Commerce Department announced that gross domestic product (GDP), the total value of goods and services produced in the U.S., grew at an annualized rate of 0.6% in the first quarter, down sharply from its previous estimate of 1.3%. This rate represents the lowest growth rate since the fourth quarter of 2002. Rising imports and a decline in business inventories each shaved a percentage point off first-quarter economic growth.

Wall Street is forecasting second-quarter economic growth of between 2% and 3%, based on expectations for companies rebuilding their inventories, a rebound in business investment and strong consumer spending. First quarter growth was also hurt by the sharp slowdown in housing. There are preliminary signs, however, that housing's negative impact will lessen in the coming quarters. In a further sign of an economic recovery, this morning the Labor Department reported that U.S. employers boosted payrolls by 157,000 in May. The Labor Department also reported that the nation's unemployment rate held steady at 4.5%, which is considered relatively low by historical standards.

**S & P 500 at All-Time High:** On May 29th the S & P 500, considered by traders as the best barometer of U.S. stocks, surpassed the record of 1527.46, set March 24, 2000, at the peak of the dot-com boom. This is hardly something to celebrate. Factoring in the dividend yield on the S & P 500, investors in the S & P 500 earned less than 2% per year for the last seven years. Investors with diversified portfolios, though, had much better performance than this, as bonds, small-cap stocks, international stocks, and REITs did much better. On the other hand, investors with portfolios concentrated in technology stocks would have done much worse. Since peaking at 5048.62 on March 24, 2000, the Nasdaq is still down 48%!

Are stock prices becoming too expensive? Stock prices are now in their 5th consecutive year of positive performance. While smaller stocks and REITs may be getting ahead of themselves, the good news is that the S & P 500 has been flat for the last seven years, while corporate earnings have almost doubled during that same time. Relative to current earnings, stocks are reasonably priced. Assuming the economy bounces back from its first quarter slump and corporate earnings continue to grow, my outlook on stocks remains positive.

**Congress Closes "Kiddie Tax" Loophole:** Last week President Bush signed the "Small Business and Work Opportunity Tax Act of 2007. In one of its provisions, the law extends "kiddie tax" to children age 18, and children over age 18 but under age 24 who are full-time students—if their earned income doesn't exceed one-half of the amount of their support. Under "kiddie tax", children's non-earned income above $1700 is taxed at their parents' tax bracket.

What prompted Congress to further expand the “kiddie tax” were reports that some wealthy parents were planning to take advantage of a tax-law change designed for low-income people that will be effective next year. For 2008 through 2010, taxpayers in the 15% and lower Federal tax bracket will have a Federal capital gains rate of 0%.

So far California has not conformed to the Federal kiddie tax changes. For CA tax, children above age 13 are not taxed at their parents’ tax bracket. Therefore, there is still a tax incentive to gift highly appreciated stock to their children over age 13.

As a result of extending the age for “kiddie tax”, the appeal of 529 Plans (College Savings Plans) is greater. Please see my April 2007 Monthly Commentary for a discussion of 529 Plans. Time permitting, I hope to research specific 529 Plans over the next couple of months.

Please call or email me if you have any questions or would like to discuss your portfolio(s).

Sincerely,

Stephen P. McCarthy, CPA, CFP