ASSET MANAGEMENT, INC.

1800 West Loop South, Suite 1790
Houston, Texas 77027

For Quarter Ending September 30, 2011

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.

Contact Info:

Tel: 713.355.7171
Fax: 713.355.7444

Joseph R. Birkofer, CFP® - Principal
jbirkofer@legacyasset.com

Rick Kaplan, CFA - Principal
rkaplan@legacyasset.com

Dennis Hamblin, AIF®
dhamblin@legacyasset.com

Jillian Nel, CFP®
jnel@legacyasset.com

In This Issue

Managing Risk 1

Third Quarter Review 2

Around The Firm 4

Managing Risk

Portfolio Management

With daily market gyrations moving from one extreme to another, I thought it would be informative to explain how we are successfully navigating portfolios in this uncertain environment. But first, one of the things I love most about my job is that I never stop learning. Each day, month, quarter and year provide opportunities to gain valuable experience that will undoubtedly be applicable at some point in the future. In late 2007 & early 2008, I made some rather unconventional moves in the equity portfolio by selling our exposure to banks and financial institutions. This reduction was prior to the demise of Lehman, the collapse of the housing market, and the credit crisis (for those doubling Thomas' – go back and re-read the newsletters on the website). These decisions were based upon financial statement analysis, a thorough reading of corporate 10Ks and a bit of intuition. The effect was a dramatic reduction of risk which helped preserved capital.

During the same period, I witnessed the dramatic fall of one of the most accomplished value managers in history, Bill Miller, head of Legg Mason's Value Trust. Leading up to the financial crisis, he had an unmatched track record and outperformed the S&P 500 for 15 straight years. But in 2007 and 2008, he chose to stick to his guns and follow his tried and true investment strategy that he had implemented over the past decade and a half. Unfortunately, he failed to recognize that applying rational valuation techniques like discounting cash flow or balance sheet analysis in an unrational and volatile investing environment are of no use. Rather than reducing his exposure to the financial sector, he "doubled down" thinking that banks could not trade much below their intrinsic value. The problem was the markets could not accurately determine the true value of banks. As a result, Mr. Miller lost fifteen years of outperformance in just two years as his fund lost over 62% between 2007 and 2008. Over the same period, the S&P 500 lost 33.5% and Legacy's Equity Value portfolio was down 20%.

Reflecting on these two different investment strategies, it is clear that having a specific and prudent sell discipline is an integral part of a successful risk management strategy. The worst thing a manager can do is watch in ambivalence as stocks go down day after day without any liquidation plan. Emotions typically kick in at the exact wrong time and managers yield to the pressure to sell after most of the damage has been done. We had several clients call to liquidate their mutual fund positions in February and March of 2009, weeks before the bottom. Those who chose cash never recuperated their lost capital as the markets rebounded in 2009 and 2010. This is a clear example of how the financial markets set up investors to do the exact opposite of what they should do. To avoid bad market timing paralysis, investors should develop and implement rules to eliminate much of the emotional duress involved in decision making. In extreme volatility, successful managers target an acceptable rate of return for a portfolio, making it easier to determine a specific maximum loss or minimum gain of a position

At Legacy, we divide the equity portfolio into groups designated by risk profile

and then place sell limit orders on the more volatile and risky stocks. A sell limit order allows us to specify an exact price at which to liquidate a stock. For example, if Legacy were to buy a high flying tech stock at $50, a sell limit order would also be placed at some predetermined level such as $45. If the stock price falls to $45, the limit order would execute, and the position would be sold. This strategy is a form of insurance that assures us that we will not lose more than 10% on that position. That being said, we don't buy stocks with the expectation that they will drop precipitously. However, in the current investment environment where corporate valuations can fluctuate 3% - 4% in a single day, we continue to think of ways to protect our client's assets.

With such dramatic volatility there are some nuances with this strategy that could affect portfolio performance. This strategy might create higher transaction costs as security turnover increases with the execution of sell limit orders. There is also a high probability that there will be tax consequences related to limit orders as they are not exclusively used for managing losses. They are also used to lock in a minimum acceptable return which can create a tax event that could reduce net returns. Sell limit order strategies backfire if volatility drives a stock to its sell limit order price, causing execution. It is possible the stock price could rebound resulting in an execution at what might be the stock's lowest price at a point in time. Thus, there could be some trades that don't work out as designed. Nonetheless, when implementing a risk management strategy, the benefits usually outweigh the costs.

Investing is challenged by trade-offs. Whether it's evaluating the opportunity cost of continuing to hold a losing stock or determining when to change an allocation due to an adjustment of risk tolerance, individual decisions should not be made in isolation, rather in the context of an overall strategy. At Legacy, balancing the preservation of capital with its growth is our primary objective. As such, when we invest, we are mindful of two types of losses - capital and opportunity. If we can protect our client's capital then we can always find opportunities. For over 13 years and two bull to bear cycles, Legacy Asset Management has used risk management strategies to successfully avoid many of the traps and pitfalls that have plagued the market. While we rarely talk about it, we are constantly thinking about how we can implement better and more efficient ways to protect our client's capital.

3rd Quarter Review

Investors felt pretty good about themselves at the beginning of the quarter. The long July 4th weekend invigorated and empowered investors to put money to work as signs of an economic rebound were popping up like fireworks. Unfortunately, the grand finale was nothing more than a dud as the S&P 500 hit a quarterly high water mark on July 7th (+7.60%). From there, the market deteriorated quickly and it took only 17 trading days for the index to turn negative for the year. The decline began with a terrible jobs report in July followed by an even weaker report in August. Goldman Sachs and Bank of America reported disappointing revenue and earnings, and the banking rout was on. Couple this with the first ever downgrade of the U.S. long-term credit rating by S&P, and a good ol' fashion game of chicken between Democrats and Republicans regarding the debt ceiling, and investors began second guessing their equity commitment. It wasn't until September, when it became obvious that the European Union was in financial disarray, before investors decided to leave equities in lieu of Treasury bonds and cash. By the end of September, the financial markets had suffered the worst quarter since March 2009.

The Dow finished the third quarter down 12% while the S&P 500 and the NASDAQ suffered losses of 14% and 13%, respectively. According to the Russell Indices, large cap growth stocks did almost 25% better than value stocks, while mid and small cap value stocks outperformed growth stocks as company size shrank. Clearly, as investors focused on smaller companies, they sought out lower volatility and higher paying dividends.

The S&P 500 was weighted down by energy (-21%), financial (-23%), material (-25%) and industrial (-22%) sectors. Slower than expected growth, regulatory and political uncertainty and deteriorating international credit were all contributing factors to lower returns. Energy, material and industrial sectors were particularly impacted by growing concerns over a global recession. The financial sector dropped due to speculation of a widespread financial contagion brewing in Europe and its impact on U.S. financial institutions. Defensive sectors such as consumer staples, healthcare and utilities all outpaced the general market, with utilities as the lone positive sector.

Positioning

(In this issue, I am combining the forward looking section with the quarterly activity.)

Typically, stock market activity does not drive our investment activity. However, due to volatility, deteriorating economic conditions, and European woes, this past quarter was the busiest in Legacy's 13 + years of managing money. Last quarter, I indicated that Legacy's investors might see more activity than usual in their accounts; however, I did not expect it to be quite this active. Nonetheless, we successfully reduced the volatility of the portfolio to weather the uncertainty. Many of our limit orders triggered, causing the sale of **Apache Corp., Archer-Daniels Midland, Citigroup, Goldman Sachs and Morgan Stanley**. It is incredibly frustrating to watch the stock prices of strong, fundamental companies executing their business

model, suffer in a wave of uncertainty, yet comforting to know that the strategy worked. The stock price of all of these companies ended the quarter considerably lower than where we sold. Don't be surprised if one or more of these companies find their way back into the portfolio at some point in the future.

We sold **Williams Companies, Forest Laboratories and Freeport-McMoRam** based on excessive valuations. **Transocean** was sold after the company announced disappointing earnings for the second consecutive quarter that highlighted worse than expected financial fundamentals and increased downtime across almost all asset classes. In addition, a handful of floater rigs were stacked in the quarter. Return on equity, assets and capital continued to fall and the company was selling at a relative valuation of 10.6x 2012 earnings compared to 9x for its peer group.

With almost 20% of the portfolio holdings turning over, most of our accounts had significant capital to redeploy and were dramatically underweight in many key sectors of the S&P 500. While I have never tried to index my portfolios to match the S&P weightings, I do try to have some exposure to all sectors. As such, we added companies that operate in many sectors that were significantly underweight. We also followed last quarter's advice by focusing primarily on dividend paying stocks.

Our portfolios essentially had no exposure to the industrial and consumer discretionary sectors, so we added **Emerson Electric** (industrial) and **Comcast Corp.** (consumer discretionary). In the oil patch, we bought **Halliburton** and **Sandisk** in technology. In the defensive sectors, we added **General Mills** and **United Healthcare**. We added **Berkshire Hathaway** (Share Class B) and **PNC Financial Services Company** to our financial weighting. Both characteristically have strong management teams and low volatility and held their value considerably better than their peer group during the quarter.

Even with these additions, many accounts still had almost 15% in money market funds. While cash is great to have when the markets are declining, it becomes a drag on performance when the markets rebound. Furthermore, with rates so low, investors can't earn any income off their cash balances. Therefore, we had to find alternatives such as the **iShares Barclays 1-3 Year Credit Bond (CSJ)**. This ETF is correlated to the Barclays Capital 1-3 Year Credit Bond Index and yields over 2%. It has been relatively stable (bouncing ± $0.50) since it was bought it early in September. This is the first time I have added a short-term corporate bond fund to the Equity Value Composite.

We also bought the **JPMorgan Alerian MLP Index ETN (AMJ)**. It seeks to replicate, the Alerian MLP Index which tracks the performance of midstream energy Master Limited Partnerships and yields a very nice 5.26%. Legacy has been using these "bridge assets" in our equity portfolio as a temporary placeholder during volatile periods and as a way of generating extra yield.

Going Forward

Looking into our proprietary crystal ball, we see more of the same volatility for the fourth quarter. The economic turnaround that was expected to blossom in the second half of 2011, has been pushed out indefinitely – or at least until The European Union (EU) can get their financial house in order. Like 2008, Wall Street is worried that U.S. banks hold significant exposure to European bank debt, causing potential loan write-down exposure. This would force U.S. banks to have to increase capital by selling assets or issuing new shares. Does this sound like Déjà Vu all over again?

Unfortunately, Europe is not the only factor affecting our financial markets. The US economy is not stable. This is the first time since I have been in the investment business (dating back to 1994) that an equal number of investment professionals believe we are heading into a double dip recession, as those who believe we are not. This uncertainty makes it hard to initiate long-term investment decisions. Every economic report has the potential to yield credence to one side or the other. Therefore, we are hedging our exposure with the "bridge assets" described above. We plan to utilize these low volatility assets until there is real and tangible evidence that the economy is tipping one way or another.

Finally, as I indicated last quarter, the earnings outlook is still too high. Currently, Wall Street is projecting S&P 500 full-year 2011 earnings of $98. However, for the first time since March 2009, more public companies are lowering estimates than raising them. It will be interesting to see if this trend continues throughout the upcoming earnings season. With soft economic conditions in the emerging economies of China and India as well as the documented problems in Europe, it will be hard for U.S. multinational companies to maintain sales and margin growth. The question for many of these companies is whether they can cut costs to make up for the shortfall. In the meantime, Legacy is looking for dividend paying stocks with cash balances and financial flexibility to build their product offerings and increase market.

While the economic, political and market uncertainty is high, it does not mean that you abandon investment opportunities when they appear. Patience, prudence and commitment will serve investors well as we navigate the volatility.

Additions to the Portfolio

Berkshire Hathaway (BRK/B) - BRK/B started as a textile manufacturer, but was bought by Warren Buffet in 1964. Mr. Buffett uses the holding company as a place holder for the various subsidiary companies that have been acquired over the years that engage in a number of diverse business activities ranging from bricks to railroads and retail. This diversification helps cushion the company against economic and regulatory uncertainty. The holding company's largest business is insurance which generates 27% of revenues and is accountable for almost 40% of net earnings. BRK/B has a very strong balance

sheet and manages its cash flow conservatively. The company trades at a forward P/E of 14X, a 12.5% discount to its 5 year medium average.

PNC Financial Services (PNC) - PNC conducts regional and wholesale banking services and asset management in 13 northeastern states, with a concentration in Pennsylvania and Ohio. The bank's credit quality continues to improve at rates greater than its peer group. Both nonperforming loans and net charge-off rates continue to decline. PNC is in a good strategic place as it is focusing on its consumer offerings which tend to perform better as credit cycles mature. PNC recently raised its dividend to yield almost 3%. We think there is considerable value and upside potential in PNC's stock price once the European banking and credit crisis settles down.

General Mills (GIS) – General Mills is engaged in the manufacturing and marketing of branded consumer foods sold through retail stores. GIS also engages in supplying branded and unbranded food products to the foodservice and commercial baking industries. Its major domestic product categories include ready-to-eat cereals, yogurt, refrigerated and frozen dough products, dessert and baking mixes, and a range of organic products. Overall, the company holds a leading market position in more than 100 markets worldwide. We added GIS to the portfolio based on its valuation, financial stability and attractive dividend in excess of 3%. The defensive nature of the company should provide stability during economic uncertainty as many of its products are viewed as essential food items.

Emerson Electrical Company (EMR) - Emerson is a large conglomerate with its hands in many different business segments from motors and wind turbines to household appliances. Although the company is well diversified, it is still vulnerable to economic cycles. However, their strong competitive position in major product lines help smooth out the cyclicality of the market. EMR is inexpensive on an absolute and relative basis. Its P/B and P/E are selling at a 30% discount to its 5 year median average. EMR has strong financial management team and its positive cash flow supports its dividend yield of 3.2% and planned capital investment.

SanDisk Corporation (SNDK) - SNDK is a developer and manufacturer of flash memory that is used in desktops, laptops, smartphones and tablets. It is also an integral part of "cloud" computing. The market for flash memory is expected to grow 10X by 2014. For a company with dominate market share, strong balance sheet, cash flow and growth potential it is considerably undervalued based on its P/E ratio, P/B ratio and discounted cash flow.

Comcast Corp. (CMCSA) - Comcast is the largest cable company in the United States, providing video, high speed internet and phone services to residential and business customers over its cable lines. The company serves approximately 22 million video customers in 39 states and the District of Columbia. We believe Comcast has significant upside as the company continues to focus on building content for its cable systems, while many of its competitors are selling theirs. Comcast is trading at a forward P/E of 11.5X compared to its 5 year median of 15X and peer group average of 14X. The company pays a dividend of 2% which is 6% higher than the S&P 500.

Halliburton Company (HAL) – HAL is an oilfield service company which provides products and services to customers in the exploration, development and production of oil and natural gas. The company's lost a third of its value in the weeks just after the drilling rig, Macondo, exploded last April. However, HAL has regained its footing by improving its operations, business mix, supply chain and cost cutting. Going forward, pressure pumping and horizontal drilling in shale properties will be focal point of revenue growth. HAL has one of the strongest balance sheets in the oil field services industry as net debt represents 15% of capital. The company has a 1.1% dividend yield which is higher than its peer group and trades at half its 5 year median forward P/E.

United Health Care (UNH) – UNH (a familiar holding for many investors and readers) is primarily a health benefit firm that serves both private and public companies, institutions and individuals. Healthcare providers have taken it on the chin as worries over the implementation of health reforms have infected the operating environment. Nonetheless, we believe UNH can leverage off its current business to insulate itself from the full regulatory impact. UNH is financially stout! It is the most profitable company in the managed care industry, reported over $3B in net cash and had $650 million in cash flow at June 30th. UNH trades at a 33% discount to its 5 year median P/E and pays a 1.4% dividend yield.

Around the Firm

There have been a lot of new developments at Legacy. We have several new corporate and institutional clients: we welcome the Houston Zoo, The Parish School, prosource.it, and Novetus Engineering. Both Rick and Joe have supplied commentary for the local ABC station, Channel 13, as well as print publications like the New York Times, and the Houston Chronicle.

We are pleased to announce the addition of Jillian Nel, CFP®, to our team. Jillian brings over six years of industry experience, and was Joe's top student in the Rice Certified Financial Planning program last spring. She will be adding depth and breadth to the financial planning function, with a particular skill focus on retirement planning and insurance concerns. We are also pleased to welcome Melissa Rodriguez. Melissa has over a decade of industry experience, including tax preparation work at H&R Block. Melissa will be supporting our client service efforts. Welcome Melissa and Jillian!