LEGACY
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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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We're three years, nine months from the collapse of Lehman Brothers and the resulting financial crisis. While it appears that the U.S. financial system has weathered the fallout without serious long-term structural damage, the economy remains quite a different story. The resulting dislocation of capital, personal wealth, standard of living and confidence has proved to be a much higher hurdle to cross.

Since 2008, two Presidents, two Treasury Secretary's and one Fed Chairman have initiated and presided over 15 different stimulus packages in an attempt to prop-up the U.S. economy. In early 2008, we had the Bush tax cuts, followed by the American Recovery & Reinvestment Act, the American Jobs Act, two rounds of quantitative easing, one Twist program, cash-for-clunkers, two housing tax credit programs, state stimulus packages and handouts, the Home Affordable Mortgage Program, numerous bank (and auto) bail-outs, small business lending programs, Central Bank liquidity SWAPS, Single Tranche Repurchase agreements, the Citi Asset Guarantee, TARP, TALF, TAF etc..., the Maiden Lane, LLC's that guaranteed loans of Bear Stearns and AIG, and last but not least, near 0% interest rates over the last three years.

Sadly, what is really amazing is with all of the stimulus and deficit spending, the economy has yet to grow over 4% in any one quarter. Furthermore, according to the OMB (Office of Management and Budget) the national debt over this same period of time increased from $9.9(T) at the end of 2008 to an estimated $16.4(T) at the end of 2012, an increase of 66% in just four years. I am sorry for the ugly truth, but that much debt is unprecedented! What's worse, U.S. debt now exceeds total GDP and the probability of reducing this debt measurably is remote.

Keynes

Where do we go from here? Some in Congress and in the media are clamoring for yet another spending bill. For three years, we have been printing money and engaging in easy monetary policy. Unemployment is still inflated at 8.2% and the U-6 (total unemployed and under-employed) stands 14.6%. Banks are still not lending freely and the housing market has yet to fully bottom. Americans holding excess cash are actually losing purchasing power as short-term interest rates hover near 0% while inflation (Consumer Price Index) stands at 1.7%.

At some point, we have to admit that this Keynesian experiment has failed. After all, Albert Einstein once said that the definition of insanity is doing the same thing over and over again and expecting different results. For three years, we have been spending money we don't have with very little benefit. At some point, we have to ask if there is evidence that any further spending bill will produce a different result. More of the same policies that have not worked should not be continued. At some point, there becomes diminishing marginal returns of whatever benefits there might be.

We should learn from history that government spending has never really been the elixir of growth. During the 1930s, implementing New Deal programs in the U.S.

doubled federal spending, while unemployment remained above 20% until WWII. In fact, FDR's Treasury Secretary, Henry Morgenthau, Jr. mused in 1939 that "we have tried spending money. We are spending more than we have ever spent before and it does not work … After eight years of this administration we have just as much unemployment as when we started … and an enormous debt to boot!" Japan initiated similar spending policies in the1990's as they passed 10 stimulus bills over 8 years. Unfortunately, racking up the largest national debt in the industrialized world did not produce the desired result. Over the last twenty-two years, Japan's economy has produced GDP growth in excess of 3% only once, in 2010. Not what I would call a glowing endorsement of success. Nonetheless, it appears that Europe has chosen to go down the Keynesian path. I am going to go out on a limb and say "it will not work there either." At some point, someone should stand-up and scream "this is insane!"

Economy

So how does all of this debt affect the economy? Historically, the U.S. was the envy of the world. It had a strong dollar and Treasury bonds that helped bolster its reputation as a global leader. In fact, the dollar was the default reserve currency of the world due to its strong and stable characteristics. In addition, foreign investors would seek out US debt in times of global crisis as they knew that US Treasury bonds would always retain their value. Unfortunately, our reputation is slipping as the rest of the world is beginning to lose faith in Congress and the current administration's ability to manage the country's finances. In fact, over the last 6 years, the U.S. dollar index has fallen close to 20% in value due to recession, government spending and financial crisis. With national debt of $15T now greater than the entire U.S. economy, there is real concern that it could fall further. In fact, foreign investors fear that the Fed and politicians will continue to let the dollar value decline, so the relative value of the debt will also decline. This occurs as foreign investors buy dollars to invest in the U.S. When the value of the dollar declines relative to their home currency, the value of their investment falls.

There are those that think a falling dollar is good for exports as our products are perceived as less expensive relative to other countries. While that might help near-term corporate earnings, it does nothing for creating long-term and productive jobs or repairing our long-term financial obligations. It is nothing more than leveraging long-term financial stability for a small short-term benefit. One last thing, as the dollar falls, the value of dollar based assets such as oil and gold increase which could cause headwinds for the overall U.S. economy.

As we look at what has happened this past quarter in Europe, we should take note of the severe consequences of racking-up excessive debt. Greece, Italy, Spain and Portugal all saw their respective interest rates spiked to new euro-era highs as investors flee from these risky regions for safer, less volatile environments. This could easily happen in the U.S. If government spending and debt continue to mount, investors will be unwilling to buy our bonds and fund our ridiculous appetite to spend. Where will the U.S. go for funding? The Fed would be rendered powerless and the markets would take over pricing U.S. assets driving interest rates significantly higher than where they are today. If you think this can't happen to the U.S. because we can always print money – think again. The perpetual policy of printing money only depreciates the currency's value over time. Keep in mind no one thought the housing crisis would ever come. Oy vey!

Second Quarter Review

The focus on Europe's economic woes has had a significant impact over both the U.S. and global financial markets. With every meeting and news conference, came headlines and rumors causing market gyrations, leading investors to change their investment strategy abruptly. Meanwhile, U.S. economic and earnings data was not met with the same significance or fervor. Investors chose the relevant data points to trade on at any given point in time during the quarter. Only those very skilled short-term traders could benefit from the rapidly changing momentum that drove equity prices in an up and down saw-tooth pattern.

Obviously, the Supreme Court's ruling to uphold Obamacare did not exactly cure Wall Street's ills. The markets were down almost 200 points after the announcement and maintained that level for most of the day until late word broke out of Europe that there seemed to be progress on a potential European banking union. That sparked a dramatic turnaround that turned investor psyche positive. Nonetheless most major indices still reported negative results for the period. The Dow, The S&P 500 and The NASDAQ Composite all fell 2.5%, 2.8% and 5%, respectively.

Jittery investors, seeking safe havens, high dividend yields and insulation from European drama, looked toward the defensive sectors as their preferred investment theme. Within the S&P 500, the Telecom Services sector was the big winner, posting returns of almost 13%. Other defensive sectors such as Utilities, Consumer Staples and Healthcare were also higher by 5%, 2% and 1%, respectively. It was probably no surprise that the Energy sector was down 6.5%, due to a sharp decline in the price of West Texas Intermediate crude (WTI) of over 17%.

Yet, it was the Technology sector, with losses of almost 7% that took home the prize as the biggest loser in the quarter. Slower projected global growth caused investors to switch out of technology stocks and into defensive names. Across the market, large-cap stocks did better than mid-cap and small-cap in the second quarter. According to the Russell U.S. Indexes, value stocks performed better than growth stocks. The gap in performance between growth and value decreased as market cap shrank. This trend validates that during uncertainty, investors become risk adverse, seeking value and dividend paying stocks more than growth.

For the year, the Dow, S&P 500 and the NASDAQ were all in the black by 5%, 8% and 13%, respectively. The Telecom, Technology, Financial and Consumer Discretionary sectors lead the way with gains of around13%. Energy was the only sector down year-to-date. While large-cap stocks are still outpacing mid-cap and small cap, growth overtook value across all markets. Similar to the second quarter, the size of the deviation increased with company size. Taken together, a cautionary tale of investor uncertainty continues to hover over the financial markets.

What's Coming

There is a litany of issues that could significantly impact the direction of equities over the next 6 – 12 months. The bulls like to reference that the markets don't have the overhang of last summer's debt ceiling debate or downgrade uncertainty. Crude oil and industrial commodity costs are significantly lower while stocks are less expensive, based on forecast earnings. Bullish analysts anticipate a turn in the housing market, a resurgent manufacturing base and an improving employment picture.

The bears contend that the structural and long-term issues that plague the markets will continue to weigh on investor's psyche. Most immediate is the upcoming earnings season. The majority of companies that preannounce earnings have guided analysts lower than what was expected. As a result, Wall Street significantly slashed second and third quarter earnings projections and growth rates. Shockingly, after all of the revisions, full-year revenue growth stands at only 2%. Should the new projection accurately reflect reality, valuations expand and stocks could have a volatile start to the quarter.

Europe continues to be a work in progress. On the one hand, there seemed to be some positive results coming out of the June 28 – 29 summit. Yet, countries still don't want to fund or support the financial deficits of other countries. This saga will continue, as countries face sovereign decisions regarding participation in the European Union (EU). Investors wanting to be in the equity market will have to accept the bumps and bruises that go along with the ever changing European soap opera. The longer uncertainty lingers, the likely it could have a negative implication for the U.S. economy.

As we get closer to the end of the year, you will be hearing frequent references to the fiscal cliff that awaits us. The cliff represents trillions of dollars in poorly conceived spending cuts and tax increases set to go into effect in January. This uncertainty will likely have an increasingly negative influence on the economy and pressure Congress to act to prevent a recession.

It's kind of bizarre that I did not mention the presidential election either in the bull camp or the bear. Frankly, the election will play-out at the ballot box and any "October surprise" will likely have a short-term effect on the markets. The implications will not be felt until this time next year. Regardless of who wins, domestic and global economics will be the focal point. How the winning administration responds will have serious implications on stock market performance. I don't pretend to know how it will end. My guess is more Keynesian if Obama wins, while Romney prefers supply side economics. Wall Street and corporate America clearly prefers the latter.

We remain very cautious on the market and look to exploit income producing assets such as regional financials, energy, staples, utilities and certain REITs (Real Estate Investment Trusts). Unfortunately, the Supreme Court's decision on Obamacare did not settle the issue as Republicans swear to repeal it if Romney gets elected. Since the decision was rendered, hospital stocks have increased and are no longer attractive. I guess we will have to take a cue from Nancy Pelosi and see how the law works now that it has passed. With all of these issues outstanding, there is no reason to go all in with equities. My Mantra remains - I would rather be out of the market wishing I was in, than being in the market wishing I was out.

The Portfolio

Legacy was a net seller of stocks in the quarter as our cash position increased in the equity portfolio from about 7% to 17%. Most of the stocks we sold were due to excessive valuations such as **Comcast** (CMCSA), **Covidian** (COV), **Home Depot** (HD) and **Southern Company** (SO). In volatile markets, investors can't be afraid to take profits even if they love the franchise. For example, Home Depot has been a staple in the portfolio since 2000. While we believe in the company and its business model, it had run too far and its financial metrics no longer fit within our value criteria. Covidian and Southern Company were also long-term holdings that too had run their course. Comcast, on the other hand, was a short-term holding (9 months) that no longer exhibited value fundaments.

Unfortunately, we sold the **CME Group** not for excessive valuation, but for opposite reasons. Recent developments caused us to question whether the company could achieve stated goals and our long-term expectations. Growth opportunities seem to be slipping as regulatory requirements increase. Recently, the CME was knocked out of the running to acquire the London Metal Exchange (LME). It was a surprising blow, considering it was the only bidder (out of three) offering metal contracts. The added business could have added volume and efficiencies. As if the MF Global debacle did not raise enough questions on the CME's regulatory oversight, now U.S. regulators, have designated derivative clearinghouses owned by the CME Group as "systemically important," meaning they are open to heightened supervision by regulators including the Federal Reserve. Topping off the trifecta of bad news, respected CEO, Craig Donohue will be stepping down when his contract expires at the end-of-the-year. Donohue has been CEO since 2004 and is credited with directing and executing the company's growth strategy. With regulatory and operating uncertainty, we liquidated position and use the losses to partially offset realized gains accrued from the aforementioned stocks.

On the buy side of the ledger, we added an undervalued tech and bank stock, as well as a perpetual turn-around story. **Broadcom Corp.** is an undervalued growth company that primarily designs and manufacturers semiconductor chips for wired and wireless communications. Their suite of products combine to deliver voice, video, data and multimedia connectivity to the home, the office and the mobile environment. BRCM's benefits from sales of iPads and other tablets through its mobile and wireless processors that enable WiFi, Bluetooth, GPS and WLAN capabilities for both Apple and Samsung products. In addition, the company is expanding into new markets and products that should bolster its market share and profitability. Overseas and emerging markets provide opportunities for significant expansion of BCRM's broadband and to the home business. Growth in cable, satellite, IPTV and Voice over Internet Protocol (VoIP) is raising demand for their set-top boxes and connected home service installations. The company meets all of our value criteria and sells at a 25% discount to its 5 year median. BRCM has the capacity and willingness to grow as cash on hand which is greater than total liabilities, provides the financial strength to seek-out strategic acquisitions.

BB&T (BBT) is an undervalued bank with approximately 1,800 branches in the Southeast from Virginia to Florida and west to Texas. Their experienced risk management team successfully guided the bank through the turbulent banking crisis and as a result, BBT has one of the best and most stable credit positions among its super regional peers. As of March 31st, the bank has over $2.1(B) in loan loss reserves which is almost 2% of total loans and 118% of nonperforming loans, both significantly better than its peer group. In addition, BBT has one of the highest Tier 1 capital positions in the industry. The catalysts for owning a bank in this uncertain environment include no exposure to Europe and their economic crisis, strong capital base and credit quality, higher loan growth, lower loan losses (higher net interest margins), lower non-interest expense and minimal effects on revenue and earnings from Dodd-Frank financial regulatory reform bill and the implementation of the Volcker Rule. In addition, BBT pays an attractive dividend of 2.6%, which is over 1% higher than a 10-year U.S. Treasury Bond. Investors are paid to wait for the uncertainty of the market and exogenous factors to clear, while downside exposure should be limited by strong U.S. operations and experienced management. When we added the shares to the portfolio in early June, BBT was selling at a slight premium to book value. However, we believe that over-time, BBT has the ability to grow and reach its pre-financial crisis valuation of 2X book value.

The perpetual turn–around strategy belongs to **Hewlett Packard** (HPQ). I know - I can hear the groans from here. However, we actually believe that new CEO, Meg Whitman has the company headed in the right direction. Revenue has stabilized and cash generation has increased significantly. The company announced a significant restructuring that will reduce headcount by 27,000 and harvest potential savings of roughly $3 billion, which will likely be reinvested back into the company's business. Whitman is also addressing strategic issues such as a smaller emphasis on PC's and investing in services, cloud computing, hardware, software and imaging and printing. The company is dirt cheap as its forward P/E multiple is at a near 50% discount relative to its peer group and a 36% discount relative to the other stocks in its sector. The company even has an annual dividend yield of 2.73%, attractive considering the 10-yr Treasury bond pays an annual interest of 1.67%. However, after the past tumultuous year, valuations are not the focal point of our expectations. Rather, it is Ms. Whitman's confidence that key management is now in place, and the company is in a better position to execute its strategy. The last two earning quarters have been surprisingly upbeat and stable. While the successful completion of the turn-around will likely take several years to complete, over-time investors should be rewarded in both income and total return. Besides, we used HPQ's depressed stock price to dollar cost average and considerably reduce our average cost basis.