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Around The Firm

We are delighted to announce a new addition to the Legacy team. We welcomed Julie Faas, client services representative, in late October. Julie comes to us with 6 years of senior administration experience in a wealth management firm in California and is an expert on Charles Schwab operations. Julie, originally from Corpus Christi, is a UT Austin grad.

Joe & Rick attended the Schwab Impact conference in Boston, mid-November. They returned with valuable insights regarding Schwab operations, best practices and relevant investment ideas.

Jillian was honored, once again, with a cover story in *Retirement Advisor* Magazine. She was featured in the Women In Insurance issue for the month of October. The cover story focused on how women in the industry become successful and improve client relationships.

Adapting

Disney Magic

Having just completed my second Walt Disney World Half Marathon, I can tell you with certainty, it's your dedication to preparation and training that set expectations and subsequently define success. If you're not willing to put in the time and the road work, then expectations should be aligned accordingly. Furthermore, without a benchmark, it becomes difficult to put your results into context.

For the record, I exceeded my expectations. I went into the race with a hamstring issue complicated by the lingering effects of an upper ankle sprain suffered on a run just before Thanksgiving. Needless to say, my expectations were extremely low and I did not know how much of the race I would have to walk. As it turned out, I adjusted my strategy the day of the race from focusing on a personal best to simply completing the race at a much slower pace. When faced with adversity, you never really know how you will react you just need to ***establish a plan and be flexible***.

Lessons Learned

Investing is a lot like running. It's individual in nature and success can be defined in the application, implementation and maintenance of a strategy. Performance can be monitored against expectations, benchmarks can be established and success can be measured daily, weekly, monthly or yearly. Like a runner who adjusts their strategy to changing weather, course layout, distance and physical ability, investors too have to adapt to changing market conditions.

Market sentiment changed dramatically in 2015 from one of optimism (in the first half of the year) to confusion and uncertainty. After reaching historic highs on the S&P 500 and Dow Jones in May, both indices churned in volatility and proceeded to fall 4% and 5% into year end. Threats of normalizing interest rates in the face of a potential global recession, a stronger dollar, terrorism and weakening corporate profits were the main catalysts that sent investors on edge.

Of all the factors listed above, the Federal Reserve continues to have the greatest impact on the markets. Investors have to constantly monitor the Fed for clues for potential changes in policy and quickly adapt their strategies if necessary. The Fed's impact on the markets is of major concern for Congress, so much so that in the fall of 2015, it initiated legislation that would invoke greater congressional oversight. Obviously, Congress is not pleased with the seemingly arbitrary Fed narrative and timing of its policy moves which are viewed as behind the curve. Janet Yellen disagrees with this assertion and believes oversight would hinder future Fed policy decisions and their ability to achieve the stated mandate. Over the last seven years, the Fed's easy money policy (zero interest rate) along with doubling the size of its balance sheet (from $6 trillion to over $13 trillion) has produced a lousy 2% GDP growth, on average. Since the end of quantitative easing in late October 2014, the S&P 500 is up less than 3% and GDP for 2015 is expected to be about 2%. Where's the growth that warrants four interest rate increases in 2016? Perhaps that is the oversight Congress is asking for.

The Fed is not the only entity loading up with debt. Outstanding corporate debt has increased over 30% since the end of 2010. Total debt issued has jumped to almost $8 trillion from $6 trillion at the end of 2010. The low interest rate environment enabled businesses to borrow funds at cheap rates and use the proceeds to increase dividend payouts and stock buybacks. While this type of financial engineering does temporarily prop up stock prices as investors receive a return of capital, it does nothing to add new business, revenues, distribution or profits. In other words, companies are using cheap funding to reap short-term benefits. If I were really cynical, I would accuse some management teams of stimulating their company stock price in order to receive an executive bonus.

Here's the thing about financial engineering; at some point the issuing company will have to pay the debt back. Firms not electing to invest back into their business in the form of capital investment, acquisition or operational efficiencies will likely have less cash flow available to pay back debt and make interest payments. This negatively affects the cost of future borrowing and access to funding sources. We will be carefully monitoring revenue growth this coming earning season to identify firms that are reinvesting in their business from those that are padding their stock price.

Far Far Away

As we look across the economic landscape for clues on how to invest in 2016, we see a very similar model replicating U.S. quantitative easing. The European Union and the Bank of Japan continue unsuccessfully to use QE as a catalyst for growth. With rates at or below zero, the central banks have to resort to currency depreciation as a form of stimulus. A falling currency can help temporarily counter a slowing economy. However, this race to the bottom of currency valuation is a zero sum game, just as the 1930s demonstrated, according to Barron's Randall Forsyth. China's recent announcement that they will no longer peg their currency to the U.S. Dollar opens up the potential for further declines in the exchange rate between the yuan and dollar.

Adapting to changing conditions requires constant monitoring of the Fed, corporate earnings, foreign exchange and many other factors. Evaluating and managing risk is an essential element of our investment process. We constantly ask ourselves "what if" to plan for scenarios that might not be so obvious. Might we be wrong? Sure, but it will always be on the conservative side. Remember, we would rather be out of the market wishing we were in, than being in the market wishing we were out.

Annual Review

Good Riddance!

2015 was the hardest year for managing money since 1999. Value managers underperformed the general market in most cases by 500 basis points (5%) or more. Whether large-cap or small, international, emerging market or domestic, the fundamentals were consistent – there was no diversification benefit. It is frustrating watching mature companies with high dividend yields, solid financial statements and growing earnings fall day after day, just because they didn't operate in the growth paradigm of social media and the internet.

Clearly, investors sought out and flocked to a small number of concentrated growth stocks, chasing performance and momentum. If it weren't for the contribution of the notorious "FANG" stocks (Facebook added 6.5 points to the S&P 500, Amazon added 15.8 points, Netflix added 18 points and Alphabet, which is now the new name of Google, added 15.8 points), the S&P 500 would have ended the year down over 3%. The breadth of the market deteriorated all year and ended at depressed levels as 30% of the stocks in the S&P 500 were in bear territory (down 20% from their high), dramatically higher than 12% in May when stocks were at their highs for the year.

The Dow and the S&P 500 fell 2.2% and 0.7%, respectively, (excluding dividends) for the year. Six of the 10 sectors of the S&P 500 posted losses. To no one's surprise, energy was down almost 24% after declining 10% in 2014. Supply and demand imbalances and a strong U.S. dollar were the primary catalysts for losses throughout up-stream and mid-stream businesses. Exploration and production fell 35%, oil and gas equipment and services declined 20% and storage and transportation (Master Limited Partnerships – MLP's) dropped 52%. The lone bright spot in the energy patch was refining and marketing which benefited from declining input costs, posted a 25% gain. As with energy, the entire commodity complex had a tough year, reflecting in a 25% decline in the CRB index of commodity prices, causing a drop of 10% in the Material sector. Construction material and commodity chemicals bucked the negative trend and recorded 35% and 10% gains, respectively.

Surprisingly, defensive and yield sensitive sectors also had a tough year. The Utility sector went from the best performing in 2014 (+24%) to the third worst (-8%) as fear of rising rates and declining margins dampened earnings expectations. The Industrial sector (-5%) was negatively affected by slowing global and domestic economies and the rising dollar. The Financial sector (-4%) was also negatively affected by uneven economic data which pushed out interest rate increases. Telecom services also fell 2%. With all of these sectors down, it's no wonder value managers underperformed in 2015.

While the broad market struggled, the tech heavy NASDAQ jumped 5.7%. Unfortunately, gains were not widespread as most of the out performance was concentrated in a few industries: internet software (+33%), application software (+20%) and home video gaming (+66%). Companies like Alphabet, Facebook, eBay and Verisign drove internet returns while Salesforce.com, Citrix and Adobe Systems propelled application software. Conversely, anything having to do with semiconductors, hardware computers, peripherals, storage and servers had a tough year.

In Retrospect

As you might have heard, 2015 was a "stock pickers" market. I'm a stock picker and I had some winners such as Lululemon, Valero, CVS, Deere & Co., Teva Pharmaceutical and even Halliburton (believe it or not) in the Energy sector. We bought Amazon and sold too soon (way too soon as it turned out) and we had our fair share of stocks that had a rough year like Michael Kors, Urban Outfitters, Glu Mobile and Chart Industries. Fortunately, for our clients, my stock picking centers on value companies with catalysts for growth or rebound, rather than the ***"hopementum"*** of certain market favorites. We have been through an environment like this before and will continue to be patient and work hard to add value to our clients as we look for opportunities to put money to work in attractive value oriented investments.

The Equity Portfolio

Navigating 2016

Seeing how 2015 ended, investors have to wonder what's in store for the New Year and how to position stock portfolio's for potential volatility. It can be challenging to grasp any sort of useful advice from Wall Street analysts, strategists and economists as they try to convince their constituency they know what is going to happen in the next 12 months. Keeping in mind that most professionals quoted in the media are marketing their firms, hoping to bring in assets by being optimistic and engaging. Last year, like the year before, the consensus view was that rates would rise on the back of a U.S. economic resurgence and its positive effect on global markets. For the second year in a row, that playbook did not work. Global growth did not materialize and the Fed finally raised rates in December, just as the ECB (European Central Bank) was engaging in more quantitative easing. With the era of easy money in the rear view mirror and the Fed signaling possibly up to four rate increases in 2016, we fear that the economic and investing environment will not change much from what we recently experienced.

We look at the New Year as a point in time or a continuum of the previous year and as such choose not to make outrageous market predictions on corporate earnings, the markets or Fed policy just because the calendar flips forward. We like to break down 2016 into two halves. Based on actual data, we believe that economic growth will be slower than Wall Street expects as manufacturing base and the consumer struggle in the first half of 2016. Over the last several months, industrial production, capacity utilization and the ISM (supply manager's survey) have steadily declined. Consumer confidence in November was near the lows of the year and down 7% from its highs. It looks as if the consumer is leveraging up once again and auto sales could be the next bubble to pop. 18 million cars were sold in 2015 and most of those were trucks and SUV's financed over 7 years as consumer's stretch out payments to fit within their monthly budgets. Car loan balances in the 3Q '15 jumped 11% year over year to almost $1 trillion. 40% of those

loans are subprime borrowers (lower quality loans), which is up 53% since the lows in 2010, according to the credit reporting firm Experian.

With a cautious consumer, weakness in manufacturing, oil, commodities and the industrial base, we will see more volatility ahead in 2016. Our biggest concern centers on future Fed action (raising short-term rates) in the face of a slowing domestic and global economy. Keep in mind, future rate increases will push the dollar higher relative to other currencies, causing oil and other commodity prices to deflate. While this might be good news for consumers, commodity deflation is actually bad news for the stock market because corporate profits shrink. This would be a repeat of what happened in the second half of 2015 when 3Q earnings shrank 0.1% and with an expected fall of 3.6% in 4Q.

What does all this mean for the markets? First, based strictly on our current data (no opinions), we don't believe the Fed can raise rates in the first half of the year, without further definitive signs of economic momentum. Therefore, we expect the dollar to recede, causing oil and commodity stocks to benefit. At some point, we will be adding to our energy positions in the coming quarters. After back to back years of declines, the Energy sector is beaten down and trades at 1.4 times book value, a multiple that is characteristic of companies coming out of bankruptcy. Valuations are below levels seen in the financial crisis. Cheap doesn't always equal value. Therefore, investors should look for those stocks or MLP's (Master Limited Partnerships) with positive and identifiable catalysts supporting growth or a turnaround, strategic assets, limited debt and experienced management.

A weaker dollar benefits yield oriented assets, which underperformed the market in 2015. As investors chased growth stocks, P/E multiples compressed and are lower than they were a year ago, in the Utility, Staple, REIT and Telco sectors. As long as corporate sales don't slow to where it might impact dividend growth, we will search these groups for investment opportunities. There are also attractive valuations in certain areas of technology, industrial and consumer discretionary stocks.

Income generation has become a big problem with rates low and equities high. Trying to uncover appropriately valued equities has caused us to carry more cash in accounts than we would normally like. Be patient with us. We will stick with the fundamentals of our investment process and wait for an opportunity to reinvest the cash.

Additions and Subtractions

With all the volatility and churn in the market in the fourth quarter, we did not see many value opportunities that fit our criteria. We cleaned out two of our alpha picks **Glu Mobile (GLUU)** and **Chart Industries (GTLS)**, and used the losses to offset realized capital gains, in order to reduce tax consequences. GLUU developed into a story where inexperienced managers could not capitalize on a great gaming application (APP) which leveraged off celebrity partnerships. Partnership costs exploded at the same time marketing dollars declined causing new user numbers to decline. Although the company has plenty of cash and hired seasoned executives from gaming giant Electronic Arts to buffer its executive ranks, we would need to see better execution and expense management before adding the name back into the portfolio.

GTLS, on the other hand was a different story. Indeed, we did sell positions across the board to reduce tax liability, but in reality, the fundamental business is intact even though the majority of their customers are producers and distributors of hydrocarbon and industrial gases. They basically own the tanks that freeze natural gas for the LNG (Liquefied Natural Gas) markets. They operate a necessary business because it is the most efficient way to export natural gas. The company has minimal debt, experienced management and strategic partnerships. While the stock's momentum goes with China, there doesn't appear to be any real hurry to jump back into the stock. However, we will be watching.

We added to positions of **Wal-Mart (WMT**) after the stock fell over 12% as the company predicted a rather gloomy outlook for 2016, due to higher employment cost and R&D spending to boost online sales. Clearly the biggest retailer needed to become more competitive in online sales relative to Amazon. With resources, scope, distribution and logistics on their side, we think the margin setback is a temporary phenomenon needed to increase their competitive position. The market reaction presented investors with an opportunity to buy WMT at a steep discount on just about any criteria. Furthermore, it has less debt, higher profit margins than its peers and pays over 3% in dividend yield. We are positive on the stock and we are putting our money where our mouth is by making Wal-Mart our third largest holding behind Apple and Boeing.