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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It's hard to believe that the equity markets just completed the best quarter in 11 years. The steady rise toward the psychological level of Dow 10,000 was met with great relief. Seven months ago, the Dow was flirting with 6,600 and the S&P 500 was closing in on 600. Yet, here we stand, just a smidge from the milestone initially crossed 10 years ago. The saying that "the pendulum swings both ways" never seemed so pertinent.

Although economic signals are mixed, the equity markets have been moving higher. Market pundits, economists and media personalities say this dynamic is a classic example of how the financial markets outpace economic growth in the early stages of a recovery by six to nine months. Referencing the last four recessions dating back to 1980, the financial markets on average have retraced close to 20% of the total stock market decline in the early stages of the economic recovery. This includes a 31% snap back in 1982 from the market trough. Unfortunately, what this country just went through was no ordinary, run-of-the-mill recession. For the first time in almost 80 years, all of the major variables that support our economic foundation were crumbling and the freezing up of credit caused all consumer and business transactions to come to a screeching halt. To complicate matters, this recession was particularly broad based as it affected all of the major economies of the globe. Most of the countries of the G-20 were unwilling or unable to step in and support those countries that were deeply recessing. In spite of all of these problems, the financial markets have recouped 56% of their value from the lows set in March. This is the greatest recovery in price appreciation over the shortest period of time than any recession since the 1930's.

The Economy vs. The Market

As stated above, the financial markets appear to be ahead of the economy and it would be fair to say that investors have priced in a strong economic recovery by the degree to which stock prices have recovered. Keep in mind that the markets and the economy are not the same thing. On a macro-level, they are intertwined, but far from perfectly correlated. For example, the economy may be humming along nicely; however, rapid or consistent growth can also be a harbinger of inflation, causing investors to worry about rising interest rates and the corresponding negative effect on equity prices. Conversely, weak economic data might be seen as a positive influence on stock prices as a slow economy would likely yield no change in short-term interest rate policy by the Fed. Also, the historical nature of economic data makes it difficult for long-term investors to develop assumptions on the health of the economy which support their investment strategy. Further complicating the relationship between the economy and the financial markets, there are groups of investors that don't consider economic variables when implementing their investment strategy. Day, technical and short-term traders rely on timing, temporary price anomalies and charts as mechanisms to determine when to execute their investment strategy. Individual assumptions, investment philosophies and timing help explain why there is not perfect symmetry between the economy and the markets.

What Now

At current market levels, investors frequently ask the question – what now? The financial system and the economy are far and away in better shape than they were six months ago. The manufacturing sector appears to be showing some signs of life due to the restocking of inventories, the housing market seems to have bottomed and some markets and regions are reporting accelerating transactions. Investors still have plenty of cash on the sidelines and there is a real fear of missing whatever is left in the current leg up. However, investors should be reminded that rarely can a $14 trillion economy go from diving off a cliff to economic growth in such a short period of time. After all, it took roughly 5 years for the housing boom to germinate to the point where it almost brought down the financial system.

We remain skeptical that the economic recovery will be strong enough to sustain stock prices at current levels once the housing stimulus and tax breaks are eliminated later this year. Our main concern centers on the weak employment data. According to a recent study by Rutgers University economists Jim Hughes and Joseph Seneca, when considering the economy lost 7 million jobs since the start of the recession in December 2007, and a growing labor force of about 1 million people per year, it will take adding more than **2 million** jobs every year for seven straight years just to get back to a pre-recession unemployment rate of 5%. An economic expansion of that duration has only happened twice in the country's history. With high unemployment, we question where the demand for goods and services come from? However, we will keep our ear to the ground and continue to monitor the health of the consumer as we believe this is the key to long-term economic expansion.

While we are not ready to jump on the band wagon or breaking out the pom poms yet, we do recognize that as long as investors remain optimistic regarding the future of corporate earnings and continue to shed risk-free assets in lieu of riskier asset classes like equities, the markets will likely continue to rise. Overall, we are more constructive than not on the prospects for a sustained economic recovery. Therefore, we believe that investment strategies with a long-term focus coupled with logical and in-depth analysis stand to benefit in the current environment.

Second Quarter Review

So much for the "dog days of summer"! The quarter began with much skepticism and concern as the markets fell leading into the second quarter earnings season. Investors feared that actual earnings would not support the move in stock prices off the March lows. Luckily, earnings as a whole came in better than feared, which proved to be an underpinning of support for stock prices. In August and September, the markets continued to tick higher as the "Cash for Clunkers" program provided evidence that a government's stimulus package can work. Furthermore, economic data centered on housing, inventories, industrial production and retail sales pointed to stabilization and improvement. Meanwhile, the dollar continued to weaken which strengthens our country's ability to export goods to other countries.

The Dow, S&P 500 and NASDAQ posted strong gains of 15.0%, 15.6% and 15.7% respectively for the quarter. Financial stocks were the strongest performing sector logging +25% off the lows set in 2008 and early 2009. The industrial and material sectors also outperformed with returns of +21.2% and +21.0% respectively, driven by a weak dollar, spending from China and other emerging market countries, as well as the restocking of inventories off depressed lows. The consumer discretionary sector added +18.8% as investors came to the realization that the consumer may not be completely dead. Finally, the technology sector posted a +16.6% gain which also exceeded the returns of the three indices.

Sectors lagging the general market this quarter include consumer staples + 10.5%, utility + 5%, telecommunication + 3.9%, and energy + 9.5%. All sectors of the economy posted positive returns this quarter which was certainly a welcome outcome!

In terms of style and characteristics, value stocks won out due in large part to a heavy weighting in financial stocks, which historically have low Price/Earnings and Price/Book ratios along with high dividends. Early in a recovery, low quality assets do much better than higher quality stocks as investor's trade out of risk-free assets for higher return potential from riskier stocks. Indeed, over the past year there was no riskier asset class than financials. In terms of size, midcap and small cap value stocks were the big winners. According to the Russell indices, midcap value stocks returned almost 24%, in the quarter. This was 33% better than its midcap growth counterpart. Smallcap value stocks returned almost 23% in the quarter, besting growth by almost one half.

Where is the Alpha

We believe that the low hanging fruit has already been picked over and stock picking will become increasingly important. With an uncertain economic environment, we continue to focus on sectors and specific companies that will not only provide a level of safety in the event of a double dip in the economy, but will also participate in market upturns. This might sound like utopia, but it is not. While our stocks may somewhat lag the markets in times of outsized gains and recoveries, the protection we seek from market volatility serves us well over the entire market and economic cycle.

Going forward, we are incrementally encouraged by the positive signs we have seen with companies willing to utilize their capital to acquire tangent businesses to grow revenue. As examples, we saw Kraft make a bid for Cadbury, Dell bought IT provider Perot Systems, Baker Hughes purchased competitor BJ Services, and Xerox stepped up to buy Affiliated Computer Services. This recent action could signal a round of consolidation that could support higher equity prices. In addition, we are constructive on corporate and economic fundamentals such as: a strong profitability outlook given significant cost cutting, revenue growth relative to the easy comparisons of last year's meltdown, the potential for inflation to remain in check due to continued wage/cost deflation, and easy money policies providing an effective bridge to sustained economic growth.

Although the debate over healthcare reform continues to evolve, we continue to look at the valuation of the constituents in the healthcare sector and we see many opportunities. In addition, we anticipate the dollar will continue to fall as spending in Washington continues and the deficit widens. This is bullish for commodity stocks as they rise when the dollar falls. Finally, we continue to upgrade our current holdings in the technology and telecommunications sectors to exploit sound balance sheets, strong cash flow and increasing dividends.

Quarterly Activity

Legacy initiated positions in the following companies:

Freeport McMoran Copper & Gold (FCX) – We added FCX to the portfolio in July due to its valuation and to gain exposure to the metal and materials industries, which benefit from a falling dollar. The company operates copper, gold, silver, colbalt and molybdenum mines in North and South America, Indonesia and the Democratic Republic of Congo. Molybdenum is a corrosion resistant stainless steel alloy used in applications that involve intense heat, including the manufacture of aircraft parts, electrical contacts, industrial motors and filaments. At the time of purchase, FCX's value metrics reflected a discount to its past early cycle valuations. The company was also selling at a discount to its peers BHP Billiton, Kinross Gold and Southern Copper. Freeport has had success in reducing costs which should help profit margins as the price for copper, gold and molybdenum rise over the next few years. In addition, management expects to ramp up production of idle capacity for copper and molybdenum with a rebound in global metal demand.

Financial Sector Select SPDRs (XLF) - Legacy initiated a position in the Financial Sector Select SPDR exchange traded fund (ETF) over the course of the quarter in order to gain exposure to the S&P 500 financial sector. Characteristics of this ETF include diversification over the entire financial sector and a low expense structure. The financial sector remains murky relative to loan growth, credit quality, and reserve requirements. In addition, the business model of financial services companies has changed significantly over the past year, with increased government intervention and regulation affecting how financial institutions do business in the future. While banks and financial institutions are currently benefiting from low borrowing costs and higher lending rates, future profitability could be threatened when the Fed raises rates to either slow growth or increase the value in the dollar. While our models and detailed fundamental work highlight few viable value opportunities, we elected to gain a diversified position through this investment while we wait for additional information from upcoming earnings reports.

Intel Corporation (INTC) – Intel is one of the world's largest manufacturers of integrated circuits used primarily in computing and communications. Its primary component products are microprocessors, chipsets, motherboards and wired and wireless connectivity. The company was added to portfolios in July due to its depressed historical valuation and growth opportunities resulting from investments in new markets and research and development. Intel has an opportunity for real top line growth as it should benefit from the release of the Windows 7 operating system from Microsoft and an aging installed base of PC's. The company has also invested heavily in a new chip called Atom as a way to expand its product exposure outside the traditional computer markets. The new chip will be used in netbooks, cellphones and consumer-electronics as a way to help customers set up and download applications. Intel is cheap with its Price/Earnings, Price/Sales and Price/Book ratios at a discount to its 10 year median and has $11.6B in cash against $1.2B in debt. Cash flow is strong and the dividend stands at 3% which is near a historic high.

McDonalds Corp. (MCD) – MCD was added to the portfolio as we believe that the shares have an interesting risk reward/profile. We believe that at current valuations, MCD is trading at an excessive discount and that investors are neglecting several catalysts that should improve the firm's strategic position within the fast food market. Revenue and earnings should continue to grow as the company focuses on: (1) sustainable growth in the U.S. and the strategic geographic regions of Asia-Pacific, the Middle East and Africa (2) new product launches (the Angus Burger) and the expansion of its breakfast menu and (3) operating efficiencies as it continues to reduce the number of company-owned stores through refranchising and developmental licensing. The company should benefit from what we believe could be a long-term shift in consumer spending habits as they trade down from more expensive restaurants. Cost cutting and margin improvements should take hold as the company continues to sell owned properties to franchisees. The shares are trading at about 13.8 times 2010 earnings estimate which is at the lower end of its historic range of 8 – 21X. The company's dividend is yielding 3.70%, near historic levels. McDonalds is also cheap relative to its peer group where most of its valuation metrics are below those of its competitors. We believe McDonalds should be trading at a premium to its peer group based on market share growth, operating efficiencies and earnings predictability over the next few years.

Visa Inc. (V) – We added Visa to client portfolios due primarily to its attractive valuation and its growth prospects. Visa Inc. operates the world's largest retail electronic payment network which provides transaction processing services and payment product platforms, including consumer credit, debt, prepaid and commercial payments. Visa gets paid to authorize, clear and settle transactions and owns one of the world's largest global ATM networks, offering cash access in local currency in more than 170 countries. Visa differs from its competitors in that its business model only focuses on the transaction side of credit cards and doesn't take on consumer credit risk. Therefore, V's balance sheet is clean, its capital requirements are lower than competitors and they don't have to engage in the costly aspect of collections, bad debt and charge-offs. The company's fundamental metrics reflect a discount to its nine month median in P/E, P/B (Visa's IPO was in October 2008). In addition the company has a dividend of almost 1%. We believe that Visa should trade at a premium valuation relative to its competitors due to a lack of credit risk, strong global brand and market share.

Walgreen (WAG) – We bought Walgreen in the beginning of the quarter because of its valuation and its exposure to the healthcare and consumer staples sectors. The company is primarily a retail drugstore chain that sells prescription, non-prescription drug and general merchandise. Prescription drugs constitute 65% of WAG's total annual sales of $63.3 billion. At the time we added the stock to the portfolio, WAG's P/E, P/B ratios were all significantly below its median average. In addition, its dividend yield was 1.92% compared to its average dividend yield of 0.6%. Walgreen has several catalysts that should help drive earnings. The company is rolling out a 90 day retail prescription initiative which has shown strong uptake and is expected to be a leading trend for competitors to follow. Also, generic drug penetration is driving pharmacy margin expansion. Management is also focusing on balance sheet improvements such as debt reduction, dividend increases and share buybacks. The implementation of its broad restructuring/remodeling initiative has helped refine inventories and sharpen profitability.

Legacy liquidated positions in the following companies:

Clorox (CLX) - We sold all positions in Clorox this quarter as our concern around the company's ability to execute in this challenging environment increased. Over the past several years, Clorox made the strategic decision to raise prices on its core branded products, such as liquid bleach and Glad trash bags, in an effort to recapture and pass along higher commodity prices and boost margins. While effective, these moves have backfired in the current weak economic environment and the company reported lost market share in 3 of their 8 biggest categories in the most recent quarter. Though the company is rolling back price increases in some key categories, Legacy believes finding the right mix between price and volumes will take some time after so much shift and dislocation among consumers. Finally, through the acquisition of Burt's Bees in FY 2008 and an aggressive share buyback program, the company had a stockholder's equity deficit of $175 million, cash of $206 million and a whopping $2.2 billion of long term debt on the balance sheet as of the close of the period. Though the stock is inexpensive from a valuation standpoint, we believe there are more compelling opportunities with value characteristics and lower operating and financial risk.

National Oilwell Varco (NOV) - We sold all positions in National Oilwell Varco as part of our rebalancing within the energy sector. Although our weightings in the sector remained largely unchanged, we made a strategic shift to move client exposure incrementally away from the oil services industry and into our preference for integrated oil companies. While NOV remains attractive from a valuation standpoint, the backlog of orders declined sequentially in the June quarter and has become more uncertain given the strong ties to orders from Petrobras in South America and the related political risks associated with these orders. Indeed, two of the first equipment orders from PBR into this market were allocated solely to less experienced Brazilian suppliers. Therefore, we elected to realize the profits generated with this position in favor of other investments within the sector.

Medtronic Inc. (MDT) - We eliminated all positions in Medtronic this quarter based on our overall skepticism around the company's ability to deliver sustainable revenue growth and earnings. Constructively, the share price is supported by multi-year lows on many valuation metrics and the company pays out a competitive dividend. However, it is our concern that the stock may be a "value trap" with little in the way of catalysts to drive the shares higher in the face of headwinds such as: slowing growth in its cardiac rhythm management and spine businesses, continued competitive pricing pressures, proposed cuts in Medicare reimbursement and more ominously, specific tax proposals on medical device companies in the healthcare reform debate. In addition, the company remains the subject of a Department of Justice investigation into its sales practices and we believe that there are better investment opportunities within the healthcare sector.

Around the Firm

The third quarter tends to be very busy at Legacy. Our interns finished up their various projects and are all back in school with refined analytical skills and an appreciation for asset allocation, yield curve analysis and investment policy statements. We thank them very much for their hard work and wish them good luck in their endeavors.

Joe met with representatives of several different mutual fund companies, obtaining updates on their outlook regarding the economy and various market sectors. Of particular interest was a presentation by one of the fixed income managers from John Hancock. He relayed their insights on inflation, foreign markets, and when the Fed might raise rates. Joe and Rick again provided media commentary to The Houston Chronicle, The Chicago Tribune, and Business.Com.

Joe taught the Employee Benefits and Retirement Plan section for the Rice CFP course. The hot topic this year was the imminent 2010 Roth IRA conversion. Basically, the Roth conversion allows IRA participants to lock in a known tax rate rather than subjecting required minimum distributions to an unknown tax rate in the future. Generally, locking in a "known" tax usually makes sense especially when there is a high probability that future tax rates will rise. Please feel free to call us with your questions or a full explanation of the benefits.

Joe also attended the Financial Planning Association's Annual Practitioner's Symposium, and came away with some interesting insights about Long Term Care insurance. Long Term Care insurance is another hot topic and we can review and analyze long term care policies. An important question to ask about Long Term Care policies is whether or not "substantial assistance" in the policy refers to "hands on assistance" or "standby assistance"-- two very different outcomes at different price points.