ASSET MANAGEMENT, INC.

3411 Richmond Avenue, Suite 750
Houston, Texas 77046

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

Rick Kaplan, CFA - Principal
rkaplan@legacyasset.com

Dennis Hamblin, AIF®
dhamblin@legacyasset.com

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

Scott Jackson
sjackson@legacyasset.com

Contact Info:
Tel: 713.355.7171, Fax: 713.355.7444

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Around The Firm

It was a busy Summer at Legacy. Our two interns, Kendrick Morris (Claremont McKenna) and Miles Clutterbuck (LSU) learned the basics of stock and mutual fund analysis, and accompanied Joe on several employee retirement plan enrollment meetings.

Speaking of enrollment meetings, Joe and Jillian conducted almost a dozen for our new client, Silver Eagle Distributing, including a few that started at 5 o'clock in the morning for their beer truck delivery drivers!

Jillian was elected to the HER Foundation Board of Directors, an endowment that supports the Women's Fund, a non profit that educates local area Houston women and girls on health and resiliency.

Joe completed his studies and successfully received the Accredited Investment Fiduciary designation. The AIF® is a recognized body of fiduciary processes and best practices, and has standard for the Department of Labor and various ERISA issues. In addition, Joe and Jillian completed another semester teaching the intricacies of retirement planning, Social Security and corporate retirement plan design for the Certified Financial Planner program at Rice University.

Due to significant growth in 2016, we are heading into the final quarter of the year, looking for an experienced person to add to our customer service team. If you know of anyone, please pass their name our way.

Growth, What Growth?

Illusions and Reality

Today's market is particularly tricky as valuations and stock prices would suggest a rather robust economic environment. However, reality can be distorted by misperceptions and illusions. For example, many believe that the financial markets have realized good returns in 2016. Reality is quite different. While the S&P 500 is up 19% from February's lows, it is up just 2% over the last 16 months from the prior highs of May 2015. Another misnomer is that the job market and the economy continue to improve. The reality is that both seem to be stuck in the mud.

There is basically no economic growth. At her press conference after the September FOMC (Federal Open Market Committee) meeting, Janet Yellen revealed the Fed had lowered its projected growth rate for GDP to under 2% for 2016 and 2.5% for 2017. It has also lowered their internal interest rate increase trajectory to 2.5%, by the end of 2019. That equates into a projected total increase of 1.8% over the next three years, or half-a-percent a year.

The unemployment rate stands at 4.9%, a nine year low. As hard as it is to believe, the rate of change of employment growth peaked in February 2015. In other words, it has been growing at slower rates. Workplace productivity is up only 0.4% since 2010, the lowest since World War II. Wage growth is barely kept up with inflation as median family incomes are still off over 2% from the highs of 1999, evidence of a real loss in purchasing power.

The Census Bureau recently come out with their 2015 survey which showed a 5% jump in wages (mainly from an increase in minimum wage). The lowest wage earners had the largest percent increase as 21 states initiated minimum wage increases, in some cases as large as 20%. However, there are still 43.1 million Americans living under the poverty level of $24,257. The official poverty rate (13.5%) has dropped slightly from 2014 levels, but is still much higher than 11.3% in 2000.

More importantly, in analyzing the last three "Bull Markets" dating back to 1983, Deutsche Bank analyst Dominic Konstam found that in each case, earnings growth was the primary driver in rising prices. However, in this cycle, the reality is earnings peaked in 2014 and have been negative for the last 6 quarters. In addition, there has been no growth in revenue or capital spending. Clearly, there is much work to do in order to get the economic picture back to where it needs to be.

Fed's Fingerprints

If fundamentals are so bad, what keeps driving equity prices higher? Two factors, the first is our old friend TINA (There Is No Alternative). This acronym describes an environment where bond yields across all maturities are so low that income investors have nowhere else to go for yields other than risk assets, such as stocks, REITS (real estate investment trusts), MLP's (Master Limited Partnerships) and Hi-yield bonds. I have been writing about this phenomenon for several years as the Fed and their "lower for longer" policies have destroyed retirees and savers ability to generate income from traditional sources. The second factor is the declining equity risk premium. As I wrote last quarter, this is the excess return investors demand from stocks over government bonds (which is considered the risk free rate). As the Fed initiated lower interest rates, the risk premium plunged and investors had no choice but to accept a smaller deviation in required returns between stocks and Treasury bonds. This resulted in inflows into stocks, causing valuations to escalate.

The Fed's "lower for longer" policies have also had a pronounced effect on market operations through lighter trading volume, inefficient correlations and at times, less liquidity. Stocks and bonds which typically move inversely to one another (due to different risk characteristics which help reduce volatility through diversification) are suddenly moving together. The same can be said about currencies, commodities and emerging markets.

When correlations among different types of risk assets move together, it becomes very hard to be an effective risk manager. This same scenario played out during the financial crisis in 2008 and early 2009 where all assets moved down together. Sure, some declined less than others, but essentially there was nowhere to hide. The only true risk averse asset then and now is cash.

Holding cash is an uncomfortable position when markets are rising, especially when money market rates are essentially zero. However, times are changing and some relief is in sight. It's not because the Fed is finally raising rates, but rather the unintended consequence of U.S. money-fund reforms set to take effect in mid-October. Historically, money market funds have had a fixed Net Asset Value (NAV) of $1. As of October 14th, money funds will be more like short-term bond funds with floating NAV's. Over the last several weeks, in preparation of new regulations, fund managers have been shorting their fund maturities by selling longer-term paper (bonds). This is pressuring the London Interbank Offer Rate (Libor) and commercial paper rates. For savers, this can be seen as a windfall as the fund yields can, in some cases, be almost 100% more than current levels. Borrowers will be paying higher rates as Libor, is the benchmark for many loans for businesses, consumers and municipalities. With so many longer dated bonds being dumped on the market at the same time, rates are rising to attract buyers. The private sector is already paying approximately 25 basis points (0.25%) more in adjusted or floating rate mortgages. By year end, analysts expect the three-month Libor to be up to 1.05% - 1.10%, almost 0.5% higher than what it was at the end of June. Goldman Sachs analyst Zach Pandl estimates that 15%-20% of household debt and 25%-30% of business debt is linked to Libor.

This unexpected rise in short-term borrowing costs can essentially be seen as an off-handed rate hike, which will likely factor into the Fed's future policy making decisions. Should the jump in Libor effect the housing market in a negative way, it would provide more ammunition for the Fed to be noncommittal on future rate movements. In other words, more "lower for longer"!

Market Review

Rotation

The second quarter market fuss over the Brexit vote, more QE and global economic slowing melted away like an ice cube in an umbrella drink at the beach. Investors seemed to sit back and take it all in stride, focusing instead on the mantra "Don't Worry, be Happy." Even the uncertainty and consternation regarding the impending election could not set investors off. The tone in the quarter was of an orderly appreciation and lower volatility as the S&P 500 did not record a move of 1% or more in July and August, its longest streak in two years. Both the S&P and the Dow managed to quietly reach 10 and 9 respectively, new record highs during that period. It was not until after Labor Day weekend when the angst over the Fed raising rates sooner rather than later, triggered a few weeks of nausea and unsettling market gyrations.

Nonetheless, both the Dow and the S&P 500 finished the quarter with gains of 2% and 3%, respectively and within 2% of their all-time highs. The real action was in the NASDAQ which gained over 9% in the quarter, propelling the index into the black for the first time in 2016, and closed just shy of record levels. Investors have been re-allocating portfolios away from bond like assets (those producing income) for riskier sectors like Technology, Financial and Industrial in order to position portfolios for an eventual rise in interest rates and a tick-up in economic activity. The rotation ignited a technology run which helped the S&P sector soar ahead by 12% on the backs of Apple +19%, Amazon +17%, Intel +16%, Microsoft +13%, Google +12% and Facebook +12%. The Financial sector jumped 4% with momentum in Investment Banking, Life and Health Insurers and Consumer Finance (like Capital One +13%, American Express and Discover both +6%). The Industrial sector received a boost from Airlines, Construction Machinery and Railroads. The Baltic Dry Index, which measures shipments of dry bulk cargo moving around the world (think intermodal or container shipping through rail, trucking or cargo ship) is up 84% and helps explain the strength in shipping.

With money flowing into growth areas, it no surprise that defensive sectors like Telecom (-7%), Utilities (7%) and Staples (-3%) under-performed. It's interesting to note that the Healthcare sector recorded a slight gain over the last three months, impressive on its own considering how poorly biotechnology, healthcare facilities, distributors and suppliers have done in the face of congressional testimony and Hillary's price control threats. What's equally interesting, even as the Fed continues to advertise their lower for longer interest rate policy, growth stock outpaced value (even with their higher dividend payouts) along most cap sizes. It was only at the Microcap level where value did better than growth, proving just how broad rotation was in the quarter.

Re-allocation was not isolated to the U.S. as investors were also moving money into emerging markets, where correlations are a bit lower, income generation is still attractive and a weaker dollar (which was -3.4% YTD) increases competition for foreign goods. The MSCI Emerging Markets ETF (Exchange-Traded Fund) was up 9% for the quarter and 18% year-to-date. Other global markets actually did better than the S&P 500 due to continued policies of easy money and Central Bank QE activity. The returns of major developed markets are Europe (STOXX 600) +4%, London (FTSE) +7%, Japan (NIKKEI) +10%.

The Equity Portfolio

Bubbles and Cash

After last quarter's active buying spree, we were a bit more reserved in our activity, this past quarter. We sold two of our equity holdings and added a new position, creating a net increase in cash. We sold Intel (INTC) which had been in our equity portfolio's since February 2009. It was a timely buy based on valuation, no debt and growth opportunities. As the microprocessor cycle rejuvenated after the financial crisis and their integrated digital technology platforms found multi uses, INTC's business began to prosper. Over the investment life in our portfolios, most accounts (depending on purchase date) achieved significant capital gains and accrued years of dividend income. Its valuation moved to the high end of P/E range and its dividend yield fell from 3.6% to 2.8%. In the low interest rate environment, debt doubled since 3Q of 2015 to $24B. Sales increased just 2.5% and net assets grew 20%. During the summer, the stock price reached levels it had not hit since November 2000 and we decided to sell all positions.

We also sold all positions in Cerner Corp (CERN). This health care information technology company was added to the portfolio as an alpha position (short-term trade) with a target return of 20%. In spite of reporting modest growth and lower than expected booking rates in its second quarter, the stock price continued to meander higher. The company was trading at a rich multiple (4X other mature software and IT Outsourcing companies) and we could not identify a catalyst that would propel the stock higher in the short-term. CERN does not pay a dividend and we decided there was no compelling reason to hold the shares and wait to see if management could reignite growth. We sold positions above our desired rate of return. Chalk it up to a successful trade.

We strategically increased cash positions in most of our portfolios to take advantage of short-term volatility that we expect to rule the day as markets work through issues ranging from election uncertainty, monetary policy, economic and geopolitical instability, corporate earnings, foreign bank liquidity, ballooning national debt and Brexit. Any one or a combination

of issues can pressure stocks and weigh on the economy. However, we are not discouraged. In fact, these issues invigorate us as contrarian investors – opportunists willing to sell winners and hold cash until compelling prospects are discovered. We don't chase markets higher nor do we buy assets at or near their historic highs. Ideally, we position portfolios where others are not, in essence creating liquidity for the market. As long-term investors, we seek investments that should revert to mean valuations and rational pricing over time.

Now that we have cash, what are we going to buy? Finding appropriately valued companies with actual catalyst for growth proved quite difficult. With rates projected to be "lower for longer," investors have had to forego valuations in order to reach for yield; similar to how bond investors are having to pay ridiculous premiums for higher paying coupons. The lower rate environment causes asset price inflation as investors continue to bid up high yielding equities prices, pushing valuations into bubble territory. Stocks like Clorox, Costco, Philip Morris, Anheuser-Busch and Constellation Brands in the Consumer Staple sector and Utility companies such as Southern Company, Duke Power and Consolidated Edison sport high multiples. As long as rates stay flat or low, these bond-like equities (those paying higher dividends) will continue to outperform and carry bloated valuations.

The risk to these stocks is linked to a rising rate environment, which make bonds more competitive. Income seeking investors who are risk averse will shift from stocks to more stable and predictable bonds. Stocks with high dividends, trading at ridiculous premiums (many in excess of 30% - 40% of their 10-year median average) will be the first to fall. We want to begin to ease our exposure to these stocks and sectors, because investing in companies with valuations greater than growth prospects is typically not a winning strategy. Investors end up paying excessive valuations for a dividend rather than growth potential. Should the economy falter and equity prices decline, these high priced stocks could have declines that outweigh the overall market.

Reflecting on the rich valuations prevalent throughout the large-cap arena, there are very few opportunities that have not been uncovered or exploited. One rare exception is Bristol-Myers Squibb Company (BMY). The stock was slapped down 20% after the biopharmaceutical company reported that their lung cancer drug Opdivo had disappointing results from a supplemental trial of previously non-treated non-small cell lung cancer patients. The results were a complete surprise considering that the drug was already approved for patients treated in conjunction with chemotherapy. It was expected to widen BMY's lead over competitors in cancer immunotherapies. The entire Opdivo franchise is projected to be worth $30B. The company has lost over $33B in market cap since the announcement, eliminating any value the Opdivo franchise might provide, in the future. Oh, by-the-way, the drug earned $840M in revenue in 2Q '16. The company has a solid stable of drugs for oncology, cardiovascular, immunoscience, virology and neuroscience. With clean financial statements and strong management team, we think most of the risk is out of the stock and that it will return to fair value once the election is over and further studies over Opdivo are complete. In the meantime, investors are paid a handsome dividend of 2.7% to wait, which is 0.5% greater than their 10-year bonds.

No matter how difficult the environment or over-stretched valuations become, we will continue to scour traditional areas of interest such as the Technology, Energy, Healthcare and Financial sectors for opportunities. In the meantime, we will also expand our horizons a bit by including mid and small-cap companies in our searches. There are two benefits for moving down cap: (1) diversification and (2) small-cap stock typically lead the market in an economic or earnings recovery. The potential downside is the lack of Wall Street Coverage which tends to help educate investors and provide liquidity. Additionally, should the economy continue to sputter, small caps in particular, can go down as a group rather than trade individually because they are perceived to all have less financial flexibility, due to their size.

While economic factors and their impact on the Fed will always influence market direction, I am hopeful that growing corporate earnings will become the catalyst for market momentum. After six quarters of declining earnings, we could finally see a rebound in the second half of 2016, and a potential larger jump for the full-year '17. A stable dollar and a Fed mantra of "lower for longer" provide a favorable cost environment. Revenue is at such a low base that any incremental increase would flow down to the bottom line. Higher oil prices should help stem the tide of lower earnings in the Energy sector and current analysts expect 3Q '16 S&P 500 revenues to rise 2%, which should create a favorable backdrop for expanding margins and higher earnings.

Word to the wise – according to the Stock Trader's Almanac, October is typically not as bad of a month for the stock markets as many investors think (based on the crashes of 1929 and 1987), except with one caveat – during election years. The S&P 500's average decline is 0.7% while the Dow declines 0.8%. However, the NASDAQ and Russell 2000 small-cap fall considerably more 2.1% and 2.6%, respectively. As Barron's author Randall Forsyth notes in his article, there is nothing average about this year's election season. So stay tuned and keep a brave heart. We will watch, monitor and act upon any volatility or activity that provides investors with attractive opportunities.