ASSET MANAGEMENT, INC.

3411 Richmond Avenue, Suite 750
Houston, Texas 77046

Joseph R. Birkofer, CFP®, AIF®
Principal
jbirkofer@legacyasset.com

Rick Kaplan, CFA - Principal
rkaplan@legacyasset.com

Jillian Nel, CFP®, CDFA - Principal
jnel@legacyasset.com

Dennis Hamblin, AIF®
dhamblin@legacyasset.com

Contact Info:
Tel: 713.355.7171
www.legacyasset.com

For Quarter Ending December 31, 2017

In This Issue

Around the Firm 1
Perfection; Well Almost 2
Market Review 3
Looking Forward 4

Around the Firm

In the 4th quarter, Legacy hired Angela Joyeuax, Retirement Plan Specialist, to support the rapidly growing retirement plan consulting practice headed by Joe. Angela has 10 years of experience supporting retirement plan operations and has a passion for educating employees and enhancing client experience.

Joe, Rick & Jillian spent a few days in Chicago in October for Schwab Impact, Charles Schwab & Co's annual convention to support their registered investment advisor groups and their clients. Through its conference, Charles Schwab provides and educates advisory groups on topics such as cutting edge technological solutions, investment research & portfolio management, tax optimization strategies, current & future industry trends and many other pertinent concepts. Schwab also brought in David Cameron, former Prime Minister of the UK, as a key note speaker, to talk about why he continues to be against Brexit and where he thinks European markets might be headed.

We are very proud and excited to announce that in December, Legacy Asset Management added Jillian Nel as the newest partner of the firm. Please join us in congratulating Jillian!

***Legacy Asset Management, Inc.** is a registered investment adviser. Information presented is for educational purposes only and does not intend to make an offer or solicitation for the sale or purchase of any specific securities, investments, or investment strategies. Investments involve risk and, unless otherwise stated, are not guaranteed. Be sure to first consult with a qualified financial adviser and/or tax professional before implementing any strategy discussed herein. Past performance is not indicative of future performance.*

Perfection; Well Almost

A Much-Needed Victory

Wall Street will not soon forget 2017, where a combination of a strengthening economy and earnings growth, fueled some of the best returns for equities in over a decade. Unfortunately, many Americans across the country have a far different memory of a year that left many having to rebuild their lives after a series of devastating natural disasters. From Hurricanes Harvey and Irma to the wild fires in California, over 1.4 million acres of land and over 10 thousand structures were destroyed in just the two months between October and December.

Houston, in a way was very lucky! In the middle of the clean-up from all the destruction, disruption and displacement, the city had the unexpected pleasure of watching the Astros exhilarating World Series run. It's hard to put into words the excitement generated from watching your favorite team win a Championship. I have been a fan of the Astros since birth and have witnessed many promising seasons implode into disappointment. It seemed as if the Astros winning the World Series was one of those unattainable bucket list items. However, in 2017, a team, comprised of young stars, savvy veterans, a patchwork bullpen and one very important trade for Justin Verlander, gave us hope, created excitement and led to euphoria. You could almost hear a collective exhale over the city as Astro second baseman, Jose Altuve flipped the baseball to first baseman Yuli Gurriel for the final out of game 7 to win the World Series.

Much like the Astros victory helped Houstonians cope with the rebuilding phase from Hurricane Harvey, the stock market returns diverted investor's attention away from all the ridiculous rhetoric coming out of Washington and abroad. Unfortunately, diversions grab your attention for short-periods of time before reality takes hold. Therefore, the question on everyone's mind is will Washington's less than perfect actions eventually affect stock market prices?

Making America Great?

Let's start with the obvious, 2017 was a spectacular year for investors as most major market indices recorded double digit gains. The rally started after the election in November of 2016 and continued straight thought the new year on expectations for a friendlier business environment and tax reform. However, it did not take long before doubters, political adversaries and Trump himself seemed to get in the way of congressional success. It all started in January with the inauguration of the first presidential candidate with no political, governmental or military experience. Zachary Taylor, Ulysses S. Grant and Dwight Eisenhower had military backgrounds but no political experience. Herbert Hoover had no military experience, but held the position of Secretary of Commerce, under Warren G. Harding for eight years.

Trump came into office as a complete novice and his inexperience showed immediately with comments on Twitter regarding attendance at his inauguration. From there, it became clear that the President would use Twitter as his personal media outlet to push back against his detractors, re-direct policy and promote agenda items. The use of Twitter set off a firestorm as many believe that this casual platform is no way for the President to formally communicate to the American people. On many occasions, Trump's humiliating and intimidating tweets did nothing but create unwarranted diversions from his own agenda, such as healthcare reform. Yet, every tweet had potential market moving implications and as such was covered by media outlets including Bloomberg and CNBC.

Shortly thereafter, Trump fired James Comey and the Justice Department appointed an FBI special counsel to investigate allegations into Russian interference in the 2016 election and possible collusion with President Trump. All this before geopolitical issues really started heating up with fellow antagonists North Korea and Iran. After six months, the American electorate seemed exhausted from the constant barrage of political drama out of Washington. Then came the cherry on top; The Republican's inability to fulfill their basic election day pledge of passing healthcare reform. The political system was broken, and the Democrats were in no mood to throw Republicans a lifeline. They were very happy sitting on the sidelines providing nothing but adversarial commentary from the cheap seats.

Throughout all the negative headlines, tweets, leaks and nuclear war rhetoric, equity markets around the world continued to move higher as most investors believed that the Republicans would eventually pass some kind of tax reform in 2017. Despite Washington's continued missteps, sentiment grew throughout the year and investors put more cash into stocks. According to the Wall Street Journal, more than $9 trillion in market value was added to equities in 2017, the biggest one-year infusion since the financial crisis. The conference Board indicated that the difference between consumers who expect stocks to rise relative to those that expect stocks to fall is the widest since 2004. Indicating that the drama from DC has basically been irrelevant; nothing more than a sideshow valued more for entertainment over political substance. However, if gridlock continues and congress can't deliver on a budget or other legislative reform, the markets might start paying attention.

Market Review

Records All Around

The moon and stars aligned perfectly to provide investors with the best returns since 2013. Across the board, from small-cap to large-cap, emerging to developed, all provided double digit total returns. For U.S. markets, earnings and economic growth both exceeded expectations and provided the catalyst for the market momentum. Inflation was nonexistent, and the Federal Reserve reacted by tapping on the breaks (ever so slightly) on its way to normalizing interest rates. On the international scene, improving economic growth, central bankers keeping stimulus in place and U.K. negotiations on a post-Brexit trade deal helped support developed country returns. Basically, there were no negative surprises for the markets to digest; except perhaps in Washington!

In most respects, Wall Street had a perfect 2017. Nothing epitomizes the year in returns more than the S&P 500. For the first time **ever**, the index did not have a single negative month on its way to returning almost 22% for the year. The closest it had come to this feat was 1995, when October was slightly negative. Investors continue to buy any market pull-back on confidence that earnings and growth would continue.

The Dow Jones Industrial Average set a record of 71 individual closing highs in one calendar year, as it posted a total return of 28%. The index ended December with positive returns, logging its ninth straight month of gains. This was the longest monthly winning streak since 1959, when it was up 12 months in a row. It was the first time **ever** the Dow surpassed five 1,000-point milestones in one year. As markets moved higher, momentum continued to build as it took only 23 trading days to move-up from 24,000 to 25,000, the fewest days on record.

While the Nasdaq did not achieve any monthly records, it completed its sixth straight year of positive returns, equaling the longest annual streak dating back to the 1975-1980 time period. Rapid earnings growth contributed to returns of almost 30% in 2017, which topped all domestic markets. Companies within the Nasdaq reported total earnings of over 21% in the third quarter compared to 7% for the S&P 500.

It's not surprising then, that Information Technology (+37%) was the best performing sector in the S&P 500 by a wide margin. Semiconductor, Software and Data Processing were the leading businesses within the group. With its recent strong returns, the IT sector now makes up almost 25% of the entire index, up from 21% at the end-of 2016. This means that IT has increased its importance within the market. Passive investors will have to add to positions if they want to continue to replicate (benchmark) the S&P 500.

As economic growth continued to garner strength throughout the year and personal spending picked up, Consumer Discretionary (+21%) stocks popped higher and was the second best performing sector. It was bolstered by a strong pick-up in homebuilding and home improvements thanks in part to rebuilding after Hurricanes Harvey and Irma. In addition, casinos, restaurants and footwear also added to momentum.

The Financial (+20%) and Healthcare (+20%) sectors were also important contributors to S&P's annual return. Rising rates help banks report higher profitability as the spread between what they can borrow and lend increases. If the economy continues to expand, moderate increases in rates will continue to support returns and profitability. Managed healthcare continued to rock 'n roll! It seems that the more pharmaceutical companies come under fire for price increases of medicine, the more the market rewards health insurers for increasing premiums. The Managed Healthcare group was up a whopping 42%! Stocks like Cigna, Humana, Aetna, Anthem and United Healthcare have P/E multiple at or near 20-year highs. Where is the outrage from congress?

The Telecom (-6%) sector was the biggest loser in the S&P 500. However, it is also the smallest and least important sector of the index. Its performance was skewed to the downside by CenturyLink (-22%). One of the most impressive rallies in 2017, was the explosive jump in West Texas Intermediate (WTI) crude prices, which popped 40% in the second half of the year from a low in late June of $43 to just over $60 by year-end. It was the first time in it 2½ years WTI had breached the $60 mark as the commodity finished the year 12% higher. This reversion helped the Energy sector (-3%) recover most of the losses from the first half of the year. Big integrated oil (Exxon and Chevron) and refining and marketing companies (Phillips 66, Valero and Marathon) lead the comeback.

For the first time since 2012, international stocks outstripped domestic stocks. The 19-nation eurozone economy expanded at its fastest clip in over a decade. Overall, the S&P Global Broad Market Index, which makes up stocks from 48 countries, jumped 22% in 2017. The Emerging-Market index popped 32%, while developed markets (excluding the U.S.) returned 23%, in dollar terms. Asian markets were big winners as Hong Kong's Hang Seng Index rose 36%, its largest increase since 2009. South Korea's Kospi rose 22% and Japan's Nikkei stock average moved 19% higher.

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 sizes. For example, growth companies with the largest market-cap (Facebook, Apple, Amazon, Alphabet or Google and Microsoft) returned almost 32% while value oriented large-cap stocks gained only 14%. The difference was more exaggerated as company size falls. Small-cap growth stocks returned 22%, whereas value stocks at the same size, managed 8%. As the economy gains steam, you would expect those smaller and more risky stocks to do better than those with a stable financial position and lower growth prospects.

Looking Forward

It's a new year and I would love to start with something novel and fresh. For better or worse, there is nothing new. Markets continue to go up and the S&P 500 has now gone 381 trading days without falling 5% or more from its 52-week high, the longest period ever. That sums up where we are. Whenever there is a slight regression in stock prices, investors step in and buy the dips. There is no current sustainable downside momentum.

Stocks will continue to drift higher over the short-term as the economy continues to gain traction and valuations catch up to accelerating earnings growth. We currently like Consumer Discretionary, Finance, Industrial and Energy stocks as higher rates, lower taxes, 3% GDP growth, easing regulation and valuations provide a favorable backdrop for business. Market leadership will change quickly and often. However, as growth peaks and interest rates continue to rise, these sectors will fade, and investors will have to adjust toward a defensive position emphasizing Healthcare, Staples and Utilities. As markets evolve and cycles mature, we could find ourselves trading a bit more frequently than usual in the coming months as the search for true large-cap value opportunities dwindle. We might have to expand our universe to include international stocks (ADR's) mid-cap, smaller-cap stocks, Real Estate Investment Trusts (REIT's) and utilities.

Stock picking will become increasingly difficult as the rate of earnings growth matures in the back half of the year. In 2017, earnings growth was the single most important catalyst for the market's momentum. A note put out by Hedgeye, indicates S&P 500 Information Technology earnings in 2017 outpaced estimates by 8.3%, more than double the 5yr. average of 3.9%. Actual forward 12-month EPS revisions are tracking 20% higher, even on top of already strong earnings in the first three quarters of 2017. This includes the future benefits of the new tax law which we believe are already priced into the market. Once it became clear that tax cuts would pass Congress before year-end, the S&P 500 bounced 4.6% in anticipation of higher earnings. Therefore, we see tougher comps going into the second half of 2018, as it becomes harder to keep up an accelerating rate of growth, particularly in IT. At some point, earnings will grow at decreasing rates.

Portfolio Position

In the third quarter, we took some risk off the table by selling a few of our alpha (volatile) stocks. This past quarter, we started to strategically reposition portfolios to withstand a bit more volatility in 2018. It was the first quarter in recent memory where I did not add or sell a universal holding from the portfolio. Instead, we were busy cleaning-up and consolidating equity accounts, utilizing market high valuations as an opportunity to sell those one-off securities we did not own across accounts or have complete conviction for. We were mindful of client specific tax issues and matched long-term gains and losses, to avoid unnecessary tax situations. We reinvested a portion of the cash proceeds back into several existing stocks to develop a core list of securities to be owned across all equity accounts. These names will have a greater portfolio weighting because of their attractive business model, stable financial position, valuation and higher than market dividend yield. While equity accounts have a slightly larger cash balance than normal, we believe the portfolios are entering 2018 in a good position, ready to take advantage of whatever Washington, the Fed, corporate America or Wall Street throws at us.

Finally, we would like to thank our clients for their continued confidence and support. 2017 was indeed a special year in the markets. We are looking forward to 2018 and hope it is a happy and healthy year for you and your family.