McCarthy Asset Management, Inc.

Registered Investment Advisor

Re: First Quarter 2010 MAM Letter

Monday, April 5, 2010

Dear Client,

The stock market started out strong for 2010 with the S & P 500 having its best first quarter in twelve years. While I wouldn't be surprised to see the market pull back a little from here, I continue to expect that 2010 will be a good year for stocks.

With this report for the quarter ending March 31, 2010, I discuss the performance of the market and MAM portfolios for the quarter, comment on the first positive jobs report since the recession began, provide a preview of the portfolio repositioning to be done later this month and discuss the new Health Care Act. Enclosed are your 3/31/10 investment reports.

Stock Market & MAM Performance for First Quarter

With the exception of foreign stocks, the stock market posted a solid first quarter. *Unadjusted for dividends,* the S & P 500 rose 4.9%, the Nasdaq climbed 5.7%, the Russell 2000 jumped 8.5%, while the international equity index MSCI EAFE rose only 0.2%. Bonds rose modestly for the quarter.

MAM Portfolio Performance: Excluding the "very conservative portfolios", 1% of MAM portfolios that were invested for the whole quarter had performance that equaled or exceeded that of the S & P 500. The composite return of assets in MAM portfolios was a gain of 3.3% (after MAM fees), versus a gain of 5.4% for the Vanguard Index 500 fund (symbol VFINX) with dividends reinvested. The quarter's composite return for assets in the "very conservative portfolios" was a gain of 2.2%.

Explanation of MAM Under Performance and Comments on April Repositioning:

- Bonds: During January, MAM portfolios fell 2.0% while the S & P 500 fell 3.6%. Portfolios were cushioned by the downside protection provided by the significant bond allocation. This bond allocation became a drag on performance when the stock market turned up in February and March. I plan to reduce bond exposure in most portfolios later this month. I expect to do this by increasing the allocation to balanced funds (which invest in a combination of stocks and bonds) and adding another fund which targets stocks that pay an increasing dividend. I may also reinitiate a small allocation to REITs.

- International Equities: International equities, which make up between 10% and 20% of most portfolios, were a significant drag on performance as indicated by the 0.2% rise in the MSCI EAFE index for the quarter. Part of this poor performance was due to pressures caused by economic difficulties experienced by Greece and certain other European countries. Furthermore,

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the U.S. dollar rallied, which also hurt foreign equities. At this point, I do not expect to make significant changes to the foreign exposure within portfolios. I feel that over the next few years the economies of most foreign countries will perform equal to or better than the U.S. economy. Furthermore, I think it is only a matter of time before the U.S. dollar once again starts to weaken.

- Hussman Strategic Growth: This fund has a tremendous track record during its ten years of existence, particularly when the stock market has slumped. In fact the only down year for the fund was its 9.0% loss in 2008, the year when the S & P 500 fell 37%. Unfortunately, to date the fund has primarily missed the 12-month recovery in the stock market, as manager John Hussman remains negative on his outlook for stocks. I am leaning towards reducing but not eliminating the fund's allocation in certain portfolios later this month.

- **Net Result of April Portfolio Positioning:** In January of 2007, at the beginning of the recession, I increased bond exposure by approximately 5% in most portfolios. Although in hindsight, I should have been much more aggressive in reducing equity exposure at that time, it was (and will always be) difficult to predict movements in the stock market and at the beginning of 2007 it was not clear that a recession had started. While I plan to reduce the bond exposure for the first time since then, the adjustments will not be dramatic. Currently I estimate that the average MAM portfolio has 60% to 65% of the volatility of the stock market. With the reduction in the allocation to bonds and in some cases the Hussman fund, I expect to increase that volatility by 5% to 7%. If and when I become more confident that the economic recovery is sustainable and interest rates increases are imminent, I may further reduce bond exposure.

Oldest Portfolio: The MAM portfolio with the longest track record is a moderately aggressive portfolio that was fully invested on September 13, 1999. As of March 31, 2010, the original $50,000 had risen to $79,533, plus $1,193 of cumulative withdrawals. This represents a cumulative return of 61.5%. During the same time, the S & P 500 (as represented by the Vanguard Index 500) rose 1.2%. For the quarter ended March 31, 2010, the portfolio rose 3.2%. All returns quoted for this portfolio (and for all MAM portfolios) are net of MAM fees. Also, past performance does not guarantee future results.

Economic Update- Finally A Positive Jobs Report

As I discussed in my February Monthly Investment Commentary, the U.S. economy may be reaching a critical self-sustaining status. The latest sign that the economic recovery is gaining momentum was the April 2nd release by the Labor Department of the March Jobs Report. In the report, the Labor Department said employers added 162,000 jobs in March, the most since the recession began. The total includes 48,000 temporary workers hired for the U.S. Census. More significantly, private employers added 123,000 jobs, the most since May 2007. While the news was good, it will probably take years for a full recovery in the labor market as the U.S. economy has lost nearly 8.5 million jobs as a result of the most severe recession in 80 years. Although the downturn probably ended nine months ago, companies remain reluctant to ramp up hiring because the economy's recovery is expected to be moderate.

Stock Market Outlook

As I mentioned at the outset of this letter, while I wouldn't be surprised to see a modest pullback in the stock market during the next month or two, I continue to feel that the overall direction for the market is up. Here are some reasons for my cautious optimism:

- Modest growth has returned to the U.S. economy: This growth is accompanied by a sharp recovery in corporate profits, which in turn should help lead to a sustainable recovery in the job market.

- Stocks Reasonably Priced (But Not "Cheap"): Even after the tremendous rally over the last 12 months, the S & P 500 is still below where it was ten years ago. Meanwhile the companies that make up the S & P 500 are now earning more than they were then. Specifically, at the end of 1999, the S & P 500 traded at 1,469 and earned about $48, implying an earnings yield (i.e. earnings divided by price) of around 3%. For 2010, the S & P 500 companies are expected to earn $70 to $75. With a price of 1169 on March 31, 2010, this represents an earnings yield in excess of 6%.

- Demand from Bond Investors: Investors have consistently exhibited a dismal record of market timing and asset allocation. Consider that in 1999, Americans shifted nearly $200 billion into equity mutual funds when stocks traded at 40 times earnings. At the same time, they yanked $4 billion out of bond funds when 10-year Treasuries were yielding around 6%. Today it's just the opposite. Investors pulled $4 billion out of the stocks funds over the past year even as the price-earnings ratio for stocks fell below 20. Meanwhile, they poured around $300 billion into bond funds after demand for Treasuries had grown so much that yields fell to less than 4%. Once interest rates start to rise (probably later this year), Treasury bond prices will slump. As that happens, I expect investors will shift part of their bonds investments to stocks, driving up the demand for stocks.

- Cash on the Sidelines: There is still a tremendous amount of cash held in very low yielding savings accounts, money market accounts and certificates of deposits. As investors slowly regain their confidence in the stock market, this cash may represent an additional significant source of demand for stocks.

Health Care Reform Act

After years of debate, a major health care overhaul has finally become a reality. On March 23rd, President Obama signed the Patient Protection and Affordable Care Act of 2010. This was followed by passage of the Health Care and Education Reconciliation Act of 2010 by Congress on March 25th. The result will be a massive overhaul of the nation's health insurance and health delivery systems. Many of the major provisions are not effective until 2014, including the mandate for most Americans to have health insurance and many new requirements for health-plan designs.

Here are some of the **key provisions** in the health care package **that will take effect in 2010:**

- Small business tax credits to help offset the cost of employer-provided coverage for companies with no more than 25 employees and average annual wages of no more than $50,000

- Temporary high-risk pool for individuals who are uninsured because of pre-existing conditions

- Temporary reinsurance program for early retirees

- No discrimination against children with pre-existing conditions

- No lifetime limits on coverage

- Coverage for young people until age 26 through parents' insurance

The requirement to have health insurance will not take effect until 2014. Most individuals not eligible for Medicare or Medicaid will be required to obtain health care coverage or they will be subject to a penalty. Those who do not have coverage will be required to pay a yearly financial penalty of the greater of $695 per person (up to a maximum of $2,085 per family), or 2.5% of household income, which will be phased-in from 2014 to 2016. Lower-income individuals, as well as some middle-class families, would receive a credit or voucher to help pay for health insurance. Large employers (50 or more employees) will be required to offer insurance or they will be subject to a penalty.

Individual Income Tax Rule Changes: Much of the cost of the additional health care coverage will be paid for by increased taxes on high income individuals:

- Medicare Tax on Earned Income: Starting in 2013, there will be an additional Medicare tax of 0.9% on earned income (i.e. wages and self-employment income) in excess of $200,000 for individuals and $250,000 for married couples filing jointly.

- Medicare Tax on Unearned Income: Also starting in 2013, there will be a 3.8% Medicare tax on investment income. The tax will be assessed on the lesser of:

    1. Net Investment Income which includes interest, dividends, capital gains, net rental income, and royalties. Note: Net investment income will not include distributions from qualified retirement plans.

       or

    2. The excess of modified adjusted gross income (AGI) over $200,000 for single individuals or $250,000 for married couples filing jointly

- Medical Expense Deduction: Starting in 2013, the threshold for the itemized medical expense deduction will be raised from 7.5% of AGI to 10% of AGI.

Other provisions:

- Long-term Care Coverage: One of the biggest and least understood provisions is a new national voluntary long-term care benefit that would pay cash to people who become disabled. You will qualify for the benefit only if you pay premiums into the program for at least five years. The long-term care coverage is not expected to be available until at least 2011.

- Flexible Spending Accounts (FSAs) and Health Savings Accounts (HSAs): Beginning in 2011, over-the-counter medicines are excluded from coverage unless prescribed by a health care professional. The health care package also caps health FSA contributions at $2,500 per year after 2012. Apparently, the maximum contributions to HSAs will not be reduced by the health care reform package.

My initial thoughts about the tax implications of this health care package:

- *Qualified Pension Plans, IRAs, and a Roth IRAs benefit* from the increase in taxes on investment income since distributions from these plans are not subject to the additional 3.8% tax. Although the additional tax on unearned income will not occur until 2013, *I recommend that higher income taxpayers should now contribute as much as possible to their pension plans, IRAs and Roth IRAs.*

- *Municipal Bonds also appear to be a winner* since income from municipal bonds will also not be subject to the 3.8% tax on investment income.

- *Find a Primary Care Physician.* One of the results of this health care overhaul could be a shortage of doctors. The law changes are ultimately expected to add around 32 million people to the insured population, with the big influx starting in 2014. Provisions aimed at boosting the supply of primary-care physicians likely won't kick in fast enough to keep up with the flood of new patients, at least in certain parts of the country.

Assets Under Management and Referrals

As of March 31, 2010, MAM assets under management were over $95 million, up from $90 million at the start of the year. I want to thank clients for their confidence in adding to their accounts. The first quarter of 2010 represented the fourth consecutive quarter that clients have added a net total of over $1.5 million to their MAM-managed accounts. Furthermore, I want to thank those of you who have referred the services of McCarthy Asset Management, Inc. to their friends and family. I really appreciate this as referrals are my primary source of new clients. While my minimum amount to manage for new clients is $350,000, I am willing to be flexible depending on the individual's situation.

Please call me if you wish to discuss the stock market or your portfolio(s).

Very truly yours,

Stephen P. McCarthy, CPA, CFP