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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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REALITY 101

A Step Forward

Many readers might not know that I started my investing career as a fixed income analyst for what is now JP Morgan Chase. It was 1994 and the Japanese banking crisis had begun. It was a fluid period and finding credible sources of accurate information was difficult. It's hard to believe, but there was no internet, Yahoo finance or Jim Cramer to lean on when data was sparse. I had a Bloomberg terminal and a phone which I used to constantly harass my contacts at Moody's and S&P to find out what was going on with our bank holdings. I gained valuable insights on the ramifications of downgrades and defaults on the global credit markets and global economies. I also learned many valuable lessons that I reflect back on today such as: (1) trust my own judgement (2) focus on the balance sheet and the cash flow statement since it is hard for management to manipulate and (3) not trust Wall Street sell side research as it is often filled with opinions subject to bias.

However, the most important lesson I learned was that the bond market is always right. If you want to know how the economy is really doing, look at the yield curve. Especially now that the Fed has ended its quantitative easing policy which has kept rates artificially low. Nonetheless, over the last several years, the yield curve has not changed much except for brief periods of rate volatility where violent spikes and dips caused dislocation. We saw this with a 150 basis points (1.5%) jump in the 10-year Treasury, between May and December 2013, when GDP accelerated over 3% in back-to-back quarters. As the economic data started to cool and problems in Europe surfaced, the yield curve quickly adjusted and rates fell back into their normal range. In spite of the recent positive trends in the jobs reports and other sporadic economic data points, the bond market continues to indicate (through low long-term rates) that the economy is not strong enough to support a series of rate increases.

At the March Federal Reserve Meeting, the Governors decided to take out the word "patient" and add "data dependent" to their meeting minutes. This is a positive development because the Fed is signaling to the financial markets that it will now respond appropriately to economic data, just as it did pre-financial crisis. It takes the subjectivity out of the Fed's decision making process and focuses interest rate policy decisions on a broad analysis of all economic data rather than some magical data point or time period. This policy change will add credibility to the process and enables the financial markets to act rationally. If investors, economists and Federal Reserve officials are all looking at the same data objectively, it becomes easier to position portfolios in anticipation of the next Fed move.

Timing

Now that the Fed is signaling that their rate decision will be data dependent, the markets are stressed and the psyche of investors has changed. Good economic news will be considered bad news – because it will be interpreted that a rate increases will soon begin. Since the Fed's announcement on March 18, the S&P 500 has moved in excess of 1% five days out of 10. The volatility seen in the last two weeks of March

indicates that investors don't really know when the Central Bank will act or how it will impact the markets.

History indicates that rising Fed Fund rates do not necessarily translate into declining stock prices. In June, 2004 the Fed initiated a 26 month campaign of consistently raising short-term rates from 1% to 5.25%. Over that time period, the S&P 500 gained over 20%. In 1994, short-term rates jumped from 3% to 6% while the S&P 500 moved 10% higher. While these are not huge moves, they are positive and greater than the 10 year average return of 7%.

We still don't believe a Fed move is imminent. While the number of U.S. citizens unemployed has improved significantly over the last 13 months, the average cost of a gallon of gas is down 30% year over year and inflation is low, yet real wages have remained stagnate. Consumers are now beginning to pull back on household purchases after spending increased 4% over the last three quarters of 2014, the biggest increase since 2006. In a recent survey conducted by Visa earlier this year, it found that consumers are putting half of their gas savings in the bank and using the other half to pay down debt and make small purchases of food and clothes.

Household debt has become another headwind for the economy as it grew 3% last year to $11.7(T). This amounts to 80% of total US GDP. Aggressive lending programs in the auto sales business might have something to do with the rapid rate of growth in household debt. Over the last year or two, 25% of all new vehicle loans have terms of 73 to 84 months (7-8 years), according to Experian. The demand for new cars can be directly attributed to the consumer's ability to stretch out payments over longer periods of time in order to keep monthly payments as low as possible. Even with these attractive terms, the average monthly new car loan is $482.

With a deterioration in retail sales in January and February of -8% and -6%, respectively (on a year over year basis) coupled with slowing capital investment from the oil sector, the Federal Reserve must be concerned about a potential downturn in GDP. In addition, a strong dollar is holding down any threat of inflation as commodity and import prices continue to fall (West Texas Intermediate Crude settled at $47.60, down 14% for the quarter). Therefore, we don't see any reason for a prolonged campaign of interest rate hikes. Even an obligatory 25 basis point increase this summer seems a bit of a reach, in light of recent economic headwinds. While speculation will continue to preoccupy the media's attention, it's refreshing to know that we are slowly moving toward normalcy when referencing fiscal policy and their effect on the financial markets.

Market Review

Familiar Reframe

See if you have heard this before - central bank easing spurs equity market buying? Seems like the rest of the world is taking their cue from the U.S. Central Bankers from countries like China, Japan, Poland, India, and Israel have all initiated short-term rate cuts while the EU started its version of quantitative easing in March. As a result, most of these markets are up better than 10% YTD, significantly outperforming the US markets. Central bank actions have impacted more than just equities. It has caused the dollar to rally 13% against the euro and Treasury prices to rise and yields to once again fall dramatically. Money will continue to flow into risky assets around the globe so long as rates stay low.

Back in the U.S., the Dow managed to reach four new highs in the quarter before falling modestly in March to close down by 0.3%. The S&P 500 followed a similar pattern but managed to finish modestly higher by 0.4%, its ninth straight quarter of positive gains. At its peak in March, the NASDAQ was up over 6% and came within 8 points of hitting its all-time high before settling up 3.5% for the quarter.

Growth stocks did significantly better than value in the quarter as investors (expecting the economy to pick-up) reallocated portfolios away from defensive and income producing equities to those with growth characteristics. The Healthcare sector (+6%) was the strongest. Managed HealthCare led the way as United Healthcare was up 20% in the quarter. The Consumer Discretionary sector was up 4% as restaurants, apparel and homebuilders all saw positive movements. Darden Restaurant Group (with their popular chains like Olive Garden, Red Lobster and Longhorn Steakhouse) and Starbucks were up 19% and 16%, respectively, as families were willing to dine out a bit more frequently. In apparel, Urban Outfitters (+30%) and Ross Stores (+12%) attracted consumers with their merchandise mix while Lennar and D.R. Horton led the homebuilders with returns in excess of 12%.

After a strong 2014 where it led the S&P 500 in total return, the Utility sector came back down to earth (- 6%) as money left the comfort of dividend paying stocks for growth. Excessive valuations played an important role in the Utility sector selloff as the average P/E ratio for the group got to levels not seen since April 2001.

In spite of a jump in crude oil prices at the end of the quarter, the Energy sector had a rough go of it (-4%) as investors continue to worry about excess supply and production increases even as the US Rig Count falls. Oil and gas drilling were the hardest hit as Wall Street firms value these companies as if the

US will never need offshore crude again. Meanwhile, large integrated oil companies like Exxon and Chevron, continue to operate their largest and most productive fields in search of new crude. When a well hits a new "find", they cap the well head so they can store the resource in the ground until prices rebound. This helps combat some of the storage capacity issues facing the industry.

The vast majority of the S&P 500 sectors did not experience meaningful moves one way or another. The Financial sector (-2.5%) was volatile as investor sentiment shifted from a likely rate rising mentality to one of uncertainty. Industrials (-1.4%) and Consumer Staples (+0.4%) were negatively impacted by a strong dollar which created a headwind for international sales and earnings. Technology, Materials and Telecom were unchanged in the quarter.

What's Next

The old trading adage known as "Sell in May and go away" refers to a strategy where ***traders*** sell their stock positions in May to avoid some of the seasonal volatility associated with the summer and early fall months. They then try to time the market and get back in to participate in the fall and pre-Christmas rebound. This strategy sounds great in theory, but market timing has never proven to be a successful investment strategy because you have to be right twice- once on the sell (at the highs) and then getting back in at the lows. If our projections hold true, it might be prudent to trim some of our positions and generate some cash to take advantage of an eventual market pullback.

We expect the financial markets to retest their recent highs of earlier this year and for the NASDAQ to finally hit and break through its 15 year record before retracing back down this summer. I want to reassure our clients that I have not lost my mind and become some sort of day trader – because I haven't. At this point in the investment cycle, I am a risk manager, trying to negotiate the volatility of an uncertain market. To that end, we see some issues that could negatively affect the markets in the short-term. My biggest concern centers on upcoming corporate earnings. Earnings are projected to grow about 2% in 2015, down from 14% in 2014. The equity markets are a discounting mechanism for future growth. With the S&P 500 valued at 18 times earnings, it seems as if there needs to be an adjustment to new expectations. This adjustment process doesn't have to take an extended period of time. Between 1985 and 1986, earnings fell 5% as oil prices plunged, the dollar surged as the S&P 500 fell 7.7%. However, the index gained 28% the following year, according to David Bianco of Deutsche Bank.

The second factor centers on the Fed and its impact on the dollar. Regardless of economics, the Fed seems resigned to raising rates in 2015. That will strengthen the dollar relative to other currencies, causing US companies with international sales to come under pressure. Products sold abroad will become relatively more expensive and less attractive. Typically, equities undergo a modest sell off after an initial rate hike and then bounce back, particularly when rates are at unusually low levels.

Therefore, we want to stay away from those companies that have had a big run in earnings growth and those sectors that are sensitive to rate increases. We see opportunities in Telecom, Information Technology and Healthcare as they are less vulnerable to rate increases. In addition, the Financial sector, with its bank and lending institutions become more profitable as rates rise and the Treasury yield curve becomes steeper and more positively sloped.

Additions and Subtractions

Market uncertainty provided opportunities to buy good quality companies at attractive valuations. With a recent increase in volatility, we thought it would be helpful to remind our clients and readers how we build portfolios and manage money. We divide our equity holdings into "alphas" and "anchors". Alpha stocks are typically more volatile and have greater prospects of short-term return potential due to catalysts like deep value, high projected short-term growth potential, M&A activity or other corporate action. Anchor stocks are usually classified as stable and mature companies with lower long-term growth potential and bigger dividends. The tricky part of portfolio construction is striking the right balance between alphas and anchors. As you read through the portfolio actions below, the difference between our two classifications of stock should become clear. If you have any questions about this or any other topic in this newsletter, please don't hesitate to contact us.

We added two tech companies to the portfolio this quarter, **EMC Corp. (EMC)** and **Amazon.com** (AMZN). Both companies had disappointing quarterly reporting in October knocking their respective share price down through the end of 2014. AMZN reported its worst operating performance and biggest net loss in 14 years, as the rollout of their Fire smartphone was less than efficient and margins collapsed due to a high entry price and slow sales. AMZN also racked up huge costs for expanding its network of warehouses, resulting in a 20% drop in its stock price from July 2014 through January 2015. We viewed AMZN's as an alpha stock because the company's extremely low valuation and Wall Street indifference toward (1) the number of subscribers added to its Prime unlimited shipping program, (2) growth in Web Services and (3) growing cloud computing business. Shortly after our purchase, the company announced 4Q earnings that beat expectations

and the stock popped 15% in one day. We sold our position to capture a quick double-digit return in less than a month. The turnover rate for alpha stocks is much higher (we usually don't hold these stocks for extended periods of time) than anchor stocks as we want to capture whatever gains we can and move on to the next opportunity.

EMC's 4Q financial report was a mixed bag, as earnings met expectations but revenue and full year guidance was weak. The stock sold off 13% on market skepticism. We think EMC is significantly undervalued as 85% of the company's market value ($51B) comes from non-business related items; cash on the balance sheet ($15B) and its 80% ownership in VMware ($29B), a software solutions company for the virtual cloud and servers. EMC's actual business activities generate $21B in revenue but is only valued at $7B, a fraction of its true worth. We think this is a perfect example of an anchor stock given our long-term investment horizon, its low-risk characteristics, cheap valuation and market dividend yield of 1.8%.

We sold all of our portfolio positions in **CVS (CVS)** as valuations had reached levels not seen since 2001. We bought this anchor stock back in May 2013 and have held it through its business cycle and the implementation of ObamaCare. By any metric, this company is overvalued! Its P/E has risen from 13.8X to 19.3X and the dividend yield had fallen to 1.1% from 1.7% from where we initially purchased the stock. Furthermore, we don't see any catalyst to warrant its current valuation.

We also sold all positions in **Freeport-McMoRan (FCX)** when the company acknowledged that it would need to seek "3rd party financing" for additional capital. The company is trying to reduce debt, but its cash flow from operations is declining and FCX had to cut their dividend by 80% to relieve financial stress. FCX is an international commodity company whose stock price has been negatively influenced by a confluence of issues including a strong dollar, weak oil, gold and copper prices, and slow growth across the globe especially in China. We bought this alpha company as a hedge against rising inflation and interest rates. Currently, global economic conditions do not favor FCX and the near-term outlook is bleak.

You might remember, last quarter we added **Halliburton (HAL)** to the portfolio as a short-term alpha position to try to capitalize on the overly negative sentiment sweeping through the energy complex. We mentioned the challenge of identifying the value traps from true value investments. We were attracted to HAL based on its valuation, strong balance sheet and its recent acquisition of Baker Hughes. HAL delivered and we were able to capture mid-double digit returns in 2 months. Although much of the positive criteria mentioned above is still applicable, we realized profits since oil prices continue to be volatile and supply/demand fundaments favor excess supply due to weak global demand. Based on its business model and financial position, we would look at the stock again if it sinks to the levels that we purchased back in November.

With the excess capital created, we bought **Procter & Gamble (PG)** and added to positions in **Qualcomm (QCOM)** and **AbbVie (ABBV)**. PG is an old favorite anchor stock with a relatively cheap valuation, big dividend of over 3% and a strong financial position. The stock is down 12% based on worries of a strong dollar creating headwinds for revenue growth. However, the long-term potential for PG is significant based on strong cash flow to stimulate investment, dividend growth and share repurchase. Plus, PG has the ability to divest part or all of its beauty businesses and the capacity to cut cost to improve margins and focus on core branding. Cash flow provides PG time to focus on its corporate strategy, so don't expect a short time horizon with this investment. I anticipate PG being a core anchor holding for years to come as the company tries to realize full valuation.

We added QCOM and ABBV as recent price declines provide opportunities to add to positions of these industry leading anchor companies. Like the other stocks mentioned above, both QCOM and ABBV have cheap valuations and a strong financial position. QCOM has a dominate position in communication chipsets found in cell phones. The stock has been hit of late due to concerns over handset revenue royalty streams in China. However, with the settlement with China behind them, they can now focus on maintaining market leadership in the ever growing cell phone market. With a new $15 billion dollar buy-back program, 30% of their market cap in net cash and a low valuation, we felt it was a good time to add to our position.

In the case of ABBV, we like their drug pipeline and recent acquisition of Pharmacyclics which will significantly add to their cancer franchise. However, the road could be bumpy as the company is waiting for a FDA vote on biosimilars on two of its bigger drugs – Humira and Remicade. A favorable vote against biosimilars would help propel the stock as it would be susceptible to less competition. Over the next 5 years they will generate over 50% of their market cap in cash. With a 2016 PE of 11.8 they have the lowest valuation in the pharmaceutical sector. We feel the market is discounting the biosimilar risk too much and their strong pipeline will give them growth when Humira sales start to decline.