LEGACY

ASSET MANAGEMENT, INC.

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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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In This Issue

NO LOVE

Diametrically Opposed

It's absolutely amazing that Congress can't work together. Politicians don't seem to understand that Main Street is less concerned with scoring political points than solving the major problems facing the country. The House, the Senate and the President are to blame as they are sucked into this media vacuum of winning and losing. Meanwhile, the country continues to spiral down a hole of financial and moral ruin. The sad fact is that neither side wants to do what is necessary to take a stand for entitlement cuts, though everyone knows, sooner or later it must be done. Ever wonder why these people want to go to Washington in the first place? Perhaps it is the cushy job, no accountability and sweet benefits.

According to the non-partisan OMB (Office of Management and Budget), tax revenue in fiscal year 2012 rose 6.4% over the previous year, as more people found jobs. Unfortunately, the government continued its out of control spending which resulted in the fourth straight $1 trillion plus annual budget deficit. Therefore, it seems logical that if the President and Congress wanted to generate more revenue and produce a balanced budget, the easiest and most politically efficient course of action would be increasing the employment base. As more people go back to work, Uncle Sam collects more revenue in payroll and income taxes. Unfortunately, political efficiency is an oxymoron in Washington as the battle between the psychological differences of the two parties rage. Rather than spending time pushing through symbolic tax hikes that will do very little to solve the budgetary problems, Congress should be exploring ways to incentivize business to invest and increase their payrolls.

Capitalism

My most memorable image of 2012 has to be Queen Elizabeth parachuting into the opening ceremonies of the Summer Olympics in London. While it was totally unexpected and incredibly witty, the symbolism of government parachuting down to save the day is rich in light of the "fiscal cliff' debate raging in Washington. I find it misguided that we celebrate a government that comes in at the nth hour to fix a fiscal crisis that they themselves created. The two parties could have worked together back in June to come up with a responsible fix for the mandatory expiration of the Bush tax cuts and the implementation of budget cuts. However, with images of European riots fresh in their mind, Congress punted because they did not want to face their constituents in an election year and have to explain benefit or entitlement cuts. Some call it smart. I call it a dereliction of duty.

I'm a free market capitalist. I don't believe it is productive or efficient to depend on government to solve the country's financial problems by throwing money at it or getting involved in free market operations. The public market is more experienced and competent at determining value, worth and survivorship. Take Obama's public investment in General Motors. Taxpayers initially put in over $49 billion of government money. The company paid back $23 billion after the Initial Public Offering (IPO). In December, the Treasury announced it would sell its remaining 200 million shares at a price of $27.50 per share. That equals $5.5 billion, and represents a total payback of only $28.5 billion, a 42% loss on an initial investment of $49 billion. I think American citizens would be shocked to know that their tax dollars were directed toward a capital market investment. I'm sure the President would counter that the civic good far exceeded the $20.5 billion loss. I don't believe that is a valid argument, but that is a debate for another day.

My motives are very clear. I want stock prices to rise. I want a pro-business environment that rewards profits and encourages innovation, capital investment and risk taking. Unfortunately, due to the dysfunction in Washington, corporate America has the ability ***but lacks the willingness*** to engage in these activities due to economic and regulatory uncertainty. Over the past year, companies have been successful at expanding margins and growing profits at the expense of research and development and investments in physical plant and human resources. In essence, capitalism has been on hold as business fears government. This path is unhealthy and unsustainable.

Financial institutions have a government target on its back. They play an integral role in any economic rebound. In most scenarios, they provide the necessary capital to facilitate growth. However, in light of the actions leading up to the financial crisis, Congress felt compelled to get involved and regulate and handcuff the lending function as well as other financial services. This caps economic growth potential and forces corporations to seek (1) non-traditional and more expensive forms of financing (2) choose not to participate at all. Either way, efficiency would not be realized. We need Congress to work together for the benefit of its citizens and unlock the chains around the neck of corporate America by striking a balance between oversight and regulation with pro-business principles that would allow corporations to operate efficiently. This would provide certainty and confidence and help reve-up the U.S. economy. Businesses flush with cash, would finally be willing to replace aging equipment, add production lines and hire employees. It's so frustrating when you see the possibilities. Yet, the powers to be in Washington would rather play games and support party lines rather than making real change that would benefit their citizens.

One Memorable Year

In 2012, markets kept climbing a "Wall of Worry" as equities gained for the 4th straight year, in spite of disconcerting headlines of negative revenue growth, Presidential election uncertainty and "falling off the fiscal cliff". While volatility was the theme in 2011, it surprisingly dropped to its lowest level in 3 years in 2012. Apple was the company of the year. It introduced a new phone and tablet with much fanfare. The stock price had dramatic swings – rising 73% from $405 to $705 in mid-September, before falling 25% to close the year. Hewlett Packard was the biggest disappointment as its stock price fell over 44% due to slowing PC, printer and copier sales. In addition, there was fraud allegations in one of its big acquisitions which will cause a multi-billion dollar write-off, and significant operating snafus that don't sit well with Wall Street. Other news worthy headlines and pop culture obsessions that cropped up in the year include: Tim Tebow going to the Jets, Facebook's disastrous IPO, the European monetary crisis, the Greek austerity program, France's failed 75% tax bracket, Hurricane Sandy, Obama's re-election, the "fiscal Cliff" and last but not least Oppan Gangnam Style! Clearly, there was something for everyone in 2012.

Volatility reared its ugly head in the fourth quarter as the election and fiscal cliff took center stage. Also, market sentiment turned sour as almost 70% of the companies that reported earnings through November reported negative guidance for the 4th quarter 2012. As a result, the Dow, S&P, and the NASDAQ all fell over 2%, 1%, and 3%, respectively.

However, for the year, the Dow, S&P, and the NASDAQ all finished with strong gains of 10%, 16%, and 16%, respectively. The significant outperformance of the S&P relative to the Dow can be attributed to the structural nature of the indices. The Dow Jones Industrial Average (DJIA) is a price weighted index and the S&P is market cap weighted. For example, Bank of America's stock price jumped over 100% in 2012. However, at $10 per share, Bank of America's bounce was less influential to the overall performance of the DJIA than say IBM which increased only 6%, but has a stock price $191. IBM has a weighting 19 times greater than Bank of America. More importantly, Apple which is not included in the DJIA is the largest contributing constituent to the S&P 500. Its price appreciation of over 31% had a significant impact on the S&P 500, representing over 7% of the index.

For the quarter and throughout the year, value stocks did better than growth as investors continued to flock to dividend paying stocks. Even among the smallest stocks that typically don't pay dividends, value did considerably better. What's out of favor one year usually turns around the next. That is exactly what happened for the Financial sector. In 2011, it was the biggest loser, racking up an 18% drop. However, in 2012 investors threw money into the high beta (riskier) money center banks, financial services and insurance companies leading to a 26% increase. As mentioned above, the big winner in the financial sector was Bank of America. As noted last quarter, consumer continued to spend on retail and cars which propelled the Consumer Discretionary sector to 22% gains. Other strong groups included Healthcare (15%), Materials (12%), Industrials (12%) and Telecom (12%). More conservative Staples stocks grew moderately (8%). The Energy sector, which led the market in the third quarter, slipped in the fourth quarter, ending the year up slightly (2%). However, the refiners continued to benefit from a glut of domestic oil supply. The Utility Sector (-3%) lagged considerably in 2012, as investors rotated out of safe (low beta) stocks in search of higher returns from riskier stocks.

Questionable Outlook

It doesn't look like it is going to get any easier for investors in 2013. No sooner are we free and clear from the political drama of the election, Congress decides to politicize and hold hostage the U.S. economy by not addressing the "fiscal cliff" and the debt ceiling. We believe that Legislators will agree on a last minute stopgap, watered down version of a Bill just to avoid going over the proverbial "cliff" and pushing off the real debate on spending cuts and deficit spending for another day. Resulting in more political rhetoric to distract and pollute the investment environment and cause unnecessary market volatility in 2013. Doesn't that sound exciting?

The majority of Americans recently polled by Rasmussen, expect the U.S. economy to fall into a recession regardless of the "fiscal cliff". I think it is too early to predict the ramifications of policy decisions without knowing the details. At this point, I am not willing to accept consensus thinking on this. There are too many variables that need to be considered. What we know now is (a) upper income earners will pay more in taxes, (2) there will be some budget cuts although

Congress doesn't have the appetite to dig into entitlement reform, (3) interest rates will stay low until the unemployment rate reaches 6.5% and (4) the debt ceiling debate is still looming as the national debt continues to grow in excess of the entire economy.

Clearly there are more questions than answers and now is not the time to be a hero. We encourage investors to stay liquid until there is some indication of what Congress will do. Most likely, January will come with little progress and much work to do, especially on the spending side of the ledger. Even if a deal is reached at the last minute, don't be suckered into an emotional rally. In addition, corporate earnings are projected to continue to slow and we don't believe the market has adjusted their expectations.

On an optimistic note, if we can successfully navigate through the fiscal cliff and debt ceiling debate with a meaningful resolution, then I would be more constructive on the short-term (through 2013) view of the market. My conviction is supported by the fact that corporations have been putting off capital investment since the financial crisis in 2008. With the guessing game behind it, businesses will finally be able to make strategic decisions on how best to grow. After all, Corporate America can't stay on the sidelines forever if they want to be considered a going concern. Increasing capital investment is a significant first step toward healing and growing the economy. As commerce begins to flow, employment, confidence and spending will pick-up which supports real GDP growth.

In 2013, we see two positive trends helping the equity markets. First, in an effort to generate more returns, investors will reallocate out of fixed income and into equities. Furthermore, we think the global economy should gain momentum, enabling investors worried about the U.S. fiscal cliff and its impact on the domestic economy, to look toward large-cap multi-national stocks, with diversified revenue streams to benefit. Typically, these stocks populate the industrial and technology sectors.

Overall, we remain cautious as anytime you have to rely on Congress to do something positive it is a risky proposition. Our motto remains – we would rather be out of the market wishing we were in, than being in the market wishing we were out of the market.

The Portfolio

This past quarter, Legacy was busy repositioning equity portfolios to better reflect value opportunities in specific industries. With the addition of Scott Jackon to Legacy's investment team, we were able to utilize his experience and insight to reposition client energy exposure to reflect the changing dynamics along the entire energy stream from exploration to refining. We sold **Schlumberger (SLB)**, one of our oldest holdings in the portfolio in favor of **Ensco (ESV)**, as the energy service fundamentals have shifted along with relative valuations. SLB is a major service provider to the shale industry. However, margins are declining as the shale revolution enters the mature stage and differentiation among service suppliers declines. SLB's margins are shrinking in North America due to (1) over building the fracking infrastructure over the past 5 years, (2) over exposure to fracking and (3) low gas prices. It will be increasingly difficult to improve profitability until the price of natural gas rebounds above $4.50. SLB has more international exposure than its peer group. However countries like Iraq and North Africa continue to be unstable and growth in these key regions has not developed as expected. Relative to its peer group, SLB trades at a higher premium and growth prospects are not as optimistic. On the other hand, Ensco (ESV) is a driller that focuses on the offshore markets. Demand for offshore rigs has been rising and is approaching historic levels. Offshore rig rates are priced off of International Brent/Waterborne crude rather than U.S. West Texas Intermediate (WTI) which is the new pricing metric for global oil. With $110 Brent oil, rig day-rates will be steady or climbing for the foreseeable future. Major future oil and gas exploration targets are offshore, mainly Brazil, Africa, the Gulf of Mexico, and the North Sea, which creates high demand for offshore drillers. Ensco trades at approximated 7 times future earnings and pays a higher dividend than SLB. Furthermore, they have one of the most disciplined and conservative management teams with the highest safety record among its peers.

We also sold **ConocoPhillips (COP)**, another long-term portfolio holding in favor of **Marathon Oil (MRO)**. COP is in a divesting phase as they have sold over $10 billion in assets to support its growing dividend and its stock buy-back plan. However, after the recent divestiture of its Nigerian Business, COP has become highly levered to North America natural gas price which should continue to trade in a depressed range from $3 to $4. As a result, the company will continue to have negative operating free cash flow until natural gas prices rise significantly. COP trades at a slight premium to other Exploration & Production (E&P) companies, while having limited growth potential and negative free cash flow. Marathon Oil is a global E&P company that derives 80% of its revenues from oil. Their steady international assets in Africa, the North Sea, and the Middle East generate free cash flow to help fund growth projects in the Eagle Ford and the Bakken oil fields in North America. MRO has invested significant capital in their Eagle Ford asset, which recently has produced positive drilling results. There is reason to believe their success will continue. The stock is very cheap relative to its peer group. It has significant free cash flow, good dividend, and its large Eagle Ford position serves as a strong catalyst to support future growth for years to come.

Finally, we bought **Suncor (SU)**, a Canadian based integrated oil and gas company with 90% exposure to oil. The company has strong growth potential in the oil sands with a steady 7% annual oil production growth through 2020. Canadian crude prices are at a historic discount to WTI oil. However, Suncor's refining assets offset this discount, and since gasoline and diesel are priced off of Brent, it gives Suncor an extremely high Brent exposure compared to its peers. With the combination of high Brent exposure, long growing asset base, 10% free cash flow, low historical valuation, and a growing dividend makes Suncor a great investment over the long term.

Legacy added three industrial companies to the equity portfolio. While each operates in a different segment, they have very similar characteristics. **Boeing (BA)**, **Deere & Company (DE)**, and **Norfolk Southern Corp. (NSC)** all trade at discount multiples relative to their five year historic average. They have dividend yields that exceed their peer group and have strong financial statements that support research and development (R&D), acquisitions, share repurchase or higher dividends. All options add value for investors and support higher share prices. In addition, Boeing is finally in position to benefit from its production cycle. BA met their delivery goal for both the 787 Dreamliner and 747-8 freighter and passenger carriers. Management expects production to double by the end of 2013. Also, Boeing has received significant launch orders for the new 737 MAX. The company's defense business is expected to maintain its margins in spite of expected defense cuts linked to Federal budget austerity.

Deere & Company operates in the agriculture and turf business and is susceptible to the nuances that affect farming. As such, DE sees tight global grain supplies in 2013, due to the monsoon in India, dry weather in Southern Europe and excessive rain in the U.K. Lower grain supplies typically supports farm equipment sales. Indeed, management has stated that combine production has sold out in the first half of 2013. The company also has an opportunity to reverse recent cost headwinds and operational snafus that have plagued the company in recent years. The combination of support for higher prices and improvements in operational efficiencies should help drive long-term profitability and enhance share price performance.

Norfolk Southern Corp. has been beat-up recently due to a dramatic reduction in thermal coal volumes associated to the Obama Administration's war on "dirty energy". However, the company is seeing a bottom form in demand and expects the bleeding to stop as demand for coal levels off. To offset coal shipments, NSC management has levered productivity gains by improving speed of delivery by over 12%. In addition, chemical shipments have increased 4% on higher crude volume from new oil business in the Bakken and Canadian oil fields to its 6 refineries across the northeast and southwest U.S. Auto parts, auto production, intermodal and natural gas shipping are all business segments exhibiting positive momentum. Improved efficiencies and leveraging growing businesses should offset slow coal shipments and provide an opportunity for the stock to move upward in 2013.

In the discretionary sector, Legacy added **Ford (F)** and **GNC Holdings (GNC)**. Both companies fit our value criteria on both an absolute and relative basis and pay an above industry average dividend. Ford sees opportunities to take advantage of an improving housing market as builders and contractors typically upgrade to new light vehicle and pick-up trucks with bigger pay loads to help meet the refurbishing demand. The company is leveraging its strong product launch cycle with attractive financing packages to lure consumers into trading up for newer body styles and technologies. Consumers have been on a new car hiatus over the last four years and there seems to be significant pent-up demand. New models should help support market share gains and profitability over the next few years. GNC, the new General Nutrition Center is a health and wellness retailer selling products including vitamins, minerals, herbal supplement, sports nutrition and diet products through a system of approximately 3,000 company owned retail stores and over 2,500 franchise stores globally. The company is riding the wave of strong industry trends as well as new product innovation. However, GNC is selling at a 12X multiple, its lowest level since the company's IPO in 2011. The market is anticipating slower sales as management initiates a broad rollout of the new Gold Card Membership program with more favorable terms and discount possibilities, along with a new marketing/media campaign for 2013. Nonetheless, Legacy believes that the momentum in the health and nutrition market is robust, long-term and sees opportunities to capitalize on short-term overreactions by the financial community. Management's conservative guidance of an 18% long-term growth rate is attainable and we look toward a rebound in the stock as Wall Street becomes more comfortable with company execution.

The last company we added to the portfolio was **American Express (AXP)**. As we indicated earlier, we don't believe the U.S. consumer is alive and vibrant. However, the upper middle to upper class will continue to spend regardless of what Washington engenders. Secondly, international trends are building momentum and should add support to earnings. AXP has done a strong job in managing its credit as net charge-offs have declined from 8.8% of balances in 2009 to 2.2%. 30 day + delinquencies have dropped from 4.6% of balances in 2009 to 1.4%, which is near a historic low. Legacy is attracted to AXP because management has developed strategic opportunities that should help the company grow their loan portfolio domestically and internationally. American Express is currently trading at a relative discount to its five and ten year average on most financial metrics. With steady credit, strong cash flow and growing loan portfolio, we believe AXP has opportunities to boost its dividend and realize full valuation.

We finally threw in the towel on **Hewlett Packard (HPQ).** While the company is financially stable with $9B in cash and cash flow to support its 4% dividend, operating problems, weak product demand and several years of neglect in capital spending on has significantly hampered the company's ability to generate revenue growth. At fiscal year-end on October 31st, HPQ reported a loss of over $12B compared to a profit of $7B in 2011. The company is under attack on all fronts; computers, printers, hardware, software and services as competitors have seized the opportunity to gain market share as the expense of Hewlett. We believe the stock is dead money until Meg Whitman can develop and implement a corporate strategy to reposition the company as a smaller, more focused technology company that is less reliant on computers and printers. We believe investors are better served in other stocks that have better growth and profit profiles.