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## For Quarter Ending September 30, 2015

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# Around The Firm

## We had a busy Summer!

The Legacy Team worked hard revamping our website. The new and improved www.legacyasset.com was launched on September 1, 2015 – check it out!

Jillian spoke on a panel called Power Roundtable: Women & Insurance at the Advisor Network Summit Conference in Las Vegas.

We enjoyed having Christopher Simon, a Sophomore at The University of Texas, Michael Kafoglis, a Senior at SMU and Tyler Cohen, a high school Senior from The Emery/Weiner as interns.

Joe and Jillian started teaching another semester of Retirement Planning and Employee Benefits for the Certified Financial Planner Program at Rice.

# Volatility = Opportunity

## Frustration

I can't tell you how many people are frustrated with the volatility in the markets. It is becoming commonplace to see massive swings in equity prices in a single day. In fact, over half of the trading days (35 of 64) in the third quarter registered at least triple digit movements in the Dow. In the last week of August, the S&P 500 fell almost 4% on Monday, 1.4% Tuesday, up 4% on Wednesday, up 2.4% Thursday and flat on Friday. For that week, the S&P 500 finished up almost 1%. These dramatic swings in a single day creates skepticism, cynicism and unnecessary psychological stress.

Understanding the source of volatility might alleviate some of the anxiety but it does nothing to help returns. For example, knowing that the US equity markets are highly correlated to China only helps identify when volatility might spike; namely when the Chinese government releases economic data. It doesn't give any clue as to what the data will actually be or what direction the markets might go. The same can be said about the Fed. This "non-government" entity can throw its weight around and hold Wall Street captive while it decides "if" and "when" it will raise short-term interest rates. All the while, investor emotions can go from peak to valley in a matter of minutes. With the memory of 2008 still in the back of everyone's mind, volatility and seemingly unpredictable market swings might cause some to lose confidence in the system and cash out.

Believe me; trying to understand these markets can be challenging and frustrating, especially with the speed in which news and information travels throughout the world. Hedge funds and high frequency traders use mathematical algorithms built into trading models that automatically move markets based on key words or phrases, adding to market volatility. In addition, market sentiment can change quickly. One week, good economic data might be viewed as good news and the market rallies. The next, it could be interpreted negatively as too much growth might necessitate an interest rate hike which could pressure stocks.

## Clarity With A Strategy

Changing market sentiment is not a new concept. Rather, it's the speed in which change is occurring that requires professional investors to be more proactive in managing their client portfolios. However, market timing and trading is not a winning strategy for long-term investors for three reasons: (1) you have to be right twice, once on the buy (at the low) and then on the sell (at the high), (2) transaction costs for both the buy and sell and (3) taxes.

At Legacy, our strategy of investing in large-cap value companies with solid financial statements and better than market dividend yields helps offset the stress of volatility and changing market sentiment. Having financially viable firms provides us with a level of safety that doesn't diminish in declining markets. Quite simply, if a company has no debt and billions in cash, chances are, it will be a winner in its industry, due to access to resources to grow market share even in a down economy and market.

When Joe and I started Legacy back in 1998, the average holding period for a stock was 5 years. Today it is about half that time. We proactively monitor portfolios on a daily basis. We don't fall in love with stocks and we will not hesitate to sell if we believe there is no more value to be achieved. When we add a position to the portfolio, we typically target a required rate of return of 25%. With volatility being what it is, we have at times; reached that level rather quickly. Regardless of the timeframe, we re-evaluate all positions on a periodic basis to determine whether there is further upside or if we should sell.

Our investment strategy is very straight forward and takes all emotion out of the trading decision. Our theorem is simple, if you buy right (cheap) then your sell discipline is rooted in your required rate of return. There is no room for second guessing. Sometimes, we might buy at a price that appears cheap but inevitably it gets cheaper. In those situations, we typically double down at lower prices if we believe the business fundamentals support higher valuations.

Having the right mindset, sticking with a proven strategy and not letting psychological bias get in the way of prudent investment decisions helps our client's weather periods of volatility. While we might not always outperform on the upside, we rarely if ever underperform on the downside. We will continue to tweak and adapt our investment process to meet the ever changing dynamics within the industry, as we strive to drive returns higher.

In short, we don't chase stocks higher and we look at volatility as an opportunity to add great companies at attractive valuations.

# Market Review

## Chasing Growth

To say there are mine fields out there would be an understatement. There's always something to worry the markets. If there weren't, then all investors would be buyers of stock which would push prices upward toward ridiculous valuations. Wait, isn't that what we just experienced? You betcha! When investors can't buy domestic or global growth and savings rates are zero, money flocks to the last pockets of growth. July's positive performance reflects investors chasing a few darling momentum stocks like Facebook, Celgene, Netflix, GoPro, Amazon and Google which all jumped 10%, 11%, 12%, 13%, 13% and 18%, respectively, in just ***one week***. For the month, the market cap of these five companies increased 19%, on average! That is a whole lot of growth chasing. However, momentum is fickle - it can change quickly and when it does it can get ugly, very quick. Since the middle of August, Amazon is down 9%, Facebook -10%, Celgene -16%, Netflix -22%, GoPro -54% and Google -10%, wiping out all of the yearly gains in Celgene and GoPro.

Overall, the third quarter was a mess. The Dow, S&P 500 and NASDAQ were down 7.5%, 7% and 7.4%, respectively, the worst quarterly performance since 3Q '11. At that time, all three indices were down mid-double digits. There was little benefit to global diversification as the US markets could not totally decouple from the impact of slowing economic growth that effected both mature and emerging economies. The STOXX Europe 600 fell 9%, its worst quarter in 4 years. Japan's Nikkei lost 14%, its biggest quarterly decline in 5 years and China's Shanghai Composite Index fell 29%, its largest drop since 2008. The proxy of all emerging markets, MSCI Emerging Market ETF plummeted a whopping 19%.

Back in the US, the Utility sector (+4.4%) was the lone bright spot in an otherwise dreary quarter. Utility stocks function much like bonds in that they usually pay a high dividend and have less volatility as their earnings are stable given their highly regulated industry. Interestingly, even with a strong dollar throughout much of the quarter (which serves as a headwind to earnings because of their disproportionate exposure to international markets), the Consumer Staple sector was down less than 1% as investors sought safety from large-cap, blue chip stocks with high dividend payouts.

Among the biggest losers were Energy -18%, Materials -17% and Healthcare -11%. While energy was no surprise based on the price of its underlying commodity and weak supply and demand fundamentals, the losses in the Healthcare sector caught all investors off balance. The speed in which Biotechs fell once Hillary Clinton announced her desire to cap the cost of medication and limit patent exclusivity was shocking! The fear of more regulation for the industry sent Healthcare Facilities and Biotechnology stocks down 12% and 8%, respectively for September and down 17% and 14% for the quarter. The Materials Sector was negatively impacted by not only weak commodity prices but also weakness in fertilizers and agricultural chemicals.

A stronger dollar, which negatively impacts commodity prices, caused gold to fall 5% and oil to plummet 22%. 10-year Treasury yields fell from 2.34% to 2.06% (prices of bonds rise when rates fall) due to demand from foreign investors who sought out Treasury bonds as global economic conditions deteriorated throughout the quarter. Lower rates also indicate that the bond market believes that the Fed will not be raising short-term interest rates anytime soon. In regards to cap size and style, growth continues to significantly outperform value and the spread between the two investment styles increases with cap size. For example, small-cap stocks lead value stocks, year-to-date, by over 7%. The margin expands to over 9% for mega-cap stocks, according to Russell Investments.

***On a sentimental note, August 15, was the last trading day for a US Treasury note with a 10% coupon. The 30 year, 10.625% coupon bond was issued on August 15, 1985 when the Fed Funds rate was 8%. Its maturity, ends all tangible memories of economic expansion, normalized rates, a functional congress and a decisive Fed. I wonder if we will ever see an environment like that again in my lifetime.***

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# Looking Forward

## Value or Growth

Stocks officially hit correction mode on August 24th as the S&P 500 fell more than 10% from its peak set on May 21st. The recent stretch of over 1,400 days without a correction is the third longest streak on record. To put this into context, since 1927, corrections tend to occur every 8 months or 250 days, according to data compiled by Bloomberg. This lasted almost 6 times longer.

What does this mean? Can we expect more downside or is the worst over? We believe that there could be more downside, but don't believe the economy will slip into a recession which is the **REAL** risk to stocks. Otherwise, it is a good time to be a value manager. Value stocks have been out of favor for the last several quarters as investors bypass high dividend paying stocks in favor of momentum growth companies. The ratio of S&P 500 value to growth index fell to a 14 year low of 0.77. History indicates that at levels this low, stocks could be in for a bumpy road, which is notoriously a great time to buy value. In volatile times, investors seek-out beaten down stocks with strong financial statements and big dividends.

I didn't talk about the economy or the Fed in the first section above because little has changed from last quarter. Economists continue to "***hope"*** for a stronger economy. Manufacturing, which is coming off of last quarter inventory build and the housing market are both slowing and the employment numbers, while positive, have been increasing at decreasing rates for 6 of the last 7 months. Consumers in general continue to be frugal with their discretionary dollars, opting to buy cars which can be financed over 7 years to fit payments into their monthly budget. The auto industry is benefitting from lenient credit terms as approximately 18 million cars are projected to be sold in 2015, a level not seen since 2006. Demand is being pulled forward and will probably drop significantly in 2016. Furthermore, car buying throughout the year might cut into holiday gift giving. Can you say bubble?

From a pure fundamental standpoint, we are concerned about estimates for 3Q '15 corporate earnings, which continue to be revised lower. Latest projections indicate that analysts expect earnings to fall almost 5% while revenues are expected to fall 3.4%. Excluding the energy sector, earnings should grow just 3.4%. Corporate profits continue to be artificially inflated by financial engineering (stock buybacks or dividend increases) which does nothing to advance organic growth.

I know I sound like a broken record, but 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 continue to sell those stocks that have outsized gains and use the proceeds to add names at advantageous prices. In general, we like financial companies because they are cheap and don't believe stocks can take another leg upward without banks and financial institution's participation. We also like the Industrial and Energy sectors for its valuations, but are mindful of the value traps that populate these sectors.

# Additions and Subtractions

In retrospect, I was 100% correct when I referenced the well-known adage of "sell in May and go away" last quarter as we became concerned about valuations, revenue and earnings growth and maco-economic developments. The famous axiom warns investors to sell their stocks in May to avoid the seasonal pattern of volatility that typically plague the time period between May – October.

Obviously, I was not implying that investors go to 100% cash. Rather, highlighting our strategy of creating cash while the markets are near record levels, so portfolios will have sufficient dry powder to capitalize on a pullback. In that vein, we sold **Valero Energy**, **Deere & Company**, **Teva Pharmaceutical**, **Fifth Third Bancorp** and **Molson Coors Brewing Co**., all near or at historic highs. The lone exception was Fifth Third Bancorp, which we sold at a price within 5% of its post-financial crisis high of $23. In all cases, market valuations far exceed growth prospects and our value criteria.

Stock market volatility created opportunities for us to increase investor exposure in the technology sector. We were significantly underweight in technology and have been patiently waiting for the right opportunity to buy in. We believe that certain technology stocks provide attractive growth prospects at interesting valuations. As usual, when we add companies to the portfolio, we do so systematically and pragmatically as we buy 1% position to establish a holding and then add to it as the price fluctuates.

We added **Glu Mobile (GLUU)**, **Google (GOOG)**, **Microsoft (MSFT)** and for a short period of time, **Twitter (TWTR)**. Starting with the most obscure, GLUU is one of those alpha stocks we occasionally add to the portfolio to try to capitalize on a short-term return potential as valuation and growth come into equilibrium. The company develops and publishes a portfolio of action/adventure and casual games designed for smartphones and tablets. Glu uses both company specific and branded intellectual property to create appealing games for many demographics. Their properties include Kim Kardashian, RoboCop, Hercules and Hollywood on the Branded side as well as Deer Hunter, Racing Rivals, TAP Sports Baseball and Frontline Commando, to name a few of their own branded games. The company plans to launch a mobile game with pop star Britney Spears in the first half of 2016.

On a valuation basis, GLUU trades at 16 times forward P/E, which is extremely cheap considering it is projected to grow 2016 full year earnings 78%. The company has no debt; in fact cash of $190 million covers total liabilities by almost 3 times. GLUU grew shareholder equity 300% last year and generates significant cash flow. Bottom line, Glu Mobile is well-run, has a stacked Board of Directors and has the financial flexibility to invest and grow organically. In April 2015, Tencent, a dominant social networking and online entertainment company in China which invests in other gaming companies like Call of Duty's Activison, bought a 14% ownership in Glu Mobile for $126 million giving the company an implied valuation of $900 million, 50% higher than its current market value of $600 million.

What needs to be said about Google? The company is financially a monster with $70 billion in cash and $5 billion in debt and short-term obligations. It generates approximately $8 billion in cash flow and sells at a reasonable P/E of 18 times. Google recently created a new public holding company called Alphabet Inc. which will house two separate operating companies: Google which will consist of the Google main internet businesses including search, Ads, YouTube, Maps, Apps, Android and Play and Other Alphabet which will include projects unrelated to Google's core internet businesses such as Fiber, Nest and Google Ventures. While the new structure should not change any operating results or create synergies, it will make reporting more transparent.

Microsoft is an old favorite for our clients as it was a core position for many years. As prudent investment managers, we don't fall in love with our stocks and hold them in perpetuity. Rather, we sell them when appropriate and harvest gains. Almost 25 months ago, we sold our shares in Microsoft as the CEO was stepping down, corporate strategy was unclear, valuations were extended and the dividend was much smaller. Fast forward to current day and we see an evolving Microsoft. New CEO Satya Nadella, has re-innovated the flagship software brand Windows operating system and Office productivity suite and will use the strong cash flow to fund R&D. In addition, she is engineering a shift in growth strategies away from devices and into cloud based offerings. Results will not rebound immediately because the company is too levered to PC's. We established our position in MSFT after the stock fell in August and September as valuations came in line, adjusting to investor expectations of slowing growth and earnings. Fundamentals are improving and margins should expand as Cloud offerings gain momentum. Window's 10 received good reviews and the company boosted their dividend by 16% to yield 3.2%. We anticipate that this could be another long-term hold as its corporate strategy unfolds.

This is no typo, our equity only clients did own Twitter for a short period of time. We bought this alpha stock on the belief that a new CEO would be named, provide a realistic and concrete business plan to generate revenue and user growth and regain Wall Street's confidence. The business is not broken, just in repair. In fact, for many, it is a viable and useful media outlet. For example, we use it to find out why stocks might be moving when no other news is available. Its headline tweets serve as a viable 4th media and is gaining traction. The stock was not overly expensive relative to other media or media tech stocks. Nonetheless, Twitter fell hard in the recent market turmoil and because our alpha holdings are on a tight leash, we sold our shares as the stock price hit our floor tolerance price. This defensive strategy usually works to the investors benefit because we limit losses and in most cases have an opportunity to repurchase the shares at a lower price. In this particular case, the stock has fallen an additional 7% and looks even more attractive than before. Don't be surprised if you see TWTR back in your equity portfolio in the near future.