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# Around the Firm

It was a busy Spring at Legacy Asset Management. Joe and Christi attended Schwab's National Summit for 401(k) advisors. They learned about the growing importance of investment planning in healthcare savings accounts (HSA's) as well as other significant Department of Labor trends. Jillian attended the Institute for Divorce Financial Analysts' conference. She became certified in this specialty almost two years ago, and her practice continues to grow rapidly.

Speaking of growing, we added Cristina Steele as a paraplanner and Elizabeth Prudhomme as our Receptionist. Cris has significant industry experience and we are glad to have her supporting our financial planning practice. Elizabeth is a lifelong Houstonian and had a long career in restaurant management and operations. We are glad to have both on the team.

Legacy was named as one of the top 25 Wealth Management firms in Houston this past quarter by the Houston Business Journal, and in June we were named for the second time to be among the top 300 Registered Investment Advisory firms by The Financial Times. Both accolades recognize the wonderful client relationships that we've developed over the past 18 years -- thanks to all of you!

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# Easy Breezy

## Active vs. Passive

In our current ADD (Attention Deficit Disorder) society, technology is enabling us to become proficient in multi-tasking. Daily mundane activities such as paying bills can be automated and accomplished without a second thought while watching (or streaming) a show, talking on the phone or walking down the street. Physically sitting at a desk writing checks, buying stamps and going to the post office are obsolete tasks that seemed normal a few short-years ago. Depositing checks is no longer necessary as a picture sent to your bank gets the job done. No wonder consumers are using less gas. With the use of technology, we are becoming more efficient. We can even see who is at the front door of our house through our phones.

While technology has made facets of our lives more convenient, it's also simplifying the investment process though passive management or indexing. In its simplest form, indexing is designed to achieve market returns by tracking the performance of a specific market-weighted index, such as the S&P 500. Index mutual funds or index Exchange Traded Funds (ETF's) hold the same securities in the same proportion as a market index. Indexing gained prominence late in the bull market rally of the 1990's as investors were able to diversify their portfolios efficiently with lower fees and less turnover.

The simplicity and ease of indexing has caused an explosion in popularity. There are nearly 6,000 indexes today, six times more than 10 years ago. Meanwhile, the number of publicly traded stocks has fallen 52% to about 3,600 from over 7,500 in 1998. Money is flowing into these investments in droves. According to Morningstar, a mutual fund database company, over the last two years, $574 billion has left actively managed funds and almost a trillion dollars has been reallocated into passive strategies. The total amount invested in passive strategies since 2012 has doubled to about $5.4 trillion. Like anything else, size creates operational complexities that could affect long-term market functionality and overall investor returns. Understanding the mechanics of what you own can be just as important as knowing what drives security returns.

Indexes make buy and sell decisions based strictly on momentum rather than engaging in research. When markets go up, indexes buy more stock and when they go down, they are selling stock. Market-cap weighted indexes (those that weight stocks by size only) must continue to buy stocks that are overweight while avoiding those that are underweight. It is a systematic and unemotional process driven by the emotional reactions of the investor. Whether indexers realize it or not, they are participating in a strategy that is the **opposite of buy-low and sell-high**.

Passive investors receive market returns. Indexes have a mandate to remain fully invested at all times, eliminating the ability to hedge, hold cash, diversify or deviate from their stated objective. As new money flows into an index it must be immediately invested. Even as markets fall, indexes must remain fully invested, exposing the investor to 100% of the next correction.

As active portfolio managers, we use risk management strategies to mitigate down-side exposure and reduce the effects of market volatility. While we might underperform a bit in a bull market, we typically outperform in bear markets. In 2008, Legacy's equity value composite was down 22% while the S&P declined 37%. Since our portfolios did not suffer the same magnitude as the S&P 500, it took our clients roughly 21 months to recover losses incurred from the financial crisis compared to 37 months for the S&P 500.

Passive funds influence markets by hoarding individual company shares outstanding (share float). Vanguard currently owns greater than 5% of the shares outstanding in over 98% of the stocks in the S&P 500, a huge jump from 2010 when Vanguard had a 5% float in only 23% of the stocks. As cash inflows increase, ETFs must continue to buy shares of stock of those companies within the index, reducing the availability and liquidity for active or individual investors. Structural problems could crop up if there were to be a mass exodus from ETFs causing more sell orders than willing buyers. The selling pressure would create inefficiencies and higher costs for the rest of the market.

Passive investing is not a panacea; it is a strategy useful to many, but not appropriate for all. Its ease of execution and low fees makes it attractive for both novices and experts. In its application, investors should assess goals, objectives and risk tolerance. There are no apps that replace fundamental research or technological advancements to make investing more convenient. To be good, it takes time, commitment and passion, qualities we utilize every day.

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# Market Review

## Revenues Take Charge

With all the noise regarding Trump's tweeting and busted agenda, the Independent Council, North Korea, China, Russia, the Fed raising rates, full employment and the continuation of sporadic economic news, it's quite remarkable that both the Dow and the S&P 500 ended the first-half of the year just 1% off their respective highs. They both returned about 8% in the first-half of the year, their strongest performance since 2013! The S&P 500 has been positive for seven consecutive quarters. The technology heavy Nasdaq (+14%) recorded its best start to the year since 2009. According to the *Wall Street Journal*, the Nasdaq set 38 closing records in the first half of the year, the most since 1986.

Given the negative headlines, what's driving the markets higher? Revenue growth backed by a more rejuvenated manufacturing base and optimistic consumer. These were the critical elements

missing from prior quarterly updates and cited by investors as primary reasons to be skeptical of future earnings. According to FactSet, a data and reporting service, average revenue growth of companies listed in the S&P 500 in the first quarter was about 8% over the previous year, its highest rate since the fourth quarter of 2011. 65% of those companies beat analysts' revenue expectations, considerably higher than the prior five-year average of 53%.

Tech companies listed on the Nasdaq had revenue growth of almost 13%, contributing to outperformance of growth stocks over value in the quarter. Three of the five largest US companies (by market capitalization) are tech stocks and have an increasingly disproportionate influence over the index. Facebook, Alphabet (Google) and Microsoft reported revenue growth of more than 13%, while their stocks returned 29%, 27% and 10%, respectively Y-T-D. Amazon and Apple, both consumer related stocks, round out the top five and were up 27% and 24%, respectively over the same period. Everyone talks about Amazon taking over the world but Apple is the 1000-pound gorilla. It's the world's largest company (by market cap). Its cash reserves ($256 billion) are more than the entire market value of 26 of the 30 companies in the Dow! Over the last six months, Apple has paid out over $25 billion to investors in stock buybacks and dividends, which is more than the annual revenues of McDonalds, according to the *Wall Street Journal*. That's also before its scheduled release of the 10-year anniversary phone later this fall - a truly amazing track record!

With growth outpacing value throughout all market caps and the strength of the top tech stocks listed above, it's no surprise that Technology (+16%) was the leading sector of the S&P 500. Other cyclical growth sectors, including Consumer Discretionary (+10%) and Industrials (+8%), were also market leaders. Healthcare (+15%), usually thought of as a defensive sector, was a surprising outperformer, especially with legislation circling through Congress to repeal and replace Obamacare. Biotech, Equipment Manufacturers and Managed Healthcare lead the group higher. On the negative side, a decline of 14.5% in the price of West Texas Intermediate Crude and global over-production worries pressured the Energy sector (-14%), one of only two groups to fall Y-T-D. Telecommunications Services (-13%) was the other, which was negatively impacted by worries over market share declines, pricing pressures and a technology vacuum, which caused investors to look elsewhere for other alternatives.

The U.S. did not have a monopoly on rising stock prices. The *Wall Street Journal* reported that all but four of the largest 30 indexes representing the world's biggest markets were positive in the first half of the year, the broadest performance since 2009. Furthermore, nearly half of those indexes closed the quarter at or near all-time highs. Emerging market indices (representing undeveloped countries) were higher by 18% while the developed country proxy, the EAFE (Europe, Africa and Far East) jumped over 13%. Many believe the performance will continue as global central bankers use easy monetary policies while economies improve.

So far in 2017, the dollar has fallen over 5% and rates on the 10-year Treasury slipped 15 basis points from 2.45% to 2.30% as growth, inflation and Trump's "Make America Great Again" agenda failed to materialize.

# The Equity Portfolio

## Managing Risk

Investors are facing interesting times. With markets at or near historic highs, metrics pointing toward fair value, the Fed raising interest rates and full employment, two important questions should be asked: (1) how do you reduce portfolio risk, (2) should investors be taking money off the table. These two questions are intertwined because by nature, taking money off the table is a form of reducing risk and market exposure. However, Legacy views cash as an investment option because strategically, holding cash enables us to take advantage of buying opportunities without having to sell a position and potentially creating a tax event. It is typical for our equity portfolios to maintain a cash weighting of between 5% and 10%. We consider this level of cash fully invested and rarely do we breach that level unless it is because of extenuating circumstances, such as the financial crisis of 2008.

There are many different types of hedging tools and ETFs (Exchange Traded Funds) available to offset a market correction. As active managers, we don't advocate moving in and out of cash in an effort to time the market which has proven to be an unsuccessful investment strategy. Rather, we work with our clients before investing assets to establish an appropriate allocation to match their risk tolerance and cash flow needs. That leaves us with the flexibility to invest the portfolio appropriately.

When managing an equity portfolio, we classify stocks into two groups: anchors or alphas. Anchor stocks can best be characterized as "Blue Chip," global brand companies with leading market share, steady revenue, earnings growth and a solid financial position. They usually have a more attractive valuation and less volatility. Alpha stocks can be a bit more risky and volatile as they typically have growth characteristics, more debt, smaller market caps, but attractive relative valuations. By classifying stocks into one of two categories, we can manage risk while being fully invested. Obviously, if we expect a period of volatility, we would increase the number of anchor stocks while reducing the number of alpha holdings. While this seems incredibly simplistic on the surface, keep in mind that there is a secondary level of analysis taking place that considers economic variables and sector weightings.

Value investing has been one of the worst performing styles this year, under-performing growth by 20% and wiping out the gains achieved after the election through the end of last year. However, we believe that the current set-up is quite favorable going into the back half of the year driven by strong consumer sentiment, improving earnings, tighter monetary policy and the potential revival of the Trump Trade (or reflation trade) where growth picks up as the economic agenda moves forward with bi-partisan support.

As a result, we believe the Financial sector will come back to life under a favorable banking landscape of regulatory relief, uptick in

M&A (Merger & Acquisition) activity, widening yield spreads, a steeper yield curve. We like the attractive valuations of the large money-center banks.

The Energy Sector will also benefit from a reflation trade. While fundamentals may not be attractive in the present, markets move fast and stocks can go from unloved to overbought in short periods of time. We believe the markets have become irrationally negative. Investors might not realize that oil inventories have declined eight of the last nine weeks ending in June, exposing pockets of opportunities. With global supply under the constant eye of OPEC, we believe that there is a greater chance of an 20% increase in oil prices rather than a further 20% slide in prices.

We are also drawn to the Healthcare sector, specifically biotech and pharmaceutical companies. For a couple of weeks in the beginning of February, biotech was among the best-performing groups. However, over the last four months, these stocks have lost momentum and traded in a tight range over concerns of drug pricing, competition and valuation. With the realization that healthcare reform may be in jeopardy and threat of price controls subsiding, the group should be ready to regain lost enthusiasm.

# Additions and Subtractions

In May, we added **Viacom (VIAB)** to the portfolio as an alpha (or short-term) holding based on its attractive valuation, high-valued content and potential synergies from company-wide restructuring. Viacom owns media content appealing to most demographics, ranging from Nickelodeon to Comedy Central and BET. They also own music properties MTV, VH1, CMT (Country Music Television) and the film and entertainment content provider of Paramount which engages in producing, financing and distributing motion pictures and television programing. VIAB has been a perennial underperformer as prior management leveraged the company with over $12 billion in debt to shore up its dividend and repurchased 15 billion shares of company stock. This was seen as nothing more than a capital structure to benefit its long-time CEO Sumner Redstone, rather than reinvesting in content or developing new channels of distribution.

The future looks encouraging especially at the top. In a highly publicized resignation, Sumner Redstone stepped down as CEO and controlling shareholder back in February 2016. Bob Bakish, President of International Operations was named his successor in late Fall. Since then, Bakish has been restructuring the company by cleaning house at Paramount and increasing capital investment. He has rearranged programing by focusing on flagship brands, revived reality TV and created more music content for MTV. More importantly, while the industry is battling "re-tiering", (popular programing is moved to more expensive or premium cables bundles) Bakish has been working to smooth over relations with cable providers and Dish Network to reposition key brands on popular programing bundles. VIAB is cheap on almost any metric. At a P/E multiple of under 9X, it's only slightly higher than expected revenue growth for 2017 and almost equal to its long-term growth rate. Furthermore, free cashflow is strong enough to pay-down debt, fund capital expenditures and support its dividend yield of close to 2.3% all from operations.

We added **First Data Corp (FDC)**, which is also in the middle of its own structural turnaround, to the portfolio. FDC is a payment processor whose systems connect retailers to banks and provide services that support credit card issuers. Back in 2007, just before the financial crisis, the company was taken private on $24 billion of debt. In the fall of 2015, it sought the equity markets and was once again public. In under two years, CEO Frank Bisignano has reduced debt to $18 billion, launched new technologies and reduced North American customer turnover rates to 29% from 40%. The company serves over 6 million business locations and 4 thousand financial institutions. They secure and process over 2,800 transactions per second and over 2.2 trillion per year. FDC generates significant free cashflow which will support a reduction of debt, reinvestment in business technologies and acquisitions. The company is the cheapest among their competitors, trading at a multiple of just 10X on earnings growth of almost 8%. This is a 52% discount to its peer group average of 21. Depending on the success of its turnaround, FDC could end-up being a long-term anchor investment as debt decreases and growth prospects improve.

We have owned **Whole Foods (WFM)** just shy of two years, and over that time investors have received about 1.73% in dividend income each year, which turns out to be significantly higher than money market rates over that time. The stock performance was less than exciting, falling by as much as 35% in the fall of 2016. However, a surprising acquisition announcement by **Amazon** in late June changed our perspective. Although WFM looked to be improving its operations as it implemented a turn-around strategy of expense reduction, margin improvement and the roll out of a new small store concept called "365", we sold all positions after a 27% one day pop in the stock price.

With the proceeds of the sale we bought an equal amount of **Amazon (AMZN)**. We look at these two transactions independently. Would we have bought Amazon without the acquisition? Not without some pull-back in price. With the acquisition of WFM, the growth assumptions of AMZN became more realistic. AMZN can take Whole Foods' brick and mortar and pharmacy businesses and make them more efficient. They will likely lower prices on WFM's premium products to increase competitiveness and still drive profitability higher. It's P/E over growth rate set-up is quite attractive at about 1.2X. Yes, it trades at a ridiculous 87X but when compared to its year-over-year earnings growth rate of 71%, it's better than most companies on the S&P 500. Don't panic, I'm not becoming a growth manager! I just think there is a unique value proposition in AMZN that can be exploited overtime as they incorporate Whole Foods and other acquisitions.