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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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Getting Interesting

What A Guy

There is no more special feeling than having your boss throw you under the bus on national TV. Yet, that is exactly what President Obama did to Fed Chairman, Ben Bernanke. In a June 17th PBS interview with Charlie Rose, Obama indicated that Bernanke had stayed longer than he would have liked. This immediately started the speculation as to who might be his replacement. Bernanke has said that "I'm not the only person in the world to manage QE's (Quantitative Easing) exit." However, the next Fed Chairman will have significant influence to and the responsibility for altering, amending or affirming the current course of monetary policy.

How massive has the bond buying program gotten? According to Barron's Magazine, Bank of America Merrill Lynch summed up the past six years quite succinctly: 520 rate cuts across the globe, $33 trillion in fiscal and monetary stimulus, half of the market cap for global government bonds yielding less than 1% and the lowest U.S. government bond yields in 220 years. Cleaning up the Fed's obese balance sheet will be a significant task. Therefore, the next choice to succeed Bernanke is critical. Rumor has it that Janet Yellen is the leading candidate. She certainly has an impressive resume. She was first appointed to the Fed's Board of Governors in 1994. She served on President Clinton's Council of Economic Advisers, President of the Federal Reserve Bank of San Francisco and a voting member of the Federal Open Market Committee (FOMC). She is uniquely qualified as having overseen the trifecta of economic bubbles – Technology, Housing and Bond. She comes from the same dovish philosophies as Bernanke and from her track record, does not seem to have the foresight to navigate and anticipate potential problems. According to Bloomberg, she is a forceful advocate of aggressive action to lift unemployment. Although, I'm not quite sure I understand what the head of the Central Banking System can do to improve employment. Let's hope there are more names on Obama's short-list of candidates or else we might find the country in many more precarious situations in the years to come.

Looking For Clues

So, its official, Bernanke is a "lame duck" and the rest of the financial world is left trying to figure out who is going to lead the charge back to financial austerity and what the implications might be for the markets. After all, there are no historical guidelines that can predict the outcomes of unwinding such a massive stimulus program like QE. When so many people are use to a certain market environment over an extended period of time, it becomes difficult to imagine operating under any other scenario. When you stop to think about it, there are a lot of people who work in trading rooms all over Wall Street that have never worked in a non-easing monetary environment. The thought of trading and investing based on normal business cycles where asset prices move in relationship to interest rates and inflation expectations are foreign concepts.

To get an idea of what an extended period of rising rates might do to the financial markets, I looked at a two year time frame between May 2004 and June 2006. In May 2004, interest rates were at a four decade low of 1%. Twenty-five months later,

the rate that banks charge each other for overnight deposits had jumped to 5.25%. Surprisingly, stocks held up very well during this period. At the end of May 2004, the S&P 500 was essentially flat for the year, up less than 1%. But by the end of the year, the index was up 9%. Even in 2005, when the Federal Reserve raised the discount rate by 200 basis points throughout the year, the S&P 500 recorded modest gains of 3%.

During this rapidly rising interest rate environment, the bond market was shockingly subdued, as the rate on a 10-year Treasury actually fell 49 basis points from 4.72% to 4.23%. In 2005, the rate was basically flat by all measures –rising less than a quarter of a point. It was not until June, 2006 that rates broke the 5% barrier (the first time in four years) to end the month at 5.11%.

We can't draw an exact comparison between the mid 2000's and 2013 because there were some unique caveats. In 2004, interest rates increased because of concerns of inflation as the country was experiencing rapid growth, due to the initiation of the "Bush Tax Cuts" that went into effect in 2001 and 2003. Real GDP grew 4.4% in 2004. In 2012, the U.S. economy grew a whopping 2.2% which was higher than 1.8% in 2011. Not exactly warp speed! Rates are rising now due to unwinding of the Fed's bond buying program. Basically, if the Fed is not in the market buying bonds, there will be a drop in demand and rates will have to rise to attract buyers. Another difference between now and the previous decade is how much the economy and the financial system is dependent on the Fed. If the Fed slows or eliminates the stimulus, the dollar will rise relative to other currencies which could have negative repercussions for all markets including equities. Finally, in the mid 2000's there was overall general optimism regarding growth and the direction of the economy. Today, the picture is mixed as steady improvement in the housing market has been overshadowed by high unemployment, tighter fiscal and greater regulatory policies. Furthermore, there may be uncertainty as to whether the Fed could actually pull off such a large unwinding without harming the basic economic fundamentals.

While this might strike a cautionary tone, it should get investors thinking about the need to be prudent risk managers in the months and quarters ahead. All eyes will be focused on the economic news of the day and how it relates to the Fed's decision to cut or unwind the bond buying program. Ultimately, we should want the economy to grow strongly so the Fed will be able to cut the noose from around our economic neck. Let's all hope that Obama nominates a qualified banker who has superior forecasting abilities, is willing to make tough decisions and can successfully navigate the turbulent currents that are surely to follow any change in monetary policy.

Quarterly Review

The second quarter was not for the faint of heart. Volatility was at a premium as there was a 17 day stretch where the Dow Jones Industrial Average had triple digit moves (either up, down or both) in 15 of those days. From a performance standpoint, it can be best characterized as the tale of two quarters. The first half there was follow through from the previous quarter where money flowed away from emerging markets and into U.S. based equities and fixed income. This caused popular emerging markets to suffer negative returns as China and India were both down 7% and Brazil plummeted 18.3%. In April, U.S. fixed income was still showing signs of strength. On April 30th, Apple took advantage of the historically low rates and issued $17 billion in corporate bonds (the largest issuance in history). Ironically, this signaled the peak of the bond market as prices began to diverge away from the stock market and yields began rising. No one could have foreseen what was about to happen to bond rates in the second half of the quarter. 10yr Treasury yield's spiked from a May 1st intraday low of 1.61% to an intraday high of over 2.6% on June 25th. The dramatic jump in rates brought volatility back to every asset class as bond and equity prices fell.

While the selloff in bonds might be one of the greatest in history, what happened to gold and other commodities was amazing. With the combination of slowing global growth, improving consumer confidence, talk of ending Fed stimulus and no evidence of inflation, commodity prices collapsed. Copper was down 11%, its worst performance since 2011. The global price for Brent crude was down over 6%, even with turmoil in the Middle East. Lastly, gold fell 25%, its biggest drop in any quarter.

U.S. equities started the second quarter with a 7% rally and peaked at 1669 on May 21st. Paradoxically, this was also the day that Ben Bernanke first indicated that the Fed could start "Tapering" if the economic data allowed it. The "Taper" talk reinvigorated global equity volatility and investors began questioning if or when the stimulus might end. Two days later the Nikkei fell 7.3%.

For the quarter the S&P, the NASDAQ and the Dow were all higher by 2.4%, 4.2% and 2.3%, repectively. The market was led by Financials (+ 6.8%), Consumer Discretionary (+ 6.4%) and Healthcare (+3.3%). The laggards were Utilities (-3.7%), Materials (-2.4%), and Energy (-0.9%). Large cap value companies did better than growth as investors continued to direct money into defensive dividend paying stocks. However, there was a clear shift in investor preference for mid-cap and small-cap companies as growth stocks did better than value. Investors are beginning to believe the improving economy could help the prospects for earnings and revenue growth of mid-sized and smaller companies before their large cap brethren.

Time For Cyclicals

Not much has changed since last quarter. There has been a lot of volatility, but at the end, our old friend TINA (acronym for There Is No Alternative), continues to wield her influence. Fortunately, this opaque environment will probably continue so long as the Fed Chair continues to implement its bond and

mortgage buying binge, and the global economy continues to sputter. The financial markets will continue to gyrate with each economic report and investors will continue to have to reach for yield in riskier assets such as overvalued dividend-paying stocks.

Just when the markets were feeling pretty good about themselves, Bernanke came out at the June Federal Open Market Committee meeting and hinted that he would begin to wind down his policy of easy money should the economy continue to improve. Investors were completely surprised and taken back by Bernanke's new timetable. For a couple of weeks in June, we did get a glimpse of what investors might be in for if/when the Federal Reserve decides to reduce or eliminate quantitative easing. All major markets including bond and commodity prices fell sharply – there was nowhere to hide. Interest rates rose and for the first time in almost six years, all things being equal, bond yields began to look attractive again. For a brief moment, markets were acting somewhat rational. But just like clockwork, when the asset prices started to fall, the Federal Reserve began to panic at the market's reaction and sent its representatives out into the media to assure the public that they support the QE program and that investors just misinterpreted the Fed Chairman's comments.

No need to fret just yet. We agree with the Fed Officials. I'm going to go out on a limb to make a prediction. With six months until retirement, I don't see Bernanke doing anything. Why would he risk ruining his legacy of stabilizing the economy during the credit crisis just to start a process of tightening money supply? Besides, the economy is not even that strong. First quarter GDP (Gross Domestic Production) grew only 1.8%. Really, Bernanke wants to tighten the money supply with an anemic growth rate? Not likely! Nonetheless, it is something to take note of and begin to think about how to protect portfolios, for the inevitable.

So bond prices have jumped dramatically this quarter making yields look bit more attractive. Indeed, the yield on a 10-year Treasury is now 2.5%, slightly better than the yield on S&P 500 (2.1%) and dramatically better than 1.85% at end of last quarter. This is important, because as yields rise, investors will be less likely to feel the need to reach for riskier assets for yield. This will cause the price of overvalued dividend-paying stocks, REITs, MLP's and preferred stocks to fall.

With all of the economic and financial challenges, how do we move forward? We want to be in a position to safeguard portfolios from the certain volatility that will follow an apparent withdrawal or elimination of the QE program. While we believe it would be a positive step for the long-term health of the economy and the financial markets, the transition will not be easy. Therefore, the sooner the Fed starts winding down quantitative easing, the quicker investors and market participants can get comfortable with investing in a more normal environment of rising rates and market cycles.

In anticipation of the end of quantitative easing, we will continue to fine tune the portfolio by selling those stocks that have had excessive run-ups and re-deploy the capital into the early cycle sectors like consumer discretionary, industrial, financials and technology. Consumer discretionary stocks tend to lead the economy as consumers begin to feel better about their situation and go out and spend money. Financial institutions tend to do better in an upward sloping yield curve as they make loans at higher rates. Technology and industrial valuations are attractive and typically, earnings get revised higher as the economy recovers. As volatility picks up, we want to have enough cash available to take advantage of attractive opportunities. By now you should have memorized our favorite adage: "We would rather be out of the market wishing that we were in, than in the market wishing we were out." Lastly, if we see yields continuing to approach new highs and plateau, short-term corporate debt may be an attractive investment.

Portfolio Activity

Legacy took advantage of the strong market momentum in the first half of the quarter to complete a rotation that began last quarter. We completely sold out of all positions of **Halliburton (HAL)** and added to **National Oilwell (NOV)** (which was added to the portfolio last quarter) as its fundamentals continue to improve with new rig orders and an extremely attractive valuation. We sold **Broadcom (BRCM)** primarily due to its exposure to **Apple (APPL)** and overlapping businesses with Intel (INTC). Currently, AAPL is Broadcom's second largest customer, representing 14% of revenues. Intel and Broadcom are in complimentary businesses that are highly correlated to the semi-conductor business cycle. At this particular time, we did not want the portfolio to have an overweight position to semi-conductors. When we sold BRCM, we re-allocated the proceeds back into Apple to reduce the average cost basis and to capitalize on the tech giant's strong cash position, dividend and solid financials.

We partially rotated out of high flying **AbbVie (ABBV)** in favor of **Medtronic (MDT)**. AbbVie represents the pharmaceutical division of Abbott Labs that was spun out into a wholly owned company last quarter. ABBV holds the rights to the blockbuster drug, Humira, and the rest of Abbott's existing drug pipeline. The company had recorded significant gains over the last couple of years and we wanted to take some money off the table and move it into Medtronic. MDT is the world's largest (over 50 billion market cap) medical supply company, focusing on cardiology and spinal devices. They trade at a cheap 13X forward year earnings multiple, have a 2% dividend yield and are growing free cash flow at a rate of 8%. Last quarter, they recorded an organic sales increase of 4.8% compared to their peers of 1.3%. With an aging population that is living longer and significant opportunities for organic growth in emerging markets like China, the company is poised for growth over the next several years.

We also sold half of our client's gold position in the exchange traded fund (ETF) GLD and invested the proceeds to bolster our **Apache (APA)** position. With the purchase, we slightly lowered client cost basis and increased portfolio exposure to the oil and gas exploration and production business. Although we sold half of our position in gold and believe the price of the commodity will continue to be volatile, we believe there is room for a small allocation of the precious metal in portfolios as a hedge to an increasing economy, inflation and geopolitical uncertainty.

We created additional cash by liquidating partial positions in many long-term favorites such as **Pepsico (PEP), Procter & Gamble (PG), Verizon (VZ)** and **Phillips 66 (PSX)**. All four of these stocks have had significant moves to the upside as investors seeking income, piled money into these defensive and high dividend names. Valuations became excessive, relative to modest revenue and earnings growth projections.

With the excess cash created, we added **Amgen (AMGN)** and **Quest Diagnostics (DGX)** to the **Healthcare Sector, Foot Locker (FL)** and **Bed Bath and Beyond (BBBY)** to **Consumer Discretionary, Capital One Financial (COF)** to **Financials and CVS Caremark (CVS)** to the **Consumer Staples** sector.

Amgen (AMGN) is a biotechnology company with three main drugs Epogen (anemia for kidney dialysis), Nuelesta (treats chemotherapy-induced neutropenia), and Enbrel (Inflammatory conditions). They have multiple drugs in their late stage pipeline which should begin to add to revenues by 2016. Although the company trades at a discount to its peers, management expects to grow earnings by an impressive 9% for the next 3 years. They currently pay a 2% dividend but plan to increase the dividend by 20% to 30% annually. Quest Diagnostics, is a diagnostic testing, information and services provider to doctors and patients for both preventative care and diagnoses. The implementation of ObamaCare promises to significantly help DGX as more people will be insured and more proactive with their preventative care and doctors' visits. DGX trades at 14.1X forward estimated earnings and has strong cash flow to support its current strategy of growth through acquisition. DGX is shareholder friendly as it has been active in share repurchase programs and pays a dividend of almost 2%.

The Foot Locker Inc. (FL) sells athletic footwear and apparel in more than 3,300 stores in 23 countries under several different brands names--Foot Locker, Lady Foot Locker, Kids Foot Locker, Footaction, Champs Sports, CCS, and Eastbay.com. The company targets the middle–to–upper class and should be a direct beneficiary of an improving economy. Foot Locker is trading at approximately 11X expected next year's earnings, which is cheap on both an absolute and relative basis. The company pays an attractive 2.30% dividend yield and should create excess cash flow needed to fund its capital expansion plans both internationally and domestically. Bed Bath & Beyond, Inc. (BBBY) is a retail company that sells domestic merchandise and home furnishings. BBBY operates over 1,400 stores in the United States, Canada, and Mexico. BBBY operates under the names Bed Bath & Beyond, World Market, Cost Plus World Market, World Market Stores, Christmas Tree Shops, Harmon, Harmon Face Values and buybuy BABY. The company also operates a wholesale textile shop, Linen Holdings, which distributes business-to-business in hospitality, cruise line, food service, healthcare, and other industries. BBBY is a classical play on the economy. As the housing market, employment and wages increase, BBBY should do well. The company is cheap on an absolute and relative basis as its one year forward P/E trades an 8% and 16% discount to its 5 year median and its peer group, respectively. The company has no debt and free cash flow of almost a $1 billion. The company uses their internally generated cash for acquisition and efficiency improvements. We expect management to continue to look for was to maximize returns over the next couple of years.

Capital One Financial (COF) is a financial services holding company that offers a broad spectrum of financial services and products to consumers, small businesses and commercial clients. Capital One N.A. and Chevy Chase Bank, F.S.B have approximately 1,000 branch locations primary in New York, New Jersey, Texas, Louisiana, Maryland, Virginia and D.C. An improving economy (employment, housing and confidence) will help accelerate consumer spending and credit trends that will directly benefit Capital One. COF has been repurchasing shares and should continue to do so through 2014. The company has improving credit quality, a strong financial position and growing cash flow that will enable it to continue to grow its dividend. Capital One's P/E, P/B and P/CF are all below their 10 year median average and their peer group.

Although the consumer staple sector has had a measurable run so far this year, we added CVS Caremark (CVS) because of its attractive valuation and because it has underperformed its peer group. CVS operates 7400 retail drugstores in the U.S. and is the leader in the U.S. retail pharmacy industry. The company will most likely grow through international acquisitions in the future. In addition, they operate the 3rd largest full service pharmacy benefit management (PBM) business in the U.S. CVS trades at a low multiple for staple like earnings and has an above average growth rate for its sector. CVS trades at 13X 2014 earnings, lower than Walgreens and with a higher growth rate. CVS will be returning cash to investors in the next few years through buybacks and doubling their dividend.

Around The Firm

After 15 years in the Galleria area, we have finally busted through the seams and are packing our boxes, and cleaning out our desks in preparation for a big move to Greenway Plaza. While we have not worn out our stay, we have outgrown the building. We will be adding more square footage, BETTER PARKING and hopefully more convenience. We will still be the same old friendly and hard-working firm that we were before – so please feel free to drop by and say hello. Please look for more information soon.