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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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LOST

Fiction Meets Reality

The TV series *Lost*, first premiered in the fall of 2004 to great fan fair and huge viewing audiences. In fact, the first season garnered an average of 15.7 million viewers per episode. Throughout its six year run, the show developed a cult like audience where fans would blog about character development, potential plot conspiracies and speculation regarding some of the mythological elements that captivated its audience. The series was a character drama about passengers that survive a plane crash in a remote and mysterious island in the South Pacific. The wreckage was never found and its passengers were left for dead.

It appears that the popularity of *Lost* is causing some to hold out hope for undiscovered survivors or signs of wreckage of the missing Malaysia Airline MH370. The mysterious circumstances surrounding the flight that disappeared from radar 45 minutes after take-off on March 8, from Kuala Lumpur to Beijing with 239 passengers on board, has caused many conspiracy theorists to project unlikely scenarios for the demise of the flight. Unfortunately, it's sad and disrespectful that media outlets choose to lend credence to these off-the-wall theories by talking about them on air. There are only two likely explanations of what happened to the missing Boeing 777 airliner; it was either hijacked or encountered some type of mechanical difficulty. Either way, it is critical for Boeing to find the wreckage and determine the cause of the tragedy. Over the last couple of years, Boeing has taken a hit to its reputation with faulty wiring and battery malfunctions on its 787 Dreamliner. Ironically, the company announced that it had discovered hairline cracks on the wings of 42 Dreamliner 787's on the very day the Malaysia airliner went missing. Last year, General Electric (GE) and Boeing alerted airlines about a potential problem with engines on the Boeing long range 777 which shut down in flight on two separate occasions. GE identified the problem and sent replacement parts to airlines. This streak of bad luck is uncharacteristic of Boeing and their long range aircraft which is typically thought of as very safe and reliable. Nonetheless, the unsolved mystery surrounding the Malaysian Airliner will cast doubts in the mind of many until there is tangible evidence of what caused flight MH 380 to disappear. In spite of recent technical issues surrounding its two commercial aircraft, we continue to hold Boeing's stock. It's fairly valued, pays an above market dividend and has a strong management team to handle just about any kind of adversity.

Hope

Air planes are not the only thing disappearing without a trace, so are investor's fear of the market. I know I sound like a broken record quarter after quarter repeating my usual refrain for caution. But I assure you, it is no more annoying than hearing the constant drum beat of optimism and hope that 2014 will finally be the year that U.S. economic growth accelerates, creating a favorable environment for stocks. While evidence of such a rebound has been hard to find, the S&P 500 and the Dow continue to bounce around their all-time highs. To get an idea of the market euphoria, Credit Suisse put out a report that surveyed the big Wall Street firms and concluded that "buy" recommendations on U.S. stocks relative to other global markets is at decade highs. In addition, 75 of 88 economists expect the U.S. economy to grow between 2.5% - 3.2% in 2014. Finally, all 21 equity strategists expect the S&P 500 to end 2014 above 1850. This would equate to another positive year, on top of last year's

remarkable 30% return. I find it amusing that all of the strategists came to the same conclusion. The cynic in me thinks that they have alternative motives or they are all looking at the same models and hoping for the best. Either way, I would rather stay objective.

Clearly, consensus building rules the day. We have been hearing about this alleged pick-up in economic activity since Vice President Biden declared the "Summer of Recovery" back in 2010. In the **14** quarters since that speech, economic growth (GDP) has exceeded 3% only **3** times. The U.S. can't seem to gather any economic momentum for more than a single quarter. There is no evidence to support the theory that 2014 will be any different than the previous four years. Yet, optimism has been the impetus for rising U.S. equity prices and the expansion of the market multiple (P/E ratio) to 17.5 from 12. Clearly, expectations for an improving economy are priced into the market.

Wall Street has not only fueled the joyous feeling among investors, they have all but ensured the upcoming earnings season will likely be better than expected. As we begin earning season, 108 companies have lowered their projections relative to only 16 that have raised their outlook. The negative-to-positive ratio of 6.75 is almost 3 times higher than the historical average. Over the last several months, Wall Street lowered consensus estimates for first quarter earnings from 6.5% to a paltry 2.1%. Reducing the bar that low almost guarantees that earnings growth will exceed expectations, which should provide a catalyst for stocks to move higher.

The Truth

What if these market gurus and economists are all wrong and economic growth does not improve? What if the winter freeze is not the only reason why economic growth appears to have slowed, in the first quarter? HOPE is not an investment strategy. Legacy can't sit idly by and ignore inconvenient data just because it runs contrary to a popular opinion. We look at all available information and try to make educated decisions based on our internal analysis. We have identified several issues that could prove to be problematic for the bulls.

The common theme of the bulls centers on a robust housing market. A critical analysis indicates that if you extract the multi-family and apartment data from the housing numbers, the reality does not look so rosy. Since last summer, housing starts, existing home sales and median sales price for existing single family homes have been trending lower. In addition, adjustable rate mortgages have risen from 3.3% to 4.4% over the same period. So why is the inventory of residential houses so low? Investors (many from foreign countries) are gobbling up our homes for cash, fixing them up with cheap furnishings and renting them out for income. Unfortunately this does not stimulate the economy because investors don't spend as much money to fix-up the homes or provide improvements as would homeowners. When housing prices rise, it's the investor (who in many cases lives overseas) who benefits. The likelihood of reinvesting the proceeds is not certain.

Whether you are looking at the housing market or the overall economy, the consumer is looking a bit stretched. While the job market might be improving as more people are going back to work, average hourly earnings and salaries are not growing. Total non-supervisory wages have gone up less than 5%, in three years - much slower than the economy! The personal savings rate as a percent of disposable income has fallen from 6.6% to 4.3%, since December 2012. Consumers are once again leveraging themselves with credit card debt, as they purchase new cars, durable goods (TV's and dishwashers) or vacations. At some point, a pullback in consumer spending is warranted.

While we are talking about consumer spending, should we bring up inflation? Let's just cover the basics – food, shelter and transportation. The CRB foodstuff index is up 18.1% year-to-date. This index tracks the price movement of 9 basic commodities whose markets are presumed to be among the first to be influenced by changes in economic conditions. The nine commodities cover just about everything needed to cook a meal including butter, cocoa beans, corn, cottonseed oil, hogs, lard, steers, sugar and wheat. Needless to say, this explains why there are higher prices at the grocery store.

We have already talked about housing in the paragraphs above, so let's take a brief look at multifamily and apartment rents. Since the financial crisis and subsequent recession in 2008 and 2009, a combination of young citizens venturing out as first time apartment renters and increased foreclosures which forced many homeowners into apartments contributed to a dramatic drop in the vacancy rate for apartments from 8% in 2009 to less than 4% in 2013. The reduction in the vacancy rate includes an additional 127,000 apartment units coming on the market in 2013. The nationwide increase in demand for apartments has caused prices to jump over 12%. The increase in the cost of housing comes as income and salaries have stagnated. This dynamic could weigh heavily on the U.S. economy which relies heavily on consumer spending.

Finally, the cost of transportation has jumped significantly as current West Texas Intermediate Crude (WTI) has jumped 16% since last April. The price at the pump has increased $0.31 per gallon in February alone. As refiners begin to reduce production due to scheduled annual maintenance, prices could spike even more in the spring. The high cost of oil has partially been blamed for the rising cost of air travel. Currently 30% of the average airline cost structure is related to jet fuel. The major U.S. carriers projected $3 billion in added cost will be incurred in 2014 to accommodate rising fuel costs. Don't feel bad for the airlines, most carriers have added a fuel cost buried in the fee structure of roughly $25 per round trip ticket. American Express estimates that between higher oil costs, more stringent regulations and fewer passenger seats, the average cost per airline ticket will likely increase 4% over the previous year.

It's clear the cost of living is increasing and consumer spending should come under some pressure. What is not known is how long this environment will last and what the ramification to the overall economy might be. Also it is hard to tell whether or not these factors will derail the HOPE factor. Nonetheless, all we can do is acknowledge the reality and try to adjust portfolios to reduce as much risk as possible. We will be monitoring the economic developments carefully and if economic growth begins to deteriorate before asset prices and valuations adjust to reality, we will not hesitate to react accordingly.

Quarterly Review

Mixed Bag

In addition to the confusing economics headlines, investors have had to make some tough strategic decisions regarding value vs. growth stocks, a bubble in the high flying tech stocks and to what extent weather played in the economic slowdown. One thing is for sure, broad correlations between sectors and individual stocks were close to zero, as there were clear winners and losers. It was a "stock pickers market" and if portfolio managers did their homework, then they were rewarded. As for the weather, who knew that it gets cold in the Northeast in January and February? Economists, analysts, and companies all blamed poor business execution and soft business sales on too much snow and cold temperatures. Indeed, Wall Street analysts have revised first quarter earnings estimates down significantly due to the weather. Fact Set, a reporting and data gathering firm, forecasts earnings to be basically flat relative to the Q1 2013, but up 9% for the full year of 2014. Obviously, there is a huge snap-back expected in earnings in the second half of the year to make up for the slow start. Time will tell if HOPE and investor expectations come to fruition.

The equity markets started off weak as prices fell just over 5% in the first 32 days of the year, due to fear of a global slowdown and profit taking after the strong 2013. When China and Europe reported some decent economic data, the markets took off just as they did for most of 2013. Momentum stocks like Facebook (peaked up 32% QTD), Netflix (peaked 25% QTD), and Tesla (peaked up 68% QTD) led the market higher in February. Suddenly, sentiment changed. Whether it was the 65 Initial Public Offerings (IPO's) (the highest level since the Q1200) or the valuation gap between growth stocks and value stocks (the highest since the tech bubble) investors hibernated and volume dried up. For the most part, March ended basically flat and trendless, except for the high-flying tech and biotech stocks. The three hot stocks that led the markets higher in February caught the brunt of the selling and profit taking. Facebook, Netflix and Tesla were all crushed 13%, 15% and 22%, respectively, while perceived value stocks like Microsoft, Intel and Hewlett Packard benefited from the rotation and were up 7%, 5%, and 8%, respectively in March.

The S&P 500 finished the quarter with a small gain of 1.81%, the DOW was down less than 1%, and the NASDAQ was up about 0.50%. So called value stocks did much better than growth in large-cap and small-cap categories. The deviation among the sectors of the S&P 500 was broad as the best performing groups were defensive areas such as Utilities (+9%) and Healthcare (+5%). From there, the drop-off was significant, as the Materials, Financials and Technology sectors were all up 2%, while Energy, Staples and industrials were about flat. The big losers were Telecom (-1%) and Consumer Discretionary (-3%). The biggest surprise of the quarter was the bond market. Bar none, the safest perceived bet investors could have made at the beginning of 2014 was that rates would rise as the economy gathered steam. However, with the harsh "winter weather", China's economic engine slowing and mixed U.S. economic data, bond prices actually rose, causing bond yields to fall. The 10-year Treasury yield fell 10% in the quarter from 3.04% to 2.73%. Goes to show you what happens to consensus thinking!

The Equity Portfolio

The Haters

We love haters who either write or appear on business TV channels espousing their negative opinions on stocks. Haters go into a public forum and pile on a particular stock that is unwanted, unloved or misunderstood just to gain the temporary spotlight or notoriety. Ironically, these individuals are typically vocalizing what the markets have already discounted. So, they are not really providing any valuable information. Value buyers salivate when stocks are unilaterally hated among Wall Street analysts, particularly when the consensus talking points are flawed or off base.

Take First Solar **(FSLR)** for example. Legacy added this to the equity portfolios as it was misunderstood by Wall Street. As a low cost producer of solar rooftop panel modules, it was thought that the company could not be profitable due to the high cost of each solar panel. Besides, investors were more infatuated with Solar City, the company started by the iconic entrepreneur Elon Musk, CEO and Chief Product Designer of Tesla Motors. Just when Wall Street analysts thought they have things figured out, the cost of solar panels significantly declining to where they are all of a sudden competitive with traditional sources of energy, especially with oil at $100+ per barrel. FSLR has been able to capitalize and win new business and drive profitability, especially in foreign countries. In addition, its steady utility like business will provide cash flow well into the future. First Solar was cheap based on any of our value metrics when we added the stock to portfolios. It is conservatively run with net no debt. By the end of 2014, cash on the balance sheet could equal almost 50% of FSLR's total market cap. On March 17, the company announced great earnings and new orders which propelled the stock price up 32% in a week. All of a sudden, I guess Wall Street now likes First Solar!

Wall Street turned its back on Baxter International **(BAX)** as their short-term view of the company's plasma and hemophilia business clouded its overall long-term outlook. BAX has two main businesses, biosciences and medical products. In Biosciences, the pipeline of late stage offerings hold the potential for significant organic revenue growth. The Medical products segment is concentrated on IVs, premixed drugs, and pumps. The stock trades at a 23% discount to its peers which we believe are unwarranted because of their stable business and the potential

for organic growth. After our purchase, BAX announced the spin-off of the company into two separate companies, which was highly praised by the market. With a 2.7% dividend, low valuation, and a spinoff coming in the next year the company should remain strong.

Nike **(NKE)** fell out of favor with analysts and investors when they missed earnings due to a stronger dollar and a $0.04 hit in currency translation. The pundits piled on Nike saying that slowing sales and a reduction of market share in the U.S. to Under Armour are early signs of a business cycle downturn. Some analysts hastily downgraded the stock and NKE continued to slide until it had lost about 8% of its market cap. We added a small position of NKE to the portfolios because we see something entirely different. We see a company that has the capacity, resources, connections and expertise to develop and maintain a strong presence in international markets. Nike is quickly establishing itself as the market leader, well before competitors in China. They have a new cleat that will be launched in coordination with this summer's World Cup. NKE has new products, apparel and sponsorships in golf which is growing due to the global popularity of new young international talent. Nike has several immediate catalysts that could propel earnings. The company is conservatively run with cash that covers 80% of total company liabilities, net no debt and pays the only dividend (1.3%) of its peer group. NKE's management team has the financial flexibility to decide how best to return cash to investors; dividend increase or share re-purchase. Wall Street, take note – these are positive developments to be applauded not sold or ridiculed!

To continue the theme of unloved and unwanted stocks, we added Citigroup **(C)** and Bank of America **(BAC),** two of the cheapest stocks in the financial sector, to the portfolios. I know, investors hate these two stocks, but they are in a good position to not only benefit from an improving economy but also rising rates. Banks tend to thrive in an environment where they can borrow money short-term at cheap rates and lend it out over the long-term at higher rates. The wider the spread between the two rates the greater the potential for margin expansion and profits. In reality, the end of the "Taper" is a good thing for banks as they will be able to operate in a more normal environment where rate changes are rational and predictable based on economic and geopolitical developments. Both banks are inexpensive and trade at a discount to their book value. In addition, they both have de-levered their balance sheets and are significantly more stable and have greater capital than at any time prior to the financial crisis. BAC recently passed the Federal Reserve's Comprehensive Capital Analysis Review (CCAR) and announced a $6.3 billion settlement with the Federal Housing Finance Agency to resolve its residential mortgage backed securities litigation. This puts to bed a cloud of uncertainty regarding future potential payments related to the financial crisis. BAC will be buying back $4 billion in shares and increase it's dividend to $0.05 per quarter for a yield of 1.2%. Citigroup did not pass the CCAR for qualitative not financial reasons. Citigroup has 30 days to submit a new capital plan or ask for an extension. Based on its cheap valuation, limited expectations, potential for a company break-up of certain businesses and concern over management's ability to negotiate a turnaround, Citigroup has the be best appreciation potential of any of large-cap money center bank. We will keep you posted on their progress.

Legacy did actually sell two high flying and overvalued equities; Proctor & Gamble **(PG)** and General Dynamics **(GD)**. While these two household names might shock many of you, rest assured, their stock price had clearly gotten way ahead of their fundamental business. Over the years, both companies had experienced significant price appreciation as low bond yields forced income investors into riskier assets such as dividend paying stocks. As a result, their value metrics rose to excessive levels which triggered our actions. In regards to PG, valuations spiked just as organic revenue growth was slowing. In particular, the beauty division experienced a 25% decline in sales and lost market share to Kimberly Clark for the second straight quarter. General Dynamics was experiencing similar issues with valuations and slowing growth to where cost reduction and financial engineering were driving earnings growth. As GD's stock price rose, its dividend yield fell from 3.7% to 2%, equaling the market yield. These are two great companies and should their valuations fall back to earth, we would not hesitate to re-establish a position.