McCarthy Asset Management, Inc.

Registered Investment Advisor

Re: Second Quarter 2012 MAM Letter

Tuesday, July 3, 2012

Dear Client,

The on-going European sovereign debt crisis and disappointing economic reports caused the stock market to stumble in the second quarter. For the first six months of 2012, though, the stock market has performed well and I am hopeful that stocks will build upon their first-half gains. Nonetheless, with the most recent portfolio repositioning, we reduced international equity exposure in portfolios to the lowest it has been in many years. This letter discusses:

- Mid-year Economic and Stock Market Update
- Melissa Tosetti of The Savvy Life—Services Now Available to MAM Clients
- Reminder of Other MAM Financial Planning Services: Long-Term Care Planning Services (via Allen Hamm) and Net Worth Analysis and Retirement Analysis

Stock Market & MAM Performance for Second Quarter

Unadjusted for dividends, the S & P 500 fell 3.3%, the Nasdaq dropped 5.1%, the Russell 2000 slipped 3.9%, and the international equity index MSCI EAFE fell 8.4%. Bonds, as represented by the Barclays U.S. Aggregate Index, were up 2.1% for the quarter.

MAM Portfolio Performance: Excluding the "very conservative" portfolios, the composite return of assets in MAM portfolios was a loss of 1.9% (after MAM fees) versus a drop of 2.8% for the Vanguard Index 500 Fund (symbol VFINX) with dividends reinvested. The quarter's performance for assets in the "very conservative" portfolios was flat (i.e. no gain or loss).

Stock Market & MAM Performance for YTD 2012

Unadjusted for dividends, the S & P 500 rose 8.3%, the Nasdaq jumped 12.7%, the Russell 2000 climbed 7.8%, and the international equity index MSCI EAFE inched up 0.8%. Bonds, as represented by the Barclays U.S. Aggregate Index, were up 2.4% for first six months of 2012.

MAM Portfolio Performance: Excluding the "very conservative" portfolios, the composite return of assets in MAM portfolios was a gain of 5.1% (after MAM fees) versus a gain of 9.4% for the Vanguard Index 500 Fund (symbol VFINX) with dividends reinvested. For the first six months of 2012, the composite return for assets in the "very conservative" portfolios was a gain of 4.0%.

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 June 30, 2012, the original $50,000 had risen to $89,897, plus $1,193 of cumulative withdrawals. This represents a cumulative return of 82.2%. During the same time, the S & P 500 (as represented by the Vanguard Index 500 Fund) rose 23.1%. For the quarter ended June 30, 2012, the portfolio fell 1.8%, and for the first six months of 2012 it rose 5.2%. All returns quoted for this portfolio (and for all MAM portfolios) are net of MAM fees. Also, past performance does not guarantee future results.

Mid-Year Economic and Market Outlook: Opinions from Two Experts

While the U.S. economy continued to grow in the second quarter, a number of recent economic reports indicate that the growth was even more anemic than the first quarter's growth. I don't believe the U.S. is likely to fall back into a recession anytime soon (assuming Congress addresses the Fiscal Cliff that the U.S. faces January of 2013—see First Quarter 2012 MAM letter for further discussion). Below are the economic and stock market outlooks from two financial experts whose opinions I respect and have discussed in prior Commentaries and Quarterly Letters:

1. **Bob Brinker's Marketimer:** In the most recent monthly report which was issued this week, Bob Brinker provides an update on his **Marketimer®** stock market timing model. The model contains four parts:

    a. **Economic Outlook:** The U.S. economy continues in a modest recovery. While some of the indicators have weakened recently, many of the housing reports have been positive. Housing is no longer a drain on economic growth, and in fact has the potential to make a positive contribution to economic activity going forward.

    b. **Monetary Policy:** The Federal Reserve has indicated that it will continue its easy money approach, and given the fact that inflation is currently very low, it is well positioned to do so. Brinker expects the Federal Reserve to use every tool in its monetary arsenal in order to fulfill its congressional mandate of maximum employment consistent with price stability. Although the unemployment rate has dropped nearly 2% since peaking in 2009, it remains well above the Fed's comfort level of 5.2% to 6.0%.

    c. **Investor Sentiment:** The Investors Intelligence survey of investment advisors shows that 38.7% of advisors in the survey are bullish. This reading indicates a high level of skepticism persists within the advisory community, which is a favorable reading for this contrary indicator.

    d. **Equity Valuation:** Based on the June 30th closing price of 1362, the S & P 500 is trading at a Price-Earnings ratio of 13.2 times Brinker's 2012 operating earnings estimate of $103. Brinker feels a reasonable value for the S & P 500 is 14.5 to 15 times earnings going forward (or an S & P 500 level of the upper-1400s to lower-1500s range). The historical average Price-Earnings ratio for the S & P 500 is 15 to 15.5 times earnings.

    In summary, the **Marketimer®** stock market timing model remains in favorable territory and Brinker expects additional stock market progress going forward.

2. **PIMCO Funds Secular Forum:** PIMCO Funds (who is the largest bond manager in the world) recently held their annual Secular Forum, where PIMCO investment professionals from around the world and certain invited investment and economic experts discuss and debate the firm's three- to five-year outlook for the global economy and financial markets.

The New Normal: The Secular Forum held by PIMCO in the spring of 2009 introduced the term "New Normal" (which I first discussed in my July 2009 Monthly Commentary). The New Normal called for long-term deleveraging that would lead to lower growth than society had been accustomed to. It called for more modest investment returns across asset classes, as the leveraging of the economy reversed course. Most importantly, it said there would be no V-shaped recovery that is typically seen after a recession. It would be a long, hard adjustment period with sustained high unemployment. It also called for a transition of stress from private balance sheets to sovereign balance sheets.

Updated Secular Outlook: Three years after introducing the "New Normal" concept, I must say that PIMCO has been pretty much right on target with their predictions. Therefore, I think it is worth hearing what PIMCO has to say with their updated Secular Outlook that was discussed at the recently concluded Secular Forum. Per an explanation written by PIMCO's Neel Kashkari (formerly Assistant Secretary of the U.S. Treasury where he oversaw the massive $700 billion U.S. Government Troubled Asset Relief Program program): "Our updated Secular Outlook calls for a continuation of the deleveraging we've experienced for the past few years. Slow real economic growth in America of 1% to 2%, a likely recession in the Eurozone stemming from the ongoing debt crisis, and—and this is really important—slowing growth in the emerging markets of 5%, down from 6% previously. Remember, emerging markets have powered the global economy for the past few years; the U.S. will have to carry more of that load now. But with more moderate overall global economic growth in the next three to five years, markets will be more vulnerable to shocks."

Why Invest In Equities?: Kashkari addressed the question: Why should someone invest in equities given the volatility of the New Normal? Why not sit in cash and wait it out? Kashkari's answer was: "Unfortunately the final end-state for the global economy following this debt-induced crisis is unclear:

- If the global economy faces *deflation*, *sitting in cash or fixed income instruments will probably be the best option*. Purchasing power will increase as prices fall. While a deflationary scenario is not impossible, it is the least likely outcome given central banks' actions to date.
- More likely is a *moderate inflation* scenario. Sitting in cash in such a scenario will see purchasing power degrade due to inflation. *Equities should perform well in a moderate inflation scenario*. This is our highest likelihood outcome.
- A *high inflation* scenario can't be ruled out either. It is possible that central banks could lose control of inflation expectations. In such a scenario, cash and bonds will likely preform the worst, with equities next. *Real assets and commodities would likely perform best*, because prices for those assets should rise with inflation."

Conclusion: Kashkari summarizes: "Because of the uncertainty regarding the end-state of the global economy and the fact that the only scenario in our view where cash performs well is the least likely (i.e. the deflationary scenario), sitting on the sidelines is unfortunately not a good option for those who have future liabilities they need to meet. We think a better investment approach is to invest globally, across asset classes, reflecting the likelihood of the various outcomes. *Given our outlook that moderate inflation is the outcome with the highest long-term probability, we believe equities should be a meaningful part of a diversified investment portfolio.* Equity investors should continue to focus on higher-quality companies with strong balance sheets that are selling into higher-growth markets, including those that pay healthy dividends."

Melissa Tosetti of The Savvy Life- Services Now Available to MAM Clients

Melissa is the founder of The Savvy Life, a financial education company whose purpose is to provide clients the day-to-day financial education that they may not have learned from parents or in school. This education is provided through her international best-selling book *Living the Savvy Life*, classes and one-on-one counseling. I previously wrote about Melissa in the February 2012 Monthly Commentary. In that letter, I said that I was impressed with Melissa and felt that she offers valuable financial services that complement the financial planning and investment services offered by MAM. Melissa teaches the basic financial skills for people to improve their day-to-day money management.

Services Available to MAM Clients: When I first met Melissa, I suggested that she offer a program where financial advisors could hire her to work with their clients. In response, Melissa has introduced a service whereby upon paying a retainer fee, certain services will be made available to the financial advisor's clients. We have paid the retainer fee. As a result, services available to McCarthy Asset Management, Inc. clients include:

- Up to 12 savvy life articles that can be sent with the MAM monthly newsletter (the first one was sent as an attachment to the June Monthly Commentary).

- 25 copies of the international best-seller *Living the Savvy Life* (on a "first-come, first serve basis" we can provide a copy of the book free to interested clients)

- Living The Savvy Life Class, Seminar or Webinar to be conducted by Melissa (details still to be worked out)

- Four 60-minute client consultations per month for one year (please let us know if you are interested in taking Melissa up on this offer)

Melissa's Approach: Melissa teaches personal finance from a lifestyle perspective because money affects everything. It affects where you live, what you eat, what you wear and how you spend your free time. For this reason, much of her focus is on the areas where you most often spend including your Home, Food, Wardrobe, Travel and Entertainment. Just one example of how Melissa works with clients is The Sherman Family. During a two part session, she taught them simple grocery shopping strategies that:

- Saved them $850 a month
- Stopped the cycle of putting Christmas and vacations on their credit card.
- Allowed them to finally start a wealth building account.
- She was also able to save them an additional $350 a month by identifying financial leaks and helping them to streamline their overall spending.

Excerpts from Melissa's book: For further insight into Melissa's approach to personal finance, here are a couple of excerpts from the Introduction Chapter in *Living the Savvy Life*:

"In the Savvy Living courses I teach throughout the San Francisco Bay Area, I was initially startled to see that the typical class had an average age of 60 and was comprised of many women making six-figure salaries. With retirement just a few years away and a potential reduction in their monthly income looming, they realized they needed to do something about their money management habits, and fast."

"…As you will hear us emphasize again and again, it doesn't matter how much money you make. It's how much you keep!...While *Living the Savvy Life* is written for women, the lessons within are directly relevant to men, teenagers and families…What do we want you to get out of this book? We want you to gain control of your finances, focus your spending on what you truly want and enjoy your life to the fullest! Life is a wonderful adventure, regardless of how much money you are making. Together we can create a plan to finance it properly."

Free Weekly Newsletter: One way to benefit from Melissa's insights is to sign up for her free weekly electronic newsletter. By signing up, Melissa will also provide the first two chapters of *Living the Savvy Life*. To sign up, access Melissa's website (http://thesavvylife.com), and on the left side of the home page, type in your email address, name, and preferred format for the delivery of the newsletter. Melissa indicated that those signed up for her weekly newsletter will receive announcements of upcoming seminars she will be conducting.

Additional Information: Please contact Alexey or myself at 650-610-9540 or by email at steve@mamportfolios.com if you would like to discuss how Melissa could be of assistance to you.

Reminder of Other MAM Financial Planning Services

Making Melissa Tosetti services of The Savvy Life available to MAM clients is the most recent addition of non-portfolio management and non-tax services we provide to MAM clients. Please let us know if you would like to take advantage of any of these other services we provide:

1. **Long-Term Care Planning Services:** We outsource this service via a retainer fee to Allen Hamm of Superior LTC Planning Services. For no cost, Allen will create a Long-Term Care Plan for MAM clients where they address how they plan to cover potential long-term care costs.

2. **Net Worth Analysis:** Annually we update our clients Net Worth Analysis to track the growth in their Invested Assets.

3. **Retirement Analysis:** This detailed, long-term analysis addresses the likelihood of the financial success of a client's plans for retirement.

Thank You For Your Referrals

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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