LEGACY
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The Big Picture

Change of Heart

Maybe I am getting caught-up in the whole New Year's nostalgia thing. Perhaps it's the optimistic talking heads constantly parading on CNBC. Whatever the reason, I am tired of being bearish and cynical. I really want to drink the Kool-Aid, climb aboard the band wagon and ride the wave to prosperity like most of the Wall Street pundits predict. The average gains expected for the S&P 500 in 2012 range from +5% to +11% - not exactly robust by any stretch of the imagination. Nonetheless, it would be a welcome sight relative to the returns of 2011.

Hold on one minute, I recall last year the same Wall Street gurus were spouting similar positive rhetoric: fiscal stimulus from payroll tax cuts, monetary stimulus from the Fed's QE II, economic growth (GDP) of 3% and the typical third-year rally of a President's term. But things did not work out as projected due to some fluky, one-time events such as a tsunami, a European financial crisis, a first ever downgrade of U.S. debt and a dysfunctional congress which got in the way. Yet despite all that, the markets were flat – I would say that is bullish by itself.

Besides, recent economic data suggests that the employment picture is beginning to brighten and manufacturing is expanding. Consumer confidence is on the rise indicating that consumers might be willing to increase consumption as they feel more optimistic about the future. With consumer spending representing 70% of the economy, this bodes well for the prospect of GDP to exceed the consensus forecast of 2% growth for 2012. Indeed, these are real substantive developments that need to occur before the markets can break out of the current trading range to the upside.

Putting It All Together

While it feels so good to be optimistic, there is something nagging me to be a bit more analytical and cautious. My primary concern centers on the global economy. It is hard to get too excited about a 1 or 2 month improvement in domestic manufacturing when over 40% of U.S. exporting partners are either in a recession or experiencing a slowing economy. Europe is in terrible shape and the debt crisis is far from over. Their financial and structural problems have been well documented. According to the Wall Street Journal, European leaders could not solidify a giant bailout fund because they just don't have enough money. Therefore, they are scrambling to assemble the foundation for a tighter fiscal union in order to encourage the ECB (European Central Bank) to support government bond-markets. What's most troubling is that the banking system in Europe is twice the size of the United States. It has taken us three years and major legislative initiatives and we still don't have a clear understanding of how our banking institutions are to operate. It will take the Euro zone far longer and several gyrations to work through their financial problems and cultural differences. The lack of political will and the fractured nature of the Euro zone will also contribute to many bumps along the way. As we found out in 2008, there is no decoupling in a global economy where money flows from one continent to another at the speed of light. Therefore, U.S. investors should be prepared for periods of uncertainty and volatility as the process unfolds.

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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In This Issue

Unfortunately, the Far East is no better. China, Hong Kong and Singapore have all released fairly disappointing economic data which has essentially gone unnoticed by the national media. All three countries have all indicated that both manufacturing and service PMI are both in contraction territory. In October, Chinese exports continued to drop on a sequential basis. Japan's government bond yields jumped as the International Monetary Fund warned about ballooning debt. Even India's industrial production dropped to its lowest level in 2 years.

The global slow-down has also infiltrated South America. Brazil, the growth engine of the continent, reported its slowest 3rd quarter year-over-year GDP number (+2.1% vs. 3.1%) in 2 years. All of this data points to ominous clouds that could seriously impact the U.S. manufacturing base. Should our trading partners experience a general economic slow-down, demand for our manufactured goods will decline and our factories will have to reduce production and cut employment. Furthermore, should the U.S. economy perform better relative to the United Kingdom, Europe and China, the dollar will appreciate in value, causing our exported goods to be more expensive relative to local products. This would then hamper the demand for U.S. products.

Domestic Answers

2012 should provide clarity for some lingering questions regarding the sustainability of the economy and the prospects for long-term growth. Consistent improvement in employment could be the catalyst to support broad based economic expansion. Although it appears that employment is stabilizing, the data is fraught with caveats. From November 2010 to November 2011, the total number of employed in the U.S. increased 1.68 million, or 1.2%. However, the total number of non-governmental employees, not in the workforce, increase by 1.79 million or 2.1%. Therefore, the number of people not in the workforce outpaced the increase in employment, even as the unemployment rate has fallen from 9.2% to 8.5%.

The political landscape will also become clear as the election draws near. Polls will provide perspective regarding who the potential winner might be. If it looks like Obama could be re-elected, then October might be a rough month for stocks as they re-price expectations for a more restrictive business environment with greater regulation and higher taxes. This scenario would likely hinder economic expansion. Conversely, if the Republican candidate looks to be the front runner, the markets could experience the opposite effect – all things being equal. Congress could also factor as a hedge on the markets. If Obama looks to be re-elected, but the House and the Senate fall under Republican control, then gridlock might be seen as a good thing. However, I would contest that view, as the country needs leadership on many fronts, especially the budget battle. Gridlock splits legislative branches and short of a clear mandate, might not produce the results needed to move the country forward both politically and economically. This would be a big loser for investors as prudent policy decisions get "kicked further down the road".

My big prediction for 2012 is that we will continue to see significant market volatility. The markets will gyrate in the current trading range until we get some resolution of the international debt crisis and domestic debt reduction. I think there will be plenty of time to be bullish this year, perhaps not quite yet. We recommend that investors keep at least 10% of their portfolios in cash and available to reinvest during periods of instability.

Annual Review

Changing Sentiment

In 2011, short-term traders had the upper hand as a tumultuous year of volatility provided opportunities to capitalize on brief periods of either trending bull or bear markets. Meanwhile, it was gut-wrenching for the buy and hold investor, who had to curb the impulse to buying stocks as prices rose and ditching them quickly as prices dropped.

The year started out innocently as the first four months produced relatively stable returns, based on what appeared to be an improving U.S. economy. The major indices hit their eventual high water mark for the year on the last trading day of May as the Dow was up over 10% and the S&P 500 and the NASDAQ were both up around 8.35%.

The exuberance did not last long as the European debt crisis began to take center stage followed quickly by our political leaders inability to agree on major debt reduction. This led Standard & Poor's to downgrade the U.S. credit rating to AA+ from AAA and stock prices continued to fall throughout the summer. In August and September, the economic data turned sour and it began to look as if the U.S. economy might dip back into a recession. The markets went crazy as volatility skyrocketed. On six separate days in August, the stock market finished either plus/minus 400 points or greater. The volume of trades (measure of investor enthusiasm) increased significantly, as fear grew. Investors did not want anything to do with stocks. By the end of September, the major indices had lost all of their previous gains and on October 3rd hit the low point of the year. The Dow was down almost 8% and the S&P 500 and NASDAQ were both down about 12%.

However, shortly thereafter, investor sentiment changed yet again on optimism for the resolution of the European debt crisis and better than expected domestic economic reports. The markets rallied strongly in October, and the S&P 500 exploded 13.6% - its best monthly performance since January 1987.

Thankfully, November and December were relatively non-eventful. Trading volume slowed significantly as investor preference shifted toward lower risk, dividend paying assets. For the quarter, the Dow and the S&P 500 were both up almost 12%, while the NASDAQ increased 8%. All of the sectors of S&P 500 were higher. However, it was the cyclical sectors of Energy (+18%), Industrial (+16%), Material (+15%) and Consumer Discretionary (+12%) that provided the catalyst for returns to move higher. The financial sector also did well by recording a 10% increase. Value stocks, with their higher dividends and lower volatility, did better than growth across all market caps.

The Dow (+6%) was the big winner for the year, out pacing the S&P 500 (+2%) and the tech heavy NASDAQ (-2%). Blue-chip U.S. multinational stocks, as defined by the Dow, outpaced riskier small-capitalized stocks of the Russell 2000 index by its widest margin in 13 years, according to the Wall Street Journal. The more risk averse and defensive sectors; Utilities (+15%), Consumer Staples (+11%) and Healthcare (+10%), with their high dividend payouts, helped the S&P 500 finish in positive territory. However, the domestic and international debt and banking uncertainty, negatively effected the financial sector (-18%) which was the worse group of the index. In fact, there were only two other sectors that were negative on the year; Materials (-12%) and Industrial (-3%). As I indicated earlier, large cap stocks significantly beat small cap stocks for the year and growth outpaced value across all market caps sizes.

Prognosticating

I love this time of year! It's synonymous to the beginning of a new sports season where anything is possible – depending on your perspective. The dreamers see visions of outsized returns while the naysayers position portfolios for Armageddon. Everyone has an opinion and they are more than willing to go out on a limb and tell you about it. For example, last December, Barron's Economic Editor, Gene Epstein, predicted that the economy would grow 3.7% in 2011. He listed 5 reasons to support his thesis – all failed to come to fruition. This year, Mr. Epstein did not make any predictions for 2012.

So why do so many pundits feel the need to engage in such propaganda when there is a high probability of looking foolish? The most logical answer is that it is fun! Who doesn't like making outrageous predictions just to see how it turns out? Besides, there are asymmetric return possibilities as there are no repercussions for being wrong, and the possibility for making a name for yourself if you are correct.

Professional investors can't afford to be cavalier with their assumptions as they help formulate investment strategy. If the strategy is wrong, then there will be a high probable that investment returns will not keep-up with the appropriate benchmark. A timely and well crafted strategy should be the roadmap for a portfolio manager to meet or exceed stated investment objectives. Periodically, strategies must be updated to reflect the fluid nature of the economy, political landscape, geopolitical events and changes in government legislation and regulation.

We don't prognosticate. Rather, we develop a strategy and follow through with identifying investment themes. In 2012, we believe that stock market volatility will continue as economic growth will be uneven. We are concerned about the growth prospects in China, India, Europe and Japan, and the repercussions on the U.S. economy. Although our economy is not as dependent upon exports as other countries, there is an economic psyche of interdependence that influences how consumers and corporations spend. What happens abroad will affect what happens here. We see declining GDP on a sequential basis, in the first half of the year, before rebounding later in the year. Secondarily, the news out of Europe will probably continue to be confusing and provide opportunities to buy and sell value stocks, perhaps all in the same week.

While companies are flush with cash, they are also comfortable with their profit margins and earnings growth rates. As such, we don't believe that corporate America will all of a sudden open up their checkbook and dramatically increase their payroll or wage rates. It is likely that employment will tick back toward 9% in the first quarter, as more people look for full-time employment. We anticipate that 2012 will provide multiple opportunities to create liquidity and find intriguing values.

Areas of Interest

Although the calendar flips and optimism is abound, we don't believe there will be an immediate improvement in economic conditions. However, we will likely liquidate the bridge assets (assets bought temporarily to stabilize portfolios and provide income during periods of extreme volatility and uncertainty) that were bought last quarter and reallocate into individual securities as evidence of a rebound builds. We would rather be a little late to ensure that economic growth takes hold, as opposed to jumping all in and realizing that we were fooled by a temporary uptick, similar to what happened in March and April of last year.

One of the winning themes for 2012 will continue to be energy. We will build on our current positions as we believe growth in North American shale present opportunities for long-term capital appreciation through both organic growth and acquisition. We have identified several American and Canadian companies that are in attractive positions to benefit from the exporting boom that is beginning to take place in gas.

We also like the industrial, consumer discretionary and technology sectors. As the economy recovers, these sectors will be direct beneficiaries from increased consumer and corporate spending. We are particularly underweight in the consumer sectors and are targeting the department store and specialty retailers as well as media companies. In the industrial sector, we are looking for defense contractors to bounce back as Middle East tensions come to ahead. Someone will have to deal with Iran. It will be scary, but necessary. My bet is that the U.S. will outsource its military action to Israel. Nonetheless, drone makers, communications and surveillance intelligence will be needed to monitor the situation on the ground.

My two dark horse sectors for the year include Financials and Healthcare. While it might be too early to invest in the large money center banks (due to the European financial mess), we do think there are some well run regional banks that have declining loan losses, significant capital, growing loan portfolios and no exposure to Europe. Besides, the general market can't sustain higher market valuations without participation from Financials. I subscribe to the notion that you can't have a healthy economy without a healthy financial system. At some point, the big money center banks must get healthy. The timing is the question.

The Healthcare sector could surprise in 2012 as we get some indication of the constitutionality of Obamacare in March. Should the high court rule all or part of that legislation is unconstitutional the sector could bounce back on hopes of higher margins. The health insurers will particularly benefit.

2012 will no doubt be interesting. We will continue to look for companies that pay dividends, have big cash balances, strong cash flow and financial flexibility. With all of the uncertainty and potential problems facing investors, our main goal is the preservation of capital. As I indicated last quarter, we would rather be out of the market - wishing we were invested, than being in the market wishing we were not. In the year ahead, there will be plenty of opportunities to put money to work. We will be ready to exploit market inefficiencies as they occur.

The Portfolio

Teekay LNG Partners (TGP) – is a Master Limited Partnership (MLP) that owns, or has an interest in a fleet of 36 oil tankers that primarily transport liquefied natural (LNG) and petroleum gas (LPG). Its parent, Teekay Corp (TK) owns a 44% interest in the Partnership. TGP negotiates long-term, fixed-rate charter contracts with major energy and utility companies. While much of the shipping sector has suffered from overcapacity and declining day rates, LNG and LPG carriers are benefitting from tight supply and rising demand due in large part to Japan and Germany. Since the tsunami and earthquake, Japan has shut-in much of the country's nuclear generation and looks to replace it with natural gas fired plants. This will increase the need for additional LNG imports. Germany is closing many of its older reactors and plans to have all of their nuclear reactors closed by 2022. The country will also look toward gas fired plants as a substitute and plans to increase LNG imports as it tries to reduce reliance on Russian supplies. The long-term fundamental shift in demand for LNG should help support higher shipping day-rates for years to come. Day-rates have jumped from $80,000 per day to $125,000 per day as demand has picked-up. Adding capacity is a quick recipe for growth. To that end, the partnership recently bought an interest in eight LNG tankers from A.P. Moller-Maarsk. Most of the tankers are new and five of the ships are booked under similar long-term agreements to that of TeeKay's current vessels. On valuation basis, the Partnership is trading at a discount to its peer group on a Price/Earnings and Price/Book basis. TGP also has strong cash flow, manageable debt and currently pays a 7.5% dividend and expects to increase its payout by 7% in 2012.

Halliburton Company (HAL) – We added additional resources to the HAL position that was established last quarter. The stock price fell as worries over a Macondo settlement over criminal liability between BP and HAL has yet to materialize, as the Federal trial date scheduled for February 2012, looms closer. However, due to the potential exposure and risk of the impending trial, we still believe a settlement is likely. The company has over $2 billion in cash on its balance sheet which should be more than sufficient to cover any settlement amount – even if it should reach the high-end of expectations around $1 billion. Halliburton's North American business remains robust while international markets are gradually improving. We believe that as the international markets stabilize, HAL should benefit. The company continues to trade at an attractive valuation as its forward P/E of 8 represents almost a 60% discount to its 5 year median average even as revenue grows 39% and earnings pop 60%.