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For Quarter Ending March 31, 2019

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to fund loan growth. Loan growth is also strong and has been driven by commercial and industrial loans which are considered higher margin. Overall, management expects deposits and loans (sources for liquidity and revenue) to grow 4% in 2019.

With a focus on products and increasing traffic, BAC operational efficiency has dropped (lower efficiency = greater cost savings) as the bank pares back its employee base. Management has also improved the bank's credit quality by focusing on a higher percentage of prime and super prime borrowers. We don't see a recession on the horizon, nor do we see the Fed staying passive all year. Therefore, we believe BAC is in a good position to grow as the economic cycle expands out.

About-Face

Market Review

"When Doves Cry" - Prince

I don't know about you, but I hate rollercoasters! I'm afraid of heights, despise being upside down and my back does not do well with herky-jerky sudden movements. The wild stock market volatility, like what investors just experienced over the last six months has been a figurative rollercoaster and I know we have all felt a little upside down here and there. The S&P 500 went from record highs in late September 2018 to falling 19.8% by Christmas, barely escaping the definition of a bear market. The Santa Claus rally kicked in after Christmas and continued unabated throughout February. After weathering a few loop the loop days in early March, the S&P 500 resumed its upward trajectory to finish the quarter up over 13%, which was 21% up over the Christmas Eve lows. Thus, completing an exhilarating and emotional ride that left the index just 3% off its all-time high. Remember, "no one get hurt on a rollercoaster except those who jump off mid-ride."

The Fed played an instrumental role in the recovery of stock prices. After two quarters of slowing growth and easing inflationary pressures, the Fed backtracked from its hardline on raising rates and went dovish by indicating that they might not raise rates in 2019. This set up a chain reaction causing the dollar to fall and asset prices to rise.

Lower interest rates and a cheaper dollar changed investor psychology for the better, leading to the year's best start for the S&P 500 since 1998, returning over 13% (excluding dividends) in the quarter. All eleven sectors of the index were positive, the first time that has occurred since 2014 (back then there were only 10 sectors of the S&P 500). Information Technology led the way with gains of almost 20% as Apple and Microsoft – two of the biggest U.S. companies – jumped more than 16%. Other top performing sectors included REITs +17%, Industrials +17% and Energy +15% which got support from lower rates and positive signs of a U.S. China trade deal. The Dow ended the quarter higher by 11% (excluding dividends) while the Nasdaq roared ahead by over 17%.

You would think that decelerating growth around the globe would be a negative catalyst for stock prices, yet when the Fed changed interest rate policy at the end of January, investors essentially turned a blind eye to the data. Instead, they put their faith into lower rates and "hope" for improving fundamentals later in the year. It was also helpful when the European Central Bank (ECB) joined the Fed in making dovish monetary comments in January, after Germany and France reported recessionary Purchasing Managers Index (PMI) numbers, indicating declining business conditions.

The importance investors place on easy monetary policy was on full display last quarter. Had central bankers not changed policy, there is no telling how low global stock markets could have fallen. China, with all its economic woes, had big returns in the quarter. The Shanghai Composite was up almost 24% and Hong Kong's Hang Seng index jumped over 12% after the People's Bank of China (PBOC) joined other central bankers from around the world and indicated twice in the quarter that they would continue to ease money supply to stimulate lending.

Though it sounds counterintuitive, China's weak economy served as a catalyst for stocks. The theory goes that the weaker China's economy gets, the more leverage the U.S. has in trade negotiations and the more China needs to consummate a deal. If that's true then we should have already had a trade deal because China's economy dipped into recessionary levels during February, after reporting a 3rd straight month of declining business activity. With increasing expectations for the completion of a trade deal, we believe that no matter what is finally agreed upon, the benefits are already priced into stocks.

In spite of synchronized global slowing, developed markets defined by the EAFE index (Europe, Australasia and Far East) and emerging markets (EEM) both returned about 10% in the quarter, much better than expected given deteriorating fundamentals. However, with the U.S. still growing, albeit at much slower rates, it has been a more attractive investment theme for investors during this period of global contraction, explaining why most U.S. markets outperformed global indices.

Back in the U.S., growth did better than value at any cap size, with the real winner being mid-cap growth which returned over 17%. In general, more volatile, smaller cap stocks with high earnings growth rates led market returns. The Russell Microcap growth stock index returned over 16% compared to only 10% return for its twin the Russell Microcap value stock index. Also, lower-paying dividend stocks did much better than higher-paying dividend stocks by 264 basis points or 2.64%.

Recent history proves that global investors are very comfortable putting money to work in a "lower for longer" interest rate environment as long as central bankers are maintaining easy monetary policies. We have been in this low rate environment for several years and global markets have responded positively. There is no reason to believe this won't continue into the future, especially with growth slowing.

The Portfolio

Warning Signs of Stagflation?

With the U.S. markets posting eye popping returns in the first quarter, investors have to consider realistic return expectations for the rest of the year. It's highly unlikely that either the Nasdaq or the S&P 500 could duplicate its first quarter performance for the rest of the year. If it does, it will be an exciting and likely emotional ride, ending 2019 with returns of over 32% for the Nasdaq and 28% for the S&P 500. While anything is possible, the reality will likely be much different. While we have been focusing on the Fed and their central banking pals around the world initiating easing policies, future returns for the markets will be a function of kickstarting the economy while trying to keep a lid on percolating inflation. We don't hold a lot of faith in the Fed's ability to be successful on either front.

Economic growth (GDP) peaked in the 2nd quarter of 2018 and has been trending lower ever since. As a result, there has been a chorus of calls from both the White House and Wall Street's economic gurus for the Fed to lower rates. Keep in mind, the Fed would lower rates only if they believed there was a real concern of the economy slowing and potentially slipping into a recession. Historically, the Fed has been too slow to lower rates and too fast to raise rates. Therefore, we are not confident the Fed can navigate a smooth transition toward its mandate of stable prices and full employment. Ironically, while growth continues to slow, it is hard to find a single Wall Street firm whose current investment strategist is not bullish on stocks.

There is another side to the story that could be equally as troubling as slowing growth. It involves rising costs of goods due to inflation. The combination of the two, slowing growth and rising inflation, sets the stage for economic stagflation. If the Fed were to lower rates, it could disproportionately affect the cost component of profitability as the dollar would fall and commodity prices would rise. As we have seen so far, West Texas Intermediate (WTI) crude prices have already jumped 33% in 2019. Wage inflation has picked up as average hourly earnings are 3.2% higher year-over-year which is trending at 9-year highs. In addition, median headline Consumer Price Index (CPI), which is a measure of the weighted average cost of a basket of consumer goods and services, hit its highest 3-month rolling average since 2011. This is less than ideal for corporate earnings as limited growth and rising costs will shrink profit margins and inflate valuations.

Where to Invest

As we enter the 2nd quarter, the economy continues to reflect characteristics of a late business cycle. The effects of 2018's tax cuts and fiscal stimulus are fading and the rate of growth of corporate profits is slowing. With the Fed seemingly on hold, at least for now, there needs to be a catalyst to boost economic activity. The obvious candidates would include finalizing a trade deal with China, removing the threat of tariffs on European and Mexican cars, a pick-up in economic activity in China and Europe and an unexpected rebound in corporate earnings growth rates.

Under a scenario where growth remains stagnate, we would expect financial markets to drift lower until one of the catalysts listed above occurs. With the returns generated so far this year, prudence would suggest implementing a defensive strategy focusing on the Energy, Utility, REIT and Staple sectors. This defensive posture would protect asset values in a declining market while generating above market income.

We have to be ready should there be a breakthrough in any one of the catalysts above. While you can never predict or market time these events, it pays to have some liquidity to take advantage of the market's changing dynamics. The same can be said about individual stocks. Last quarter, we were able to quickly take advantage of the negative market sentiment in Facebook's stock due to disappointing earnings and unflattering business disclosures. We also added to positions of Boeing following the second plane crash in six months of the 737Max. In both occasions, we made timely strategic buys of market leading companies that were victims of short-term business operating risks. Being nimble may temporarily hamper portfolio returns, but as cash gets deployed, long-term returns should outperform.

Additions & Subtractions

In last quarter's newsletter, I indicated that we would add positions in the Energy sector due to valuation and improving fundamentals. The sector has come under pressure over the last few years and its overall influence within the economy has dwindled from almost 30% of the S&P index weighting in the 1980's to a mere 5% today. Over the last 30 years, consolidation within the industry has increased while valuations have declined as fundamentals have changed. In the 70's, 80's and 90's, generating proven reserves was the life blood of company survival and stock valuation. Today, with the U.S. awash in reserves due to technological advances in fracking, making discovery and recovery of hydrocarbons in geologically unexpected terrain cost efficient, the name of the game is margin, location and acreage.

With supply a non-issue, the real question supporting higher crude prices and higher stock valuation rests with global demand. With evidence of global growth slowing, climate activists clamoring for cleaner, greener future, greater regulations and geopolitical uncertainties, some might question our timing. However, U.S. sanctions on two OPEC members, Iran and Venezuela and cuts in Saudi Arabia has pulled an estimated 2.5 million barrels a day off the market, giving the U.S. the power to reduce or increase production at will to meet demand. Global pricing has stabilized around $60 so far in 2019. At this price, U.S. producers can find, extract and transport at profitable levels.

We like the midstream and transportation energy companies like **Kinder Morgan Inc. (KMI)**. KMI is one of the largest midstream (infrastructure) energy companies in North America. The company is natural gas-focused with exposure to the Permian Basin. In August 2014, the company reorganized as a C-corporation, abandoning the popular tax-free financial structure known as master limited partnership (MLP). The C-Corp structure frees the company from having to pay incentive distribution rights to its parent company, enabling KMI greater financial flexibility to pursue a growth strategy focusing on expansion and acquisitions.

The company operates pipelines for crude, natural gas, refined petroleum and natural gas liquids; produces carbon dioxide (CO2) which is used in oil fields; and maintains tankers and terminals for gathering, storing, processing and treating product. The key component of growth will be two natural-gas pipelines running from West Texas' Permian Basin to the Texas Gulf Coast. Midstream energy companies trade primarily with the price of crude and secondarily on credit quality and debt levels.

We added KMI to the portfolio based on its cheap valuation, attractive C-corp structure, significant improvements in its balance sheet, strong operating cash flow, and a commitment to raising its dividend. In 2018, KMI sold the Trans Mountain Pipeline for $3.5 billion which was used to reduce debt. It gained rating upgrades from Moody's and S&P while funding all investment needs with internally-generated free cashflow. KMI is also expected to declare a $1.00 a share dividend for 2019, up from $0.80.

With the purchase of Kinder Morgan, we wanted to change the composition of the portfolio's oil service holdings to reduce exposure to West Texas fracking and add more global diversification. We sold all positions in **Halliburton (HAL)** which is primarily the leading oil service provider supporting fracking in the Permian Basin and bought **Schlumberger (SLB)** which is a global leader in oilfield services with operations in 85 countries. SLB is known for its deep-water and reservoir management technology which holds the #1 or #2 global market share position in 12 of 14 product lines, according to Goldman Sachs research. With 60% of company revenues coming from oversea markets and international spending expected to increase 6%-8% in 2019 compared to -7%-10% in the U.S., SLB has a clear advantage over its competitors. The company recently won integrated contracts for both drilling and services in Iraq, India and China.

On a valuation basis, SLB is trading at a slight premium (10%) to its peer group which is actually at the lower end of its historical range of 10% - 40%. The company is trading at a discount to its 5 and 10-year median multiple relative to most of our value metrics. The company is paying a $2.00 dividend which equates to a yield of 4.7%, close to a historic high and 2.5X greater than the dividend on the S&P 500. With global central bankers willing to add liquidity at the first sign of weakness, the probability of a global recession is small. Therefore, we expect the energy complex will gain momentum in the back-half of 2019 and provide 20%+ returns throughout the next several quarters.

Some might be a bit surprised to learn that we added **Facebook (FB)** to value equity portfolios in the past quarter as an anchor or long-term investment. This once high-flying social media company with its 2.3 billion users and popular platforms Instagram, Messenger, WhatsApp and Oculus has fallen upon hard times due to a constant drumbeat of reports of mismanaging user private data, the Cambridge Analytics election data manipulation scandal and recent departures of key senior executives.

We regard the recent headlines as short-term operational issues that will be fixed and should not affect Facebook's profitable business model particularly when compared to other media and social media firms. FB provides content to readers and collects advertising revenue from businesses who want to reach those readers. What makes their model so profitable is that they have 2.3 billion readers providing content for free, where as other media companies have to pay for their content. In fact, ad revenue continues even if you click "unfollow." Currently, only Instagram and Facebook provide advertisement revenue while WhatsApp and Messenger are seen as significant future sources of revenue.

Even with negative headlines, there appears to be no notable evidence of erosion as the userbase continues to grow and revenues increased by 37% in 2018. Daily Active Users (DAUs) increased by 9% year-over-year, which is consistent with Monthly Active Users (MAUs). The consistency in DAU/MAU suggests that users are loyal to the platform.

Facebook is a cheap, debt-free and growing company with a highly profitable business model. The company has strong cashflow and a pristine balance sheet with $41B in cash. FB uses its cashflow to reinvest back into the company in data centers, mobile pay, technology, engineers and acquisitions. FB bought back $10B in shares last year and expects to accelerate buybacks in coming years. Based on historical valuation metrics, FB looks like a bargain. Its forward P/E and enterprise value/EBITDA multiples trade at 19X and 14X, which represents a 41% discount and a 51% discount, respectively to its 5-year average.

They have long-term growth opportunities in Instagram Stories, Messenger and WhatsApp. They have announced new products such as online dating services, Facebook Marketplace and Oculus Rift headsets. In our opinion, we view FB as an attractive value company. At the end of the day, we are comfortable with the idea that people will continue using Facebook in light of security worries.

Bristol-Myers Squibb's (BMY) immune-oncology drug, Opdivo, has had a hard time keeping up with Merck's competing drug, Keytruda. With limited growth options, BMY entered into an agreement to buy fellow cancer drug manufacturer and biotech firm **Celgene Corporation (CELG)** in a cash and stock deal worth over $74 billion. Considering debt, the value of the transaction jumps to over $95 billion - the largest health-care deal on record. We **sold** all shares of Bristol-Myers on the news as we were concerned about the massive premium paid for Celgene and the ridiculous amount of debt the new combined company will carry. While Celgene does bring some new promising drugs to Bristol's cancer pipeline, we are concerned that the high value and huge debt load is not worth the risk. In addition, Revlimid, CELG's biggest drug comes off patent in the next few years. Basically, BMY bought a company similar to itself - with mature drugs, a questionable pipeline, and is now highly levered. We don't like this deal and believe the opportunity cost of holding the stock is too great.

We added to positions of **Alphabet's Google (GOOG) and Bank of America (BAC).** Both stocks had intriguing value propositions and were underweighted based on their long-term outlooks. GOOG's stock started to fall in early February after "Wall Street" cast doubt on what was really a good fourth quarter earnings beat. Analysts seemed to ignore strong growth in core businesses and instead focused on the lack of perceived transparency in reporting on "Other Bets" business, which reported a $1.3B loss probably from Waymo (driverless car technology) or Verily (their life sciences research business). *Not to be lost, YouTube and advertising is growing 23% year/year*. On a value basis, GOOG's P/E was trading at a 10% discount to its peer group when we added to positions. Other value metrics like Enterprise Value (EV)/ Sales, or EV/Earning before Interest and Taxes (EBIT) were also screaming value. We continue to like Google's businesses and believe they are well positioned to grow over the next several years.

We added to positions of Bank of America based on a valuation that is so cheap it provides a level of safety built into the stock price should BAC report disappointing earnings. Banking fundamentals don't look great right now due to a flat yield curve, concerns over a potential recession, and a Fed that has indicated rate increases are on hold for the remainder of 2019. Nonetheless, with strong deposit growth, the bank has the luxury of having a low cost of funds because they don't need to borrow from the Fed or other financial institutions

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