McCarthy Asset Management, Inc.
Personalized Wealth Management

October 2012 Monthly Commentary

November 1, 2012

Stock Market & Portfolio Performance

Inside this issue:

Stock Market Performance for October: The stock market slipped this past month. Unadjusted for dividends, the S&P 500 fell 2.0%, the NASDAQ dropped 4.5%, the Russell 2000 dropped 2.2%, and the international equity index MSCI EAFE rose 0.8%. Bonds, as represented by the Barclays U.S. Aggregate Index, rose 0.2% for the month.

MAM October Performance: MAM portfolios outperformed the S&P 500 for the month. Excluding the "very conservative" portfolios (which rose 0.1%), MAM portfolios slipped 0.7% (after all fees), versus a drop of 1.9% for the Vanguard Index 500 fund (symbol VFINX) with dividends reinvested.

Year-To-Date Performance: For the first ten months of 2012, unadjusted for dividends, the S&P 500 rose 12.3%, the NASDAQ climbed 14.3%, the Russell 2000 rose 10.5%, and the international equity index MSCI EAFE climbed 7.8%. Bonds, as represented by the Barclays U.S. Aggregate Index, rose 4.2% for the year-to-date. Excluding the "very conservative" portfolios (which rose 8.2%), MAM portfolios rose 9.2% (after all fees), versus a rise of 14.2% for the Vanguard Index 500 fund (symbol VFINX) with dividends reinvested.

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- **Investment Management**
- **Financial Planning**
- **Tax Advisory**

Key Tax Issues to Watch Post Election

Whatever the outcome of the presidential election on November 6th, the next Congress and president will face a tremendous amount of unfinished tax business. Some of this relates to the fiscal cliff, a series of tax increases and spending cuts that are scheduled to be effective January 1, 2013. Here's is a list and discussion of the most significant unresolved personal tax issues:

Bush Tax Cuts on Ordinary Income: Without Congressional action and the president's approval, the current 10%, 15%, 25%, 28%, 33% and 35% tax rate brackets will be replaced in 2013 by the pre-Bush brackets of 15%, 28%, 31%, 36% and 39.6%. The would mean across-the-board tax hikes for most American taxpayers.

Prediction: If Obama is reelected, the highest brackets will go into effect for married taxpayers with adjusted gross income in excess of $250,000 and single taxpayers in excess of $200,000. If Romney is elected, the existing tax brackets will be retained for at least one more year for all taxpayers.

Capital Gains & Qualified Dividend Tax: Currently long-term capital gains and qualified dividends are taxed at a maximum Federal rate of 15%. Absent a tax law change, effective January 1, 2013, this rate is scheduled to increase to 20% for long-term capital gains and to the taxpayer's ordinary tax rate for qualified dividends (i.e. up to 39.6%). In addition, for higher income taxpayers, a 3.8% Medicare surtax becomes effective, raising the rate for long-term capital gains to 23.8% and to as high as 43.4% for qualified dividends.

Prediction: If Obama is reelected, only high-income taxpayers will be subject to these higher rates while if Romney is elected, the 15% rate will be retained for all taxpayers (although "Obama Care" would need to be repealed for the 3.8% Medicare surtax to not become effective).

Note: Those of you with large long-term capital gains should seriously consider realizing at least some of those gains before the end of 2012. Please contact me if you would like to discuss this further.

Payroll Tax Holiday: For 2011 and 2012 there has been a 2% reduction in the Social Security tax rate on salaries and self-employment income. This temporary payroll tax cut expires at the end of 2012. The maximum tax-saving benefit if extended for 2013 would be $2,274 for one person and $4,548 for a working couple.

Prediction: My guess is neither Obama or Romney would extend this payroll tax holiday for 2013.

Personal Exemption and Itemized Deduction Phase-Outs: For 2010-2012, these unfavorable rules were phased out, but they will come back with a vengeance starting next year unless changes are made.

Prediction: If Obama wins, these stealth tax increases will probably be back for at least higher-income taxpayers. If Romney wins, the phase-out rules will stay away.

Alternative Minimum Tax Patch: It's become an annual ritual for Congress to pass a "patch" to the AMT rules to prevent millions of additional households from becoming subject to AMT. The patch consists of allowing bigger AMT exemption amounts and allowing various personal tax credits to offset the AMT.

Prediction: An AMT patch will be passed for 2013 whether Obama or Romney wins. If Romney is elected, though, it is possible that AMT will fully disappear starting in 2013 (he has vowed to repeal it).

Estate Tax: For those who die in 2012, only estates in excess of $5.12 million are subject to estate tax. Estates worth more than that owe a flat 35% tax on the excess. Next year, however, the estate tax exemption is scheduled to plummet to only $1 million, and the maximum tax rate is scheduled to rise to 55%. Particularly for CA homeowners, it doesn't take much for an estate to exceed $1 million.

Prediction: Regardless of who wins the election, the 2013 estate tax exemption will be somewhere in the $3 million to $5 million range, and the maximum tax rate will be somewhere between 35% and 50%.

Gift Tax: Gift tax laws are generally coordinated with estate tax laws. For 2012, the federal gift tax exemption is $5.12 million. Next year the exemption is scheduled to drop to only $1 million. *This is why some wealthy individuals have made large gifts to family members this year.*

Prediction: Whatever adjustments are made to estate tax for 2013 will be applicable to the gift tax laws for 2013.

U.S. Economy: Slight Improvement for 3rd Quarter 2012

Last week the Commerce Department released its initial estimate of the third quarter gross domestic product (GDP), reporting that it grew at an annual rate of 2% from July to September, faster than the 1.3% rate in the second quarter. This modest increase in third quarter growth was boosted by stronger consumer spending, an improved housing sector and increased defense spending offset by the first cutbacks in investment in more than a year by cautious businesses.

The 2% current rate of growth is sluggish. A growth pace of at least 2.5% to 3.0% is needed over several quarters to make substantial headway in increasing employment. Furthermore, details of the report did not bode well for acceleration in output in the fourth quarter, as a spurt in government defense spending was seen as temporary.

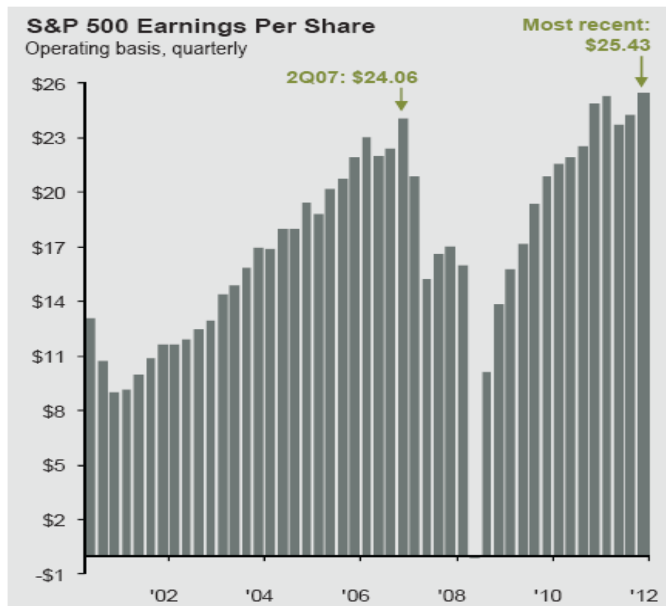
3rd Quarter Earnings: Disappointing As Expected

As discussed in our 3rd Quarter Letter, Thomson Reuters said that earnings for companies in the S&P 500 were projected to drop 3% this quarter from the prior quarter (the first drop since 2009). As of the time of this writing, 247 companies have reported actual results so far, with 174 (63.5%) exceeding analysts' expectations, 34 (12.4%) matching projections and 66 (24.1%) trailing estimates.

While these figures may appear to be fine, history shows a slightly better rate of companies beating forecasts.

More importantly, the top-line revenue numbers have been disappointing as Bloomberg shows that only 28% have topped consensus while 53% have lagged behind. The main reason causing the slight drop in earnings and the poor revenue figures are companies with significant international operations were impacted by the European recession.

Quarterly earnings for companies in the S&P 500 hit an all-time high during the second quarter of 2012, as can be seen in the chart on the right.



Source: Standard & Poor's, Compustat, BEA, J.P. Morgan Asset Management.
EPS levels are based on operating earnings per share. Most recently available data is 2Q12.
Past performance is not indicative of future returns.

Data are as of 9/30/12.

Stock Market Outlook

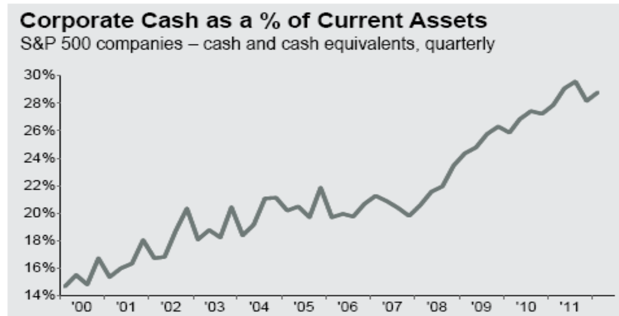
As I mentioned in our Third Quarter Letter, given my concern about the pending elections and fiscal cliff, I had mixed feelings on my fourth quarter outlook for the stock market. My outlook has not changed and I remain comfortable with the relatively conservative positioning of most MAM portfolios (with most expected to experience 60% to 65% of the stock market's volatility), and don't expect to make any significant changes when we reposition portfolios later this quarter.

While I believe no one can consistently predict short-term movements in the stock market, I was heartened to hear that history may be pointing toward a decent fourth quarter. According to Ned Davis Research, since 1925 the S&P 500 has risen more than 12% during the first three quarters of the year 31 times (this year it had risen 14.6%). The median gain for the fourth quarter in those 31 years has been 4.9%, and the S&P 500 finished in positive territory 81% of those times in the fourth quarter. If history is any guide, I like the odds for a decent 4th quarter this year.

High Cash Levels - Four Ways This is Beneficial for Stocks

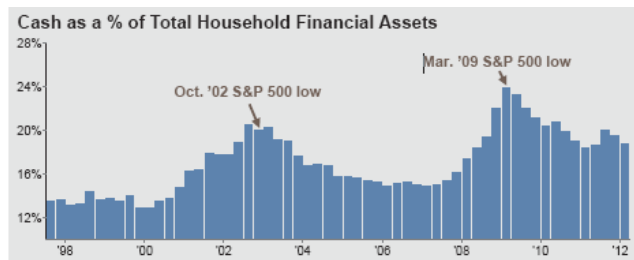
They say a picture is worth a thousand words. Given our new ability to display images, perhaps our future Monthly Commentaries will be much shorter! Over the last couple of years, I have discussed the reasons why I feel large cash holdings may act as a positive catalyst for the stock market. I am now able to illustrate this with charts:

Corporate Cash Holdings: Corporations now hold a record amount of cash on their balance sheets. As can be seen in the chart to the right, cash as a percentage of current assets is now nearly 30%, double the level from 1999. Corporations can use this cash to buy back shares and institute or increase dividends.



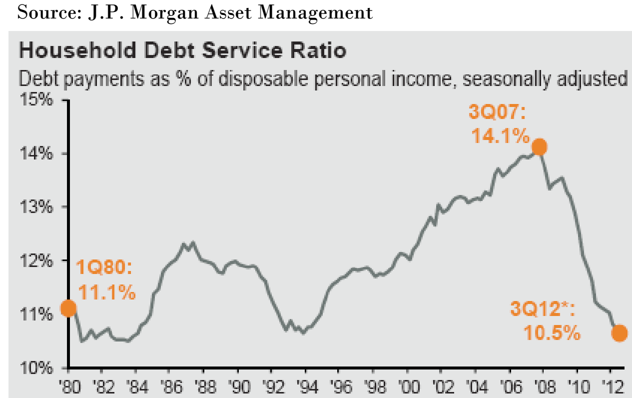
Source: J.P. Morgan Asset Management

Individuals Cash Holdings: The chart to the right shows cash as a percentage of "total household financial assets" is now approximately 20%. While this is still lower than the peaks reached back in the 2002 and 2008-2009 stock market lows (when some investors sold low and went to "cash"), it is higher now than it was at most other times since 1997.



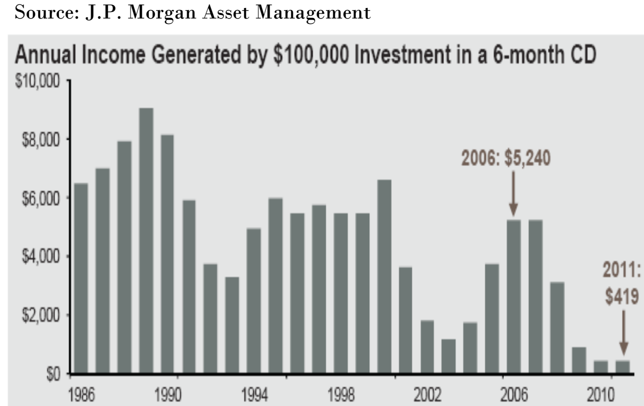
Source: J.P. Morgan Asset Management

Improvement in Household Debt Service Ratio: As shown on the chart to the right, consumers have made tremendous progress since 2008 in "deleveraging" and reducing their debts. Debt payments as a percentage of disposable personal income is now down to 10.5%, the lowest it has been since 1980. While record low mortgage rates is a major reason for this, it suggests consumers are now in a better position to increase their spending, which drives nearly 70% of the economy.



Source: J.P. Morgan Asset Management

Cash Doesn't Pay Well: Some feel that one of the reasons the Federal Reserve is planning to maintain interest rates near record lows is to motivate investors to move away from cash assets. The chart to the right shows the annual income generated by a $100,000 investment in a 6-month CD from 1986 through 2011. While over $4,000 (4.0%) was earned most of these years, for 2011 the earnings fell to only $419 or 0.4%. With the average dividend yield on S&P 500 companies of just over 2.0%, savers have a motivation to invest their cash savings in dividend-paying stocks.



Source: J.P. Morgan Asset Management

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 and Workshops by best –selling author Melissa Tosetti**

Reminders

Don't forget to vote on

Tuesday, November 6th!