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Around The Firm

Legacy is growing! Please join us in welcoming Christina (Christi) Bridges, client service coordinator, to the firm! She comes to us from AXA advisors. Prior to financial services, Christi worked for Humble ISD as one of their food service managers. We are thrilled to have her with us to expand our customer service base specifically in the 401K plan & employee servicing department.

Joe & Jillian just wrapped up 2 sessions of teaching Retirement Planning & Employee Benefits for the Certified Financial Planner program at the Glasscock School of Continuing Studies at Rice University.

Legacy was a sponsor of the JCC's Annual Children's Scholarship Ball & the annual film festival. Joe raised over $2000 for the Periwinkle Foundation's Cycle For life and Jillian is currently co-chairing the underwriting committee for Periwinkle's annual Gala held at the end of April.

What A "Gig"

I write this newsletter to try to educate readers on topics that are, in my opinion timely, important, market centric and typically ignored by your local fishwrap. This quarter, I write passionately to all parents with young adults who are getting ready to graduate (or have recently finished) college, graduate school or other institutions. The harsh reality is that the prospect for employment in a job related to their educational background is bleak.

Now that I have peaked your curiosity, you might be thinking, what is he talking about? The monthly jobs reports have been stronger than expected. Indeed, 9 million jobs have been created under Obama's tutelage since taking office (14 million if you start counting from the depths of the financial crisis in February 2010) and the unemployment rate is once again below 5%. However, the reality is that most of the job creation is related to low wage paying jobs created in the service economy where employers typically pay slightly better than minimum wage. There has been zero wage inflation over the last 7 years and young adults are having a hard time finding jobs that not only correspond to their training and interest but fall within their meager compensation expectation.

Taking a step back, it might be useful to recall that job growth is a function not only of economic policies but technological advancements. For example, in the 1980's it was Reagan's corporate and individual tax cuts that spurred capital investment which led to the creation of 13 million jobs. In the 90's it was the explosion of the internet revolution and all of its potential benefits that sparked the creativity and entrepreneurial spirit which lead to a record 21 million new jobs under President Clinton.

The economics of employment have been challenging for Obama. While most of the issues relate to his economic policies, other exogenous factors such as technological advancement and demographics have not helped. In short, employment costs are rising much faster than corporate profits due to voluntary and involuntary increases in the minimum wage, regulation, trade, Affordable Care Act (ACA), and other taxes. As federal, state and corporate leaders push increases in the minimum wage, companies are altering their employment policies by holding flat or shortening the average work week, shedding noncore jobs, hiring more part-time workers and investing in automation that will help reduce the work force.

A classic example of the delicate balancing act between raising the minimum wage and corporate profitability is Wal*Mart. Last April, Wal*Mart instituted a series of voluntarily increases in its base wage from the federal minimum of $7.25 to $9 an hour. But in November, the stock price got hammered as the company reported a 10% reduction in third quarter earnings. This year, the company will once again raise its base hourly salary to $10. As a result, the company lowered its projected 2017 full year earnings by 12%, will close more than 150 stores and displace at least 10,000 workers as they streamline operations to improve efficiency and profitability.

I doubt Wal*Mart will be the only company facing these challenges as evidence shows broad increases in the minimum wage hurts job creation. According to a survey sponsored by the Fuqua School of Business at Duke, nearly three-quarters of the CFO's polled said they would trim current or future payrolls if the minimum wage increased to $15 an hour as some presidential candidates suggest. The CEO's in the survey stated that there are significant" unintended consequences for such a mandate. 41% of the CEO's said they would lay off current workers while 66% would likely slow future hiring. If it's not the minimum wage controversy then technology will impact employment. As Randall Forsyth of *Barron's* writes, Starbucks has a mobile order and pay app for most smart phones. As the technology becomes more main-stream, it will reduce the need for fast-food order takers and cashiers per store.

The "Gig" Is Up

The change in the composition of the work force, as well as the invention of new service technologies is psychologically affecting all workers throughout the entire wage scale. Uncertainty regarding pay, longevity, advancement, benefits and flexibility are causing millennials to question the validity of traditional employment. This disruption in attitudes is giving birth to a phenomenon called the "Gig Economy", named for those workers that choose unconventional working arrangements such as part-time "on-demand" or "sharing". Well's Fargo, in a recent research report, explained the concept best as "… connecting available workers more directly to customers via new marketplaces…". Uber driving is a classic example. Drivers are essentially independent contractors of the company and they choose when, where and how long they want to work.

This lifestyle has been gaining traction. Over the last two years, more than 2 million part-time jobs have been created for "non-economic reasons". These are employees that choose part-time work (less than 34 hours per week, see the Bureau of Labor Statistics website at http://www.bls.gov/) in order to gain the freedom to choose one or two part-time jobs rather than settling for full-time and/or under-employment with less flexibility. Untraditional employment arrangements are spreading to industries and occupations not typically associated with the "Gig Economy" such as healthcare, industrial manufacturing, education, transportation and administration. White collar jobs are not immune from this trend. Anna Louie Sussman of the *Wall Street Journal* recently wrote; the number of legal industry workers with alternative arrangements has doubled over the last 10 years. The business process outsourcing industry (which consists of mostly white-collar contracting firms) racked up over $136B in industry sales last year, after growing at a mid-single digit rate over the last several years, according to research firm IBIS World. As companies continue to reduce in-house costs, there is a high probability that previous full-time vacant positions will be filled with untraditional working

arrangements.

The Economics Of The Gig

What does this mean for the economy? Clearly, there are pluses and minuses to alternative arrangements. While workers do get flexibility to control their own schedule and choose projects that fit their interest, they will continue to be underemployed making less money than they otherwise would as a full-time employee. More importantly, they will potentially lose out on company sponsored benefits such as healthcare and/or 401(k) or other savings plans. While workers might be able to hold down multiple part-time jobs or "Gig" arrangements, their less reliable and uncertain income streams would negatively impact spending and saving patterns which could have long-term implications for the U.S. economy.

The college kids I talk to regarding potential employment opportunities seem realistic in their expectations. They realize that there are few high paying occupations with an abundance of openings. Of the almost 400,000 jobs created Y-T-D, almost 60% are in low-wage and part-time industries such as retail trade, leisure and hospitality, healthcare and social assistance (see the BLS website link above). Furthermore, corporate earnings are projected to fall for a third consecutive quarter, which could have negative implications on hiring and salaries. As the U.S. service economy continues to grow, there is plenty of actual and anecdotal data suggesting that this "Gig Economy" could permanently change the structural paradigm of U.S. employment.

Market Review

Similar to 1Q 2015 and the 1Q 2014, economists and investors had to once again pare back expectations for growth. Unlike the previous two years where weather was the primary driver (too cold or too snowy), this year's downgrade was linked to mixed economic data, a strong dollar and weak corporate profits. As investor's reset their expectations, oil, commodities, market sentiment and stocks turned negative quickly. After just 28 trading days, the Dow, the S&P 500 and the NASDAQ were down 10%, 11% and almost 15%, respectively for the year.

But then, just as it looked as if stocks were going to fall into the abyss, sentiment did a 180! Oil jumped on rumors that OPEC would cap production, the dollar fell and commodities bounced as Janet Yellen made dovish comments on the rate of change of future interest rate movements. By the end of the quarter, the Dow and the S&P 500 added 1.5% and 0.8%, respectively. It was the Dow's biggest quarterly comeback since 1933. The NASDAQ finished March -2.75%. West Texas Intermediate (WTI) crude jumped 3.5% for its first positive quarter in the last three. The dollar index dipped 4%, marking its worst quarter since the third quarter of 2010 when it fell over 8%. The bond market moved sharply higher on Yellen's dovish comments as 10y-Treasury yields fell from 2.3% to 1.8%.

Not surprising, stocks with bondlike characteristics (big dividends) such as Telecom (+15.1), Utility (+14.5%) and Consumer Staple (+4.9%) sectors, lead the market's rebound. Utilities had their best first quarter on record while Telecom had its best first quarter since 1998. On the down-side, Financial and Healthcare sectors endured their worst first quarter since the financial crisis, -5.6% and -5.9%, respectively. On a global perspective, the U.S. markets fared better than other developed countries as Europe (STOXX 50) -5.6%, the UK (FTSE 100) -1.1% and Japan (Nikkei 500) -9.4%. Surprisingly, as the dollar dropped, emerging markets went from a 10% mid-quarter loss, to an 18% pop, ending the quarter up almost 6%. Saving the best news for last, after several years of underperformance, value stocks finally beat out growth in all market-cap sizes. Hopefully, this trend will continue throughout the year as investors continue to seek out income.

The Equity Portfolio

A Clear Picture

In spite of the extreme market volatility at the beginning of the year, the first quarter played out as expected; minimal returns, cautious consumer, weakness in manufacturing, oil, commodities, the industrial base and most importantly a stagnate Federal Reserve. The financial markets should finally get the message that Janet Yellen is a dove. Since her appointment as Fed Chairwoman, I have been pounding the table that Yellen had no interest in normalizing interest rates. The fact that the Fed raised the Federal Funds Rate in December is still a headscratcher. After all, corporate profits were falling for a second straight quarter and the Bank of Japan (BOJ) and the European Central Bank (ECB) had just enhanced their monetary easing policies.

In a market where interest rate movements are inconsequential, investors must resist the temptation to chase stocks higher, especially after such a dramatic rebound off the February lows. Since the financial crisis, easy money (zero or very low inter-

est rates) has been the primary catalyst propelling equity markets higher. Stocks and bonds have both benefited from the low rate environment and valuations in many sectors and asset classes have become difficult to justify. For example, Hormel, the maker of the popular processed meat "Spam" is trading at a P/E multiple of 28 times, while earnings are only projected to grow 6%. While trading at almost 5X its growth rate for a staple or defensive company might be the norm, it's excessive considering it doesn't have leading market share, margins or dividend yield. Bonds are expensive too! Especially those with longer durations (maturities) and lower credit quality as investors compromise on risk in order to maintain some level of income.

As the six year bull-run matures and P/E multiples expand, picking winners won't be easy. Corporate profits are projected to fall for a third straight quarter and only three of 10 S&P 500 sectors are expected to have quarterly increase; Consumer Discretionary, Telecom Services and Healthcare. With corporate debt rising, there is a good chance that the number of corporate stock buy-back plans initiated and year/year dividend increases might fall significantly. This could create a huge headwind for stocks and could impair return potential for the remainder of the year. However, money managers that can successfully identify individual stocks that have been ignored, attractively valued, have strong financial position and/or unique businesses opportunities should benefit.

Additions and Subtractions

In our equity only portfolio, we used market volatility and churn to continue to reduce the number of core holdings in the portfolio and increase weights of key positions. We lowered the portfolio standard deviation (volatility or risk) by eliminating some of the more volatile or alpha names. We sold two of our larger core financial positions; **Capital One Financial (COF)** and **PNC Corp (PNC)** as well as two smaller alpha retail positions; **Urban Outfitters (URBN)** and **Michael Kors (KORS)** in an effort to reduce portfolio risk and cultivate gains. Selling the financial stocks coincide with our belief that banks and financial institutions will continue to underperform until rates rise and the yield curve shifts to upward slopping. The two consumer stocks were sold based on their rebound in price, uncertainty of their turnaround and strength of the consumer.

In the Healthcare sector, we sold one of our oldest positions, **United Healthcare (UNH)** due to its valuation. They say you are not supposed to fall in love with your stocks, but this was certainly one of our best. There comes a time where you have to say goodbye. By almost any criteria, the stock was expensive on both an absolute and relative basis. In January, Shire PLC, a Dublin, Ireland biotech company agreed to combine operations with our global biopharmaceutical, **Baxalta (BXLT).** The terms of the agreement were favorable and we took advantage of the premium offered by Shire and sold all positions. While we believe the two companies will be successful in their combination, we wanted to limit the number of pharmaceutical positions in the portfolio.

With the additional capital we added **Cerner Corp. (CERN)** and an old favorite, **Amgen (AMGN)**. Cerner is a healthcare information technology firm that captures and manages data for hospitals, doctors and other medical practitioners, allowing providers to access electronic health records at the point of care. The stock had fallen by 1/3 as performance and guidance was lower than expected. Nonetheless, booking and backlog orders continue to grow. Most importantly, there is a high barrier to entry in that switching costs are very high and come with years of maintenance and support contracts. The company is cheap on both an absolute and relative basis. We are excited about adding CERN to the portfolio as this is the first time that its valuation fits within our criteria. While it does not pay a dividend, we believe over the long term, investors will benefit as the valuation multiples revert back to more normal levels. It's a great trade-off to our sale of United Healthcare.

We are also back in one of our old favorite biotech stocks, **Amgen**. Its valuation was just too attractive after a 20% drop in its price, when Hillary started campaigning against the high cost of prescription drugs. The stock price reflects the volatility and uncertainty centered on the election and the positions held by the various candidates. However, the company is in an enviable position with blockbuster drugs, solid pipeline, strong cash flow, financial flexibility and an above market dividend.

We added to positions in **Boeing (BA)**, which is now one of the portfolio's largest holdings. The stock fell hard in February as it provided disappointing 2016 profit guidance and then a couple of weeks later indicated that the SEC was investigating their accounting for costs and sales associated with the 787 Dreamliner and 747 jumbo cargo carriers. We have confidence that the magnitude of the potential penalties and fines would not be material and that management would successfully work with regulators to resolve the inquiry. BA's valuation reached 4 year lows even as research suggested that the health of global new orders (specifically Asia) would remain strong, especially with massive deliveries of the popular 737 MAX on the horizon. This was one of those rare unusual gifts that Wall Street provides on occasion and we were lucky to have the capacity to pounce.