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# THE RECURRING QUESTION

*The content format of this issue is a bit different, focusing directly on the financial markets, opportunities and portfolio position. I hope you find the material more relevant. Feel free to comment – I love constructive criticism!*

## MARKET REVIEW

### TRADER'S DREAM! VOLATILITY

The first quarter was a teeter totter of volatility as Washington politics turned from a tailwind to a headwind for stocks; causing traders to salivate and long-term investors to stress. The quarter began with the bull market rally of 2017 steamrolling into the new year as the Nasdaq's market leadership continued to build momentum throughout January. The Nasdaq finished the month of January up 7.4%, its best start to a year since 2012. The S&P 500 finished higher by 5.6%, its best January since 1997! The Dow's 5.8% equaled its best opening month since 2013.

Just as quick as you can say "wage inflation," the tenor of the market changed. The January employment data released in early February was much stronger than expected. Wage inflation jumped unexpectedly, catching investors off guard. The threat of the Fed raising rates more frequently to combat potential inflation caused investors to re-evaluate future earnings growth. In the nine trading days between January 26 and February 8, the markets fell more than 10% and into correction territory. All S&P sectors dropped as there was nowhere to hide. Energy, Healthcare, Tech and Materials all fell more than the overall market. Defensive sectors with bond-like characteristics (high dividend yields) such as Consumer Staples, Real Estate and Telecom, declined about 8%. The highly regulated Utility sector, which typically trades in an uncorrelated pattern to most other sectors, sold off almost 7%.

Just as volatility was spiking higher, the markets staged the third momentum shift of the quarter, as stocks rallied through the middle of February and early March. The Technology sector waged a comeback and soared almost 12%, significantly outperforming the S&P 500 5.9%. If you weren't in Tech, you seriously underperformed.

Finally, the middle of March brought investors the "Tariff Tantrum" which ushered in the final trading pattern shift of the quarter. The fear of a potential trade war between the U.S. and China that would have far reaching implications for the global economy, and slowing economic data out of Europe, caused investors to become skeptical of the viability of the global growth theme.

However, it was the revelation of Facebook's mishandling of user data and the potential for tighter regulation for all Tech stocks that changed momentum and market leadership. No longer was Tech the darling of the market as fast-growing companies were replaced by defensive sectors such as Real-Estate and Utilities.

For the quarter, the Nasdaq managed to eke out a small gain of 2.3% despite a negative March where the large-cap momentum FAANG stocks (Facebook, Amazon, Apple, Netflix and Alphabet (Google)) were **down** on average 5.1%. The total return (including dividends) for the S&P 500 **fell 0.8%**, its first quarterly loss since 2015. The Dow, with its heavy inclusion of large-cap multinational companies with significant exposure to foreign trade, declined 2.5% for the quarter, as they were affected by uncertainty surrounding the implications of Trump's tariffs and the impact on future growth. Investors should not fret too much because even with the volatile quar-

ter, the Dow, S&P 500 and Nasdaq are all higher by 19.4%, 14% and 20.8%, respectively over the last 12 months.

Only two sectors in the S&P 500 finished with gains in the quarter, Technology 3.2% and Consumer Discretionary 2.8%. A rosy growth scenario and tax cuts provided the momentum for the Technology sector to lead the markets for the third consecutive quarter. The sector reported year-over-year earnings growth of almost 23% in the 4<sup>th</sup> quarter, much faster than the 11% growth reported in the 3<sup>rd</sup> quarter of 2017. Sequentially, Technology earnings continue to grow at accelerated rates, a trend expected to continue through the first half of 2018. Semiconductor and Semiconductor equipment firms such as Lam Research, Applied Materials, Intel, Micron Technologies and NVIDIA provided the spark.

The Discretionary sector was powered by internet & direct marketing firms such as Amazon, Netflix, Tripadvisor Inc. and Booking Holdings (formerly Priceline.com). This group had average returns of about 19%. Department stores like Kohl's, Macy's and Nordstrom also had a strong quarter as expectations for improving economic growth contributed to rising prospects for earnings.

Telecommunication Services -8.7%, Consumer Staples -7.8% and Energy -6.6% led on the down side. The Telecom sector was constrained by expensive infrastructure upgrade cycles and constant competition and cannibalization from new ways of communicating. As economic growth spiked higher in February, the sector sold off on worries of higher rates affecting their cost structure, especially the cost associated with large debt balances. Staples and Energy sectors were primarily affected by the "Tariff Tantrum" and its implications on global growth. Tariffs create trade wars which limits growth and causes prices of goods and services to rise and stocks to fall. For example, China is the biggest importer of U.S. oil. Tariffs would cause China to go elsewhere for their crude supplies hurting demand and pushing down prices for West Texas Intermediate crude (WTI).

Growth stocks, those with revenues and earnings expected to increase at a faster rate than the overall market did significantly better than value stocks in all cap ranges (large, mid, small and Micro-cap). The 10y-Treasury rose from 2.45% at the beginning of the year to 2.74%, indicating that bond traders believe rates will continue to rise. Meanwhile, the dollar fell over 2% in the quarter versus rival currencies, predominately on worries of a trade war with China and better economic data out of Europe.

# LOOKING FORWARD

## QUESTIONS

The biggest strategic question facing investment professionals centers around their opinion of whether the markets are at or near the end of the bull market run that began on March 9, 2009. In what has turned out to be the second-longest bull market in U.S. history, the Dow, the S&P 500 and Nasdaq have returned almost 300%, 400% and 500%, respectively. Every week *The Wall Street Journal*, *The New York Times*, *Barron's* and other financial periodicals have perceived experts providing narratives supporting both views. However, in truth, no one really knows how or when this remarkable market run will end. Currently, there are just as many variables supporting the bull market as there are warning of an imminent correction.

With that said, the answer to the burning question – “is the bull market run over?” ... not totally! Without a doubt, the midcycle low inflation, low wage pressure environment is in the rear-view mirror. That was the low hanging fruit. Now the economy and businesses have hard work to do. This year's earnings by quarter are expected to grow 18%, 20%, 22% and 19% in the 4th quarter. This is coming off six consecutive quarters of earnings growth for the S&P 500. Keep in mind, the new tax plan passed by Congress at the beginning of the year will add around 10% to 2018's expected earnings growth. As we get closer toward the end of the year and businesses have to anniversary these robust numbers, it will become much harder to generate the revenue and earnings needed to push stock prices higher. Additionally, we must factor in the implications of tariffs and their effect on costs and corporate profit margins.

Furthermore, as a risk manager, we are constantly planning for contingencies. When there is a high level of uncertainty as to where the markets are trending, we rely on real-time facts, economic data and asset valuations to guide our investment strategy. We have recently added a “Washington Effect” into our thesis. This requires building in a risk adverse scenario that takes into effect the potential implications of a sudden shift in economic, geopolitical and/or regulatory policy. The “Washington Effect” has the potential to either propel the financial markets toward new heights or into a protracted correction.

## MACRO FACTORS

Recent economic data point toward slowing conditions. Retail sales have fallen short of expectations in the first two months of the year, just as projections for 1Q '18 GDP (amount of goods and services produced in the economy) has been revised lower. Business wages have cooled a bit from January's unexpected robust growth and manufacturer's enthusiasm and confidence has leveled off since January. All the while, the Federal Reserve has indicated they are on course to raise rates at least two, maybe three more times this year. Taken together, we believe the economy is in the late stages of an economic cycle.

As the economy evolves through the cycle, we will be watching and evaluating how companies handle the rising cost of debt. Over the past several years, firms used cheap debt to fund stock buybacks and increase dividends which helped manufacture synthetic earnings and return during the slow growth environment. Corporate debt is at an all-time high of \$8.9 trillion, growing at about 6.5% year over year. With the Fed indicating they will raise interest rates two, per-

haps three more times in 2018, companies with levered balance sheets might have to cut those dividends, reduce stock buybacks or cut capital spending budgets resulting in a headwind for stocks.

Consumers typically exhibit shopper fatigue, late in economic cycles as they deal with high credit card and auto loan balances. The Personal Savings Rate hit 2.6%, its lowest level since September 2005. This means for every \$100 in after-tax income, only \$2.60 is being saved for retirement, emergency expenses and rainy-day savings. One of the main reasons the Personal Savings Rate is so low is household debt, excluding mortgages and other home loans jumped 5.5% to \$3.8 trillion increase from a year earlier. That is the most debt since the Federal Reserve Bank of New York began tracking data in 1999. Quite simply, consumers will be paying almost 6% of their disposable income in nonmortgage related interest cost, according to Federal Reserve Data. We will be watching closely to see how consumers react to this debt burden.

## OPPORTUNITIES

Are there investment opportunities late in the economic cycle? Absolutely, but market leadership will change quickly and often. We might find ourselves in a position to continue to trade a bit more frequently than usual in the coming months as we search for real value. We might have to expand our universe to include international stocks (ADR's), mid-cap and smaller-cap stocks.

Nonetheless, we think income paying stocks will once again come back in vogue. When the S&P 500 bottomed in 2009, the top five companies Exxon, Procter & Gamble, Johnson & Johnson, AT&T and Chevron represented 14% of the total index and offered an average yield of 4.2%, according to the *Wall Street Journal*. Those same stocks now account for only 6% of the index and have yielded leadership to the likes of Apple, Microsoft, Alphabet (Google), Amazon and Facebook which pay an average dividend rate of 0.65%.

We still like Technology and Financial stocks. Although Tech is a super crowded (code word for expensive) sector that has benefited from globalization, there are still attractive value propositions even with Trump's sudden protectionist policy swing. This might expose the sector to greater volatility and opportunities. Tech is also the only sector with net cash on corporate balance sheets, adding a level of safety and potential for rising dividend payouts.

The Financial sector not only held up well in the market turmoil in February and March but should benefit from several catalysts that could support higher prices. As I mentioned previously, the Fed has communicated on various occasions they are on course to raise short-term rates at least two more times this year. Higher rates help bank lending profitability. In addition, Congress continues to ease regulations, which cuts costs and enables financial institutions to have the freedom to expand into new business lines. Financials have attractive dividend growth prospects as their dividend payouts ratios are much lower than their five-year average.

# THE PORTFOLIO

## ADDITIONS & SUBTRACTIONS

Last quarter, we embarked on a strategy of utilizing market high valuations as an opportunity to sell high priced and valued stocks and use the cash to reposition portfolios to withstand more volatility. I must say, our actions could not have been timelier! As equity prices ripped higher in January, we reduced portfolio risk by selling a portion of the two largest positions in equity portfolios, **Apple (AAPL)** and **Boeing (BA)**. These two stocks have been core holdings for many years and have provided fantastic returns. Rising returns create excessive portfolio weighting. These two positions represented almost 9% of the equity portfolio, bumping up against the maximum 5% allowable threshold for any holding. Therefore, we strategically reduced exposure in individual accounts with disproportionate positions. We realized capital gains and trimmed exposure to more manageable sizes. Boeing, was clearly the stalwart of the group with returns of more than 200% since initially adding it back in February 2016. The position had grown to over 4% of client account balances. While we still like the company, it has a huge backlog of 737 MAX and 777X aircraft, looming large expenditures for a new services unit and growing margin debt. These facts, coupled with a 20% pop in the stock price in the month of January and excessive valuations left us with no alternative but to sell about half of our investor's shares. The same story holds for Apple. With a hefty portfolio weighting of 4% and a jump-in stock price of almost 6% in January, we sold about a quarter of all shares. Again, we were able to realize gains and reduce the size of the position to a manageable level.

We also sold portions of **AbbVie Inc., (ABBV)** a biopharmaceutical company that was spun out of Abbotts Labs in 2013. The company, best known for its popular autoimmune treatment, HUMIRA and other products focused on oncology and hepatitis C, has seen its stock jump almost 80% between August 2017 and the end of January, due to solid earnings and strong guidance for 2019. We realized gains by selling investor cost basis (initial investment) leaving nothing but profit. Therefore, as long as ABBV does not go to zero, investors will make money.

We reduced exposure to **Chart Industries (GTLS)**. Just like AbbVie, this alpha stock popped more than 80% over the same period. GTLS services the energy, chemical, cryogenic and biomedical fields. Basically, they provide services and solutions for low temperature storage used in transforming LNG (Liquid Natural Gas) and medical applications. Based on the extreme price appreciation, lofty valuations and the desire to reduce portfolio risk, we sold half of our investor shares.

Finally, we sold all positions in **Amazon (AMZN)**. You might remember that we added Amazon in July of 2017 when they acquired our position in Whole Foods. While this strategic position did not fit the usual value methodology, the company showed growth potential that exceeded its P/E multiple. Over the six months that we owned the stock, it did not disappoint. Its valuation multiples expanded on a monthly basis as the stock price surged. By February, its valuation exceeded the "ridiculous" level and we said "thank you very much" took our profit and went on our way!

With significant cash generated in January, we were able to take advantage of market volatility and strategically re-invest most of the cash proceeds back into several current portfolio holdings that were under-valued, under-weighted and provided a unique value opportunity. Two companies are in the Consumer Discretionary sector and

have lagged its peer group and the overall Consumer Discretionary Exchange Traded Fund (ETF). The first company we added positions to was **Time Warner Inc. (TWX)**. The company has been acquired by AT&T. However, the Federal Government is suing the telecommunications giant claiming the transaction will create anti-competitive activity. As a result, the stock price is selling at a 14% discount to the acquisition price. If the deal goes through, investors should see an immediate jump in the stock price toward the acquisition price. If the transaction is ultimately blocked by the Justice Department, shareholders could also benefit from its appealing assets (Turner Broadcasting, HBO and Warner Brothers Studios), earnings power and franchise value.

The second stock which we accumulated additional shares was **Target (TGT)**. The company's equity had fallen over 8% after announcing earnings in March. Same store sales grew at the fastest pace in three years, indicating that recent merchandise changes and store improvements are well received by customers. However, margin (profitability) fell quickly as well, due to rising wage pressure and digital fulfillment costs. Nonetheless, we like the direction and progress the company is making to improve operations and their competitive offering. We will continue to monitor progress, profitability and market share gains as they go after competitors Wal\*Mart and Amazon.

We also added to positions in **Wal\*Mart (WMT)** and **McDonalds (MCD)**. These two anchor stocks have held key positions (on and off) in our equity portfolio since Legacy opened its doors almost 21 years ago. They both have strong management, attractive valuations and evolving businesses. WMT is constantly looking for opportunities to grow and compete against Amazon. The company is trying to negotiate a bigger footprint in healthcare either by partnership or acquisition. MCD had a rough February, falling over 16% due mostly to disappointing comparative sales and questions regarding the strength of the breakfast menu. Although management lowered 1Q sales expectations, we remain constructive on McDonalds long-term position and expect better results in the coming quarters once advertising and brand awareness picks up. TV ad spend was down 20% in January, compared to the same period in 2017. MCD should also gain from greater awareness of the \$1/\$2/\$3 meal launch as well as the 2 for \$4 breakfast sandwich. McDonalds has strong and consistent cash flow and over 2.5% dividend yield.

The lone new position added to portfolios this past quarter was **DowDuPont (DWDP)**. Late last summer, Dow Chemical and DuPont merged to form the world's biggest chemical company, in terms of sales. Within the next 12 months, the company will be split into three independently run, owned and traded companies: Materials (Dow), Agriculture (Corteva) and Chemicals (DuPont). After following the company for several months, we added initial positions to client accounts after shares fell about 12% in late January, once management's disclosure that the timing of the spin-off would be pushed out until 1Q '19. Our purchase price represents a minimum 15% - 20% discount to Wall Street's average sum of the parts break-up valuation. We think this is an attractive opportunity as there are many catalysts forming that could boost the company's combined valuation over the next couple of quarters, especially for the new *DuPont* and new *Dow*. This will be a very fluid situation for the next couple of quarters as DWDP prepares to operate independently, clarifies cost synergies, balance sheet optimization and other initiatives to increase shareholder value.