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Around The Firm

After 13 years as the voice of Legacy Asset Management, Janet Mascio will be leaving our little family for retirement in the quiet rolling pastures of Burleson County, Texas (just west of Bryan and College Station). As we wish Janet a fond adieu, we would like to welcome Sherri Kuberski to the team. Sherri hails from Chicago and is looking forward to an exciting transition and becoming a true Texan! Please welcome her as she settles into her new role.

A Tough Spot

Going Low!

If you need any further evidence of how Central Bank policy has turned global financial markets topsy-turvy, just look at how investors have reacted to nearly $13 trillion in negative yielding sovereign debt. It seems unfathomable that a rational investor would be willing to accept a loss on bond investments just for safety. Nonetheless, in this low or no return environment***, investors have turned to equities for income and bonds for capital gains.*** This stark "role reversal" is unprecedented, but then again so is the coordinated effort of global Central Banker's trying to spark growth through QE and/or negative interest rate policy. According to Bloomberg, 78% ($27.2 trillion) of all global sovereign debt issued, yields less than 1%. What does that say about the potential outlook for the global economy? Especially when institutions and individual investors seem more worried about an equity market correction than holding securities yielding negative rates.

The longer this environment persists the lower US treasury yields will likely fall as global investors seek out positive returns of US Treasury bonds. The 10y-Treasury bond is already trading at HISTORIC lows and will likely continue to fall lower. This puts the Fed in a difficult position. Should the economy falter and stimulus be needed, US bonds rates will surely slip into negative territory. Negative rates would likely be the precursor to stagflation or deflation. Should the economy pick up and the Fed finds a need to raise rates, it would only exacerbate Treasury buying which forces yields lower. Additionally, the dollar would strengthen which would act as a tourniquet on US growth causing exports to be more expensive and uncompetitive. This leads me to question, do banks like or benefit from negative rates? I can't see how they would. Banks around the globe are seeing their market caps decline dramatically on worries of loans and profitability. If banks aren't making money, how can that be good for the global economy? Who is going to provide capital for all the mysterious "corporate spending" Wall Street keeps chirping about? I guess Janet Yellen and her global central planning buddies have a plan for that as well.

Expected Return

With rates at historically low levels, we believe investors should temper return expectations to reflect the current rate environment as well as limited economic growth. After all, major US indices have not broken through to new highs in almost 14 months. Expected return comprises two elements: (1) a risk free rate and (2) equity risk premium. The risk free rate is typically designated as the rate you could earn on a US Treasury of a desired time period. We typically use the 5y-Treasury because it matches the average holding period of our anchor (or long-term) stocks. As of the end of June, the 5y-Treasury yielded 1%.

The equity risk premium is the excess return of investing in stocks over the risk free rate. The risk premium is a theoretical value that can only be estimated and varies depending on the level of risk of the portfolio. To avoid being too technical, boring or mathematically confusing, I will make this as basic as possible. The first factor in solving for the risk factor is determining the portfolio dividend rate. Over the past 80 years, dividend payments represent about 75% of total equity returns over time. Therefore, with the yield on the S&P 500 composite at 2.1%, the dividend portion of the risk premium would be (2.1% X 75%) 1.6%. The second factor of the equation is the equity premium which equals 1.9% (computed as taking the risk adjusted rolling 5-year portfolio returns discounted by the 5-year portfolio standard deviation, multiplied by the remaining 25%). Adding the two returns (dividends = 1.6% and equity risk =1.9) equals the equity risk premium of 3.5%. That is then added to the risk free rate from the 5y-Treasury (1%) to get a total equity risk premium of **4.5%.**

This is a significant deviation from traditional thinking where most investors still look toward the 7% historical annualized rate of return as a valid benchmark for evaluating performance. Unfortunately, "lower for longer" seems to be the new Fed mantra, forcing investors to adjust their return expectations to reflect the realities of the current environment. Keep in mind that the expected return is fluid and adjusts with the investment environment. Portfolio and asset allocations should also be reviewed to ensure cash flow optimization and proper alignment of risk and return. Otherwise, investors run the risk of being overly optimistic and disappointed when returns don't support spending habits.

Low yields don't necessarily equate to under performance. Rather they just make the job a bit more difficult. You might notice an increase in the frequency of trading in an effort to capitalize on short-term opportunities. The average holding period of equity portfolio could fall as we look to liquidate and realize long-term capital gains. While we are always mindful of tax liabilities, we don't let that supersede our investment decisions. We are looking forward to a challenging investment environment in the second half of the year, as we embrace for the fallout from the US election, global QE, low rates and the ramifications of the Brexit vote. In spite of some inflated relative valuations, we will continue to focus on creating income and finding value in whatever asset class we can.

Market Review

More QE, more easy money and over $12 trillion in global debt with zero or negative interest rates sparked huge inflows into US Treasury bonds, resulting in one of the biggest bull markets for the asset class. For the quarter, 10y-Treasury rates fell to a multi-year low of 1.49% from 1.78% at the beginning of the quarter, and 2.27% on December 31, 2015. As rates fall, prices rise. This "risk off" trade reflects investor concern over the likelihood of a global recession and its effects on the equity markets. Gold, which serves as a hedge against political and economic uncertainty is up 24% year-to-date, one of its best years in decades.

In spite of the market volatility, the Brexit vote, geopolitical instability, slowing global growth and uneven U.S. economic data, the Dow and the S&P 500 managed to eke out small positive gains of 1.4% and 1.9%, respectively. For the year, the two popular indices are both up about 2.8%. The NASDAQ, which finished 2015 with gains of almost 6%, still can't manage to find its way into positive territory. For the last 3 and 6 months, the index has fallen 0.6% and 3.3%, respectively as technology and biotech continues to weigh down the index. West Texas Intermediate (WTI) crude prices rebounded 28% over the past three months and 84% since this year's low in mid-February on supply disruptions and expectations of falling production. Although the dollar rebounded in the quarter, the "Greenback" is still down about 3% verses a basket of foreign currencies.

The Energy sector finally had a rebound quarter, jumping almost 11% and compiling YTD gains of almost 15%. Oil and gas drilling and exploration and production (E&P) companies ignited the recovery and offset "downstream", losses in refining and marking. Not surprising, stocks with bond like characteristics (big dividends) continued to lead the market. For example, Telecom and Utility stocks were both up over 5% for the quarter and over 21% YTD. Healthcare was also a leader posting gains of 5% in spite of pressure from biotech. On the down-side, Technology was the big loser falling over 3%, due mostly to weakness in hardware and system software sales. Consumer stocks were also weak as retail, across all spectrums (households and housewares, home furnishings, apparel, department stores, general merchandise, autos and footwear) fell on disappointing earnings and lower guidance for the near future. On a global perspective, the U.S. markets fared better than other developed countries as Europe (STOXX 600) fell 10% and Japan (Nikkei 500) sank 18%. Value stocks continue to 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

Liquidity

Liquidity and volatility go hand in hand. If there is no liquidity (institution willing to take the opposite side of a transaction enabling immediate execution at a stable price) to support a popular trade, volatility usually spikes to extremes until investors see an opportunity to step in and fill a market void. For example, take the Brexit vote, where all of the pundits predicted that a vote to "stay" would prevail. When it didn't, investors wanted to sell all risk and at any price. With few investors willing to step in and make a market, a significant imbalance of sell orders materialized causing dramatic drops in global equity prices.

As contrarians, we choose to position our portfolios where others are not, in essence creating liquidity for the market. Realizing that Legacy is not a big institutional player in the market trading system, we don't expect to step in and buy at the bottom or sell at the top. Rather, as long-term investors, we seek investments that should revert to mean valuations and rational pricing, over time.

In addition to liquidity events, we primarily spend our time analyzing the overall economic and financial landscape to develop a thesis to guide our investment strategy. Since last quarter, our data indicates that a slight downturn in housing, manufacturing and employment coupled with added uncertainty thrusted upon global economies from the Brexit vote could result in headwinds for equities, in the near-term. As a risk manager, we get paid to protect our investors from volatility. Therefore, until there is some fundamental change in economic, monetary and/or fiscal policy as well as corporate financial engineering, we believe the status quo will remain. Bond-like equities (those paying higher dividends such as utilities, telecom, staples and REITS) will continue to outperform. Therefore, we strategically overweight client equity portfolios in Staples and Telecom and have limited exposure to Discretionary, Energy, Financial and Material stocks. We also have considerable cash built-up in portfolios to take advantage of future disruptions in the market that might create attractive liquidity opportunities.

Additions and Subtractions

Like sharks circling their prey, we entered the quarter with unusually high cash balances ready to pounce on any dislocation of value. The late April early May equity market sell-off provided opportunities to pick-up several high quality names at discounted prices. We bought back into **Teva Pharmaceuticals (TEVA)** and **Limited Brands (LB)**, two very well run companies with strong business models. We added TEVA at a 7% discount to where we bought it back in 2014, due to the hysteria of a Clinton election and the potential for price controls on drugs. The generic pharmaceutical developer focuses on solutions for the CNS (Central Nervous System), respiratory, oncology and women's health areas. Teva has a deep pipeline of drugs and is the lowest cost producer in generic drugs. At a paltry 8 times earnings, the stock trades near historic lows reached in 2011 and doesn't reflect the reality of growth in its drug pipeline.

Limited Brands is the parent company of Victoria Secret (VS) and Bath & Body Works (BBW). As of January 2016, 58% of the 2,700 store units were BBW, 36% VS, 5% PINK and 1% Henri Bendel. The stock had been caught up in the wave of weak retail earnings and broad based negative investor sentiment. Although LB did marginally lower guidance for the year, management has implemented several strategic initiatives to position the company for growth and drive future profitability by (1) eliminating certain product lines (swim, online apparel and shoes), (2) restructuring business units into three groups: Lingerie, PINK and Beauty, (3) integrating and coordinating eCommerce with Victory Secrets and PINK store businesses by eliminating direct mail promos and reducing promo on key band categories and (4) initiating headcount reductions. Valuations have come down significantly and LB now trades at a discount to both its 5-year median average and its peer group. The company pays a dividend of over 3% which pays investors a significant premium to wait for management to execute its strategic initiatives and manage inventories and markdowns to drive profitability.

We added to our energy exposure by creating an initial position in **Southwestern Energy (SWN)** and adding to our small position in **Apache Corp (APA).** While we believe the current momentum in oil prices are synthetically supported by (1) disruptions in Canada due to wild fires and (2) sabotage of Nigeria's pipe line, price stabilization is not far off as U.S. markets are close to supply and demand equilibrium. Increasing demand will soon catchup with the deep cuts in production forcing a rational and permanent pricing relationship.

While valuations are inconsequential at this point in the cycle, SWN has an attractive business model which is levered to improving fundamentals in natural gas. We see demand increasing through year end, due primarily to laws enabling exportation, utilities switching from coal to natural gas and the electrification of automobiles. Meanwhile, supply should remain flat as drilling has been cut over 65% over the past 12 months. SWN's business is derived from 97% natural gas and natural gas liquids (NGL's). They have reduced capital spending and currently deploy only one rig. However, management has indicated that as gas prices continue to rebound, more rigs will be deployed. From a capital standpoint, they do have a good bit of debt scheduled to mature in 2018. Management recently renegotiated and increased their line of credit through 2020, which should alleviate anxiety that the company will not be able to meet their debt obligations when due. Therefore, support from stronger supply/demand fundamentals and access to capital should provide the momentum to move the stock higher.

We added to positions of **Apache Corp. (APA)** based on what we see as improving economics and fundamentals within the energy complex. Legacy has been significantly underweight energy through most of the correction but now think it is appropriate to begin to increase exposure to select companies that should lead in the early stages of an energy revival. APA has been an anchor or core holding in our portfolios since 2013. They have a diverse asset base which adds value as they continue to sell assets to strengthen their financial position. Legacy is not the only investor with an eye on APA. Two different buyers have approached the company as a consolidation transaction. However, in both cases, management turned down the deal based on where we are in the energy cycle, and believing that valuations could be at or near the bottom. Besides, exploration and production (E&P) companies are best positioned to take advantage of the current spike in crude prices while costs for drilling is low as the US rig count has fallen from over 2000 active rigs in December 2011 to a paltry 421 in late June 2016. E&P companies usually lead early in the cycle whereas oil service stocks outperform later, as the cycle matures and service and maintenance cost rise with heavy usage. While valuations are still meaningless at these levels, a cost benefit analysis of drilling versus not drilling at these prices and above, indicate intriguing future valuations. Therefore, we expect our dollar cost average strategy to pay off as APA approaches full valuation as the energy sectors continues its recovery.

We also added to positions of **First Solar (FSLR)** which we have held since January 2014. It is amazing to me that this stock continues to be misunderstood by Wall Street. As the **ONLY** low cost producer of solar rooftop panel modules, FSLR continues to post quarter after quarter of profit growth. Look it up! It is absolutely amazing that the smartest analysts in the world (those on Wall Street) lump this company in with the other bankrupt models of Solar City and SunEdison. Sorry, I digress. FSLR continues to win new business and drive profitability, especially overseas. In addition, its steady utility like business provides cash flow well into the future. First Solar still trades cheaply based on any of our value metrics. Oh, did I mention that it has zero debt? That means no chance of bankruptcy and cash on hand equals 40% of total market cap. At some point, Wall Street has to wake-up and give this company a proper valuation.