LEGACY
ASSET MANAGEMENT, INC.

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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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THE NEW ADMINISTRATION

GOVERNMENT UNCERTAINTY

As we have seen over the last six months, capital markets and government intervention do not play nicely together. The uncertainty inflicted when government intervenes on behalf of business creates a shroud over the potential landscape for which companies must compete. Operating efficiencies are questioned and the ability to profit becomes harder as the government can change the rules of the game either to the benefit of or detriment to the company. This produces an atmosphere of indifference, providing investors with a legitimate excuse to sit on the sideline and wait for clarity.

The days of companies deciding for themselves whether or not they are economically viable seem to be long gone. General Motors, Chrysler, AIG, and Citigroup are nothing more than pathetic examples of great American symbols of capitalism and ingenuity that have deteriorated to such depths that they are relegated to pandering to politicians for their mere existence. These companies know that they need massive re-organization that comes with Chapter 11 bankruptcy protection in order to become self-sustaining and viable.

Rick Wagner, former CEO of GM, could have possibly saved his job and had a hand in reshaping the future of General Motors had he chosen to take the company into Chapter 11 bankruptcy filing and not taken federal bailout money. The company could have used the bankruptcy system to reorganize business units, union contracts and debt structure to downsize into a going concern. Unfortunately for Wagner and taxpayers, he chose to play the government game. When business did not improve, the President asked for his resignation and gave the company 60 days of government support to develop a comprehensive plan for restructuring the firm in a way that is "acceptable to the administration."

I don't know about anyone else, but this scares me. Corporate America should not be going to the Federal Government for money. However, in a unique situation, the act of seeking temporary funding should not dictate that corporate boards relinquish their fiduciary duty to a government entity or a president's administration that might have a political agenda that differs from the company. The providers of the emergency funds should have the sole discretion of determining how long they are willing to maintain life support for the company, rather than making strategic decisions. It is much more efficient for the company to go through the bankruptcy process and have an independent (non-political) judge working with all parties of a firm to develop long-term strategic goals and objectives that coincide with its core competencies.

Unfortunately, it appears that the new administration and Congress seem comfortable in thrusting their weight upon corporate America. Dictating executive compensation, validating certain contracts at the expense of others and deciding which companies and management teams should stay or go are anti-capitalist policies that are causing another layer of corporate angst and investor uncertainty. Hopefully, as the economy improves, the government will find other more pressing issues in which to engage rather than business and the capital markets.

POLICY "CHANGE"

There is a new mindset in Washington D.C. and it's going to take some time to see how it is all going to play out. The financial markets can't seem to digest the proposed changes. It's somewhat like reflux – the policy changes might sound good in theory but when we start thinking through the practical applications and potential outcomes it comes back up with a nasty aftertaste. We are talking about Obama's proposed new monetary and fiscal policies and how they will impact the economy.

Before discussing Obama's proposed programs, it is important to note that the U.S. economy is suffering through a demand crisis. When the general economic outlook is gloomy and unemployment rises, wages stagnate and housing values and the stock markets fall, consumers cut spending and pay down debt. This reduces the demand for all goods and services. Logically speaking, the best way to repair the economy is by providing incentives for job creation and stabilizing the housing and capital markets.

Back to Obama – his new administration wasted no time in initiating a $787 billion stimulus package to provide a short-term boost to the struggling U.S. economy. Unfortunately, I don't believe Obama's stimulus package will work any better than the Bush stimulus package of last year, but for different reasons. As you may remember, Bush sent lump sum rebate checks of up to $600 for individuals and $1,200 for working couples. However, most taxpayers chose not to spend their refund, rather to save, pay down debt or offset the rising cost of gasoline. Regrettably, the Obama plan misses the mark as it is nothing more than government spending wrapped in a stimulus bow. If you strip out the normal $69 billion in AMT exemptions that reoccur every year, $200 billion (or 30%) of the stimulus bill is deferred spending to 2010 and beyond.

In addition, I am not sure how a tax rebate from weekly payroll taxes will provide enough incentive for consumers to increase discretionary spending in a meaningful way. Essentially, taxpayers receive the benefit as a withholding tax **reduction** rather than an actual cut in tax rates. According to the IRS, individual workers making less than $75,000 will pay about $400 less in withholding tax which equates to about $8 added to their paycheck each week. Married couples making less than $150,000 will pay about $800 less for a total of $16 extra in their combined pay checks each week. What workers may not know is that they will be taxed on their extra income come next April. Remember, the consumer makes up 70% of the U.S. economy. Call me cynical, but I can't see an eight dollar per week bump up in taxable salary as sufficient to entice consumers to go out and buy cars, TV's, clothes or any other consumer discretionary item.

While the stimulus package was designed to provide an immediate jolt to the economy, Obama's proposed budget, if passed as intended, would bring about long-term fundamental change to monetary and fiscal policy that could have a significant impact not only on the economy but also Americans' spending and savings behavior. This will be the largest budget ever submitted to Congress at $3.6 trillion, 16% larger than last year. It will increase the deficit to $749 billion, 33% bigger than Bush's 2008 budget. However, based on his initiatives of spending for national healthcare, renewable-energy development and education, one has to wonder if this projection is significantly understated. He is planning to pay for these spending programs through higher taxes, reductions in mortgage and charitable deductions and higher capital gains and interest taxes. Unfortunately, I don't believe the tax increases on Americans will stop there. For example, the top tax rate in Obama's budget will increase to 39.6% from 35%. Regrettably, I believe this will be the initial increase with many more to follow. If his proposal for renewable energy passes, all citizens will be paying higher rates (or taxes) for all types of electricity and energy. Cigarette taxes have increased from $0.39 to $1.01 per pack. This is just a small list of what is coming. Going forward, U.S. citizens will have to live with higher taxes to help subsidize the out of control spending.

Meanwhile, the Treasury continues to print money at the speed of sound. Someone has to pay for all of our spending programs and the Treasury believes that foreign governments will continue to invest in U.S. dollars. However, foreign leaders are beginning to question how much debt they actually want to own. Even Russia has questioned U.S. fiscal prudence and warned of the potential disastrous effects of increasing the money supply. Printing money to pay for our spending will lead to troubles down the road in the form of inflation. Should inflation begin to rear its ugly head, then the U.S. could be quickly approaching a 1981 - 1982 type economy in the coming years.

Indeed, 2009 has been and will continue to be a year of "change." Reshaping the economic landscape through monetary and fiscal policy will be a long and painful process. I fear that taking money out of consumers' pockets (in the form of higher taxes) and placing it in the hands of the Federal Government will not stimulate our $14 trillion economy. Corporate America needs incentives to hire employees and invest in their business and product lines which made them successful in the past. Leveraging the future of America by printing money and punishing one group of citizens at the expense of another is no way to grow a country or an economy.

First Quarter Review

Hope Meets Reality

Well it certainly could have been worse! After sweating through a tough January and February, where all major market indices were down 8 of the first 9 weeks of the year, investors finally showed some interest in getting back into the equity markets – in March. At the market depths, the Dow Jones and the S&P 500 were both down close to 25%, while the NASDAQ had fallen a mere 18% before. December's optimistic tone evaporated quickly as it became clear that the incoming administration did not have any better grasp of the credit crisis than the Bush administration. Reality set in as selling was exacerbated on February 10th when Treasury Secretary Geithner came forth with the details (or lack thereof) of his bank rescue plan which did not impress Wall Street or investors. The equity markets proceeded to fall 11% over the subsequent two weeks. Just when it looked as if the Dow would dip below the 6,000 level and S&P 500 would hit 650, Citigroup and other major financial institutions announced that their operating earnings would be positive in the 1st quarter (well if they can't make a profit now, when the cost of borrowing from the Fed is basically nothing – then they should go out of business). Home sales grew unexpectedly and Geithner disclosed the Treasury's plan to buy "toxic" securities from banks. Before you know it – we had a 20% rally on our hands. At the end of March, the Dow was down 13.3%, the S&P 500 was down 11.7% and the NASDAQ was down 3.1%.

For the quarter, Legacy's value equity composite (net of fees) lost 6.6% which again compares favorably relative to other major indices. Legacy's performance was attributed to a large cash position and increase in the portfolio allocation to both oil and technology. As noted in last quarter's newsletter, we added CISCO and Qualcomm to the portfolio as well as added to our Microsoft position. While cash remains king, we have reduced our cash position to roughly 25%.

Overall, growth investing smoked value, while mid-cap stocks did better across the board relative to its large-cap and small-cap cousins, in the 1st quarter! For example, according to the Russell indices, large-cap growth declined 2.8% compared to large-cap value that fell 15.1%. Mid-cap growth fell 2.1% while mid-cap value slid 13.3%. Small-cap investing was the big loser in the quarter as investor steered clear of small companies in fear of the implication of widening spreads in the credit markets and the unwillingness of banks to lend to smaller clients. Technology was the only sector with positive returns in the quarter. Materials were down 2.8% followed by telecommunications, healthcare and consumer discretionary which were all down roughly the same amount 8.5%, 8.5%, and 8.6%, respectively. Meanwhile, financial stocks continue to be the worst performing group of the S&P 500, with a loss of 29.5%.

Strategy and Opportunities

I have been asked many times how a portfolio manager can make money in this market without actively trading accounts. The short, straight forward response is that you can't. **However**, there is no guarantee that you will be successful at trading either. Trading is nothing more than identifying a short-term trend and exploiting it. The only problem is that in this volatile environment, where the equity markets might open down 100 points but end the day up 200 points, makes implementing this strategy difficult. It seems as if short-term trends can last as little as an hour before some reversal occurs.

Long only managers can gain an advantage over the general market by prudently allocating portfolios among the 10 sectors of the economy and through the allocation of cash. Therefore, when the markets do turn around, investors will have less ground to make-up. In addition, managers can overlay tax efficient hedging strategies within a buy and hold portfolio to provide some insulation to the market volatility. In the past quarter, Legacy bought the ProShares UltraShort S&P 500 Exchange Traded Fund. This ETF corresponds to 2 times the inverse daily performance of the S&P 500 Index. In other-words, as the S&P 500 fell in February, the ETF increased in value at twice the rate. Legacy initiated this short-term trade strictly as a hedge to offset the negative sentiment in the market and knew that we would reverse the position as soon as it was deemed appropriate. This strategy added to the portfolio performance in the quarter.

Going forward we continue to see good value and investment opportunities in the agriculture, technology and energy sectors. Although agriculture is the growth engine of the world, many of the companies are priced at discounts values to future cash flow prices. Low stock prices reflect world wide low demand for grains seeds and fertilizer. However, farmers will be the beneficiary as falling fertilizers prices should help boost operating margins for corn, wheat and soybeans. We believe that some companies in the agricultural industry can benefit from the current environment and grow their business. The technology sector continues to exhibit fundamental that are attractive even in this depressed business environment. Typically, Legacy's looks for companies with cash in excess of total debt, positive free cash flow and the ability to utilize cash to support and grow market share. Finally, there are multiple reasons to be bullish on energy. First, Legacy believes that the domestic and geopolitical landscape is ripe for the price of oil to rise. Secondly, as the economy improves, demand for oil will increase as factories boost production to meet anticipated demand. Finally, the fundamental de-leveraging of the service segment has created an opportunity to consolidate and steal market share when the economy rebounds.

QUARTERLY ACTIVITY

LEGACY DID NOT ADD ANY POSITIONS TO THE PORTFOLIO THIS QUARTER:

LEGACY LIQUIDATED OR REDUCED POSITIONS IN THE FOLLOWING COMPANIES:

News Corp. (NWSA) – It is no surprise that TV and newspaper advertising revenue is down. Unfortunately, so are DVD sales and the film entertainment business. What is worrisome is that the company's big exposure to newspapers will continue to pressure margins due to falling ad revenue and higher costs. NWSA has also been unable to monetize some important growth businesses like MySpace where revenue growth has lagged expectations and margins have been low. With valuations uncertain, we focus on cash flow and balance sheet fundaments. In 2008, cash flow declined by over $3B and halfway through 2009, the company lost an additional $1B in cash flow due to weak operations. Lack of confidence in management and execution risk worries us specifically, the succession issues within the Murdoch family which will come to a head soon as President Peter Chernin steps down in June. The likely successor would be James Murdoch, Rupert's oldest son. However, many believe he is not ready to lead the company as some of his actions to-date are questionable. We don't see any clear catalyst over the near term that will help NWSA right the ship other than an improving economy. Should that scenario play out, we believe that there are better opportunities to capitalize on an economic rebound.

Pfizer Inc. (PFE) What a huge disappointment! PFE has been a core holding in Legacy's equity portfolio for over 8 years. Although the company had generally underperformed the market due to research and development snafus, the bullish thesis was supported by the company's strong pipeline of potential new drugs and an experienced management team that would prudently utilize over $20B in cash on strategic acquisitions that would replace the $13B (or over 25% of total company revenue) in lost revenues resulting from the 2011 patent expiration of the firms biggest drug, Lipitor. All of that hope flew out the window on January 26th when the company announced a deal to acquire Wyeth for $68B. The company plans to pay for it with a combination of cash, stock and debt. While the combined company will be the world's largest drug maker by revenue, we sold Pfizer because of the four D's: Dilution, Dividend, Debt, and Desperation. As a result of the acquisition, the company's debt exploded by over $22B while its cash declined the same amount. In addition, current shareholders will see the value of each share decline by 20% due to dilution. PFE cut the quarterly dividend in half, from $0.32 to $0.16, in order to save over $1B per quarter. Basically, management panicked. Early in January, the company announced that they would lay off over 800 lab technicians and researchers as the tens of billions of dollars they had pumped into R&D had failed to deliver a new blockbuster drug. Pfizer knew they had to do something quick and they made a non-strategic acquisition that did nothing but double the size of the company. Unfortunately it did little to address the faulty drug pipeline. The company may get its act together, but it will take a long while. Good luck with the merger, Pfizer – we will re-allocate our dollars in a company that will actually grow.

AROUND THE FIRM

It was a truly historic Quarter with the combination of the inauguration and market volatility. At Legacy Asset Management, we stayed in close contact with clients while setting-up and welcoming several new investors into the firm. You may not remember, but Legacy experienced its greatest growth during the last bear market as many frustrated investors fled their advisors due to a lack of customer service and poor investment options and results. We are currently seeing some of the same trends today. If you have friends or family who might benefit from sensible advice, please contact Joe or Rick.

Joe traveled to Minneapolis in January to participate in due diligence and a client service panel at our clearing firm, The Royal Bank of Canada. Many of you might find this hard to believe, but Joe was able to establish quite a rapport with many of the support personnel that make Legacy's job easier. More importantly, RBC remains one of the strongest financial services firms in the world.

Over the course of the past couple of months, Joe has met with investment professionals, portfolio managers, and analysts from many of the mutual fund families that we choose to invest with. These experts prove to be a valuable resource by providing insight into the U.S. and global markets and economies that help shape our asset allocation models and perspective of the markets.

Rick and Joe were both asked to provide needed commentary on the markets, specific investment related questions and compensation issues for various new media outlets including the *New York Times, Money Magazine, CBS Market Watch* and the *Houston Chronicle*. Joe continues to teach Retirement Planning and Employee Benefits for the Certified Financial Planning (CFP®) Course at Rice University.

We would like to wrap up this busy quarter by congratulating Kyle Ezer, who is sharpening his analytical skills by successfully passing Level 1 of the three part Chartered Financial Analyst exam. Way to go! Good luck on the next level.