McCarthy Asset Management, Inc.

Registered Investment Advisor

Re: First Quarter 2012 MAM Letter

Tuesday, April 3, 2012

Dear Client,

This year has started out great with stocks posting their best first quarter in fourteen years. The Dow and the S & P 500 closed out their best first quarter since 1998 and the Nasdaq had its best first-quarter since 1991, largely on the back of improving U.S. economic data. While I am hopeful that stocks will be able to build on their gains, I am concerned about the economic impact of dramatic tax increases and federal spending cuts that are scheduled for the beginning of 2013. This letter discusses:

- Stock Market & MAM Performance for the 1st quarter of 2012
- Economic Outlook- Employment Growth Has Been Good
- Concern About 2013 Tax & Fiscal Policy Changes

Stock Market & MAM Performance for First Quarter

Unadjusted for dividends, the S & P 500 rose 12.0%, the Nasdaq jumped 18.7%, the Russell 2000 climbed 12.1%, and the international equity index MSCI EAFE rose 10.0%. Bonds, as represented by the Barclays U.S. Aggregate Index, were relatively flat, inching up 0.3% for the quarter.

MAM Portfolio Performance: Excluding the "very conservative" portfolios, the composite return of assets in MAM portfolios was a gain of 7.2% (after MAM fees) versus a rise of 12.5% 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 4.0%.

Discussion of MAM Portfolio Performance: What caused MAM portfolios to rise "only" 7.2% for the quarter when the Vanguard S & P 500 rose 12.5%? Here are the three reasons:

1) Bonds: The main factor was the impact of bonds, which make up between 30% and 40% of most MAM portfolios. As indicated above, the Barclays U.S. Aggregate Index was up only 0.3% for the quarter. Fortunately, MAM portfolios have very little Treasury bond exposure, which was the weakest part of the bond market this past quarter. In fact, the bond funds most commonly used by MAM returned between 2.9% and 7.0% for the quarter (which is why the "very conservative" portfolios, which are generally over 80% invested in bond funds, were able to rise 4.0% when the aggregate bond index was relatively flat).

2) Sector Performance: The sector weighting of the U.S. equity portion of MAM portfolios hurt performance. While the overall S & P 500 index was up 12.0%, MAM portfolios were underweighted in the two strongest sectors: Financials (up 21.5%) and Information Technology (up 21.1%). Meanwhile MAM portfolios had a larger weighting relative to the S & P 500 in two of the weaker performing sectors: healthcare (up 8.4%) and consumer staples (up 4.8%).

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3) Alternative Assets: The alternative asset funds used by MAM performed relatively poorly for the quarter. The JP Morgan MLP ETN rose only 1.6%, PIMCO Commodity returned 3.2%, and the Permanent Portfolio rose 5.8%. The lagging performance of MLPs may provide a good opportunity for us to add additional exposure to this high-yield sector. Meanwhile the poor performance of gold for the quarter hurt the latter two funds. I think it is still prudent to maintain a small allocation to gold and other commodities as a hedge against the inflationary impact of the Fed maintaining interest rates at near record low levels in their effort to infuse more and more liquidity into the economy.

Note that the Asset Class Performance Summary (which for most clients is P.5 of their reports) provides a good insight into the relative performance of your portfolio's asset classes. For the Year-To-Date report for most clients, alternative assets and fixed income returned 3% to 5%, while international equities and U.S. equities returned 9% to 11%.

Are You Tempted To Get More Aggressive?: I imagine that some investors may now feel inclined to get more aggressive with their investment allocation. In fact after five consecutive years of investors reducing their exposure to the stock market, inflows into equity mutual funds may finally turn positive this year. As I have written numerous times before, many investors have been terrible in their market timing decisions. This past month was the 3-year anniversary of the stock market hitting its low in March of 2009. Since then the stock market has doubled in value. While I think stock prices are still reasonably valued relative to their earnings and to alternative investments, they are no longer the bargain they were. In fact, despite investors warming up to stocks as prices rise, the stock market actually becomes more risky and susceptible to becoming overvalued.

I am pleased with the current asset allocation of portfolios and am not looking to make any significant changes at this time. On the one hand, I don't think we need to get more aggressive given the sharp rise in the stock market over the last six months. On the other, I don't think it is necessary to get more conservative as I feel portfolios already have significant downside protection with a large allocation to bond funds and balanced funds.

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, 2012, the original $50,000 had risen to $91,568, plus $1,193 of cumulative withdrawals. This represents a cumulative return of 85.5%. During the same time, the S & P 500 (as represented by the Vanguard Index 500 Fund) rose 26.6%. For the quarter ended March 31, 2012, the portfolio rose 7.2%. 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 Outlook- Employment Growth Has Been Good

Evidence that the U.S. economy continues its slow but steady progress was probably the main reason for the strong performance of the stock market so far this year. I feel that one of the most important indicators is the monthly employment report. The report for February was good as for the third month in a row, job growth exceeded 200,000 while the unemployment rate held steady at 8.3%. Furthermore, the factory workweek (average hours worked) and temporary hiring, which are two leading indicators of the labor market, showed further advancement.

For the economy to continue self-sustaining growth, it will be important for monthly job growth to remain above 200,000. Hopefully 2012 will break from 2011's pattern of strong job growth in the winter followed by a slowing in the spring and summer. One reason for optimism now is that job growth has spread to more of the nation's largest metro areas. Furthermore, initial claims for unemployment benefits, which are a reliable indicator of hiring, have declined for five consecutive months.

Behind this job-market progress is a national economy now firing on more (but not all!) cylinders. The recovery, which started in manufacturing and exports, has led to a ramp-up in business investment, higher consumer spending and, finally, more hiring. That in turn has boosted the economies of most major U.S. cities. Such a broad-based recovery is critical at a time when an economic shock could be triggered by rising oil prices or the European sovereign debt crisis. An improving housing sector will provide confirmation that growth has become self-sustaining. As discussed in the next section, though, there is something on the horizon that could derail the growth in the economy.

Concern About 2013 Tax & Fiscal Policy Changes

The 2013 Federal budget is going to have the biggest impact of any budget in decades if no action is taken in Washington. The fiscal impact of both the tax increases and spending cuts scheduled to take effect in 2013 is a decrease of $500 billion, or 3.5% of GDP. The scheduled tax increases are already in the law and would need to be changed to mitigate or restructure them to be less of an economic drag. If Congress does nothing, the risk of these huge tax increases and federal spending cuts is throwing the U.S. economy back into a recession next year. Here is what is in store for us effective January 1, 2013:

- **Expiration of the "Bush Tax Cuts":**
    - **Tax rates will increase**: The current six federal tax brackets (10%, 15%, 25%, 28%, 33% and 35%) will be replaced by five new ones (15%, 28%, 31%, 36%, and 39.6%).
    - **Capital Gains Rate**: The maximum 15% rate will rise to 20%.
    - **Qualified Dividends Tax Rate**: The rate on qualified dividends will rise from 15% to the taxpayer's ordinary income tax bracket (as high as 39.6%).
    - **Alternative Minimum Tax (AMT) Patch Expires:** (this is actually effective January 1, 2012 unless Congress acts by this December) If the AMT "patch" is not extended, millions of Americans will become subject to AMT for the first time in 2012.
    - **Itemized Deductions Limit:** Taxpayers with AGI over $150,000 will once again have part of their itemized deductions phased out.
    - **Phaseout of Personal Exemptions:** High-income taxpayers will have their personal exemptions phased out.
- **New Taxes from the Health Care Reform Act (i.e. National Healthcare):**
    - **3.8% Medicare contribution tax on unearned income:** A new 3.8% Medicare contribution tax is imposed on the unearned income of high-income individuals. The tax will generally apply to the net investment income of individual with modified adjusted gross income that exceeds $200,000 ($250,000 for married filing joint). ***Note that combined with the 5% increase to long-term capital gains rate from the expiration of the Bush tax cuts, for high-income taxpayers the long-term capital gains rate will increase nearly 60% by next year (i.e. from 15% to 23.8%)!***

- **Additional Medicare Payroll tax:** The Medicare portion of the payroll tax increases by 0.9% (from 1.45% to 2.35%) for those with wages exceeding $200,000 ($250,000 for married filing joint). The rate for self-employed individuals increases from 2.9% to 3.8% on any self-employment income exceeding the dollar thresholds above.

- **<u>Spending Cuts and Other:</u>**

  - **Automatic Spending Cuts:** You may recall that last August our Federal government came very close to a shut down due to Congress delaying approval of an increase in the national debt ceiling. As part of the last-minute Agreement that was reached, a Super Committee of Congressmen was appointed to come up with a combination of budget cuts and tax increases. Over the ensuing three months, the Super Committee failed to come to an agreement. As a result, $100 billion in automatic spending cuts become effective starting in 2013. The cuts are to be split evenly between defense and the rest of the federal budget.

  - **The Obama payroll tax cut and emergency unemployment benefits are also slated to expire at the end of 2012.**

Will Congress take action to delay or prevent some of these changes? Procrastination is part of the problem. Congress probably won't address the projected tax increases or automatic spending cuts until after the November elections, giving it less than two months before the New Year for a complex lame-duck negotiation. It may come up with some kind of temporary "fix" that hands the problem to the new Congress that takes office in January.

I am concerned that without action, these Draconian tax increases and spending cuts could push the U.S. economy back into a recession. Clearly Congress needs to address the ballooning federal deficits. Hopefully, our representatives will have the sense to create and approve a long-term plan that credibly shrinks deficits with a phase-in combination of spending cuts and higher tax revenues. Stay tuned.

<u>Assets Under Management and Referrals</u>

As of March 31, 2012, MAM assets under management were over $120 million, up from over $110 million at the beginning of 2012. I want to thank those of you who have added to their investments or have referred the services of McCarthy Asset Management, Inc. to their friends and family. I really appreciate this as referrals are our primary source of new clients. While our minimum amount to manage for new clients is $500,000, 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®

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