LEGACY
ASSET MANAGEMENT, INC.

1800 West Loop South, Suite 1790
Houston, Texas 77027

For Quarter Ending March 31, 2012

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.

Contact Info:

Tel: 713.355.7171
Fax: 713.355.7444

Joseph R. Birkofer, CFP® - Principal
jbirkofer@legacyasset.com

Rick Kaplan, CFA - Principal
rkaplan@legacyasset.com

Dennis Hamblin, AIF®
dhamblin@legacyasset.com

Jillian Nel, CFP®
jnel@legacyasset.com

In This Issue

"What If"

Brief History

In the fall of 2011, I provided insight as to how I manage portfolios in an effort to mitigate risk in volatile markets. With the S&P 500 now up approximately 29% since the October 3rd low, it's logical that I address managing for risks in an upward trending market. I know it sounds oxymoronic – risk in an upward market – but risk is ever present even when the headlines and pundits report otherwise. I have been managing money since 1994 and I have seen cycles where stock valuations have been pumped up by overzealous optimists who fail to ask the critical question "what if." I saw this in the late 90's. The technological boom leading up to Y2K created a so called new dynamic where economic cycles were shorter and volatility was reduced. Everyone was a stock picker and the rising tide of stock prices lifted all boats. The stupidity and justification for higher earning multiples was centered upon Wall Street's rally cry "earnings don't matter." Rather investors were told to focus on operating earnings. Clearly, the cost of technology was irrelevant as capital was flowing into startups quicker than contestants could line up for Who Wants To Be A Millionaire. Millionaires and billionaires were created, as IPO's flooded the market and investors gobbled up the offerings as if it were a free buffet. No one was asking the critical question "What if". The music stopped in March 2000. (By the way, the music always stops.) The NASDAQ hit 5,048 on March 3 and five weeks later, it had fallen 34% to 3,321. Investors were left in a daze asking "what happened?" Risk pops up quickly and if you are playing the game, you better ask the critical questions. By-the-way, where was the S&P 500 on December 31, 1999? How about 1,469. Where is it today after the huge run we have had over the last six months, 1,409. Makes you want to go "hmm"!

For the Record

In the late 90's I did not play the game. I stayed far away from the high multiple, high valued stocks that drove the momentum market. Go ahead, check my old newsletters from 1998 and1999 posted on our website at legacyasset.com. Performance lagged the general market. I fought the urge to deviate from my investment discipline and join the momentum band wagon. Clients were threatening to walk if I did not invest in more growth oriented stocks. I could not understand why the markets kept going up and why valuations did not matter. Then, on a dime, everything changed. Y2K was in the rear view mirror and the immediate need to upgrade computers systems and other information technology subsided. The economy began to slow and the stock market fell. 2000 ended with all major market indices down. The lone bright spot for the markets were value stocks. Legacy's value composite was up 3% while the S&P 500 fell 9%. Redemption felt good.

Risk

Risk is a hard concept to quantify because it is intangible. It's not a part of the five senses, yet you know when you have it because it causes stress. Each investor has their own unique risk profile that typically affects the psychological being in asymmetric patterns. When the equity markets are going up, risk aversion disappears and the benefit of volatility is exploited to earn maximum returns. However, when markets retrace their gains, investors tend to worry much more about the stability of their portfolio. Risk aversion increases as preservation of capital becomes the primary objective. The psychological nuisances cause investors to react irrationally and emotionally rather than calculated, logical and informed. Behavior such as selling at the bottom of the market because of an arbitrary feeling of helplessness or adding money to equities after a huge run-up for fear of missing another positive market move are typical examples of imprudent investment decisions driven by investor psychology.

Investors should develop and follow an investment strategy that closely matches their risk tolerance to help guide critical decisions making in the face of emotional duress. For risk averse investors, value investing can be an attractive alternative as it identifies securities that are fundamentally undervalued and less volatile than the market. Stocks become undervalued for one of three reasons; 1) the company operates in an industry that is out of favor with investors (think banks in 2011), 2) the company stumbles in the execution of their business plan due to a strategic or operational miscalculation (Hewlett Packard), 3) the company's operations are misunderstood by Wall Street Analyst's and/or ignored (GE - Wall Street analyst don't understand how leveraged the company is to the energy sector). Value stocks are typically less volatile because they trade at market prices that are depressed relative to historical norms. As such, they tend to fall much less in declining markets. In the typical investing cycle, value managers buy stocks based on the three criteria listed above. Overtime, as stock prices rise and valuations revert back to their mean, value managers sell their stocks to growth managers who are looking for companies with earnings that will grow at rates exceeding the general market. Therefore, the natural progression from value to growth helps mitigate risk by locking in profits before market valuations become excessive. Keep in mind that investors can't have it both ways – if stocks are less volatile on the way down, they will likely lag in upward trending markets.

In rising markets, the threat of upheaval or volatility does not dissipate. Investors have to consistently ask "What If" to be able to identify potential land mines. On October 9, 2007, the S&P 500 reached its peak of 1,565. Yet, investors had no idea what was on the horizon. Exactly 17 months to the day, the equity markets bottomed as the financial crisis played out. When the smoke cleared, the S&P 500 had lost almost 57% of its value. Three years later, the index is still down 10% from its high water mark. Makes you want to go "Hmm", yet again.

Thinking back to about the time the S&P 500 was reaching its high in the fall of 2007, one of our core holdings, National City Corp., warned that greater than expected mortgage exposure would hurt earnings and the company disclosed that they would have to take a significant write-down. Alarm bells went off in my head and I began to look at all of the other bank holdings in the portfolio to quantify the potential exposure to mortgage write-downs. It took me a couple of months, but by early spring of 2008, the portfolio was free of bank holdings and the risk component fell significantly.

By asking "What If", listening to my gut and engaging in thorough research, we were able to protect and insulate our clients from the majority of the losses that swept over the market in 2008 following the Lehman Brothers bankruptcy. Our long-term focus filters out much of the daily noise that can impact less disciplined and short-term oriented investors. Legacy's track record validates the confidence we have in our investment philosophy and discipline to successfully maneuver client portfolios in both trending and trendless markets.

First Quarter Review

What if there was one stock that defined the equity markets? It would be "the most interesting stock in the world". It would be its own index. Others would try to replicate it, but go bankrupt. Product launches would become national holidays. The United Nations would redraw national boundaries when they open new plants. Businesses would close their doors when they vertically integrate and the moon would actually move out of the way as their revenues grow. When managers need outsized returns, they would invest in it. I usually don't invest in momentum stocks, but if I did I would invest in Apple!

Not only is Apple the world's largest company, but with a market cap of $576(B), it is larger than the economies of either South Africa, Argentina or Saudi Arabia. Apple's influence on the equity markets is no joke. For the quarter, the Dow, S&P 500 and the NASDAQ soared 8.1%, 12.6% and 18.7%, respectively. Note that Apple is not a component of the Dow. However, it makes up 4.4% of the S&P 500 and almost 20% of the NASDAQ. Apple represents about 15% of the gains of the S&P 500 and a little less than 50% of the NASDAQ. According to Howard Silverblatt of S&P Indices, the S&P Tech sector (+18%) would have been DOWN 4% in the quarter, if it were not for Apple. Furthermore, the S&P 500 would be below 1,400. When you think of Apple's growth it is truly amazing. In the first quarter alone, Apple grew its market cap by $181(B) which is greater than the entire market cap of Wells Fargo, Johnson and Johnson or JP Morgan. In other words, if Apple's growth in the first quarter were a company, it would be the 10th largest company in the S&P 500. Can you say excessive!

As you would probably guess by Apple's influence, growth alone beat out value in the quarter by about 30%. The dominance of growth was pervasive throughout all market caps. In regards to the individual sectors, the financial (+21.5) and technology (+21.1%) sectors far and away outpaced the rest of the sectors of the S&P 500. Together, the two groups represent 33% of the entire index. The financial sector surged on the back of large money center banks like Bank of America (+71%) and Citigroup (+39%) as well as super regional's such as Regions Financial (+51%) and Sun Trust (+37%). The consumer discretionary sector (+15.5%) jumped as consumers flocked to the malls and the auto dealer to celebrate the unseasonably warm weather throughout the country. Obviously, rising oil prices from escalating tensions in the Middle East, did not dampen consumer spirits. Unfortunately for the energy sector (+3%), higher oil prices were also met with declining natural gas prices which resulted in modest sector returns for the quarter. The telecom (+0.6%) and utility (-2.7%) groups lagged all other sectors as investors moved money away from less volatile, higher income assets in favor of higher risk securities.

What To Watch?

The equity markets have had quite a run on the back of improving U.S. While the data is not exactly eye popping, it is nonetheless impressive as Europe continues to deal with its financial crisis and recession coupled with slowing economic growth in key emerging markets like China and India. Astute investors have to wonder how long our economy can withstand these exogenous headwinds. More importantly, how much of the good news is already priced into the market. Typically, when equities have a quarter of outsized returns, the preceding quarter(s) is/are muted. Nonetheless, most economists and Wall Street pundits remain uniformly optimistic, throwing out projections of Dow Jones 15,000 or even 17,000.

Unfortunately, I can't share their optimism because I think the markets moved too far, too fast and might have front loaded returns for the full year. Last quarter, I indicated that I had changed my tune and was becoming more constructive on our markets. However, coupling the extraordinary pop in the markets with unresolved domestic and geopolitical issues could haunt the market psyche.

In short order, we should get an indication of how rising costs and slowing global growth are affecting profit margins. At the end of 2011, most companies were struggling to post operating profits that matched the previous year. It is interesting to note, that according to Factset, (a database reporting company) EPS estimates for the S&P 500 fell 3% during the 1Q' 12, while the index jumped in price 12%. This marks only the 4th time in 40 quarters that the percent change in the earnings estimates and the price of the index have moved in the opposite direction. The expected decline in earnings is broad based as seven of ten sectors are predicting lower earnings. Yet, nine out of ten sectors are expected to report revenue growth.

While we are unwilling to commit money to the market at these levels, we will be buying on pullbacks. There are sectors and industries that look appealing for long-term appreciation. We see opportunities in some banks and financial services companies that have limited exposure to rising rates. We also will continue to look for technology companies that have unique opportunities to exploit strong distribution channels and limited exposure to rising commodity costs and a rising dollar.

By the time I write the next newsletter, we should know the fate of the Affordable Care Act, (i.e. Obamacare). Whether you believe the law will be repealed or not, the clarity of a decision will be welcome as uncertainty has pressured the sector. Managed care companies are poised to benefit from any outcome as almost 90% of insured Americans are in some form of a Health Maintenance (HMO) or Preferred Provider Organization (PPO). While we currently have United Health Care (UNH) in the portfolio, we might look to add to the position at some point in the quarter. The pharmaceutical industry will likely be unaffected by either decision because the law has constraints and benefits that would offset. Therefore, the industry will continue to trade primarily on their product pipeline. However, if the bill is repealed, they will save billions of dollars in taxes and fees (to fund Obamacare). Conversely, the drug companies will lose the pricing benefit as cheaper prescription drugs from Canada would not be restricted and generic versions of biotech drugs would not qualify for longer patent protection. Nonetheless, we will continue to look for value opportunities and exploit cheap valuations in this sector.

The Portfolio

Sysco Corp. (SYY) – We sold our position in this stock after holding it for much of the past decade. Although SYY's price barely moved over the 10 year period, investors benefited from a dividend that increased almost 300%. The fundamentals of the food service business are challenging as SYY has been unwilling to dramatically raise prices to cover rising commodity costs. Over the last 10 years, growth through acquisition has come at the expense of debt which has increased 137%. Capital expenditures have been growing faster than revenue and profitability has declined as return on average shareholder equity has fallen from 31% in 2001 to 28% in 2011 and return on invested capital has declined from 20% to 17%, over the same period. While management has identified some options for potential growth, we can't identify catalysts that would propel the stock higher. While rising dividends are attractive in the current low interest rate environment, we believe there are better investment opportunities yielding higher total returns. At current valuations, investors are paying a premium valuation for high dividend growth rather than business growth.

Travelers Insurance (TRV) - The insurance industry as a whole is dealing with poor fundamentals as a combination of declining underwriting rates and billions in claims from natural disasters have compressed margins. In addition, the amount of money insurers have been able to earn on their investment portfolios has suffered in the volatile equity markets. While Travelers will be pushing through price increases on their policies, cost conscience customers will likely shop policies to find the best possible deal. We sold all positions based on price appreciation and the absence of a clear and sustainable catalyst.

General Dynamics (GD) – We added shares of General Dynamics based on several catalysts that should enable the company to achieve consistent growth in the future. For starters, we believe the companies Gulfstream business remains underappreciated. Deliveries of the new G650 should ignite demand as the U.S. economy stabilizes. Furthermore, the additional demand from the BRIC countries could drive incremental demand that was nascent in previous cycle. The Aerospace division could contribute up to 30% to company profits in 2012, up from 20% in 2010. In addition, GD's defense business looks resilient even as the Defense Department resets it budget. There is opportunity for growing demand for US border security work and from foreign countries seeking weaponry. From a valuation prospective, the company is valued as if it were solely a defense company, trading at a slight discount to its peer group. They are getting no credit for generating a substantial percentage of revenue from the higher growth aerospace business. Their balance sheet is in excellent shape as they have below peer group debt, giving management opportunities to growth the company should an opportunity present itself. Their operating cash flow is very strong and more than supports the company's 2.8% dividend. We believe the stock price will rise and the multiple will expand as Wall Street begins to appreciate the strength and contribution of the aerospace business.

E I DuPont De Nemours & Co (DD) – DuPont was added to the portfolio based on improving operating fundamentals in many of their businesses, attractive valuation and significant cash flow that easily covers its debt coverage, dividend obligation and capital investment. The company has eight reporting business lines, and a diversified portfolio of popular brand names that include but are not limited to Pioneer seed, Teflon non-stick coatings, Tyvek house wrap, Kevlar body armor and Zodiac and Corian counter top products. However, the majority of its revenue and profit is generated in four Segments – Agriculture, Performance Chemicals, Performance Materials and Performance Coatings. The company is pursuing a strategy of divesting non-core, lower margin businesses (such as the October 2011 sale of its pharmaceutical business to Bristol-Meyers Squibb) and pumping the capital in higher margin chemical business such as titanium dioxide (TiO_2). The company is benefiting from tight supply/demand fundamentals and limited competition due to high capital barriers to entry. DD is the world's largest manufacturer of (TiO_2), which is a white pigment added to paint, paper, plastics and laminates in order to give opacity to products. DD is a low cost producer of TiO_2 and significantly benefits from rising prices. To let you in on a big secret, the reason why I know so much about TiO_2 is that it is they key ingredient in keeping the cream filling white in an Oreo Cookie! DD is cheap on both an absolute and relative basis on just about any criteria. In addition it has a 3.1% dividend yield. While Dupont is typically thought of as a defensive name with a high dividend, we believe that based on its repositioning strategy, it has many elements of potential growth that is ignored by Wall Street. Overtime, investors will be rewarded as sales and profitability grow at higher rates due to a successful repositioning strategy.

Harman Industries (HAR) - Harman develops, manufactures and markets audio products and electronic systems. The company has three business segments, Auto, Consumer and Professional However, the Auto segment generates 73% of company revenue and 68% of operating profit. We added HAR to the portfolio because we think that its discounted absolute and relative value does not accurately reflect growth opportunities in the global auto industry. The company manufactures a infotainment system installed in many upper-end automobiles, prominently displayed on the center console between the two front seats. This system combines the critical information and the convenient entertainment components into one multi use integrated-control center for Global Positioning System navigation, traffic information, voice-activated telephone and climate control, rear seat entertainment, wireless Internet access, hard disk recording, MP3 playback and an audio system. The integrated-control systems are currently installed on Mercedes, BMW, Toyota and Harley-Davidson touring motorcycles. The growth catalyst stems from opportunities for a scaled down version of its current integrated-control system for Volkswagen and Peugeot and potentially Ford. The more basic equipment would provide for a higher level of profitability. The company is conservatively managed as total debt to equity fell from 57% to 26%. In addition, the company has cut costs by opening plants in Hungary, China and Mexico. They have strong cash flow which supports capital expenditures and its small dividend. We think that HAR should command at multiple equal to its peer group based on its growth potential.