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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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Looking For A Catalyst

Let's Make a Deal

In an environment that teeters back and forth between bull and bear sentiment, investors are constantly searching for the precise indicator to base investment decisions on. Recently, two of the most accurate predictors of future market movement have regained footing on Wall Street – merger activity and dividend increases.

Over the past 18 months, U.S. companies have been forced to become highly efficient, by cutting employment and other costs, in order to preserve cash and survive in such an uncertain economic environment. Capital investing and research & development projects were put on hold as securing loans from banks and raising other forms of capital became exercises in futility. As a result, companies built cash balances in zero interest money market funds or bank accounts in order to maintain liquidity for future contingencies. However, with signs of an economic recovery beginning to take hold, corporate executives are choosing to reinvest their free cash flow in more productive ways in order to achieve both greater revenue growth and profitability metrics.

Acquisitions are a positive sign for the economy because they signal confidence on the part of business leaders that commerce is returning to a more stable or normal pattern. Within the technology sector, a select group of large, cash-rich companies have engineered all cash transactions as an avenue for expanding, into new business lines. Recently, Oracle paid $7.4 billion to buy into Sun Microsystems hardware business while Dell purchased the technology services expertise of Perot Systems. Cisco Systems has spent more than $7 billion to acquire six companies within the last twelve months. Tech companies are not just using their cash hoards for acquisitions, but they are also choosing to initiate capital spending projects as a way to stimulate growth. For example, Google is using its cash to develop computer operating systems and mobile phones while rival Microsoft has pumped millions of dollars into Bing, its new search engine, designed to compete against Google.

Cash transactions can be considered a leading economic indicator. Typically, only companies with significant cash reserves have the financial flexibility to take on the risk of an acquisition and fund it internally in the early phases of a recovery. With credit conditions tight, banks hesitate to take on risky loans until there is evidence that the economy is transitioning from recession to recovery. Therefore, acquisitions can be seen as a barometer of the health of the overall banking sector. The willingness of big, money center banks to participate in merger and acquisition (M&A) activity can be directly correlated to expectations for economic growth and the ability to extend new lines of credit based on the bank's financial strength and flexibility. Through the first two months of the year, the percentage of all cash deals in the U.S. has more than doubled from 2009, according to Thomson Reuters.

Ironically, the two most noteworthy cash acquisitions of the year were not even technology firms. Berkshire Hathaway made a surprising all cash purchase of Burlington Northern Santa Fe railroad for $31 billion and Walgreen's acquired New York City's drug store chain Duane Reade.

There have been several large debt oriented transactions in the past quarter, signaling that banks are becoming more active in both traditional lending and participating in M&A and other corporate actions. Examples include Kraft's bid for Cadbury, Schlumberger's acquisition of competitor Smith International, and Coca-Cola's move toward more vertical integration with the purchase of its bottler, Coca-Cola Enterprises. These transactions help support the belief that the overall economy is improving.

Value in A Dividend

Dividends are coming back into vogue. After a year of cuts and suspensions, corporate America is once again choosing to reward shareholders with its excess cash flow. Companies in the S&P 500 have announced $4.4 billion in combined net dividend increases so far this year, according to the Wall Street Journal. This compares to dividend cuts of over $38 billion in the first quarter of 2009. Since dividends are paid from cash flow, payouts can be seen as a sign of management's confidence regarding company prospects over the next several years. With projected payouts increasing by an estimated 5.6% in 2010, there is a high likelihood that management sees earnings in the next couple of years increasing. Indeed, S&P estimates that earnings will increase between 20% - 35% in 2010.

Unfortunately, there is a high probability that the administration will push for higher taxes on dividends and interest income as a way to pay for the newly passed Health Care Reform Act. All indications point to a tax level of between 20% - 25% from the current rate of 15%. While this rate is lower than many of the proposed personal income tax rates, it could temper some of the enthusiasm investors have for seeking out dividend yields or returns that rival the 10 year U.S. Treasury.

While some of the market rebound is related to improving economic conditions, by far the greatest contributor is related to improving corporate outlook and profits. Indicators such as M&A as well as dividend increases are signs that corporate executives are confident profits should stay relatively robust throughout 2010 and into 2011. We continue to look for more corporate action as management teams seek to uncover strategies to grow revenues, market share, profit margins and net income.

1st Quarter Review

Equities continued their upward momentum in the quarter for several reasons. First, encouraging economic reports advanced the perception that the economy was becoming more self-sustaining. Additionally, Federal Reserve Chairman Ben Bernanke hinted that he would continue to buffer the economy by keeping interest rates near 0% for an extended period of time. Finally, with the passage of the Healthcare Reform Act, service providers should gain clarity regarding the future operating environment so they can develop strategies to maintain market share and profitability.

Following a solid 4Q earnings reporting season, stocks sold off briefly as investors searched for new catalysts for earnings growth. The healthcare reform debate in Washington hit center stage and rhetoric and uncertainty from both political parties reached a fever pitch. However, similar to the correction in the Fall of '09, the pullback proved to be short-lived. The markets recovered and maintained a slow-but-steady rise throughout the remainder of the quarter, supported by generally upbeat earning reports, credit improvement and general confidence in business conditions resulting from corporate actions.

The Dow, S&P 500 and NASDAQ posted strong gains of 4.8%, 5.4%, and 5.7%, respectively for the quarter. All but two economic sectors posted positive absolute returns. Industrial stocks were the best performers, delivering gains of 13.1% driven by rebounding demand and strong outperformance from market leader General Electric. Financials were also up a strong 11.1% as investors placed higher valuations on evidence of real stabilization and improvement in their businesses. Macro factors such as the steepness of the yield curve, credit improvements and a resurgence of deal activity added to enthusiasm for the sector. Consumer discretionary stocks posted impressive returns of 10.4% as the 2009 holiday shopping period largely met expectations and improving consumer confidence led to more store traffic and spending on leisure and discretionary items. In terms of weaker performers, the telecom sector delivered the most disappointing results for the quarter, down 4.3% as investors' concerns over increasing competition and dividend sustainability took center stage. Utility stocks declined 3.5% on uncertainty around the regulatory environment and the potential for rates to rise. Finally, the energy sector was basically flat, reflecting a stronger dollar in the quarter and concern about high inventories in the natural gas space.

In terms of style and characteristics, value handily outperformed growth stocks. This was largely due to the huge gains seen in the more value focused financial sector. Small and mid cap stocks' returns were significantly better than their large cap counterparts with the Morningstar small and mid cap indices up 8.7% and 7.6% respectively versus large caps up a mere 1%. These results reflect a greater willingness on the part of investors to take on risk. Other common characteristics of stocks that have benefited from the "risk trade" include high relative debt, valuations and embedded expectations.

Where Do We Go From Here?

You may remember that in last quarter's write-up we

provided three possible scenarios for the direction of the equity markets. (If you would like a copy of the previous newsletter please let us know.) As a review, we expected equities to retreat and slowly recover (like a Nike Swoosh) as signs of economic improvement materialized. While we were correct in expecting stocks to retreat, our time frame for a recovery was much longer. Naturally, with the speed of the market rebound, we remain somewhat guarded in the near to intermediate term, especially when considering the potential risks of increasing legislation and regulation on businesses, the implications of higher taxes on consumers and the economy as well as ballooning national debt that could cause interest rates to rise. In our opinion, the easy earnings growth is underway now. The problem is that markets are forward looking and valuations are increasing rapidly. If earnings growth stalls later in the year, the markets could fall just as fast as they have gone up.

In uncertain markets, it is critical to make educated equity choices based on valuations. In the late 1990's, the markets were roaring upward and investors were buying anything just to get in – fearing they would miss the market rally. We have a similar feeling today as investor risk is clearly to the upside. We will continue to look for investment opportunities in sectors that seem attractive based on valuations. For example, the technology sector remains compelling as we believe that the corporate investment cycle has just begun. Revenue gains have the potential to have a multiplier effect on earnings given the enormous productivity improvements already achieved. Basically, companies have cut expenses so much that any increase in revenue will fall straight to the bottom line, causing profit margins, cash flow and dividends to increase.

Certain financial stocks have value characteristics and will begin to cycle against easy earnings comparisons stemming from the worst of the recession. While non-performing assets and write-offs of bad debt will continue to trend higher, we believe that the rates of change in key metrics such as returns on equity, returns on assets and net interest margin should improve significantly. Also, book values of many regional, super regional banks and insurers are below their 10 year median averages. In addition, we believe that the potential for reversion to more normalized dividend levels may serve as an important catalyst for financial stock performance.

The healthcare space continues to reflect attractive absolute and relative valuations as many of the participants were left for dead last year due to the uncertainty and ramifications of the passage of the healthcare legislation and an investor preference for more risky stocks with higher growth potential. Nonetheless, many companies in this space have very strong cash flow that can support future research and development, acquisitions and/or dividend yields. Like other areas of intense regulation, healthcare participants will learn how to adapt and thrive within the environment.

Quarterly Activity

Legacy initiated positions in the following companies:

Hudson City Bancorp (HCBK) - Legacy initiated a position in this New England based bank due to its strong fundamentals, cheap valuation and conservative management team. Hudson City fits Legacy's value criteria given its strong returns on assets and equity as well as book value growth driven by its affluent customer base, strong capital position and tight expense control. The conservative nature of the company's lending and business practices served Hudson City well during the downturn and should enable the company's credit profile to turn earlier than that of industry peers. Improving credit quality has been an important driver of valuation expansion of financial shares coming out of a recession/downturn. The company also has something of a tailwind in terms of net interest margin expansion as it is scheduled to reprice the rates it has been paying on deposits (i.e. CD rates) down through 2010. Valuation characteristics are attractive as the stock is trading at 13X trailing P/E, 11.8X forward P/E and 1.3X Book Value which represent significant discounts to historical medians as well as industry peers. Finally, HCBK has a history of raising its already high dividend which currently stands at 4.3%.

Morgan Stanley (MS) - We initiated a position in Morgan Stanley this quarter based on its attractive valuation resulting from the negative headlines around financial services regulatory reform. After a difficult 2008 and 2009, trends within the leading investment banks are stabilizing and key metrics such as return on equity (ROE) appear to have bottomed. The meltdown of this industry in late 2008/early 2009 resulted in a significantly altered competitive landscape given the ultimate demise of such firms as Lehman Brothers and Bear Stearns along with the consolidation of other key franchises such as Merrill Lynch, Wachovia and Bank of America. This should lead to greater opportunities for survivors like Morgan Stanley to grow market share, particularly given the recent trends in M & A, initial public offerings or secondary issuance. Relative to its valuation, it currently has an ROE of 4.3% compared to a 5 year average of 14%. MS is trading at

9.6X forward P/E and 1.0X Book Value which compares favorably to historical medians and industry averages. Though the company's yield is below its historical trend, we view the potential for reversion back to more normal levels as an important potential catalyst for the shares.

Merck (MRK) - We initiated a position in Merck this quarter as part of a broader strategy to increase our healthcare weightings given the extreme valuation anomalies caused by the healthcare reform debate. Legacy believes that the terms of the healthcare reform package for pharmaceutical companies is at worst neutral to what investors were expecting. The more likely scenario may end up a bit more positive than what was initially thought. In 2009, Merck acquired rival Schering Plough and the combined entity became the second largest U.S. pharmaceutical company in terms of both market capitalization and revenues. As a result of the merger, Merck has the smallest risk of patent expiration within the industry. Indeed, while its key competitors face patent expiration of up to 30% of currently marketed drugs over the next 5-6 years, Merck now faces an approximate 14% "patent hole". With Schering Plough, Merck acquired a viable stable of late stage products to go along with its 19 Phase III potential drugs in its pipeline. Even with the merger, MRK has a strong balance sheet with free cash flow projected to be $12B per year through 2015, and this should enable the company to cut its debt roughly in half over that time period. On a valuation basis, the stock is inexpensive at 10.7X forward P/E, 3.2X P/S, and 1.8X Price/Book which compares with historical levels of 15.1X, 4.5X, and 5.7X respectively. The dividend yield of 4.0% is also attractive.

Legacy liquidated positions in the following companies:

Wellpoint (WLP) - Legacy bought and quickly sold Wellpoint this quarter. Wellpoint is a leader in the healthcare insurance industry (operating under the Blue Cross/Blue Shield banner) and is the country's largest commercial insurer. We found the company's prospects to be compelling given the stabilization in premiums and revenues after the employment led downdraft of 2008-2009. As the largest player in the space with a strong balance sheet, Wellpoint is also poised to benefit from consolidation in the industry. In addition, valuation supported our investment thesis with the stock trading at multi-year lows on P/E, P/S and P/BV. With the resurgence and eventual passage of the healthcare reform bill, however, controversy around the industry again increased substantially. Wellpoint landed front and center in the political cross-hairs amid Congressional scrutiny around recent premium increases within its California Anthem unit. As a result of this media onslaught and public testimony from CEO, Angela Braly, the company came under immense pressure as uncertainty regarding its operating environment was questioned. Our downside stock price limit was breached and a sell order was executed. We still see tremendous value in this industry, and will likely revisit the space again once the dust settles and more is known about the actual ramifications of the legislation for insurers.