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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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The Wealth Effect

Oh Ben!

I've got to hand it to Ben Bernanke, he is one stubborn ole Fed Chairman. He has been pursuing a policy of easy money, even though many economists, bankers and politicians believe his dovish stance could harm the long-term health of the economy. For the last 51 months, Bernanke has held interest rates near zero, in an effort to stimulate the economy and encourage businesses to invest and banks to lend. The only problem with his grand plan is that there have always been exogenous factors that have caused hesitation by both parties. Business leaders have been unwilling to invest capital due to broad based concerns over the economy, perceptions that the Obama Administration is unfriendly to commerce and the reality of higher costs due to the implementation of ObamaCare, taxes and regulation. Banks, on the other hand, have been unwilling to lend based on the implementation of a host of regulatory standards and strict capital requirements designed to increase liquidity and reduce leverage. Limits on the amount of capital banks and other financial institutions can put at risk, requires lending officers to be vigilant in extending credit to those they know can afford to pay the loan back. These factors have contributed to the economy's lack-luster performance.

Finally, after four plus years of keeping rates artificially low by buying bonds and mortgages, it looks as if things are beginning to change and Bernanke might be getting what he so badly desires. The housing market is on the mend and evidence suggests that pricing may actually be increasing, due to a drop in the supply of available houses. In addition, there has been a pick-up in manufacturing and auto production as companies rebuild inventories off of depressed levels. Corporations have finally begun to utilize cheap money and their cash hoards to engage in Merger and Acquisition (M&A) activity, stock buy-backs, dividend increases or capital expenditures in order to enhance capital returns. According to the Wall Street Journal, Bernanke estimates that his cheap money policies have helped output jump 3%, between the 2008 – 2012 by making it easier for households and businesses to borrow and by boosting stocks and household wealth. These maneuvers have helped push security prices to record levels.

Illusions

The wealth effect comes about as a byproduct of rising or inflating asset prices. It is believed that pricier assets make investors feel richer and inspire greater spending which fosters economic growth. However there is reason for concern as many economists believe we have been down this road before. The illusions of permanent wealth led to the financial crisis in 2008. As we found out, illusions can become painful when reality sets in. When the housing bubble popped and home prices fell, consumers realized they could no longer use their home as a piggy bank and get equity from their house to support their lifestyle or other investments. The more prices fell, the bigger the crisis grew as the cash cow asset became worthless because homeowners owed more than their house was worth. This dramatic drop in prices and the ensuing ceasing of credit and liquidity seriously damaged the foundation of our capitalistic

financial system.

Some within the Fed's circle believe this scenario could play out again as an environment of perpetually low interest rates have artificially inflated the value of assets. Equity prices in particular have significantly increased in value over the last four years. In addition, professional fund managers that typically invest in different classifications of fixed income products are changing their investment focus as the prices for these assets have increased to the point where the risk /return profile is no longer attractive. High bond prices and low yields force savers, who need income, out of the bond market and into more risky assets classes in search of dividends that exceed Treasury and corporate bond interest. This exodus, or rotation out of bonds and into equities, helps support the current market run. The only problem is this trade is tired as it has been working for the last year. Prices for attractive income producing assets are extended and savers coming to the party now are late. Some fear that when the Fed reverses course and ends its free money policies, the equity markets will fall in the same manner as it did from March 2000 through 2002.

Markets vs. The Economy

With all the excitement about new highs in the equity markets, one has to wonder why the euphoria did not spread equally to the economy. While the low interest rate environment was effective in establishing a floor for the economy, the treat of big government intervention with new regulations, and taxes created enough uncertainty to curtail a stronger recovery. In spite of the new highs on the Dow and the S&P 500, there is less economic depth than when the equity markets were last at these levels back in October of 2007. Consider that the 3rd quarter GDP in 2007 was 4.9% versus 0.4% in the 4th quarter of 2012. The unemployment rate was 4.7% with actual unemployed in the labor force of 6.7 million. Today, the unemployment rate is 7.7% with 13.2 million unemployed. Gas prices at the pump were $2.75 compared to $3.73. Also, 26.9 million Americans were on food stamps compared to 47.7 now. The national debt stood at $9 trillion in 2007 verses $16.4 trillion today and debt as a percent of GDP was 38% then and is 74.2% now. While you are sitting there asking yourself how the markets could be at these levels with economic fundamentals so weak, just keep in mind that the Federal Reserve levered-up over 200X so we could have this type of lethargic recovery. Back in the fall of 2007, the Fed's Balance Sheet was slightly under $1 trillion, while today it is over $3 trillion.

While we can look back on the data from 2007 and say that it was possibly distorted by the wealth effect, it no less validates that the U.S. economy is operating below its potential. Unfortunately, we are probably stuck with this type of economy until we get real change in leadership in Washington and at the Fed. Until then, monetary policy will remain supportive and the Fed will continue to buy bonds and mortgages so long as confiscatory fiscal policies (taxes) gains momentum.

Quarterly Review

Not So Usual

Wow, this past quarter was certainly one for the record books. It was the strongest first quarter in 15 years. Some have even classified this bull market run as the most "skeptical" in history. Why was it skeptical? Equity movements were irrational and did not accurately reflect the inherent risks of the domestic and international markets. Typically, Mr. Market is a discounting mechanism where stock prices reflect all information and takes into consideration current and future events. However, this quarter stock prices moved up without any consideration of valuation or fundamentals. For example, the Dow Jones Industrial Average was up 10 straight days in a row, a feat that has only happened 5 times in history. The last time it occurred was in 1996. In addition, the indices continued to rise in the face of financial chaos in Cyprus, and weak global economic news out of Europe, Japan and Asia. Typically, events like these would have sent the U.S. markets into a tailspin. To put the current market run into context, consider that according to the Wall Street Journal, the value of the U.S. Stock market is equal to about 133% of gross domestic product compared to a 60-year average of 82%. Only during the run-up to the dot-com and housing bubble was it higher.

Nonetheless, this quarter was truly different as 65% of the trading days were positive. In the end, the DOW, S&P, and the NASDAQ were each up 11%, 10%, and 8%, respectively. Normally, when the markets have such a dramatic rise, consumer cyclical stocks lead the markets. Not this quarter! Surprisingly, it was just the opposite, as the three leading sectors were all defensive sectors which usually lead in down markets. Healthcare stocks led the way with returns of 15% as biotech, pharmaceutical and health insurers carried the majority of the load. Consumer staples returned almost 14% as investors sought out stable, low beta, dividend paying stocks that usually provide attractive valuations and reduced volatility. As a result of the recent jump in prices, valuations have become extended and dividend yields are on the decline. Companies like Coca Cola, PepsiCo, Proctor and Gamble and 3M have all seen their prices jump over 11% and are trading at multiples that are greater than their 3 year average P/E. Utilities returned almost 12% which is highly unusual. Like consumer staples, utilities usually outperform in down or volatile markets.

The sectors that typically lead rising markets fell to the middle of the pack as Industrials and Financials were up 10% and 11%, respectively. While that is nothing to sneeze at, Industrials got a big bounce late in the quarter due to saber rattling by North Korea's dictator Kim Jong-un. The financial sector was

up almost 11% due surprisingly to large multinational banks that did much better than regional banks even in the face of banking, financial and debt issues throughout Europe. Investment banks were also out performers and helped the sector returns. However, the big disappointment was the Tech sector which was up a meager 4%. Most of the drag was due to Apple's 18% drop. Apple, which is the largest holding in the Tech sector by a wide margin, was discarded because the company lowered its earnings growth prospects due to lagging sales and being in between product offerings. Other tech heavyweights that have struggled like Oracle and Intel have also warned that slower international sales and increased economic uncertainty could hit earnings.

It should be no surprise that value continues to trump growth. Investors of all market capitalizations are seeking a bias toward undervalued, dividend paying stocks with lower volatility. Obviously, with more investors looking for the same stock characteristics, prices are rising and real value is becoming harder to find. Furthermore, risk and volatility will inherently increase as investors continue to chase this style of investing.

Tough Questions

What Now?

Regardless of whether you are bullish or bearish, the fact of the matter is that we are experiencing the phenomenon of TINA – There Is No Alternative. Investors from all over the globe are investing in U.S. markets due to the perception of being the "least ugly" of the developed markets. Relative to the rest of the world, the U.S. economy looks encouraging. We have a positive and growing GDP, low inflation and positive real returns. Money finds its way to its highest and best use. Even with all of our domestic issues, at the current time, we are the Prom King! Therefore, money has been flowing into our markets and stock prices have risen. As investors continue to seek out income, dividend paying stocks will remain hot. For value investors, this is particularly challenging as stocks that typically pay outsized dividends have seen their prices rise (dividend yield fall) causing valuations to become extended. For example, Johnson and Johnson, Procter and Gamble, 3M, Boeing and Wal-Mart all trade at P/E multiples that exceed their 5 and 10 year median. We typically sell stocks when their valuations become extended. However, when managing money, you have to remain flexible and continue to evaluate the landscape. We listen to and analyze economic data, read industry periodicals and newspapers, collect our own data and develop a thesis on where we believe the economy is in the business cycle. Similar to 2007 and 2008 when we decided it would be best to liquidate assets prior to the crash; we believe that investors should remain in these somewhat over-valued stocks until there is a shift in monetary policies or investor sentiment.

Our equity only portfolios are fully invested. We classify portfolios with less than 5% in cash as "fully invested". While we are temporarily holding with our status quo and not making dramatic changes, we believe that there are some reasons to keep a sharp eye on the tea leaves. I know, what a surprise – right?

On a 50,000 ft. basis, we don't believe that the U.S. economy is going to crash this year. However, we don't believe it is going to break-out of the recovery stage either. We look for things to continue to muddle along until Washington makes some progress on the budget and/or deficit reduction. As we have seen over the last four years, government can function without passing an annual budget. However, it causes a great deal of uncertainty throughout the year as Congress has to continuously revisit spending limits and debt ceiling requests. This type of noise is not productive for investors.

February's economic data was fairly encouraging and suggested that we might be breaking out into a full recovery, but global economic data suggested otherwise. There was a nice size inventory build that boosted manufacturing, but it remains to be seen if this is a one quarter phenomenon or a potential trend. We are skeptical because many of our exporting partners are experiencing slowing or contracting economies. Who is going to buy our manufactured goods? Listening to tech and consumer staple executives on conference calls can get you a little spooked as they all indicate that future global orders are weak and uncertain. While we don't have a full grasp on the magnitude of the problem, we must keep in mind that if one company says it, then it is an anomaly. If several companies confirm the trend, then it should be taken seriously. Unfortunately, we don't think U.S. investors are listening.

Housing is bumping up off seriously depressed levels so any increase seems significant. Interest rates are low, and Bernanke is hoping that this will continue to entice home buyers to dip into the excess inventory or refinance to help ease the default rate. With unemployment high and compensation and average hourly earnings flat, it is unclear who is buying the excess inventory. Unfortunately, it is too early to determine whether this is a long-term fundamental change or a temporary bump-up in the data. A permanent fundamental pick-up in housing would benefit the entire economy.

We are a little anxious about first quarter earnings as investors expect the S&P 500 to report flat quarter over quarter growth. This is troubling, considering the index reported 7.7% growth in the previous quarter. According to Capital IQ, earnings expectations for 1st quarter 2013 were 6.2% way back in October. However, throughout the first quarter, expectations have fallen from 3.7% at the way down to 0.5%. Moreover, of the

108 companies that have issued forward guidance, 74, or 69%, have already pre-announced that profits will come in lower than expected. That is above the historical average of two or more warnings for every positive one.

Nonetheless, we will continue to seek out value oriented dividend paying stocks to add to the portfolio. Should we find an appropriate candidate, we have prioritized those over-valued stocks that we would sell to create cash. Keep in mind, there are only two types of losses in investing – real capital losses and the loss of opportunity. Our job is to avoid the former while capitalizing on as many of the latter as we feel appropriate. We are risk managers and will continue to monitor the markets for opportunities and threats.

Portfolio Activity

Once again we were very busy this past quarter. Although the markets went up in a straight line, we had opportunities to make strategic changes to many positions within the portfolio. As a review, we classify our equity securities into anchors and alphas. Anchor stocks typically have global brands and leading market share. They also have characteristics such as low volatility, stable earnings growth and greater than market yields. Alpha stocks typically are more volatile, risky and usually have a shorter holding period. A portfolio of alpha stock would be expected to significantly outperform a specific benchmark in rising markets and underperform in down markets. While the vast majority of equity holdings in the value composite have characteristics similar to anchor stocks, we do periodically add alpha securities to the portfolio, providing they have a compelling valuation, short-term catalyst and/or a mispricing of a security. For example, we bought GNC Holdings back in December due to its valuation and the roll-out of a new marketing campaign. Evidentally, everything clicked during Christmas as fourth quarter earnings and future guidance was better than what Wall Street expected and the stock jumped over 20%. We realized our targeted return and liquidated the position in February. We also sold our alpha position in Harman International as they duplicate the portfolio's exposure to the auto industry with Ford. We believe Ford is in a better position relative to Harman to capitalize on current industry fundamentals. Additionally, Ford has a more attractive valuation, higher dividend and more attractive growth prospects. Finally, we reduced the portfolio exposure to Halliburton, after its stock price ripped up over 25% in the first six weeks of the year. The fundamentals for the largest U.S. oil service company are still positive and its valuations still attractive. Nonetheless, we wanted to take some money off the table.

As the equity markets moved steadily higher throughout the quarter, we sold three of our long-term holdings. Monsanto could no longer be classified as a value stock as its metrics resembled that of a growth company. Its multiples were higher than its 5-year average and its dividend yield had fallen below its relative and peer group average. We sold Exxon for similar reasons. Exxon's multiples were trading at a premium to its peer group while its oil production had fallen. We continue to believe Chevron is operating at a higher level than Exxon and its valuations are more intriguing. Chevron also pays a higher dividend. We sold Abbott Labs after the company spun out the pharmaceutical division into a wholly owned company called AbbVie. We kept our allotted shares in AbbVie as it holds the rights to Abbott's blockbuster drug, Humira and the rest of the existing drug pipeline. Although AbbVie has run up significantly since the split, we continue to believe that there is value in the company's pipeline of drugs and its significant cash flow. AbbVie's dividend yield is over 4% and trades at discounted valuations relative to its peer group.

With all the sales in the quarter, we did add two new names to the portfolio; National Oilwell Varco and Molson Coors Brewing Company. Both companies were trading at cheap multiples relative to their historic average and their respective peer group. **National Oilwell Varco (NOV)** is a service provider to the oil and gas upstream business. Over half of the company's revenue is generated from the rig technology business, which provides drilling equipment to onshore and offshore rigs and platforms. The rest of the business is split evenly between wellsite servicing and supply chain integration. The company has a leading market share, net no debt, an industry leading management team and a healthy backlog of equipment contracts and drilling rig packages. **Molsen Coors Brewing Company (TAP)** trades at a deep discount relative to its peer, Anheuser-Busch Inbev, yet has over 10% free cash flow, higher dividend, less debt and strong selling trends in the Coors Light division. Furthermore, TAP has better global growth potential as they are in fewer markets in the Americas, the United Kingdom, Central Europe and Asia. Any incremental gain in market share will add a great deal to the company's net income.

Lastly, we added capital to **Marathon Oil (MRO), Norfolk Southern Corp. (NSC), Deere & Company (DE), Boeing (BA)** and **BB&T Corporation (BBT)** on meaningful stock pullbacks during the quarter. All of these companies have strong business models and are similarly valued. However, at some point in the quarter, investors sold shares due to some short-term anomaly like a battery problem with the new Boing 787 Dreamliner or in the case of BB&T, failure to gain the Federal Reserve's approval for its proposed capital restructure on a technicality. In the grand scheme of business, we like to call these one-off events, "noise". When noise clouds the judgment of investors and makes them act irrationally, we like to jump in and capitalize on valuations that are too attractive to ignore.