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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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In This Issue

Investing or Poker

All In

There has to be something intoxicating about the popular poker game Texas Hold'em. It is very addicting and is one of the most widely played games in Las Vegas. In 2004, ESPN prominently marketed and televised The World Series of Poker (WSOP). The WSOP is a world-renowned series of poker tournaments held annually in Las Vegas where the winner of the big event receives a bracelet and a monetary prize. However, the game is not limited to professionals. Online poker sites enable amateurs to learn and hone their skills cheaply and anonymously. The ease and accessibility of games online 24/7 help drive the popularity of Texas Hold'em and provide an avenue for small time players to enter large feeder tournaments that could eventually propel them into the WSOP.

Typically, when a player believes he/she has a strong probability of winning a hand, they may go "all in". This means that the player is so confident they are willing to bet all of their money on the outcome. From reading newspapers, periodicals and proprietary research, it appears, from an investment point of view, the media and macro economists are trying to get investors to go "all in" and make a bet on higher equity prices in 2011. This optimism must be resonating, as many market gurus and economists have increased their projections for both economic growth and equity market returns for the upcoming year. I fear that all of this enthusiasm could be nothing more than an adrenaline rush similar to what a poker player feels in anticipation of winning a big pot of money. More applicable to investors would be a desire to increase their risk profile after seeing the rising balances on their year-end statements.

To reduce the temptation of succumbing to emotional and irrational decisions, many good Texas Hold'em players have a disciplined process of (1) surveying their cards, (2) developing a strategy based on likely probabilities and outcomes and (3) monitoring and adjusting their strategy as the game progresses. Of course, there is always a bit of "Lady Luck" thrown into the mix. We use a similar process when implementing our long-term investment strategy. Our analysis begins with a brief overview of macro economic conditions and the potential impact on the financial markets. From there, we develop a strategy to determine which sectors might outperform based on the environment. Finally, we make our security selections based on a combination of factors including macro economics, valuations and financial metrics. As in poker, it doesn't hurt to have some luck on your side.

Check

When a player doesn't want to divulge their strategy or is unsure what other players might have, they often "check" – which means passing on a bet to see how the hand unfolds before taking action. Similarly, we are currently "checking" (or taking a pass) before buying into the consensus that all is rosy in 2011. Clearly, there are positive signs that could help propel the economy forward. Most of the euphoria centered on strong profit growth, which helped support robust equity markets in 2010, and somewhat optimistic job market and improving consumer confidence, which helped champion the holiday shopping season to its best performance in five years. Furthermore, Congress passed legislation extending the Bush tax cuts, reducing payroll taxes and adding an additional 13 months of unemployment benefits. While the legislation did not permanently address the tax issue, it will in the short-term stimulate the economy by providing extra dollars for consumers and corporations to spend.

The most damaging headwind facing investors is the potential onslaught of inflation. At this fragile point in the economic cycle, inflation would severely hamper the prospects for an economic recovery, meaningful job growth and further equity prices appreciation. Currently, economists and market gurus believe that the economy is not strong enough to support either inflation or higher interest rates. These self proclaimed experts sight stagnate wages and the weak housing market as support for their position. However, we see inflation already seeping into the system on the manufacturing side. Input costs are rising in the packaged food industry. Kraft, General Mills and Sara Lee are pushing through price increases to help offset the rising cost of wheat, corn and soybeans. Other food commodities such as sugar and coffee have seen prices jump 40% - 50%, year over year. Raw material costs are escalating for manufacturers as well. The prices paid component of the Supply Managers Index remains high, suggesting that input prices of base metals such as copper, steel and aluminum will continue to pressure profits. Companies from 3M, Proctor and Gamble and Whirlpool have already come forward to admit that they face margin pressure from rising costs. Let's not forget about the rising cost of oil, which has pushed prices at the pump up from $2.68 in October to over $3. Finally, while not a manufacturing input, the cost of healthcare (which represents 12% of the economy) will significantly factor into inflation.

Never fear my fellow Americans! We have an ace in the hole. We have a Federal Reserve Chairman, Ben Bernanke, who believes that he can 100% guarantee that he and the Fed can control inflation. His comment in a *60 Minutes* interview early in December, (Please type http://www.youtube.com/watch?v=LxSv2rnBGA8&feature=related into your browser address window and fast forward seven minutes into the interview to hear Bernanke's audacious comment) blew my mind, not from an arrogant point of view but from a realistic prospective. Bernanke indicated that he could raise rates quickly to combat inflation. That will kill the equity markets! If you know higher prices are working their way through the production pipeline, a gradual uptick in rates would be a lot less painful than a quick shock to the system. China has been aggressively raising rates to combat rising global commodity prices, and over the last 2 months, the Hong Kong Hang Seng Index has fallen over 8%.

As we move through 2011, I will be watching for several trends: 1) will companies be able to push higher prices to the consumer, 2) as companies cope with higher costs, will they also be willing to increase employment cost and benefits, 3) will Ben Bernanke become fiscally responsible or remain a political pawn, 4) will inflation start to matter to U.S. Equity markets.

We have surveyed the landscape, we have laid out our strategy (see below) and we put it on the record. Now, we have to wait to see how it plays out and make the necessary adjustments as the year unfolds.

Fourth Quarter and Year-to-Date Review

Investors were down-right giddy in the quarter thanks in large part to a heavy dose of economic stimulus and an unexpected, growth-oriented tax legislation. The financial markets took off in August when Bernanke announced that The Fed would engage in a new round of stimulus (Quantitative Easing part II) by pumping $600B into the markets by buying Treasury Securities. From that point, the markets discounted any and all bad news, including a pathetically weak employment report (in early December) and a weaker than expected December consumer confidence number. The euphoria grew throughout the quarter as expectations for future economic stability and growth carried all three major indices higher in the final quarter of the year. The S&P 500, the Dow Jones and the NASDAQ were all up 7.3%, 10.2% and 12%, respectively, in the quarter. The two best performing sectors were Energy (21%) and Materials (18.5%). Other strong performers include Consumer Discretionary (12%), Industrials (11%) and Financials (11%). The weakest performers in the quarter were Telecom Services (6%), Healthcare (3%) and Utilities (0%). Growth stocks did much better than value stocks across all market cap sizes.

For the year, the Dow, the S&P 500 and the NASDAQ jumped 14%, 15% and 17%, respectively. The best performing sectors for the year included Consumer Discretionary (26%), Industrials (24%) and Materials (20%). The two lagging sectors were Healthcare and Utilities which both notched negligible (1%) gains.

Growth stocks continued their dominance over value stocks across all market caps for the year. However, the performance was not equal. The gap expanded as the company size decreased. According to the Russell Indices, the smallest stocks had the greatest variance in performance. Growth did better than value by 16% in small cap stocks. That deviation shrinks to 8% for large cap stocks. The deviation validates the sector performance as traditional growth sectors (Consumer Discretionary, Industrials, Energy and Materials) lead the markets higher in the year.

Bifurcated Strategy

The equity markets have had quite a run. Since the financial crisis bottom in March 2009, the Dow Jones and the S&P 500 have retraced almost 77% and 86% of their respective value without much of a correction. Based on optimism and consensus forming, many believe that 2011 will be a continuation of the bullish run for equities. Typically, such group think provides investors with a false sense of security.

We believe 2011 will be a year of two separate market environments. The first half of the year should be constructive for equities as the effects of QE II continue to flow through the system, a general expansion in business conditions, marginal progress in employment and improving consumer confidence. Under this scenario, stocks could continue to see short-term momentum. Under these conditions, we would continue to invest in Commodities, Energy, Materials and Industrials.

At some point during the year, interest rates will rise, and could push the economy from late growth to the mature phase of the economic cycle. There are two possible scenarios that would cause an increase in rates. The first is where the economy continues to gain strength at a faster rate than what the Fed expects. This would typically be bullish for the Consumer Discretionary, Materials, Industrials, Energy and Financial sectors.

Rates could also rise if the world loses confidence in the U.S.'s ability to cut spending and reduce leverage. This would imply that the economy was not growing fast enough to support social and debt obligations. Capital would likely flow to stronger foreign economies, forcing the Fed or bond vigil antes to push Treasury yields higher in an effort to attract capital. Under this scenario, the U.S. dollar would depreciate relative to other foreign currencies, resulting in higher import and commodity prices. Inflation will creep into the economy as corporations will have to eventually pass higher costs along to consumers. In this environment, Commodity, Consumer Staples and Healthcare sectors would likely out perform.

We are strategically positioning portfolios to perform best in a higher interest rate and inflation environment. Industries that we are focusing on follow the acronym COCA – Commodities, Oil, Chemicals and Agriculture.

Like an astute poker player, we have developed a strategy that should place investors in the best position to benefit from an improving economy yet provide some protection against the implications of inflation. However, we reserve the right to alter our investment strategy based on changes or developments in economic conditions. As always, we will keep you informed of any changes to our investment strategy. Let's hope for a winning economy and of course, some "Lady Luck".

Quarterly Equity Activity

Communications: Legacy sold all shares in AT&T (T) and re-invested the proceeds into the Verizon Communications (VZ). Verizon's strength is its wireless business which has over 81 million subscribers and generates approximately 60% of the $104B in total company revenue. Verizon is more efficient than AT&T. Its operating margin of 30% exceeds that of AT&T (23%) and VZ generating an extra dollar in average revenue per unit (ARPU) over AT&T. VZ has been upgrading its wireless network in anticipation of an Apple/Verizon agreement to offer the iPhone. Should an agreement between the two companies be reached, VZ stands to cannibalize a considerable number of AT&T wireless clients due to unreliable reception and coverage. Over the long-term, fees associated to smart phone data plans can generate twice as much revenue as traditional wireless phones. On the wireline side of the business, Verizon is rolling out its FiOS service which bundles voice, internet and TV service. This will provide consumers with a legitimate alternative to AT&T's U-Verse service. Management is also upgrading and expanding broadband capabilities to facilitate video services such as web based conferencing, international ethernet and VOIP. Overall, we like the direction management is taking the company as well as its strong cash flow which supports both capital investment and a 6% dividend.

Williams Companies (WMB) – WMB is an integrated natural gas company focused on exploration and production, midstream gathering and processing and natural gas production operations. Most of the company's interstate gas pipeline and midstream assets are held through its 77% ownership interest in Williams Partners – a Master Limited Partnership. The company's cheap valuation (both absolute and relative) is largely due to the 27% drop in natural gas prices in 2010. We bought WMB in October when natural gas prices were bottoming around $4. We feel that there is significant value in the quality of the company's operations, exposure to natural gas liquids and their pipelines that deliver approximately 12% of all natural gas consumed in the U.S. WMB is cheap based on any metric. Its P/E, P/B, EV (enterprise value/sales) and EV/Operating Earnings are all below their 10 year and 5 year median average. The company pays a 2.1% dividend and has a strong flow to support both capital expenditures and the dividend.

Cree (CREE) – Legacy bought and then sold all shares in this LED (light emitting diode) and chip manufacturer, due to rapid price appreciated over 40% during the quarter. We initially accumulated shares in October after the company gave disappointing revenue and inventory guidance for 2011. After a chorus of Wall Street downgrades, the stock sold off. Legacy saw an opportunity to exploit the negative sentiment and cheap valuation. However, as China provided standards for LED streetlights and parking lots, much of the headwinds dissipated. The stock started to run and we executed our sell discipline once the stock's valuation rose to levels that exceeded comfort level.

Corning (GLW) – Corning is a world leader in manufacturing specialty glass and ceramic components that are used in high-technology systems for consumer electronics, telecommunications mobile emissions control and life science. Over half of the company's revenues and profits come from the manufacturing of liquid-crystal display (LCD) glass for computer monitors and televisions. Corning is a typical value stock with strong financial metrics. It has over $2.5B in net cash (worth almost $5.00 per share) and trades at a significant discount to its 5 and 10 year median average Price/Earnings, Price/Book and Price/Sales ratio. Catalysts for moving the stock forward include: an improving economy, new product development which will help diversify economic exposure and initiatives to improve the efficiency of the supply chain. We see significant opportunities for price appreciation as new products gain momentum.

Monsanto Co. (MON) – Monsanto is a provider of technology-based solutions and agricultural products that improve farm productivity and food quality. The company is in the middle of a transition from herbicides and pesticides to developing seeds for genetically engineered crops. The company's once signature product, Roundup weed killer, has lost sales and market share due to strong competition and a loss of effectiveness due to a crop of super resistant weeds. Out of necessity, MON has successfully redirected company initiatives to where seed sales account for almost 70% of total company revenues. We believe that global economics, volatile weather patterns, production efficiencies, new seed development and increased demand for superior genetic seeds provide catalysts for future revenue and earnings development. From a valuation perspective, the company is cheap. At the time we purchased the stock, the company was trading at multiples that were roughly 10% discounts relative to its 5 and 10 year median average. The firm is conservatively run and its growth is being funded internally through cash flow. Furthermore, MON is paying a dividend in excess of 2%.

Transocean (RIG) – RIG is the world's largest offshore drilling contractor and provider of drilling management services. RIG has 139 mobile offshore drilling units plus three ultra-deepwater drillships under construction. We added RIG on the basis of a turn-around story as the company rebuilds its business and its reputation following the aftermath of the explosion and sinking of the Deepwater Horizon oil platform in May. The platform was owned by Transocean, but leased by BP. BP had indemnified RIG of all operating responsibilities and, as such, should limit the potential liability from a potential large settlement or law suit. While the operating logistics remain murky in the Gulf, other regions of the world (such as India) are providing opportunities. Industry dynamics and consolidation should help RIG capture market share, as competitors operating in the regulated and scrutinized Gulf Region, sell offshore assets to large well capitalized players. On a valuation basis, the company is trading near 10-year lows relative to Price/Operating Earnings and Enterprise Value/Operating Earnings. Over the long-term, we believe RIG's management will restore the company's reputation while valuation metrics return to normal cycle profitability.

U.S. Bank Corp. (USB) - U.S. Bancorp is the 5th largest commercial bank in the United States with $291 billion in assets. The Company operates in 24 states and provides a comprehensive line of services to consumers, businesses and institutions. Like most financial institutions over the last few years, they were negatively impacted by the financial crisis. However, due to the bank's conservative management team and lending practices, USB's mortgage portfolio did not have the same destructive impact on its capital structure as many of its peers. The banks credit quality continues to improve as net charge-offs and non-performing loans continue to decline. At the time of the purchase, the bank was selling at discounted valuations to its 10 and 5 year median Price/Earnings and Price/Book metrics. We believe that once USB begins paying a meaningful dividend, valuations will return to pre-bubble levels.