McCarthy Asset Management, Inc.
Personalized Wealth Management

November 2013 Monthly Commentary

December 2, 2013

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Stock Market & Portfolio Performance

November 2013: For the month, U.S. stocks performed well, while foreign stocks were modestly higher and bonds posted small losses. For the first eleven months of 2013, U.S. stocks surged, foreign stocks posted strong gains and bonds declined moderately.

	Nov 2013	YTD 2013	Description:
Without Dividends:			
S&P 500	2.8%	26.6%	500 Largest Public U.S. Companies
NASDAQ	3.6%	34.5%	stocks trading on the Nasdaq
Russell 2000	3.9%	34.6%	2000 of the smallest U.S. stocks
MSCI EAFE	0.6%	17.8%	international stock index
U.S. Aggr Bond	(0.4)%	(1.5)%	index of U.S. bonds
With Dividends, after all fees:			
MAM portfolios	1.4%	17.5%	non-very conservative MAM portfolios
MAM Conserv	0.7%	7.0%	portfolios with 50%+ bond allocation

Comment: While we don't think stocks have (yet) reached the level of a bubble, the market is overdue for a correction. Nonetheless, the slow growth economy continues to provides a good environment for stocks.

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Stock Market– Are We In a Bubble?

Recently there has been an increasing amount of discussion as to whether the stock market is experiencing a bubble. The concern is understandable given that U.S. stocks are enjoying their best year since 1997 during a time when the economy is only growing slowly. Our feeling is that while the stock market is probably getting ahead of itself, it is not in a bubble (at least not yet). Here are our thoughts regarding this:

- **Current Environment Is Favorable:** As we have discussed a number of times in previous Monthly Commentaries, although the economy is growing only modestly, a "slow growth" environment is great for stocks ("not too hot and not too cold"). Furthermore, with the Federal Reserve maintaining short-term interest rates near zero, investors have been transferring part of their low-earning savings into stocks. We have been favoring stocks over bonds this year and have shifted part of the bond allocation to stocks on three different occasions. As a result, we estimate that the bond weighting in non-conservative portfolios has been reduced from around 40% at the start of 2013 to around 30% currently.

- **Federal Reserve Tapering:** As discussed in a previous Monthly Commentary, the Federal Reserve is likely to start tapering its monthly purchases of treasuries and mortgage bonds by early 2014. This could provide a headwind for stocks as long-term interest rates slowly move up. The Fed is likely, though, to maintain short-term interest rates near zero until at least 2015.

- **Future Bubble?:** There is a bigger risk of a bubble in U.S. stock prices if the Federal Reserve continues to keep interest rates at rock bottom for a couple of more years, which could possibly lead stock prices to continue to outpace the growth of corporate profits and economic fundamentals. This could lead to a bear market, which is defined as a drop of 20% or more in stock prices. If the stock market continues to climb sharply over the next year or two, it is likely that we will add additional downside protection to portfolios.

- **Overdue for a Correction:** The stock market is overdue for a correction, which we define as a drop of 10% in stock prices. We had thought that would happen in September or October, which are historically the weakest months for stock market performance. Even with the added drama this year of the Federal government shutdown and the risk of a default, stocks rose during that time.

As we have said many times before, we don't try to time *market corrections*. These *are regular, healthy occurrences that we feel are impossible to predict and time.* On the other hand, we do try to position portfolios to protect against bear markets. For now, unless and until we feel that stock prices have reached a bubble level or the economy takes a significant turn for the worse, we don't see a bear market on the horizon.

College Planning

Next to the gift of life and proper upbringing, education is arguably one of the most valuable gifts a parent can give to a child. It is also is a gift that keeps on giving. According to the 2011 American Community Survey, an undergraduate degree translates to more than $1 million additional earnings over a lifetime and a doctorate degree to over $2 million. The unemployment rate for college graduates is just half that of those who never graduated. There have even been studies linking a college education to longer, happier and healthier lives.

However a college education is not cheap. After factoring in tuition, fees, room & board and other costs, the annual price tag for a college education comes close to $22,500 for a public in-state school in California and $60,000 for a private school. Historically, those costs have grown at a faster pace than general inflation. Put another way, in order to save up enough to fully pre-fund a 4-year education at a private university, a family must save as much as $850 a month starting on the child's first birthday.

Because the expense of saving and paying for college is a significant one, it requires careful and detailed planning. Furthermore, deciding how to pay for college is a family affair. The family's financial condition and who owns the various financial assets may affect financial aid eligibility. Various instruments receive different tax treatments and come with both advantages and limitations. A comprehensive discussion is beyond the scope of this article, but here is a summation of the major borrowing and investment options:

Financial Aid, Grants and Scholarships are need-based and merit-based awards to students that do not have to be repaid. They can come from the federal or state governments, non-profits, private organizations or colleges themselves. Some of the grants include Federal Pell Grant, FSEOG, and TEACH grants. Note that most MAM clients would not be eligible for need-based aid due to their income being too high.

Student Loans and Work-Study Programs allow students to borrow or earn additional funds to pay for their education. Student loans usually have advantageous rates and flexible repayment options. Choices include Federal Perkins Loan, Stafford Loans (subsidized and unsubsidized) and Direct Plus Loans.

College Savings Instruments- for those who want to save up for college, the following saving and investing options are available:

- 529 College Saving Plans- a savings plan that allows for customized investing, tax-deferred growth and tax-fee withdrawals for higher education, subject to rules and conditions. This is one of the most robust and flexible choices available today.

- UTMA/UGMA Custodial Accounts- a custodial account for the child, which has to be used for the child's benefit (not necessarily education) and becomes property of the child once he or she assumes the age of majority (generally either "18" or "21", depending on how the account was set up).

- Coverdell Education Savings Accounts- these allow for tax-free growth for any level of education, subject to age and contribution limits.

Tax Considerations- understanding the tax implications of educational savings and expenses is also key.

- Federal Tax Credit– The American Opportunity Credit and Lifetime Learning Credit allow eligible taxpayers to claim qualified expenses up to $2,000 or $2,500 per year (not available for higher income taxpayers).
- Student Loan Interest Deduction- allows qualified taxpayers to deduct up to $2500 per year in student loan interest (not available for higher income taxpayers).
- State Tax Deduction- a few states (California is not one) allow 529 Plan contributions to be deductible for state tax purposes.
- Tax-Free Instruments- Contributions to 529 Savings Plans and Coverdell Education Savings accounts, while not deductible, allow for tax-deferred growth and tax-free withdrawals for qualified expenses.

Based on what we have seen, most MAM clients are not able to save up enough to fully pay for college and yet earn too much to be eligible for financial aid. Don't be discouraged, though. Saving what you can starting when your kids are very young will help in reducing what you need to come up with out-of-pocket once they are in college.

Planning for college does not have to be complicated or intimidating. There is a wealth of resources on financial aid, grants, scholarships and aid, taxation, college plans, strategies , etc. available online. If you have questions about your situation or would like to schedule a time to discuss your options**, please contact us** for more information.

Roth IRA Conversions and "Back Door" Roth Contributions

Tax Benefits of a Roth IRA: The tax benefits of having assets in a Roth IRA are huge. All appreciation is tax-free for qualified withdrawals. In addition, unlike an IRA account, there are no minimum distribution requirements for Roth IRAs. In fact, a Roth IRA account holder can leave all assets in their Roth IRA as long as they are alive. Furthermore, once the account holder dies, the beneficiaries can roll over the assets into an Inherited Roth IRA account, which will continue to allow the assets to grow tax-free (although there are minimum distribution requirements for the heirs).

Roth IRA Conversions: A Roth IRA conversion is when IRA assets are transferred to a Roth IRA. Generally the amount converted is added to the taxpayer's taxable income (i.e. assuming there is no "cost basis" in the IRA). Because of this taxation, most people don't want to do a conversion. Toward the end of each year we contact clients for whom we think a Roth IRA conversion may make sense. *In particular, we look for clients who expect to have very low or even negative taxable income for the year.*

Please contact us ASAP if you think you are a possible candidate for a Roth IRA conversion. The deadline for 2013 Roth IRA conversions is December 31, 2013.

"Back Door" Roth IRA Contributions: While taxpayers with any level of income are eligible to convert their IRA assets to a Roth IRA, only taxpayers with adjusted gross income below $127,000 for single taxpayers and $188,000 for married taxpayers are eligible to contribute directly to a Roth IRA. We have found a way around this income limitation called "back door" Roth contributions that we utilize annually for a number of clients. The process works by first making a non-deductible IRA contribution. There are no income limits for making a regular IRA contribution. The only requirement is that either the account holder or their spouse has sufficient earned income for the year. Subsequent to the non-deductible IRA contribution being made, we convert it to their Roth IRA. This conversion is done tax-free if they don't have any other IRA assets.

Please contact us if you would like to discuss whether the "back door" strategy can work for you.

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:

<u>Investment Management Services:</u>

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

<u>Financial Planning Services:</u>

- **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.**

<u>Tax Services:</u> 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.**
- **Medicare Advisory Program (MAP) - Allen Hamm**
- **The Savvy Life® Classes, Workshops , and One-on-One Consultations**

Reminders

1) **Property Tax payments** are due December 10, 2013.

2) **Roth IRA Conversions:** Please contact us ASAP if you would like to discuss. The deadline for 2013 conversions is December 31, 2013.

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Discover the difference with a Registered Investment Advisor.