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In This Issue

About Legacy

Legacy Asset Management, Inc. is an independent Registered Investment Advisory firm, committed to providing the best solutions for our clients' success.

We offer professional money management and sound objective advice throughout a full range of investment and Qualified Retirement Plan consulting services for the institutional and high net worth client.

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Around the Firm

Legacy enjoyed much deserved, high profiled press in the first half of 2015

In January, Jillian Nel, who directs Legacy's Financial Planning Group, was awarded the Certified Divorce Financial Analyst designation by the Institute for Divorce Financial Analysts, a premier national organization dedicated to the certification, education and promotion of the use of financial professionals in the divorce arena.

In March, Jillian was also on the cover of *Retirement Advisor Magazine* and featured in the cover story for the issue. This industry periodical targets financial planners and advisors around the country who subscribe for insight on practice management strategies.

In April, the Houston Business Journal named Legacy Asset Management Inc., a top Houston Area Wealth Management Firms with Investment Minimums of less than $1 Million.

Finally in May, Joseph Birkofer, Principal of Legacy Asset Management, was named a Top 401 Retirement Advisor of 2015 by the Financial Times. The list recognizes the top financial advisers who specialize in serving defined contribution (DC) retirement plans around the country.

Tough Spot

Symbolism

Over the last several quarters, I laid out clear and concise data supporting my belief that the Fed would not raise interest rates until after the second half of 2015 at the earliest, but more likely next year. Over the last 18 months, "lower for longer" has been my mantra as Wall Street experts and Nobel winning economist all predicted rising rates. The economic data did not support their thesis and I knew the dovish Fed Chairwoman was more than willing to prolong the inevitable for as long as possible.

In spite of what is happening in Greece, which would support my original beliefs, I am changing my tune. This is not because I expect an eminent bounce in the economy or looming inflation threats. Rather, I see the Fed raising rates sooner as a symbolic gesture to U.S. investors and global central bankers that the Fed has their eye on the ball. Indeed, there has been some good news - recent economic reports have been a bit better than expected with consumer confidence, the housing market and jobs data all trending higher, but not enough to justify a rate increase. I do sincerely hope my intuition on this is wrong because appeasement is not an appropriate policy making tool. The potential unintended consequences and timing of such a decision could have negative implications based on where we are in the economic cycle. With manufacturing and capital investment at cyclical lows and I can't imagine how higher borrowing costs will help.

James Paulsen of Wells Capital Management recently referenced these issues in a broad economic article where he summarized that corporate profit margins are near all-time record highs and the unemployment rate is approaching full employment. This is not the ideal backdrop to begin a policy of rate increases because the Fed typically relies on recovering corporate profitability as an offset to tighter monetary conditions. As noted by Paulsen, in every case since 1960, monetary tightening began when profits were still in an early stage of recovery. Unfortunately, because the Fed has waited so long to raise rates, this buffer might not be helpful as most of the profit gains for this cycle have already occurred.

Some might argue that "it's different this time" because profit margins have been artificially sustained due to financial engineering (cost cutting and share buybacks) rather than actual revenue growth. Therefore, a more normal growth cycle with recovering revenues could support margins and offset interest rate increases. The only problem with this theory is that according to Factset Research, revenue growth is projected to decline 4.4% in 2Q 2015 and decline 1.8% for the full year. In 2016, S&P 500 revenue is only projected to rebound 6% which might not be fast enough to help earnings offset rising operating and borrowing costs. Most of the recent market volatility can be traced to investor anxiety regarding when and how much rates will move. Therefore, I just can't see the Fed initiating a campaign of tighter monetary policy, just as the economic cycle is peaking. Nonetheless, that doesn't mean they will not still raise rates just to prove a point. Whatever the Fed decides and whenever they decide to do it, it will at least be slow, measured and telegraphed.

Productivity

If my intuition is right and the Fed does raise rates sooner rather than later, Paulsen suggests that one of the best ways to combat the quandary of high profit margins and near full employment is for corporate America to aggressively invest in productivity. Productivity stretches out and rations available labor while keeping costs manageable. When the economy is growing and demand increases, productivity offsets the costs associated with inflation and rising rates. Basically, strong productivity can help prolong economic recoveries by counterbalancing the high costs of full employment. Since the beginning of the post-war era, productivity and the stock market generally move in tandem. In fact, there has only been two periods where this relationship did not hold – during the first half of the 1990's and from 2012 to today. In both cases, bond yields and interest rates were flat or down. Clearly, the U.S. is considerably under invested and without sufficient productivity gains it will become difficult for the economy to maintain a growth trajectory in the face of higher employment and borrowing costs that will support earnings growth and stock market momentum.

FORE!

In golf, if you hit an errant shot, you yell "fore" to alert those around you to take cover. So prepare to take cover…FORE! …there are some issues that could interfere with the summer's market momentum. First, the economy is far from robust and there must be some sustainable momentum in housing, wage growth and consumer spending that will serve as a catalyst for earnings growth. Second, the market is not cheap. According to FactSet, the forward twelve month P/E ratio of 16.9X is more than double the projected full year 2015 earnings (excluding energy) growth rate and over a 50% premium to the projected 11% growth rate for full year 2016. The P/E is also above the 5-year (13.8X) and 10-year (14.1X) average. Third, if the Fed does raise rates, the dollar will continue to strengthen relative to other currencies, which will pressure margins and earnings of U.S. companies that sell products overseas. A stronger dollar will also negatively affect the economies of emerging market countries as their products become more expensive relative to U.S. products. Finally, in the slow news cycle of the summer months, global markets and geopolitical events will continue to be short-term, de-stabilizing forces for the markets. With so many potentially disruptive headlines, ranging from Greece's default to China and Europe's slowing economy, Russia's saber rattling and the Middle East civil wars, investors will constantly have to deal with the market impact and volatility associated with these exogenous factors. Portfolio risk will temporarily shift from maximizing returns to capital preservation as front-page noise tests investors' nerves.

Market Review

Record For A Day

Break out the champagne and party hats! The NASDAQ **finally** broke through and set a new record high, its first in over 5,500 days! It's been a long haul since the heady days where tech stocks were valued based on terms such as "eye-ball", "clicks" and EBITDA. It was the "new normal" where earnings losses were rewarded so long as there was potential for people to visit a website. Remarkably, since the last record close, we have lost the World Trade Center buildings; fought two wars; had 4 Presidential elections; lived through corporate malfeasants (think Enron, Worldcom and Tyco); survived the financial crisis and Hurricane Katrina; seen steroids in baseball, the creation of the Department. of Homeland Security, TSA, You Tube, Dodd Frank, the Affordable Care Act, guns in theaters, schools and campuses, the Boston Marathon bombing and the end of the space shuttle program. I'm sure I left out some of your favorites, but you get the message.

Oh by the way, the record lasted exactly one day, as the NASDAQ set five record closing highs in the quarter, on its way to end up 1.75%. The Dow and the S&P 500 both finished down 0.88% and 0.23%, respectively. It was the first loss for either index since 4Q '12. Except for healthcare and social media, not much else was working for investors. It felt like summer vacation started in April with low volume and narrow trading ranges as symptoms for a disengaged market. Health-care led all sectors in the quarter as hospital facilities, managed care providers and biotech led the way. Consumer discretionary followed closely behind, aided by strength in auto, internet and leisure retail sales. Financial stocks came in a close third as expectations for higher rates lifted investors' hopes that margins would expand.

Investors pulled money out of the Utility sector. Since utilities led the markets in 2014, there was profit taking ahead of slowing expected revenue growth in the back-half of 2015. Although oil prices increased 27% in the quarter (more than offsetting the 13% decline in the 1Q '15) the Energy sector declined 2.6% on lower expected earnings.

10-year Treasury bond yields jumped as prices fell by 40 basis points in the quarter from 1.93% to 2.33%, ending five straight quarters of falling yields. The dollar index which is a measure of the dollar relative to 16 currencies closed down 1.3%. In regards to cap size and style, small cap stocks eked out a small gain over their large cap brethren, while growth did better than value among all cap sizes, according to Russell Investments.

Looking Forward

Picking Carefully

Economists and strategists on Wall Street continue to be hopeful that stronger economic reports on the horizon will give support to corporate earnings and fuel the next phase of the bull market. As I have advised many times, "*hope*" is not an investment strategy. Therefore, these self-proclaimed gurus are either ignoring economic reality, pimping their own investment book, or clairvoyant. Either way, their investment advice seems misplaced. With choppy economic reports and Greece and Puerto Rico's financial system in flux, it seems as if once again, we could miss the consensus year over year GDP growth of 2.5% - 3%. The dollar will likely remain strong relative to other currencies for the duration of the year, causing inflation worries to dissipate. A strong dollar pushes oil, commodity and import prices down, while providing support to the "lower for longer" crowd.

While the Fed might raise rates in the second half of 2015, for psychological reasons only, I don't expect higher borrowing costs to dampen investor psychology; there are too many other factors to worry about. We will continue to look for ways to add value to our portfolios albeit carefully. This is a stock pickers market and it pays to keep the basic tenet of investing in mind – buy low, sell high. We will be selling those stocks that have outsized gains and use the proceeds to add names at advantageous prices. In general, the Industrial, Financial and Technology sectors look the most attractive. However, you must be careful, because within each sector, the spectrum of opportunities is very narrow. For example, the NASDAQ might be up 5.3% for the year, but technology hardware, storage and peripherals have dropped on average 20%, semiconductor equipment declined almost 12%, software and communications equipment both fell about 3%. Clearly, a high tide does not lift all boats and investors have to be careful on where to focus.

Additions and Subtractions

In last quarter's newsletter, we indicated that a scaled down version of "Sell in May and Go Away" might be a prudent strategy for the short-term. Not that we wanted to liquidate all of our holds, but rather look for opportunities to create cash as the markets march toward record highs and redeploying the capital into new value propositions. To that end, we sold all positions in **Lululemon Athletica, Inc (LULU)** and **Target (TGT)** after both stocks had achieved full valuation, in our opinion. We added LULU to the portfolio at the end of 2014 as a short-term alpha holding in anticipation of capitalizing on better operations, assortments and merchandising. Our expectations were met quickly, as better sales, inventory management and margins all materialized in a much improved 4Q earnings report. The stock rallied hard as short-term concerns over consumer spending and their fickle taste for apparel dissipated. As a result, the stock quickly reached its full valuation based on our metrics and it became an easy decision to realize our gains. We still like the company's concept, management team and financial position and would not hesitate to add a position in the future, should its price fall back to a more attractive level.

Most of our clients have had **Target (TGT)** in their portfolio for at least 7 years, if not longer. It is one of those anchor stocks that has rewarded investors with both significant capital appreciation and an above market dividend yield. However, as with any long-term holding, there comes a time when the valuation becomes inflated relative to its prospects. That is what happened to TGT. I love the stock – yes I know they have had their problems (credit card hacking excluded) but overall they have grown and managed their business responsibly. Unfortunately, earnings growth is projected to slow from the 20% level to less than 9%, while its P/E multiple hovers around 17X. Other value metrics like Price/Book and Enterprise Value/Operating Earnings was at 9 year highs. Apparel sales are an extremely competitive business where it is hard to stay on top for long. Therefore, we decided to realize our gains and reallocate our capital in other areas with more attractive valuations and growth possibilities.

We also sold half of our position in **Teva Pharmaceutical (TEVA).** We initially purchased this alpha stock to the portfolio in August of 2010 and subsequently added to the position on two separate occasions. The stock has done well but it does carry with it much uncertainty due to competition, patent expiration and "soap opera like" acquisition turmoil. We wanted to reduce (not eliminate) our position after the stock ran-up in late April on news that it was planning to acquire Mylan Labs. The only problem is that Mylan was in the middle of its own acquisition of Pergo Company and Teva's offer just muddied the water in the generic pharmaceutical industry. Mylan has rejected two offers by Teva, but the company is still committed to completing the deal, even as Mylan has made reference to possibly making an offer for Teva – time will tell how this will all play out. From an operational perspective, TEVA's generic pharmaceutical business has become much more profitable. However, there is concern regarding the timing and pricing of its biggest drug Copaxone, as a generic form of the drug could be on the market within the next few years. We feel comfortable with a 1% holding of this volatile alpha stock. The company is in a good financial position, has a talented management team and is not terribly expensive. We believe that the risk/return dynamics are still favorable and warrant a position within the portfolio.

Legacy has been terribly underweighted in the consumer cyclical sector for the better part of 12-18 months as valuations stretched in anticipation of greater economic growth. As the economy sputters along, consumer spending remained non-existent and earnings disappointed, valuations have come down and investors have had an opportunity to dollar cost average and invest in some quality names. We established small positions in both **Whole Food Markets (WFM)** and **Michael Kors Holdings (KORS)** and added to **Urban Outfitters (URBN)**. All three retailers posted either disappointing earnings or sales which caused the shares to fall by mid-double digits. In the case of Whole Foods, they missed their second quarter comparative store sales by 30%. While they are still growing, the rate of change from last year's second quarter was not what Wall Street was expecting. The company sighted increased competition, bad weather and store cannibalization in certain key markets reasons for soft sales. We added Whole Foods to the portfolio because it has an attractive valuation, no debt, improving margins and good cost controls. Plus, management announced the launch of a new concept store which should complement existing stores. Furthermore, Wall Street has now lowered expectations to the point where WFM should be able to exceed full year expectations.

URBN's 1st quarter earnings announcement was misunderstood by Wall Street causing a unique opportunity to add to client positions. The company is a well-run and forward looking specialty retailer, yet it did not meet earnings expectations as its usually reliable brand – Anthropology experienced inventory and execution issues in women's' dresses and accessories in the last two weeks of the quarter. Nonetheless, gross margins are recovering, costs are moderating and the company is investing in its distribution channels to create efficiencies in online delivery. URBN's valuation is very attractive as its P/E dropped 22% and now trades at a discount to its peer group. Buybacks continued in the quarter and we expect the pace to accelerate which should provide support to shares over the next few quarters.

We initiated a small position in Michael Kors after its shares sold off over 12% on expectations of slowing sales due to a strengthening dollar, slower traffic and the West Coast port shutdown. Its shares were cheap on both a relative and absolute basis and the company had strong cash flow and no debt. However, at the end of May, market expectations became reality as the company announced disappointing earnings. Wall Street reacted by whacking an additional 25% or $3(B) off its market cap. Strength in shoes and handbag sales could not offset weakness in watches and accessories. While management indicated that the first half of 2016 will be characterized by negative same store sales, margin compression and capital investment, the back half should see better profitability which should yield overall 5% EPS growth for the year. Based on the markets overreaction (on something that was expected) we added to positions in KORS as we believe that capital investment will pay off with growth in digital E commerce and new styles and fashions. While we don't expect any short-term miracles to support a higher stock price, we are confident that investors will once again seek out this stock based on its deeply discounted valuation, significant stock buybacks and growth prospects both domestically and abroad.