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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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No Worries

Improvements, But ....

Through the 1Q 2011, investors have been anything but bored. Market returns have swung from positive mid-single-digits to negative and back again to finish in positive territory. There is not a shortage of issues to ponder. Yet, Mr. Market seems to take it all in stride. Quick one or two day hiccups just to acknowledge that something potentially troublesome has taken place and then it is back to the races. Truly, stock prices seem to be climbing that proverbial "Wall of Worry". It is quite remarkable that neither (1) an act of God, (2) multiple geopolitical uprisings in critical oil developing and producing countries of the Middle East and North Africa nor (3) acknowledgement from the globe's only real growth engine, China, that they are taking systematic steps to slow growth, can derail the equity markets.

Sure, it can't be denied that certain economic data points support a U.S. economic recovery. Employment looks to be picking up, manufacturing is rebounding and consumers are hitting the malls. But let's be realistic – where are the consumers getting money to spend? Real wage growth is non-existent and home values (which historically serve as the consumer piggy bank) are still at depressed levels. At the same time, the cost of living is increasing as gas prices have jumped over 30% per gallon (since the beginning of the year) while food and commodity prices have spiked. The logical answer is that consumers are either taking loans out of their 401k accounts or dipping into whatever saving they might have left to satisfy their spending habits. Neither option is ideal or sustainable. I guess Americans are doing what they do best – live in the now.

Seeing Red

With all of the news events that have captivated the media, there were a couple of stories that could have a direct economic impact on the U.S., yet received little, if any, air time. In February, China's premier announced that the government would be initiating steps to reduce the impact of inflation, while restructuring its economy. While economists expected further rate increases and perhaps a strengthening of the Yuan, what they got instead was an announcement of a detailed economic plan that could have long-term strategic ramifications for America and other developed markets. Essentially, China (the world's second largest economy behind the U.S.) will be reducing its dependence on exports and capital-intensive industries in favor of domestic demand. While this might sound like utopia for environmentalists, China's trading partners might feel otherwise.

China is America's largest provider of goods – representing almost 20% (or $364B) of the country's total annual imports. Therefore, a meaningful cut in China's exports would be inflationary as manufacturing costs rise from the loss of cheap labor. In addition, shifting domestic sources of demand would translate into slower growth rates as the country adapts to new ways of doing business and the implementation of stricter environmental laws.

From a U.S. exporting perspective, China's decision to target slower growth comes

at a time when the rest of the world is trying to grow their way out from under the effects of the global financial crisis. In 2010, America shipped $92B in goods to China. While this is by no means on the same scale of either Canada ($249B) or Mexico ($163B), it would still prove to be a headwind for future manufacturing, jobs, production and GDP growth. There is evidence that China's three previous interest rate hikes are beginning to affect demand. J.P. Morgan's technology analyst, Mark Moskowitz indicated in a recent research report that PC demand in China is "stalling out". Unfortunately for computer hardware business, China represents approximately 20% of global PC demand.

Ironically, on the day the China premier made his grand announcement, U.S. stock markets increased by an average of almost 0.50%, indicating a nonchalant attitude toward the potential negative affects of a slower China economic engine.

While China deals with excessive growth problems, Russia is just trying to feed itself. Last year, devastating droughts and fires significantly damaged the country's wheat crop. Russia, the world's third largest grain producer, with 13% global market share, typically exports its surplus to the Middle East. However, in March, Russian officials cut their 2011 forecast for this year's harvest to 82 million – 85 million tons of wheat, barely enough to achieve self-sufficiency. The shortage comes at a tenuous time as floods in Canada and Australia have further cut crop estimates and spurred a 64% increase in wheat future prices. The higher cost of wheat is the latest data point suggesting that U.S. consumers will face higher prices which could, over time, stifle the economic recovery that has been building since the lows of the financial crisis.

Obviously, the financial markets are discounting higher commodity prices as a short-term phenomenon. Perhaps Mr. Market sees something that I don't. Typically, higher costs translate into lower margins. Oh well – there is a first time for everything.

While we are talking all things red (China and Russia) let's acknowledge that the European banking system continues to operate in the red. In March, European leaders initiated a €500B ($700B) bailout fund that would help prevent debtor nations from defaulting on their government bonds. Unfortunately, the situation has gone from bad to worse. While Greece and Ireland are already in receivership, Portugal and Spain look to be on the brink. Interestingly, Spain has a government debt to GDP ratio of 72%, which is lower than Italy's 131%, France's 95% and Germany's 80%, which are perceived to be the three most financially stable countries in the European Union.

Basically, it seems as if this bailout is nothing more than a giant Ponzi scheme – where debtor nations are lending money to debtor nations. This situation could end badly should the European economy slide back into a recession. Continued problems within the European banking system and sovereign debt could eventually weigh on U.S. banks and cause the Fed to keep rates artificially low and/or issue more debt to support and bail out the European banking system.

The good news is that the equity markets don't care any more or less about the ability of our trading partners to continue to buy our products, than it does about radiation exposure. At some point investors will find something they don't like. In the meantime, "let the good times roll".

1st Quarter Review

The equity markets continued their upward trajectory in the quarter, in spite of an epic earthquake and tsunami, a jump in oil prices and political unrest spreading across North Africa and the Middle East. No worries, the volatility only lasted four weeks. By the middle of March, investors said the "the heck with these exogenous global events" and focused instead on the domestic economy. Voila, the markets bounced 5% in a week in a half, and ended the quarter with gains of 6.4%, 5.4% and 4.8% for the Dow Jones, The S&P 500 and the NASDAQ, respectively. For the Dow Jones, it was its best quarterly performance in 12 years. Large cap growth and value stocks performed equally well. However, small cap growth stocks did much better than value.

The energy sector (+16.4%) was the best performing part of the stock market on the back of a 16% jump in oil prices. The industrial sector (+8.25%) fared well too, as above average growth in emerging markets translated into higher earnings for companies that supply equipment to those countries. The two worst performing sectors were Consumer Staples (+1.75%) and Utilities (+1.62%). The Consumer Staples group underperformed the general market as many of the companies in the sector are mature, slow growth businesses. Many times staple stocks are the first to be hit with margin compression from higher commodity costs. Utilities lagged all other areas of the economy because they operate in a highly regulated industry that caps growth opportunities and their stock price is negatively correlated to interest rate movements. Like bonds, higher rates cause the stock price of the utilities to fall. Currently, many expect the Federal Reserve to raise rates by the end of the year or early 2012 which could pressure utility share prices.

What is Priced In?

The S&P 500 is up 96% from the market lows set in March of 2009. In addition, the index has retraced all but 16% of its all time high set in October 2007. That is big time momentum! I think if you were to ask any investor two years ago if

they thought the markets would be bumping up near it's all time high at this point in the cycle, they would probably smile and say "I wish". Yet here we are. It is logical and prudent to look at the market (S&P 500) and question what is priced into the current P/E multiple of 13.8X. On the surface the market looks cheap when compared to the average current year multiple (dating back to 1900) of 15.7, according to S&P and Yale University Economist Robert Shiller. However, there are some factors that I don't think investors can completely wrap their arms around – such as earnings growth.

According to Bloomberg, 1Q '11 earnings are expected to grow 14% on top of the 45% jump in 1Q '10. I'm not sure that earnings will be as robust as expected. So far this quarter, Kraft, 3M, Nike, Intel, Pepsico, General Mills, Hersey's, Cisco, Delta, Procter & Gamble and Fedex have warned about higher costs pinching margins. I'm quite sure that this list is not all inclusive as many companies have yet to disclose the implication of rising commodity costs. You should notice that this list of companies cuts through a cross section of the economy and does not focus on any one or two sectors. Rather, it is broad based and could multiply quickly. This would throw a monkey wrench into 1Q 2011 earnings. If earnings fall shy of expectations, it could be a rough spring for stocks.

Unfortunately, oil and commodity prices are rising and at some point this has to affect corporate earnings. It may not happen this quarter but it will impact market momentum at some point in the near future. With this in mind, where do investors turn? As contrarian investors, we believe that new money should flow into healthcare and consumer staples stocks. The healthcare sector is considered defensive in nature because the products and services are always needed regardless of the ebbs and flows of economic cycles. In addition, certain healthcare stocks pay rich dividends and outperform the general market when commodity prices and input costs are rising. Although the consumer staples are usually one of the first groups affected by rising costs, they typically react quickly by raising prices to offset higher costs. For example, Hershey recently enacted a 10% across the board price increase for all of its candy to offset the higher cost of sugar.

We would also continue to add money to the energy and materials sectors as geopolitical and economic uncertainty continue to dominate the headlines. The price movements in oil and other commodities so far are associated more with the weak dollar, unrest in the Middle East, Japan's disaster, and growth in emerging markets than they are inflation. Therefore, we believe there are fundamental reasons to continue to look at energy and materials.

In the middle of March, Exxon announced that they would be tilting their R&D dollars toward oil rather than natural gas. On the same day, both the Quebec and Alberta provinces stepped up scrutiny of unconventional means of fracking for natural gas. Quebec halted shale-gas extraction while Alberta is testing the environmental effects of producing oil-sands deposits. These two articles taken along with permitting in the Gulf of Mexico and other anecdotal evidence suggests that exploration and production (E&P) companies will continue to be in demand and will be a driving force in growing U.S. reserves.

Quarterly Equity Activity

Apache (APA) – Apache Corporation is an independent energy company that explores for, develops and produces natural gas, crude oil and natural gas liquids. We added APA to the portfolio due to its attractive valuation and to gain exposure to the exploration and production (E&P) industry. We believe that E&P companies will outperform the market over the long-term as the pressure to add oil and gas reserves, increases globally. In 2010, Apache invested over $11B in acquisitions to leverage existing properties as well as increase exposure in several important geographic locations such as the Permian Basin, western Alberta and British Columbia and Egypt's Western Desert. APA also acquired the Gulf of Mexico oil and gas assets and operations from Devon Energy. Management believes there are significant opportunities to exploit the "undeveloped" nature of the Gulf of Mexico since the Obama administration initiated a drilling moratorium in April 2010. Recent short-term production disruptions from pipeline outages in the North Sea and an active cyclone season in Australia, have-distorted APA's risk/reward profile and presents an attractive absolute and relative valuation. We look toward normalization in Egypt, the resumption of activity in the deepwater Gulf of Mexico, strong oil and natural gas prices and higher production in Permian and Argentina properties as catalysts to propel valuations back to a historical mean.

Archer Daniels Midland (ADM): We added ADM to equity portfolios in an effort to capitalize on a cheap valuation within the highly attractive agriculture commodity and products industry. The company's primary business is to utilize over 240 processing plants to convert corn, oilseeds, wheat and cocoa into products for food, animal feed, chemical and energy use. ADM has one of the worlds most sophisticated and fully integrated crop origination and transportation networks, encompassing rail, ground, river and ocean shipping. According to Morgan Stanley, Agricultural Services is expected to generate over $34B (or 45% of sales) in revenue for 2011. The company is trading at a 19% discount to its five year median P/E and a 10% discount to its peer group, in spite of projected revenue growth for FY 2011 of 24%, an industry high dividend yield

of 1.8%, a diversified business mix and a conservative management team. The potential catalysts that should help ADM's earnings and stock price revert back to its five year mean include: (1) higher commodity prices, (2) greater GDP growth in developing countries, (3) higher ethanol blend cap regulations from E10 to E15 for all cars over time, (4) improving supply/demand fundamentals for ethanol and (5) a continual secular demand increase for agriculture products.

CME Group (CME) – The Chicago Mercantile Exchange (CME) is the parent holding company of four futures exchanges and an international clearing house. The four exchanges include: (1) the Chicago Board of Trade (CBOT) which trades agricultural and U.S. Treasury futures and options, (2) the Credit Market Analysis (CMA) which provides a market for credit derivatives, (3) The New York Mercantile Exchange (NYMEX) where customers trade energy futures and option contracts for crude oil, natural gas, heating oil and gasoline and (4) The Commodity Exchange (COMEX) for those who trade metal futures and options contracts for gold, silver and copper. We added the CME Group to the portfolio because it is very cheap and it adds to our financial sector exposure. The company trades at a discount to our value metrics and has a market value that is 10% below its book value. In addition, the company pays almost 2% in dividends. CME generates the majority of its revenue from clearing and transaction fees, surcharges and volume-related charges for contract execution. Because revenue is transaction oriented, sales increase during periods of economic and geopolitical uncertainty, as traders and investors seek to manage risk or speculate on market volatility. Additionally, if interest rates rise, so will revenue. Due to the nature of the business and regulatory requirements, the CME Group is conservatively run as strong cash flow more than covers total long-term debt. We believe there is considerable value in the CME Group due to its valuation, new product and expansion opportunities, uncertain economic and geopolitical environment, and globalization and consolidation among exchanges.

VF Corporation (VFC) – We sold all positions and realized capital gains in VF Corporation as valuations had become somewhat extended at the same time input costs were beginning to rise. Since the beginning of the year, cotton prices have jumped almost 50% raising the cost of manufacturing. With rising oil prices and an already frugal consumer, there is real concern that the company will have limited pricing power, causing operating margins to decline. While the management team and financials are very strong, we believe that premium valuations relative to its peer group do not provide an attractive risk/return profile. Therefore, we are more than happy to sit on the sidelines until we get some indication as to how rising costs will affect company gross and operating margins. We are likely to revisit this name in the future.

Walgreens (WAG) – Clients realized gains as we sold all shares in Walgreens for many of the same reasons as VF Corporation. In addition, we don't see a near-term catalyst that would propel valuations to support a meaningful move in the stock price. We believe the company is fairly valued as pharmacy sales continue to trend about 3% while "front end store" sales should continue to grow at a modest rate. In addition, we think that the company has operational risk as management continues to update and renovate existing stores and oversee the integration of Duane Read. The company operates in an attractive sector of the economy. Should the stock price fall to attractive levels, we would not hesitate to once again add Walgreens to the portfolio.