McCarthy Asset Management, Inc.
Registered Investment Advisor

Re: Third Quarter 2010 MAM Letter

Monday, October 4, 2010

Dear Client,

With the best September since 1939, the stock market performed well for the third quarter as signs emerged that the risks of a double-dip recession are fading and investors anticipate changes in Washington as a result of the November mid-term elections. While I am pleased to see the stock market perform so well recently and I continue to feel 2010 will be a positive year, I remain cautious with portfolio positioning. In particular, I am wary of the impact of the pending expiration of the Bush tax cuts. Raising taxes at a time when the economy is so weak would not be prudent. At a minimum, I think it is very important that these tax cuts be extended for one or two years for at least the middle class.

With this report for the quarter ending September 30, 2010, I discuss the performance of the market and MAM portfolios for the quarter and first nine months of 2010. In addition, I provide an economic update and discuss the wisdom of investing with the crowds. I then analyze the historical impact of mid-term elections and the third year of a presidential term on stock market performance and make a tax planning recommendation related to the possible expiration of the Bush tax cuts.

Stock Market & MAM Performance for Third Quarter

The stock market had a very strong third quarter of 2010. *Unadjusted for dividends*, the S & P 500 rose 10.7%, the Nasdaq climbed 12.3%, the Russell 2000 rose 11.0%, and the international equity index MSCI EAFE rose 6.3%. Bonds rose modestly and REITs climbed sharply for the quarter.

MAM Portfolio Performance: For the quarter, 1% of MAM portfolios that were invested for the whole quarter had performance that equaled or exceeded that of the S & P 500. Excluding the "very conservative" portfolios, the composite return of assets in MAM portfolios was a rise of 8.5% (after MAM fees), versus a rise of 11.3% 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 4.1%.

Stock Market & MAM Performance for YTD 2010

For the first nine months of 2010, unadjusted for dividends, the S & P 500 rose 2.3%, the Nasdaq climbed 4.4%, the Russell 2000 jumped 8.1%, and the international equity index MSCI EAFE slipped 0.8%. Bonds and REITs rose for the first nine months of 2010.

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MAM Portfolio Performance: For the first nine months of 2010, 91% of MAM portfolios that were in existence for the whole period had performance that equaled or exceeded that of the S & P 500. Excluding the "very conservative" portfolios, the composite return of assets in MAM portfolios was a rise of 4.7% (after fees), versus a rise of 3.8% for the Vanguard Index 500 Fund (symbol VFINX) with dividends reinvested. The year-to-date composite return for assets in the "very conservative" portfolios was a gain of 6.5%.

Explanation of MAM performance: Given that most MAM portfolios are currently positioned to experience 60% to 75% of the volatility of the S & P 500, it was no surprise that MAM portfolios under performed the S & P 500 in a quarter when returns were double digit. Still I was very pleased with the 8.5% return for the quarter. For the first nine months of 2010, over 90% of MAM portfolios outperformed the S & P 500 because they fell significantly less than the overall market during the rough 2nd quarter. Although I continue to feel the stock market is reasonably valued, I think it is prudent to remain defensive with portfolio positioning given the sluggishness of the economic recovery.

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 September 30, 2010, the original $50,000 had risen to $80,737, plus $1,193 of cumulative withdrawals. This represents a cumulative return of 63.9%. During the same time, the S & P 500 (as represented by the Vanguard Index 500 Fund) fell 0.3%. For the quarter ended September 30, 2010, the portfolio rose 9.0%. 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

Recent Economic Reports: During the summer, investors became increasingly concerned that the U.S. economy could experience a "double dip" recession. I was not particularly concerned about this risk. As I wrote in the 2nd Quarter 2010 MAM letter, history strongly suggested that the occurrence of U.S. double-dips is exceptionally rare and more likely the economy should grow for at least a couple of years before the possible onset of another recession. Most of the recent data on economic activity—while hardly robust—have indicated that the economy is continuing to recover:

- In the August Jobs Report, the Labor Department said that private employers added 67,000 jobs in August, more than the 40,000 economists had predicted. While this report was mildly positive, there is still a long way to go. The economy will need to generate roughly 150,000 to 200,000 jobs per month to reduce the unemployment rate.

- The August retail sales numbers showed that sales were a little higher than expected.

- Unemployment claims for the week-ending September 25th decreased by 16,000 to 453,000. The drop was larger than the expected decrease of 5,000.

- The Case-Shiller survey reported that home prices rose 0.6% in July from the prior month, versus an expected decrease of 0.1%. Home prices in the 20-city national index have now risen 3.2% compared to one year ago.

Quantitative Easing: Importantly, the Federal Reserve recently announced in a surprisingly transparent statement that inflation is too low and they may take additional steps to promote growth.

Since the Fed has already lowered interest rates effectively to zero, they intend to engage in "quantitative easing" by expanding the supply of money in the financial system in an effort to encourage lending and economic growth. To accomplish this, the Fed will likely once again start to purchase long-term U.S. Treasury securities. While it is unclear how effective the Fed's action will be, it should at least provide some support for the fledging economic recovery.

Wisdom of Investing With the Crowds

Gold or Real Estate? I have often written about the dismal track record of investors' performance resulting from the ill timing of their purchase and sale decisions. This pertains to not only the stock market, but also to bonds, commodities and real estate. A common tendency is for an investor to "chase performance" and purchase an investment after it has had very strong performance. Much of this can be explained by human nature. From an emotional standpoint, after an investment has performed well for an extended period of time investors either get greedy for returns (e.g. buying technology stocks in the late 1990's) or become complacent about risk (e.g. investing in real estate in the mid-2000's because "real estate prices never fall"). I recently read an interesting comment from Richard E. Band's Profitable Investing. Band wrote that with gold trading at over $1300 an ounce, it now costs 138 ounces of gold to purchase a typical existing home in the United States. Ten years ago, the same house cost 498 ounces of gold. In other words, during the last ten years home prices have dropped 72% relative to the price of gold. Which is the better buy now? While many may now be looking to invest in gold as an inflation hedge, it is clear to me that real estate currently offers better long-term value.

Bonds or Stocks?: During the last year I have had a few clients ask why I don't sell off the equities in their portfolios and load up on bonds. After all, they can see that the best performance came from their bond funds. It is easy to see why investors can be so negative in their outlook on stocks. During the last ten years the return on the S & P 500 Index has been slightly negative. This dismal 10-year track record was accompanied by two periods when stocks plunged by 50%. Meanwhile bond investors enjoyed strong returns during this time. Therefore, they figure bonds must be a better investment than stocks. Investors appear to think so based on mutual fund inflows and outflows.

According to the Investment Company Institute (ICI), from January 2008 through June 2010, outflows from equity funds total totaled $232 billion, while bond funds saw a massive $559 billion of inflows. This trend has not abated this year. For the first seven months of 2010, $185.3 billion was invested in bond funds, the most for the first seven months of any year since 1984, when ICI started compiling the data. This shift out of equities and into bonds is the exact opposite of what investors were doing in 1999 and 2000. During those two years ICI reports that investors added $496.9 billion into equity funds when stocks traded at 40 times earnings. During that same time, investors were liquidating bond funds with 10-year Treasuries yielding around 6%. We know how this move played out as the stock market tanked from 2000 through 2002 while bonds started a 10-year period of very strong performance. With interest rates now at a near all-time low, one has to wonder about the wisdom of those investors who have been exiting stocks and piling into bonds.

Appeal of Dividend-Paying Stocks: Although I don't feel bonds are currently at risk of suffering significant losses because I expect the Fed to keep interest rates very low for at least another year, I do think dividend-paying stocks are now a very compelling alternative to bonds. As of August 31, according to data compiled by Bloomberg and Bank of America, 68 stocks in the S & P 500 paid dividends that exceeded the average corporate bond yield of 3.8%, more than at any time in at least 15 years. Today the 10 largest dividend payers in the U.S. are AT & T, Exxon Mobil, Chevron, Procter &

Gamble, Johnson & Johnson, Verizon Communications, Phillip Morris, Pfizer, General Electric and Merck. These ten companies sport an average dividend yield of 4%, approximately 1.5% ahead of the yield on standard 10-year Treasury bonds. The average price-earnings ratio, based on 2010 estimated earnings, is 11.7 for these ten companies (versus a price-earnings ratio of 40 for the S & P 500 when investors were pouring into equities back in 1999 and 2000). Furthermore, these 10 companies are paying out only approximately 50% of their earnings as dividends (or said another way, their earnings this year are projected to cover their dividend by more than 2 to 1).

Even more importantly, stock dividends have historically grown faster than the rate of inflation. This is in contrast to the fixed coupons paid by bonds. In fact, the average dividend income from a portfolio of S & P 500 companies grew at a rate of 5% per year since the index's inception in 1957, fully 1% ahead of inflation over this period. That growth rate includes the disastrous dividend reductions that occurred in 2009, the worst year for dividend cuts by far since the Great Depression.

Dividend-paying stocks is a theme that I have emphasized since last fall. In the portfolio repositioning done in November, I added to most portfolios Vanguard Dividend Appreciation, an ETF that focuses on stocks which pay an increasing dividend. This spring I added Thornburg Investment Income, a mutual fund which focuses on global stocks and bonds, and sports a yield of 6%. This fall I am considering adding a mutual fund that focuses on Asian-dividend-paying stocks and pays a yield of over 3%.

Stock Market Performance- Impact of Mid-Term Elections and Third Year of Presidential Term

Why was September so good? While historically September is the worst performing month for the stock market, this September was an exception to the rule. As indicated by the 8.8% rise in the S & P 500, this was the best September since 1939. Many investors have been surprised by the rally's size this past month, given that the underlying economic data remains mixed. An analysis of election-year stock market behavior may explain some of the movement. In election years, the stock market typically hits a road-block in the first half of the year as investors worry about the looming vote. Performance improves as the year progresses, as investors start looking past the election.

Outlook for the Next Five Quarters: Historically, the fourth quarter of mid-term election years has been almost always favorable for stocks. According to LPL Financial, Bloomberg, in the 15 mid-term election years since 1950, 13 have been positive with the average gain being 7.9%. While some or all of this gain may have been "pulled forward" with this September's strong performance, I am hopeful the stock market still has some room to run. Looking forward to 2011, which will be the third year of President Obama's 4-year presidential term, history is also very positive. According to BTN Research, the S & P 500 index has been positive on a total return basis during the last 17 "presidential 3rd years".

While I don't put too much credence into historical returns from Presidential cycles (there can always be exceptions), the favorable outlook for equities over the next five quarters based on history gives me comfort in my cautiously optimistic outlook. While I remain fairly conservative with the asset allocation of portfolios, this is partly reflective of the risk aversion of many MAM clients. For those of you who may want to become more aggressive at this time, please let me know so we can have a discussion.

2010 Tax Planning- Reduce CA Tax Paid In?

Over 50% of my tax clients are subject to alternative minimum tax (AMT) on their Federal tax return. For many, this is because under AMT, state income taxes and property taxes are not deductible. The pending expiration of the Bush tax cuts raises a possible planning opportunity. If the Bush tax cuts are not extended, marginal tax rates will be increased. (For instance, the maximum tax bracket will be increased from 35% to 39.6%.) Since the AMT tax rate will remain at 28% (whether or not tax cuts are extended), for some the effect of the expiration of the tax cuts will be an increase in their regular Federal taxes accompanied by a decrease or elimination of AMT for tax year 2011. *If you are a taxpayer who is subject to AMT in 2010 and not in 2011, it would be beneficial to minimize state income taxes paid in 2010 (down to a level that will still avoid an underpayment penalty), and pay in the balance of the state tax owed when filing your 2010 return in 2011.* This benefit of this tax planning is uncertain because it is unknown whether the Bush tax cuts will be allowed to expire. Obama and most Democrats only want to extend them for the middle class while most Republicans want to extend them for everyone. Congress is not expected to take action on extending the tax cuts until after the November elections. Please contact me if you would like to discuss how this relates to your individual tax situation.

Assets Under Management and Referrals

As of September 30, 2010, MAM assets under management were over $95 million, up from $90 million at the beginning of 2010. 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 my primary source of new clients. While my minimum amount to manage for new clients is $400,000, 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