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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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Still Skeptical

A Big Sigh

You can feel the sense of relief; hear the sound of air, quickly rushing out of the mouths of investors as they exhale and high-five their nearest compadres. Indeed, pulling out of the equity market's nose dive with an arousing 36% bounce sure can improve the psyche of investors. The U.S. financial markets have survived six long quarters (eighteen months and a 667 point decline in the S&P 500 index) of a constant drumbeat of negative news, earning losses, asset write-downs, bankruptcies, bailouts and ponzi schemes. While the general tone of the markets has turned positive, investors must decide whether the recent stock market rally reflects expectations that the recession is about over and growth will ensue or that the rebound has gotten ahead of itself and does not correctly reflect the challenges and pot holes that lie ahead.

Where is The Growth

Economists and professional investors continue to debate the breadth, depth and duration of the current recession. While recent government reports do support the thesis that the economy is no longer in a free-fall, it would be a leap of faith to suggest that economic growth is around the corner. We wonder if it would be more productive to move the debate from a timing issue of when we emerge out of the recession to a discussion of how and what will drive future normalized growth.

When you look back on what propelled the financial markets over the last 25 years you have to wonder if past catalysts can rejuvenate economic growth. From December 30, 1983 through December 31, 2008, the S&P 500 grew at an average annual rate of 7% or 447%, cumulative. A recent PIMCO (Pacific Investment Management Company) presentation, attributed the growth to macroeconomic factors such as declining inflation, deregulation, lower taxes, globalization, technological revolution and the use of leverage for consumption.

Unfortunately, under current political and economic landscape, these elements appear to be played out. At some point in the near future, taxes will have to rise to pay for the massive amounts of debt spending by the administration for stimulus and bailouts. Congress is licking its chops at the prospects of re-regulating the financial, energy and healthcare sectors. The days of accumulating debt are over. Home equity loans to support consumption are a thing of the past while corporate spending has declined as management teams shift strategic focus from growth toward stability of profits and margins. Finally, the technological revolution has matured. In the 80's, consumers jumped on the PC bandwagon. The 90's brought on a paradigm shift with the popular rise of the internet. The new millennium featured mobile computing and multi-tasking with PDA and phone technology.

Unfortunately, we can't look toward the government for much help. The combination of billions and trillions of dollars that have been set aside and earmarked as economic stimulus and bailouts plus new entitlement programs initiated by the administration has drained the government's coffers. Printing money only burdens future generations with the responsibility of having to pay back the irrational decisions of today. We need not

look any further than Japan as an example of where we might be headed. They are still trying to dig themselves out of their debt spending hole of the 1990's. Besides, government spending is notoriously inefficient, politically motivated and fraught with waste. Moreover, capital does not flow to its highest and best use as politicians do not evaluate and base spending decisions on the potential return of taxpayer money.

The U.S. economy can best be summed up as DEMANDLESS. As predicted, the administration's feeble attempt to stimulate demand by providing a withholding tax rebate has thus far been ineffective. The May consumer income and expenditure report highlighted that while consumer income rose modestly (due to the tax rebate), savings as a percent of disposable income hit its highest level on record. Americans have turned into net savers, as they continue to worry about the economy and the stability of their job in the face of an unemployment rate of 9.5%.

The elements of sustained economic growth must come from private sector job creation. While employment has historically been a lagging economic indicator, we believe that in this recession, job growth could very well become a leading indicator. Consumers will continue to save until there is clear evidence that employment is improving and the risk of losing one's job has subsided. One of the most proficient ways to promote job growth is to propose a series of tax breaks for capital investment. With the cost of a full-time employee rising due to higher medical costs, taxes and regulation, Corporate America needs enticements to invest in new projects that ultimately create employment. Furthermore, there should be incentives for firms to increase research and development budgets and inspire the creation of new technological advances with broad base acceptance and applications to help stimulate demand and growth.

Without a catalyst to spark the economic engine, we believe that the recent run-up in the overall equity markets has gotten ahead of supporting fundamentals and does not reflect the challenges that lie ahead. While we are hopeful that growth will soon return to the economy, we remain skeptical of pundit and professional projections of 3.5% – 4% normalized growth for 2010. Our comments should not be interpreted to mean that we expect to revisit the March lows; rather, we see the equity markets as range-bound until the economy can generate job growth or create constant demand.

Second Quarter Review

It's been a busy quarter as the financial markets have had to digest a rocky earnings season, the bankruptcy of GM, bank stress tests and conflicting economic data. Through it all, the markets managed to have one of its best quarters in years, driven primarily by the financial sector and a general improvement in consumer confidence. One of the factors leading to the "feel good" sentiment could be a reflection that the nineteen largest banks and financial institutions survived the government's "stress test". Ten of the nineteen banks were found to be short of capital by a total of $75 billion with Bank of America contributing over half of the shortfall. The report seemed to provide a boost for investors who sought reassurance that the financial system was stabilizing.

For the quarter, the Dow was up 11.0%, the S&P 500 was up 15.2%, and the NASDAQ popped 20.0%. Overall, the financial sector led the way for the broader market and netted a 35.1% gain for the quarter. This strong performance is of little solace for long-term investors, as this sector is still down over 66% from its highs in 2007. Surprisingly, gains in this sector were largely driven by banks deemed to be undercapitalized by the Fed; Bank of America and Wells Fargo were up 74.6% and 59.4%, respectively.

The technology and industrial sectors were strong performers racking up returns of 19.4% and 18.0%, respectively. Technology was driven by strong returns from blue chip companies such as Microsoft and Apple. The industrials sector was driven by an inventory re-stocking push as inventories fell to historically low levels, as the economy stalled.

Despite oil prices that have continued to climb to $70/barrel, the energy sector was a below average performer for the quarter (+10.0%). Large gains from oilfield services companies were offset by stagnant returns from the major integrated oil companies, whose stock prices are far less sensitive to oil prices.

Telecom, health care, utilities, and consumer staples each had positive returns but significantly underperformed the overall market with returns of 1.9%, 8.3%, 8.8%, and 8.9%, respectively.

In terms of investing style, both small caps and mid caps outperformed their large company counterparts for the quarter. According to Russell indices, small caps returned 4.2% more than large caps while mid caps returned 4.3% more. The difference between growth and value performance was negligible among large and mid cap companies, while small cap growth companies outperformed small cap value companies by 5.4%.

Planning for Value

It has been 60 years since Benjamin Graham first published *The Intelligent Investor*, which Warren Buffet described as "by far the best book on investing ever written." Legacy celebrates the fact that the value-oriented philosophy and principles established in 1949 remain relevant today by continuing to evaluate investment options with a "margin of safety" and strong dividend payments.

The future of the economy is hard to predict, and even Ben Graham couldn't have envisioned what we've seen. Government ownership of once-private enterprises has put investors at odds with government and political agendas. The government relegated GM's bondholders to a minority stakeholder in the new company while taking 60% for itself. Somehow, even the company's

unfunded pension liability received a higher priority of refunding in bankruptcy than senior bondholders. We've also seen the government take significant equity positions in many of the nation's largest banks. This unprecedented shift in government intervention in the capital markets creates an unbalanced playing field and uncertainty causing many investors to sit on the sidelines.

The Fed continues to keep interest rates low as a way to stimulate the economy by encouraging homeowners to refinance loans which creates more discretionary spending opportunities. Unfortunately, in a low interest rate environment, investors struggle to find fixed income securities that have yields that meet their income needs. Many investment grade bonds and CDs are paying rates that are on par with the average bank savings rate. Legacy sees opportunities to capitalize on high dividend yielding stocks to supplement income while waiting for the market to recover.

Some sectors that currently pay higher sustainable dividends include the energy, technology, and industrial sectors. Within the energy sector, the major integrated oil companies continue to pay strong dividends, while many of the oilfield services companies do not. Recently, Legacy added positions in ExxonMobil, ConocoPhillips, Royal Dutch Shell, and Schlumberger, while cutting holdings in Transocean. Many of the larger companies in the technology sector typically did not pay much in dividends.

However, after accumulating large quantities of cash and having few attractive investment opportunities, management teams have decided to return money to investors through dividends. This quarter, Legacy increased its holdings in Microsoft, Oracle, and Qualcomm, all of which pay a dividend. In the industrials sector, dividend yields have become increasingly attractive as stock prices have fallen, while dividend payments have remained largely unchanged. Legacy looks to exploit attractively valued, dividend paying stocks in this sector in the upcoming quarter.

In spite of the recent rally in financials, we remain hesitant to establish a position in the sector. While we believe the stress test was a significant hurdle for large money center banks to cross, other measures of financial stability show that the sector is far from out of the woods. Questions regarding loan quality continue to raise uncertainty. The number of loans over 90 days past due climbed over all major loan categories. Additionally, two-thirds of banks increased their loan loss provisions during the quarter. Banks also charged-off $37.8 billion in troubled loans during the first quarter. Skeptics continue to question whether the severity of the worst case scenario used in the stress tests was severe enough. For example, the government's worst case for 2009 average unemployment was 8.9%. With the release of the June data, unemployment reached 9.5% for the month and a 2009 average of 8.7%. It is easy to imagine a scenario where unemployment exceeds the government's worst case projections, causing the likelihood of defaults and write-offs to rise.

It is during times like these that we are thankful for the investment ideals of Benjamin Graham and the *Intelligent Investor*.

Quarterly Activity

Legacy initiated or added positions in the following companies:

Paychex (PAYX) – Paychex is a payroll, human resources and employee benefits company. The firm targets small to medium size businesses who need to outsource the human resource function comprising of payroll processing, tax and regulatory filings, tax payments, employee benefits administration, workers' compensation insurance, and other HR services to. PAYX is conservatively managed. They have no debt and $500 million in cash on their balance sheet. They have greater revenue growth and higher profit margins relative to their closest competitor ADP (Automatic Data Processing) yet they take less operating risk.

PAYX has historically traded at anywhere from 1.3x – 2.5x the value of ADP, depending on the particular ratio. Currently, PAYX is trading at levels significantly lower than its historical average. PAYX is currently trading at 47%, 43% and 51% discount to its 10 year average forward looking Price/Earnings, Price/Book and Price/Sales, respectively. Although the job market looks grim, investors are getting paid to wait for the economic turnaround as the company is paying almost 5% in dividend yield, near its highest dividend yield on record.

National Oil Well Varco (NOV) - National Oilwell Varco, founded in 1862, is a worldwide leader and provider of equipment and components used in oil and gas drilling and production, oilfield services, and supply integration to the upstream oil and gas industry. The company operates in rig technology, petroleum services and supplies and distribution services. The majority of the company's revenues and net income are derived from the rig technology segment, followed by petroleum services and supplies, and distribution services. The wide breadth of products and services provided allows for the company to maintain a competitive advantage within the industry. NOV has the financial where-with-all to capitalize on the weak economic environment to build its market share. The financially conservative management team has built cash reserves of $2.2 billion with debt of only $900 million, as of the end of Q1 2009. The strength of NOV's balance sheet enables the firm to continue to pursue its acquisition strategy in any economic environment. On a valuation basis, the stock is cheap. It is trading at a 50% discount to its median forward looking P/E ratio. In addition, it is trading at book value. However, over the last 12 year, NOV has traded closer to 2.3X book value.

Oil Sector – In April, Legacy added to current holdings in Royal Dutch Shell, Schlumberger, CononcoPhillips and XTO energy. We believe the large capitalized energy names had fallen to levels

that did not reflect the current environment. We like the energy names as most pay a higher than market average dividend, represent attractive valuations relative to their respective 10 year historical average multiples and can be used as a hedge against rising inflation and a falling dollar.

Cisco Systems (CSCO) – Legacy added to its holdings in CSCO at an attractive value. The company is gaining market share and has over $23 billion in net cash on their balance to support internal growth. In addition, the company's Price/Earnings and Price/Book ratios are trading at a 43% and 46% discount to the 10 year average, respectively. While it doesn't pay a dividend, we believe the company is in a unique position to capitalize on growth of the internet and the way consumers use technology to connect, communicate and collaborate.

Legacy liquidated or reduced positions in the following companies:

Fortune Brands (FO) – We sold all positions in Fortune Brands as its valuation got to levels that reflect full value in the current economic environment. While we continue to like the company and its management team, the stock price had rebounded over 110% (from $17.86 on March 9th to $37.98 on May 12) on expectations that the economy and the housing market would rebound. The company's forward Price/Earnings multiple had doubled from 8.02X to 16.83 over the same period. The stock price fell in sympathy with the housing market and the economy as many of the firms revenue lines correlate to discretionary spending. We will continue to watch, evaluate and revisit FO as a possible value investment for the future.

United Parcel Service (UPS) – We sold all of our positions in UPS for many of the same reasons that we sold Fortune Brands. The stock price had jumped 50% off its lows set on March 9th. In addition, the company's Price/Earnings multiple had jumped 40% in eight weeks while its Price/Book value jumped 32%. Company debt increased 38% at the end of the first quarter 2009. In addition, UPS warned that earnings would drop due to lower shipping volumes especially in the profitable next day air service. Like Fortune Brands, we will continue to watch, evaluate and revisit UPS as a possible value investment should the value re-emerge.

Other Transactions – Legacy bought and quickly sold Morgan Stanley and JP Morgan Chase. Both of these banks are well run and have particular niches within the financial sector. JPM is considered a money center bank which engages in traditional consumer and retail banking services, while Morgan Stanley operates in a transactional or investment banking capacity. While we attempted to establish a position in the financial sector with these two highly regarded financial institutions, volatility increased and a sell order was executed when our downside limit was breached. Since selling out positions, evidence suggests that loan quality is not improving as loan loss provisions and non-performing loans are mounting. With unemployment rising, this trend is likely to continue. We will likely revisit these two companies in the future as fundamentals stabilize.

Around the Firm

The second quarter was busy as Joe met with representatives from ING, Western Asset Management, Fidelity, John Hancock and American Funds. All shared their prospective on the markets – particularly what they believe is likely to happen in the near term (Quite frankly, many of them seemed to be quoting Rick's economic commentary from the prior pages.)

Joe attended a series of seminars on retirement plan trends, behavioral finance and portfolio strategies in a rising tax environment. Rick presented an economic review for a small community forum sponsored by Sterling Bank in Bellaire.

Rick and Joe were sought out for media commentary throughout the quarter. Rick's insights into the bond market, and in particular "bond vigilantes", were the centerpiece of a column written by Loren Steffy in the Houston Chronicle. Joe provided commentary regarding "young investors and inflation" for a piece in the Chicago Tribune, as well as an article on "financial steps to take after a job loss" that was featured on Yahoo and other sites.

Legacy opened its doors this summer to three interns who will be learning in-depth financial analysis. We are pleased to welcome Nader Daylami, of the University of California at San Diego, James Carreker, a second year MBA at Rice, and Michael Albert, a recent graduate of Indiana University

As we approach 2010, I wanted to remind readers of the opportunity to convert Traditional IRAs into Roth IRAs, without any income limitation starting in 2010. This may be a significant financial planning opportunity, and I would encourage readers who think it may make sense to please contact us. A Roth IRA conversion may be a smart move if you expect higher taxation in the future.

The past several months have been challenging, to say the least, and yet I would like to thank all of our friends and clients for their continued support, through their business and through their referrals, as our firm continues to grow in what is now our eleventh year.