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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A Year Of Change

Chickens Roosting

2008 was a year for the record books on many levels – economic, financial, investment, political and geopolitical. However, the year might best be remembered as when the "chickens came home to roost." Over the past decade, a lack of regulatory oversight and lenient capital requirements supported well-intended legislation to extend credit to first time homebuyers and low-income Americans. With a cast of many willing accomplices - from elected representatives, bankers, mortgage brokers, investment bankers and rating agencies - a facade of easy wealth creation blossomed into a feel good scheme that would ultimately undermine our financial system.

Financial Mess

The financial meltdown began in late Summer 2007. It came to a crescendo this Fall as home prices tumbled and Americans, who had leveraged their homes to support their spending habits, found themselves unable to meet mortgage obligations which caused the mortgage market to collapse. Financial institutions, carrying too many illiquid and risky assets linked to mortgages and mortgage derivatives were required to raise capital to offset declining valuations. As capital became scarce, bailouts, bankruptcy and forced mergers flooded the front page of the nation's newspapers.

The structural landscape of Wall Street changed with the demise of the "Big 5" Investment Banks. In the blink of an eye, over a century of history went up in smoke as these once great symbols of capitalism, financial leverage, risk and greed came to a cataclysmic end. Lehman Brothers went bankrupt. Bear Stearns and Merrill Lynch were acquired at the last minute by J.P. Morgan Chase and Bank of America, respectively. Morgan Stanley and Goldman Sachs were forced to file with the Federal Reserve to become commercial banks and no longer operated in the capacity in which they started the year. It's ironic that while the primary co-conspirator of the financial chaos no longer exists, the mess they helped create will linger to affect our economy and financial system for many years to come.

Changes in the regulatory environment created uncertainty as equity market participants had to adjust to "on the fly" modifications in investing rules. Suddenly, capitalism had given way to socialism as the government seemed to be in control of which financial institutions would succeed or fail. In addition, the Securities and Exchange Commission (SEC) initiated temporary emergency action to prohibit short selling of financial institutions for 10 days giving the markets a chance to catch their breath. Unfortunately, these policies did not help calm the markets. A combination of continued financial and regulatory uncertainty and investor fear of owning risk drove security prices down by percentages not seen since 1931. Investors flocked to ultra-safe Treasury securities forcing negative yields of the one and three month Treasury Bills.

Meanwhile, the Treasury was printing dollars as fast as the presses could go so the Federal Reserve could use the "monopoly money" to buy-up "troubled assets." Once again, it was left to the government to determine whose assets were worthy of collateral. To make matters worse, banking institutions receiving federal TARP (Troubled Asset Recover Program) money were not lending at the rates intended by the government. Bottom line, the credit crisis was alive and kicking. Creditworthy companies were finding it hard to secure short-term lines of credit and those that could paid ridiculously high rates. Payrolls are being cut nation-wide as employers react cautiously to the slowing economy by trimming operating expense. Clearly, all sectors of the economy are feeling the effects of the credit crisis and the financial meltdown.

What's Next

Fortunately, the financial markets appear to have bottomed in the middle of November, as President-elect Obama began assembling an economic team that seems capable and willing to continue the current monetary and fiscal policies of the Bush administration. In fact, the President-elect has indicated that another staggering economic stimulus package will be in the offering soon after his inauguration. Additionally, Obama staffers have hinted that perhaps targeted tax-cuts may be appropriate in light of the economic realities. This would be greeted with cheers from investors.

Nonetheless, there is more uncertainty on the horizon as the realities of the breadth and depth of the recession continue to filter throughout the economy. Employment and other general economic data will likely continue to deteriorate throughout the better part of 2009. Furthermore, regulators and legislators will be busy investigating and re-regulating the financial industry. Banks can expect greater oversight as lending practices and its implications on capital structure undergo a thorough analysis. The hope is that the financial industry does not revisit the days of restrictive over-regulation which limits ingenuity, efficiency and growth. The Securities and Exchange Commission (SEC) and its rules for regulating registered investment advisory firms will probably undergo significant overhaul in light of the Bernie Madoff Ponzi scheme.

Indeed, 2009 will begin the process of "change." The new President will have a unique opportunity to not only reshape the economic landscape through monetary and fiscal policy but also transform the regulatory environment to reflect operating and disclosure requirements that should help investors evaluate risk and transparency.

4th Quarter Review

Alt + Control Delete

Many investors look toward the "flip of the calendar" as an opportunity to re-boot their investing strategy. While it sure would be nice to delete and wipe from memory the devastating losses that accrued in the financial markets in 2008, I find it more constructive to analyze and evaluate what worked and what didn't in an effort to learn, anticipate and insulate client accounts from experiencing similar losses in the future.

For the year, Legacy's value equity composite lost 22% which compares favorably to the losses on the Dow, S&P 500 and NASDAQ of 34%, 39% and 41%, respectively. Overall, value did better than growth in 2008. However, on a relative basis, small cap and mid cap value did better than their growth counterparts by 25% and 13%, respectively. Large cap value was only 4% better than large cap growth. Defensive sectors such as consumer staples and healthcare did better than the general market by recording losses of only 18% and 24% respectively. Meanwhile, it will probably surprise few that financial stocks were the worst performing sector of the S&P 500 with a loss of 57%.

Legacy's relative performance was attributed to an early exit from financial stocks, an underweighted position in the energy sector, equal weighting in the healthcare and consumer staples sectors and a 25% weighting (at times) of cash. While cash was clearly king in 2008, investors received very little (if any) interest on their cash holdings.

There were no broad-based winning themes in 2008. However, good stock picking and luck provided some bright spots in an otherwise dreadful market. Most of the year's winners were the result of deal making. United States Tobacco (UST), Genentech (DNA), Anheuser Busch (BUD) and Rohm Haas (ROH) are examples of equities that rose in response to acquisitions. Wal-Mart (WMT) +19% and McDonalds (MCD) +7% were the only two stocks in the Dow Jones index that were up for the year, as consumers traded down to more value oriented products in the wake of the recession. Legacy's investors were beneficiaries of both the Anheuser Busch and Rohm Haas acquisitions, while Wal-Mart is the largest holding in the equity composite with a weighting of 3.3%.

What Didn't Work

The principal strategic lesson to emerge in 2008 was that "decoupling" is not a valid concept in times of intense volatility. Decoupling is a fancy word for support of diversification. Traditional theory hypothesizes that world markets with strong economic fundamentals were insulated from the economic problems facing the U.S. That concept broke down during the year as the problems in the U.S. mortgage and financial markets quickly spread and greatly impacted the economies of not only developed but emerging countries. Apparently, in this global economy, the correlation between U.S. stock markets and global markets is rising. Specifically, as U.S. consumers slow spending, demand for foreign products diminishes. This causes foreign production to decline. As a result, the Average World Index fell by 46%, according to Dow Jones. The Japanese Nikkei 225 had its worst year ever, dropping 42%.

Secondly, there was no place for investors to hide. While it is well documented that global equity prices fell, many investors don't realize that the bond markets suffered the same fate. According to Merrill Lynch, investment grade corporate bonds lost nearly 7%, corporate "junk" bonds fell 26% and tax-exempt municipal bonds lost 4%. Treasury bonds were by far the best performing asset class rising about 14% as investors flocked to perceived ultimate safety. However, as stated earlier, as prices increased, yields dropped. The yield on the 10 year Treasury dropped 44%, while the 30 year Treasury fell 40%.

Strategy and Opportunities

In spite of recent articles questioning the validity of the Buy and Hold strategy, Legacy still believes this is the most efficient and profitable way to invest over long periods of time. Consider the following data points. Dating back through the last 10 recessions, the S&P 500 index has shown an impressive turnaround after the market hit its bottom. On average, the index has shown a 24% return after six months and 32% after a year. It is interesting to note that an investor who bought $1 worth of stocks in February of 1966 would have had $16.58 in May of 2007. However, if that same investor had taken his money out of the market for only the five best days of each of those years, his $1 would have been worth 11 cents. This example illustrates the importance of keeping a designated long-term equity portfolio invested to take advantage of unexpected equity price movement.

An offshoot of the past year's volatility is the extreme accumulation of cash in investor accounts. Individual investors, as well as mutual fund portfolio managers, have taken more of their money off of the table, and are patiently waiting to see what will happen next. This provides a substantial opportunity because eventually that excess cash will likely be reinvested, boosting the market as a whole, or spent assisting the general economy. Over the course of the next few months, Legacy will be reducing its clients' cash positions and investing in those sectors that we believe stand to benefit from this financial inflow.

President-elect Obama has promised to pay special attention to our country's infrastructure, specifically roads, bridges, clean energy and natural gas. In addition, early cyclical industries such as heavy machinery, transportation, regional banks, technology and certain consumer discretionary should be first to rebound as evidence builds that the U.S. and global economies have begun to pick up. Regional banks may not be the ideal investment just yet, but their write-offs should decline, soon. With loan losses peaked and reserves high, many banks will be pressured by shareholders to increase lending in an effort to boost return on assets and equity.

To that end, Legacy has begun positioning portfolios to capitalize on the trends mentioned above. Specifically, we recently invested in the infrastructure stock, **Fluor Corp. (FLR)** and oil and natural gas producer **XTO Energy Inc. (XTO).** In addition, we added two technology companies **Cisco Systems Inc. (CSCO)** and **Qualcomm (QCOM)** to our equity portfolio.

It is impossible to predict at what level the market will bottom. However, it is safe to say that the market has recently priced in some pretty tough times ahead, and most of the selling pressure may have already been absorbed. While the U.S. economy may not see a miraculous return to its previous levels in 2009, we believe stock will stabilize and form a sustained foundation. We are cautiously optimistic and will be watching the markets for opportunities to utilize and invest cash.

Quarterly Activity

Legacy liquidated or reduced positions in the following companies:

Legacy sold many of its industrial holdings early in the quarter due to concern of the credit crisis and its effect on demand for industrial products. While both **Eaton Corp (ETN)** and **Illinois Tool Works (ITW)** are well managed companies, they operate in some of the most economically sensitive businesses with the greatest global exposure. Eaton has exposure to the truck and automobile sectors as well as fluid power which offers hydraulic power systems for almost anything mobile. The company has lowered its earnings estimates twice this quarter, going from $1.75 all the way down to $0.90. Illinois Tool also operates in the automotive sector, as well as food and restaurant services, consumer durables and commodity metals. The company's 4th quarter earnings are projected to fall between 36%-40%. Neither company is giving guidance for 2009. As the global economy continues to sputter, industrial companies will continue to lag the general market.

Avery Dennison (AVY) - Avery too is in the industrial business. However, the firm focuses on manufacturing office services and supplies in economically sensitive graphics, specialty tapes and films. AVY is a mature company with slowing internally generated sales and declining margins. The company's growth strategy relies on establishing a significant footprint in emerging and international markets. Unfortunately, timing is not on their side as many of those international markets, in many circumstances, are in worse economic condition than the U.S. The company continues to lower earnings expectations as management indicates that business conditions continue to weaken. The firm is cutting costs and inventory in an effort to combat weak economic conditions. Valuations are attractive, only if growth prospects materialize.

Legacy also sold **Tyco Electronics LTD (TEL)**, **Lincoln National Corporation (LNC)** and **UnitedHealth Group Incorporated (UNH)**. All three of these securities were sold due to their exposure to the consumer and/or financial sector. Although UNH is classified in the healthcare sector, its revenue and earnings growth is highly correlated to employment growth. Unfortunately, in the current economy, it is unemployment that is growing. In fact, many economist project the unemployment rate could expand from the current rate of 6.5% to over 10%. This reduces the number of employees in UNH's medical plans. Coupled with the high probability that the government will place further caps on prescription drug reimbursements makes the prospects for this and all medical insurance companies uncertain. Lincoln National was the last financial position in most client portfolios. The equity was sold in early October due to the natural progression of the credit cycle and concern over everything financial. We remain cautious about continued write downs and capital needs through the first quarter of 2009. Finally, TEL was sold as many of its businesses have been declining in the face of the economic slowdown. This technology firm is exposed to many economically sensitive sectors and has lowered its earnings expectations twice. Margins should compress due to too much inventory and slowing sales especially in the automotive market.

Legacy added the following positions to portfolios this quarter:

There is a similar theme for all equities purchases in the quarter – attractive valuation (Price/Book, Price/Sales and Price/Earnings – relative to its 10 year median average), strong balance sheet, net no debt (cash is greater than short and long-term debt), growing cash flow, significant market share and brand identity to sustain a company through an economic recession.

Alberto Culver (ACV) – ACV develops, manufactures and distributes branded beauty care products as well as Mrs. Dash salt free seasonings and Static Guard spray throughout the U.S. and in more than 100 countries. The company products range from upper-end styling and ethnic hair care to natural skin care solutions such as Noxzema and St. Ives. Alberto Culver utilizes broad distribution channels from upscale beauty salons to CVS and Walgreens. ACV should benefit from the slowing economy as the firms wide product line can appeal to any socioeconomic consumer as they slide up and down the quality product scale. The firm has over $150MM in cash and basically no debt. From a value perspective, the company sells at a discount to its 10 year median P/E, price to sales and price to book ratios while selling at a premium to his 10 year average dividend yield.

Costco Wholesale Corp. (COST) – Costco operates membership warehouse-based outlets that sell merchandise in a broad range of categories. The company buys directly from the manufacturers and provides a convenient and clean environment for customers to buy in large quantity. It is a low margin business model for which COST makes a small spread (usually 1.5% - 2%) as middleman. There is plenty of competition in the business space so COST competes on name brands and its ability to negotiate deals with various suppliers. The company trades at attractive valuation most notably, a 21% discount to its 10 year median price to sales ratio and an 83% premium to its 10 year median dividend yield. COST has over $600 million in net cash and management focused on cost containment.

Cisco Systems Inc. (CSCO) – Cisco designs and manufactures internet protocol (IP) based networking and other products related to and used in transporting data, voice and video on the internet. Its routers and switches help people connect and stay connected to their data or internet source. The company has tremendous market share and plenty of cash on their balance sheet (almost $20 Billion in net cash) to defend and grow its global position. In addition, the company has generated over $500 million in cash flow through the first half of 2009. It is trading at 10.9X its projected earnings of $1.30 for 2009 – a valuation not seen since December 1990. Its price/book and price/sales ratios are trading at discounts of 42.6% and 52.8%, respectively.

Qualcomm (QCOM) – Qualcomm designs and manufactures market leading digital wireless telecommunications products such as integrated circuits and software for wireless voice and data communications. The company also receives patent royalties from most handsets using 3-G technology. QCOM sales are highly correlated to the cell phone sector and the company will see significant international and emerging markets growth as the population shifts from older wireless platforms to 3G networks. The company has plenty of cash (almost $6 Billion in net cash) to survive and thwart off competition. Its valuation is attractive as its Price/Book and Price/Sales are selling at 38.5% and 36.3% discounts to is 10 year median. In addition, QCOM's dividend yield (1.87%) is at its highest level in company history.

Fluor Corp. (FLR) – Fluor is an infrastructure firm that provides engineering, procurement and construction management for projects in oil & gas and its by-products, industrial and infrastructure and government sectors. FLR has over $2.2B in cash and only $150MM in debt. The company is selling at a discount to its Price/Book and Price/Sales ratio of 22% and 12%, respectively. Its cash flow is more than sufficient to cover the company's planned annual dividend payment, operations and capital expenditures. We believe that demand for horizontal drilling will continue while the potential for growth in government, industrial and infrastructure work is high in light of President-elect Obama's grand plans for a massive infrastructure initiative.

XTO Energy Inc. (XTO) – XTO Energy is primarily a gas and natural gas liquids exploration and production (E&P) company. The company will benefit from an up-tick in prices due to its strategic position, superior management and cost cutting. XTO has hedged 77% of its gas production and is in a position to significantly cut costs as roughly 80% of their rigs are coming off higher cost contracts enabling the firm to re-negotiate lower contract prices. XTO is also positioned for organic growth due to its high quality asset portfolio with significant acreage in resource rich properties. From a value perspective, XTO has its highest dividend yield in 12 years. Its Price/Book and Price/Sales ratios are discounted 66% and 42% respectively, to its 10 year median average.