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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 POLITICS OF OIL

THE SKIDS

The U.S. economy hit speed bumps in the 2nd quarter as manufacturing, employment, investing, spending and confidence all lost momentum. Productivity and growth decelerated as the U.S. Gross Domestic Product dropped from 3.1% in the 4th quarter of 2010 to 1.8% in the 1st quarter of 2011. Unfortunately, the slowdown was so broad and unexpected that both the Fed Chairman and the World Bank had to lower their assessment for total U.S. growth in 2011, on the same day. The World Bank now predicts that the U.S. will grow at a slower rate than 2010.

Typically, slower economic growth perpetuates lower input and commodity costs. Indeed, corn and wheat have dropped 15% and 27% respectively, from their peaks earlier this year. Cattle and hog prices have fallen 7% and 6% respectively, while copper and silver have slid 10% and 29%. These commodity costs are adjusting to the new reality of slow and uneven economic growth.

TAPPING RESERVES

When I woke up on June 23rd and heard that the U.S. and its International Energy Agency (IEA) partners were going to release 60 million barrels of oil reserves to make up for disruptions from the Libyan Civil War, I was mystified. First of all, the 30 million barrel commitment (over a 30 day period) by the U.S. is purely a symbolic gesture. Total average global demand is close to 89 million barrels per day. Secondly, Libya's 1.5 million barrels a day of production is less than 2% of the total daily global production. Besides, Saudi Arabia had indicated two weeks prior to the announcement that it would boost output in an effort to ease concerns that rising oil prices might derail the global economic recovery. Finally, any short-term benefit from a price reduction would quickly dissipate as the tepid supply worked its way through the system.

So why tap the reserves at all? Several answers come to mind, predominately European pressure. The U.S. probably agreed to go along with the IEA member countries in an effort to maintain global economic harmony. Releasing the reserves would hopefully bring down the cost of Brent Crude – the global grade from which the developing world makes diesel - which was trading at a 14% premium to America's West Texas Intermediate Crude. Secondly, the release could have been a response to China's suggestion that they would be willing to swap oil reserves for capital reserves in an effort to lower their cost of oil imports. Essentially, if the cost of oil averages $100 a barrel for all of 2011, China will have to spend $206 billion on oil imports, which is $50 billion more than they spent last year. Finally, conspiracy theorists might perpetuate the concept that the additional reserves would help lower domestic oil prices (which would help the Obama Administration) just as Americans hit the road during the summer vacation months. I believe it was probably a combination of European harmony and Chinese influence that provided the pressure for the U.S. to participate in the release of the Strategic Petroleum Reserves. Besides, I don't think

President Obama would have initiated or pressured the IEA to release reserves because he just doesn't think that much about energy. Like many of the Presidents before him, he does not have an energy policy and it doesn't appear that he really wants to develop one, either.

Oil Fundamentals

Oil prices are volatile. At any point in time, the price of a barrel of oil reflects not only industry supply and demand fundamentals but exogenous factors such as geopolitical risks, global economics, foreign exchange inputs and inflation expectations. Therefore, in order to make educated investment decisions regarding the energy sector, one must have at a minimum a good understanding of the basic dynamics of the oil patch.

Legacy is bullish on oil based on its long-term fundamentals. In general, the IEA predicts that global demand will increase at a faster rate than supply through 2016. Ironically, global supply hit an all time high in February, by pumping out 89 million barrels per day. Unfortunately, total demand will likely reach 90 million barrels per day by the end of the year, creating a supply/demand imbalance. The rise in global demand can be attributed to the booming emerging market economies of Brazil, Indonesia, Saudi Arabia, and a host of smaller economies across Asia, Latin America and Eastern Europe. The one glaring name that is missing from the list above is China. Through the first half of the year, China's growth and subsequent demand for oil decelerated as Beijing attempted to head off an overheating and inflationary economy. While China's void is expected to be temporary, its long-term demand for diesel will continue to track in an upward trajectory as the country continues to build out its transportation and power infrastructure and satisfies its growth in automobile and truck sales.

Japan's demand will surely rebound at some point. The IEA expects Japan to recover in two phases – the current low demand environment and a growth period that should kick in once the country can assess its needs and begin to rebuild. In the meantime, Japan's low demand for oil is offsetting the supply disruptions in Libya. Domestically, many experts predict that U.S. demand will expand modestly until the economic recovery takes hold and businesses begin to invest and expand their employment base.

With the inevitable upswing in future demand, the real concern lies with the supply side of the equation. As the Saudis (an OPEC member) ramp-up production to compensate for Libya's disruptions, many analysts fear that this unnecessary, proactive response will adversely affect OPEC's ability to respond to future supply shortages. The glaring supply and demand problem centers on the inability of non-OPEC producers to keep up with growing demand in non-OPEC countries. According to Barron's, since 2000, global oil consumption has grown by a yearly average of 1.1 million barrels per day, while non-OPEC output has risen by just over half a million barrels per day. To further illustrate the growing problem, in 2000, non-OPEC demand was approximately one-third of the world's total consumption. Today, it amounts to almost one-half. This upswing in demand is adding pressure to OPEC producing nations as they are the only source of excess global capacity. With Saudi Arabia now working overtime to make-up for the Libyan shortfall, one has to wonder who is going to step-up to the plate in the event of a real supply disruption.

Future economic cycles will support short-term price fluctuations where extreme movements either up or down will be the norm. Unfortunately, the outlook for short-term capacity is not expected to improve anytime soon. Even if China's economic expansion begins to slow; other emerging economies are expected to grow at rates that exceed developed countries. This should continue to pressure the supply side of the equation. Over the long-term, the imbalance between oil supply and demand will not improve without a significant change in attitude and investment regarding how to power transportation and create energy. There are many ideas chasing limited investment dollars. It is going to take a wealthy visionary to get the next broadly used power source implemented and marketed. In the meantime, there is nothing dramatic on the horizon that will alter the energy landscape. There is not much else we can do but "drill baby drill".

2nd Quarter Review

If you are totally quiet for a moment you might be able to hear the collective sigh of investors. Market fundamentals were turning down-right scary going into the last week of the quarter as the S&P 500 and the NASDAQ were on the verge of falling into negative territory for the year. Then, all of a sudden, the Greek Austerity Plan passed, the government releases a good manufacturing report and QE II ended and investors became temporarily bullish. I use the word temporary because business and investing cycles are becoming shorter. Investor psyche changes on a whim as news breaks one way or another. Forward looking investing has been replaced by emotional and reactive behavior. Nonetheless, over the last four trading days of June, the Dow, S&P 500 and NASDAQ all rebounded over 4%.

For the quarter, the Dow (+0.8%) and the S&P 500 (+0.1%) finished basically flat while the NASDAQ (-0.3%) was slightly negative. According to the Russell Indices, the growth style of investing did significantly better than value investing. However, the deviation between the two styles expanded at smaller market cap sizes. For example, large cap growth stocks did better than value by 1.25%. However, the percentage grew to

2.3% and 2% at the mid and small cap level, respectively. One of the reasons why value lagged growth was due to weaknesses in the financial sector (-6.3%) which was the worst performing group of the index. Slower than expected growth, regulatory unknowns and a volatile credit market were major contributors to the low returns. Energy also fell (-5.1%) this quarter due to the decreasing price of oil. On the positive side, the defensive sectors led the way as health care (7.3%), utilities (5%), and consumer staples (4.5%) were the best performing groups in the S&P 500. For the year, health care (+12.7%) is the best performing sector. Despite energy's weak quarter, it held the second best return for the year at (+10%). Reinforcing the concept that investors react to short-term disruptions rather than longer-term fundamentals.

What's Next

A proverbial crystal ball would be nice. Short of that, investors should be ready for more volatility. The economy is the ace in the hole. Over the long haul, (in this day and time I refer to the next 6 – 12 months) the financial markets will get its cue from the economy. Unfortunately, the economy is growing uneven and each new government report could send stock and bond prices on a rollercoaster. Trading (hedge funds) and buy and hold strategies have not done well this year. Just as the fragile economy looks to be gaining strength (January and February) the government released a sour economic report coupled with a country default scare and the markets go on a two-week slide. The good news is up to now, investors have been willing to buy the dips, which add a level of support to security prices. Looking forward, there are still plenty of problems both domestically and globally that could send the markets into a tail spin. With the looming uncertainty regarding the depth and breadth of the economic recovery, investors might want to lock in profits and be patient with redeploying capital. As such, Legacy's equity investors might see more activity in their accounts than usual, as we alter our sell decision by slightly lowering our total return criteria and focusing less on duration specific considerations. Rest assured our investment decisions will continue to be based strictly on valuations.

Looking toward the third quarter, we believe pricing will become an issue as manufacturers are having difficulty passing "inflation costs" down to end users causing profit margins to contract. Although oil prices have fallen from the $114 peek, we do expect a rebound above $100 during the upcoming quarter. This could hinder any long-term economic rebound that may be taking place throughout the economy and pressure certain sectors such as consumer discretionary, manufacturing and industrials. Therefore, we believe Wall Street has yet to come to grips with the fact that their projected earnings assumptions for the second quarter are too high. Conventional wisdom suggests that 2Q '11 earnings will grow 5% to $95 which would constitute record quarterly earnings for the S&P 500. This could make for a rocky earnings season.

Legacy will be focusing on dividend paying stocks, as yields rose slightly in the second quarter from 2.4% to 2.5%. The number of companies that raised dividends, voting bonus dividends or disbursements grew 30% in the quarter. As stated above, we believe the energy sector has good long-term fundamentals that will periodically harvest attractive valuations. As was referenced above, we will continue to focus on the oil service and exploration and production (E&P) names as potential value candidates as opportunities present themselves. We will also continue to look toward the healthcare sector for viable investment names. This sector continues to be cheap as many analysts and investors are skeptical of truly long term growth due to a large number of patents expiring in 2011, austerity pricing in Europe, and increasing generic drug availability. However, acquisitions, corporate actions and increased R&D should help provide a catalyst for some names in the sector. Finally, we are intrigued with valuations in the financial group. The sector fell in absolute terms and underperformed the general market in the second quarter. Many financial institutions are selling at valuations below their stated book value. Typically, investors want to buy financials when they are valued at or below book value and sell once they get above 2 times book value. As usual, we will be very cautious when looking in this area, as there are many potential pitfalls that could upend investors.

Quarterly Equity Activity

Goldman Sachs Group (GS) – We added this old favorite back into the portfolio based on its cheap valuation and potential growth opportunities that could boost return on equity (ROE) and return on Assets (ROA). Goldman Sachs is a bank and financial holding company whose primary business includes market making in stock, bond, commodity and derivative products, providing clearing activities for clients around the globe and investment banking and money management. The company is cheaply valued on both an absolute basis and relative to its peer group. GS trades at approximately 9 times earnings and at book value, a significant discount to historical averages. One of the reasons GS has come under valuation pressure is due to its large proprietary trading business which has come under regulatory scrutiny from the recently enacted Dodd-Frank legislation. The extent to which this regulation will impact GS's business is still not fully known. Nonetheless, we believe the valuation is compelling and its global footprint entrenched to not give up significant market share without a fight. GS's culture of creating new products and revenue streams will help the company thrive once the operating environment becomes clear.

Morgan Stanley (MS) - We increased positions in Morgan Stanley primarily due to valuation and positive forward looking catalysts. The company is trading at almost 30% below its book value. The company's P/E trades at a 25% discount to its 5-year median and its peer group average. Management believes that market volumes and new products will help valuations revert back up to their mean. In addition, the prospects for clarity regarding Dodd-Frank regulations should also help boost valuations. We believe management will be able to execute in a more stable environment – pushing revenues toward high double digit growth and supporting return on assets and equity. Furthermore, we expect the company to begin paying a dividend as soon as they get clearance from the government.

CME Group (CME) – We added to positions of The Chicago Mercantile Exchange (CME) based on valuations as shares came under pressure, in the quarter, due to concern over: the slowing economy, weak trading volume and regulatory uncertainty that would curb speculative trading. We do not think the implication of the Volcker Rule will dramatically impact trading volumes over the long-term, but could temporarily suppress volume as initial implementation takes hold. CME continues to trade at a discount to all of our value metrics and has a market value that is 5% below its book value. In addition, the company has a 2% dividend yield. We will continue to monitor the legislative developments as this provides the biggest potential headwind for earnings and cash flow growth.

Transocean (RIG) – Shares of RIG came under pressure in the quarter as the company reported a temporary increase in downtime which could pose a near-term risk to earnings. As a result, the company's stock price fell almost 14%. We added to positions in Transocean, as all is not bad for the firm. It was awarded extensions or new contracts on 7 rigs at market rates. Overall, the firm outlook is more than stable, yet its stock price was crushed. We believe that the company's rig utilization for deepwater and high specification floaters will continue to improve as excess inventory diminishes and exploration and production resumes in the Gulf and other key regions of the world. In addition, average contractual day rates should rise, especially for the company's high-spec floaters and jackup rigs, as well as and mid-water floaters. On a valuation basis, the stock trades at a 10% discount to its peer group on a P/E basis and EV/EBITD. The dividend yield is 1.5% and we believe most of the bad news is already priced into the stock. We believe that the risk and reward opportunities are compelling.

Texas Instruments (TXN) – We sold all shares of TXN as its valuation had become extended. While we continue to like the firms business and believe that analog/mixed signal semiconductors will continue to be a high volume business, competition will flatten margins and limited profit growth could become systemic. On a relative basis, there is not much more value to be realized. Based on any of our value criteria, the company is expensive relative to its peer group. For example, TXN is selling at a 30% premium to its peer group on a forward P/E basis. We will continue to monitor the progress of TXN. Should the company stock pull back to our target level, we would not hesitate to own Texas Instruments in the future.

United Technologies (UTX) – Rule # 1 in investing – Do not fall in love with a stock. Well, I must admit, after doubling our investment over the last 7 years, it is very hard to say goodbye to this industrial giant. From Otis elevators, to Carrier, Sikorsky and Pratt & Whitney engines, UTX is not only a great company but a great investment. However, even great companies become expensive. I tried to find a reason to continue to own UTX, but the excessive valuation was overwhelming. On both an absolute and relative basis, the P/E, P/B, P/S, P/Cash Flow and EV/EBITDA were all at premium valuations. Had I held the stock it would have been the most expensive and only growth stock in the portfolio. That goes against my investment philosophy. Oh, well; I have a feeling that we will own UTX again at some point in the future.

Fluor Corp (FLR) – Fluor is another company that has served our clients well over the years. FLR has been a staple in portfolios since 2004 and on average returned over 50%. The company's engineering, procurement, construction and maintenance businesses continues to grow and its backlog reached an all-time high. As you would expect, Fluor's absolute valuation had gotten ahead of itself. Since its expected growth rate is greater than the market, the company would be classified as a growth stock rather than a value stock. Indeed, all valuation criteria support this view in that the financial metrics are selling at premiums to its 5 year median average. The company should continue to grow at rates greater than the market as the economy gains strength. However, should valuations revert to more attractive levels in the future, FLR could once again find its way into investor portfolios.