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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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HOLIDAY CHEER

The Perfect Exit

If you have been reading this newsletter for any length of time, it is no secret that I am not a fan of Fed Chairman, Ben Bernanke's policies. Sure he was dealt a bad hand. In his first three years at the helm, he had to deal with the popping of the housing bubble, the financial crisis and both a domestic and a global recession. I can see the benefits of initially lowering interest rates and easing monetary supply to avoid any possibility of a depression. Once the economy stabilized, his policies should have been a bit more fluid; instead he kept the liquidity pedal to the medal throughout the next 5 years. Through a series of bond and mortgage buying programs A.K.A. Quantitative Easing (QE), he grew the Fed's balance sheet from $890 billion just before the financial crisis to over $4 trillion at the end of 2013. He pumped trillions of dollars into the economy by printing money and keeping long-term borrowing rates historically low with up to now, very little to show for it. The U.S. Dollar was shredded by the implementation of his easy money policies and is just now regaining its footing. Although the Dollar rebounded over 5% in the second half of 2013, it is still down almost double digits relative to the British Pound and high single digits compared to the Euro and Japanese Yen. Talk about unintended consequences. Bernanke's low interest rate environment made it very difficult for retirees to generate enough income in bonds to live comfortably. That is quite a legacy!

Nonetheless, the Fed Chairman successfully navigated the banking system through the financial crisis without any permanent damage. The S&P 500 has not only completely recovered from the 2009 lows, but has reached new all-time highs. While it may be hard to quantify exactly how much of the stock market gains are attributed to earnings growth, an improving economy or zero interest rates, there is no disputing that those willing and able to invest in risk assets were richly rewarded during the equity market rebound. Calculating how much of the economic recovery is already priced into the market is nearly impossible. That analysis will be relegated for another day.

At the December meeting of the Federal Open Market Committee, Bernanke scripted the perfect "Swan Song" for his departure by giving hawkish investors a slight reduction in QE while appeasing dovish investors by promising to keep short-term interest rates near zero into 2015. He truly did speak out of both sides of his mouth and Wall Street loved it! All major indices popped on the news. In fact, since the December 18th announcement, the Dow was down only one day through the end of the year. No doubt about it, Wall Street loves low rates.

The Legacy

Bernanke will be going out on top. Unfortunately, his true legacy will not be known for some-time as it will take several years before the full implications of his policies play out. You might remember that Bernanke's predecessor, Alan Greenspan retired as Fed Chairman in 2006 after 19 years at the helm. He was dubbed the "Maestro" for the way he navigated the economy through many domestic and geopolitical crises. However, it took only 24 short months before cracks in the housing and subprime mortgage markets caused many to question the validity of Greenspan's policies. By 2010, Greenspan was branded a co-conspirator to everything related to the financial crisis.

While Greenspan's tenure was spotted with policy changes, Ben Bernanke was, to a point, very consistent. As the economy continued to slowly grind forward, many politicians and economic critics wanted to see what would happen if he had eased his foot off the liquidity pedal. The theory being that the dollar would rise, commodity prices would fall and corporate investment would spur employment and manufacturing growth, while reducing the potential for long-run inflation. Nonetheless, Bernanke stuck to his guns in the face of intense pressure and never wavered from his easy money policies. As we head into 2014 with a new Fed Chairperson, the likelihood of a significant deviation in monetary policy is highly unlikely. Janet Yellen's policies regarding the unwinding of Quantitative Easing and their effect on economic growth, national debt, employment, wages and consumer spending over the next several years, will factor into Bernanke's legacy.

While I can't change my political and economic views regarding monetary policy, I do sincerely hope Yellen is up to the task of managing the transition to a rising rate environment. Bernanke deserves to be remembered favorably for his hard work under incredible duress. I am going to miss ranting about his overzealous monetary policy. Although, I have a sneaking suspension that the new Fed Chair will provide plenty of fodder to keep me busy for a while. Good luck Mr. Bernanke – and Godspeed.

In Case You Missed It

Cheers to 2013! What an incredibly interesting year it was! While the national media was captivated by diverse stories of The Boston Marathon bombing, the new Pope, NSA spying, gay marriage, Nelson Mandela, the birth of the royal baby and of course, Miley Cyrus and her twerking; business and financial news was much more mundane. The top stories focused on the stock market reaching seemingly new weekly highs, Ben Bernanke's retirement and QE "tapering". There were a couple of noteworthy business related stories that seemed to slip by the media's scrutiny.

In 2013, we may have experienced the next big wave of potential market manipulation through social media. In August, Carl Icahn, the billionaire hedge fund manager tweeted that he had just bought shares in Apple stock and within an hour of the tweet, according to Fortune Magazine, the company increased its market cap by $17 billion or 3%. Mr. Icahn has 90,000 followers willing to act on his tweets. Sounds like the potential for a classic front running scheme. While Mr. Icahn is probably not actively trading Apple stock, there are many unscrupulous investors that would not think twice about manipulating the market for a quick gain. Regulators better address this before individual investors withdraw their money in protest thinking once again the deck is stacked against them.

What is going on with old technology companies? The Win-Tel monopoly has crumbled due to an apparent paradigm shift as mature tech stocks are no longer considered the growth vehicles of the 90's. Rather, they are considered more defensive as they bring value to investors in the form of dividends and financial engineering. A lack of vision and innovation into the next generational change has caused revenue to slow and competitors to capture market share with new ideas. We are at an inflection point in the cycle where new leadership is needed to articulate a direction that will create future growth and markets. In 2013, Microsoft and Intel were both in the market for a new CEO in order to bring about new ideas to generate growth, particularly in international markets. Intel looked internally for their CEO, while Microsoft has yet to announce their replacement for Steve Ballmer, even though he announced his retirement over four months ago. Wireless chip manufacturer Qualcomm also announced the hiring of a new CEO. Other mature tech companies that have replaced their CEO's in the last 2 years include IBM and Hewlett Packard; both are struggling with the same industry issues.

Quarterly Review

Risk Rising Like Bubbles in Champagne

It has been a long haul, but after 12 years, 11 months and 28 days, the S&P finally reached a new all-time high in February, after surpassing the previous high set in March 2000. The momentum did not stop there, as the S&P subsequently moved higher, recording 55 additional new highs through the end of the year. The Dow too surpassed its previous peak and ended the year at new all-time highs, after adjusting for inflation. The Dow, S&P 500 and NASDAQ all jumped 26.5%, 29.6% and 38.3%, respectively. In spite of the NASDAQ's impressive year, it remains 872 points or 17% below its all-time high set at the top of the Tech bubble in March, 2000.

With the economy finally showing signs of improvement and stabilization in mature international markets like U.K. and Europe, risk became the most profitable theme in 2013. After years of living with sub-optimal income from low interest rate securities, investors changed their allocations to include volatile stocks with little or no dividends. This proved to be the winning strategy as growth stocks outperformed value over all market cap sizes. According to web-based financial media company Hedgeye, low yielding (or growth) stocks were up 44.2% relative to 17% for high dividend paying stocks. In fact, high risk stocks returned 38% in 2013.

Another contributing factor to the equity market's steady rise was due to corporate managers deciding to buyback a record amount of shares of stock rather than invest in their business. According to Birinyi and Associates, the 30 Dow components alone have authorized $211 billion in buy backs in 2013. That is nearly three times what the group spent on research and development, according to S&P Capital IQ. That is not the only reason the number of available shares are shrinking. According to Barrons, the number of public corporations has been cut in

half—from around 9000 firms at the turn of the millennium to 5000 today. When the number of available shares outstanding decline, demand for stocks increases, and as a result, the value of each share goes up. A classic example is Twitter. When the company went public in November, management offered just 80 million of its 544 million shares outstanding to the public. The limited amount of float, coupled with high demand, explains why the price of the stock escalated from an IPO price of $26 to over $44 on the first day. To complete the illustration, 125 million shares traded hands on that first day. However, with only 80 million shares issued, each share changed hands almost 1.5 times, causing the price to rise almost 73%. For those lucky soles that received shares at the IPO price and held the stock throughout the year, their return would have been 142%. As you can see, momentum can be a powerful force on Wall Street. In a slow growth environment, is it any wonder why companies are electing to buy back shares?

While the U.S. domestic and other developed international markets did remarkably well, other investments did not. The biggest laggards this year were the emerging markets, commodities and treasury securities. Emerging markets suffered from outflows of capital as investors realized gains from 2012 and rotated into developed markets. Gold, and other commodities, declined due to the strengthening U.S. Dollar, a pull-back from speculative highs of the past years and no sight of inflation. Lastly, we saw Treasury prices fall on the medium and long-end of the yield curve in anticipation of the wind-down of QE. The yield on the 10-year Treasury, which moves in an opposite direction to price, jumped 140 basis points from a low of 1.6% in May to slightly over 3% at the end of 2013.

The top sectors of the economy for 2013 included Consumer Discretionary (+41%), Healthcare (+39%) and Industrials (+38). The worst performing sectors were Telecom (+7%) and Utilities (+9%). The biggest individual stock winners for the year in the S&P 500 were Netflix (+298%), Micron Technology (+243%) and Best Buy (+237%). The two worst performing stocks were both from the Materials sector – Newmont Mining (-50%) and Cliffs Natural Resources (-32%).

The Consumer Discretionary and Industrials sectors are highly correlated with the economy. As economic growth picks up, it would be expected to see these two sectors lead the markets. However, not all groups within these sectors were out performers. For example, in Consumer Discretionary, anything related to autos, internet retail and casino activity significantly propelled higher returns. Surprisingly, and in contrary to all the headlines, homebuilder's significantly lagged the market and were the worst performing discretionary group, for the year. In the Industrial sector, the high flyers were concentrated to office services & supplies and airline & aerospace. Biotechs and health care distributors were the top performers in the Healthcare sector.

For the year, small cap stocks did better than their mid and large cap brethren. As it turned out, the larger the market cap, the lower the return. This is because large cap stocks are perceived to be less risky as they have greater access to capital, financial flexibility and typically pay higher dividends. Therefore, in this risk accepting environment, they considerably lagged small cap equities, with higher betas and more risk.

Good news! According to stock market history, after a year like the one that just concluded, it is not far-fetched to expect to see another year of double-digit returns. This begs the question, "Where should you put your money in 2014?"

Consensus Thinking

The Media, economists and most of Wall Street strategists believe 2014 is setting up to be another good year for the markets. Perhaps not quite as good as what we just experienced, but acceptable. RBC and JP Morgan appear to be the most bullish, with projected returns of around 12% for the S&P. Wells Fargo is by far the most bearish with a flat market projection. The truth will probably lie somewhere in the middle. So what is going to propel the market higher? It's all economics. Consensus has built in a stronger economic model for 2014. Everything from jobs to manufacturing and oil production should finally work its way through the economy. Stock market strategists predicting double digit gains site 3% -4% GDP growth for 2014.

The $100,000 question is what if they are wrong? When all of the gurus are thinking the same way, I become skeptical. Moreover, the so called experts seem to all be overlooking or discounting some important issues. If economic growth appears to be accelerating at a greater pace, the fear of more aggressive taper and corresponding rising rates could spook investors. Furthermore, none of the market strategists have stipulated any concern over the added cost of Obamacare or rising tax rates on consumer disposable income. In addition, a strengthening U.S. dollar (as we wind down on QE) could throw a monkey wrench into the rosy projection.

In order for me to buy into the whole group think concept, I would need to see corporate revenue growth exceed 5% and investment spending pick-up. Since the second quarter of 2011, revenue growth has constantly lagged earnings growth. Over the last two years, companies have been growing earnings via cost cutting and financial engineering (buying back shares). At some point the rate of earnings growth will subside unless substantial revenue growth returns. Corporate managers will also be under increasing pressure to seek out growth through acquisitions, capital expansion and research and development. As we see it, 2014 will likely be the year where economic strength and consumer and corporate confidence will play a larger role in the success of the Financial Markets relative to the financial engineering of years past.

After a run like we had last year, where all sectors of S&P 500 were up, we expect 2014 to be a stock pickers market. There is a high likelihood that clients might experience a greater number of transactions in their portfolios than in previous years, as we look to capture gains and redeploy capital into those companies that underperformed their peer group and the market. For example, as a group, the Consumer Discretionary sector had a fantastic year. However, on both a relative and absolute basis, the group is now expensive and trades at a multiple of 22 times earnings compared to 17 times for the rest of the market. However, that lofty valuation would not preclude us from possibly researching and investing in a stock from that sector that satisfies our value criteria. That is where stock picking will become a premium for investors.

Should the economy pick up steam, cyclical sectors like Discretionary, Industrial, Technology and Financial could have another banner year. If the global economy continues to stabilize and grow, then commodity and internationally diverse stocks should be direct beneficiaries. However, if it turns out that economic growth is only a one or two quarter phenomenon before reverting back to its recent stagnation, stable and income producing sectors like Telecom, Staples and Utilities should lead the market.

Regardless of the economic conditions, we will continue to stick with our individual value based criteria. We have had success with this strategy in the past and expect it to work in the future. With new ideas constantly evolving, we will continue to look for alternative ways to increase portfolio returns while reducing volatility. Legacy is looking forward to an exciting and challenging year as we continue to grow both organically and externally.

Portfolio Activity

With positive stock price momentum and limited available cash, we made only minor cosmetic changes to the equity only portfolio in the quarter. As discretionary managers, we have an obligation and fiduciary duty to execute the most efficient investment strategies for our clients. Therefore, with equities prices continuing to rise, we made the conscience decision to temporarily waive our policy of selling stocks that have excessive valuations until the beginning of 2014. This allows clients to defer capital gain tax ramifications for 15 months, rather than having to come up with cash to cover the liability in April. Furthermore, by waiting until 2014, investors can keep their money invested and working hard throughout the year to cover any potential tax liability.

We traded out one material sector stock, **Dupont (DD)** for another in **Freeport-McMoRan (FCX)**. Dupont is a science company with its roots in diversified chemicals. Over the last 18 months, the company has successfully transformed its business model by exiting high cost/low margin businesses such as coatings and colors, performance materials and nutrition in favor of the higher margins of agriculture. Investors have obviously liked this move as DD's P/E multiple has increased over 40% since the summer of 2012. Other valuation metrics are also significantly higher than its 5 and 10 year median. At the same time, earnings and revenue growth are expected to peak in 2014. In addition, as the stock price has risen, the dividend yield has dropped from 4% a year ago to 2.8% today. We believe the company could face headwinds in 2014 as easy cost cutting has been achieved and higher commodity prices and capital investment needs weigh on earnings. Therefore, we sold all positions in Dupont in order to seek out other opportunities within the Materials sector that have underperformed the market in 2013.

Freeport McMoRan is a diversified metal and mining company. It's one the world's largest producer of copper, gold and molybdenum. In May, FCX completed its acquisition of Plains Exploration & Production Company which further diversifies its product offering to oil and gas. Freeport's stock has significantly underperformed the market in 2013 based on a seemingly endless continuum of concerns ranging from copper prices and a potential work stoppage in Indonesia to an unnecessary and unwanted acquisition in the oil and gas sector. In addition, the talk of Fed taper has not helped matters as investors are concerned that the end of quantitative easing (QE) will lead to a stronger U.S. Dollar which could spell doom for commodities.

While there is some reason for caution, we believe many of these issues are being addressed by management and will subside in early 2014. For example, it seems unlikely that Indonesia will implement a ban on exporting raw or unprocessed mineral ores, especially when FCX is linked to a significant proportion of the country's exports. Secondarily, the price of copper has bounced off its lows on the back of an economic rebound in China and better overall global economic news. Finally, investors are beginning to see the advantages of the Plains Exploration acquisition as its on-land operations in the Eagle Ford and off shore deepwater drilling in the Gulf of Mexico add diversification to revenue. The company is clearly navigating through churning sea. Nonetheless, management is pairing debt, strengthening cash flow and increasing its dividend. On a valuation basis, FCX trades at an absolute and relative discount to its historical median averages as well as its peer group. However, as economic conditions improve both domestically and internationally, FCX will reach its full valuation.

Around The Firm

We would like to welcome Nicole Ventura to Legacy Asset Management. Nicole comes to us after five years as a financial advisor and branch office administrator with Edward Jones. Her experience there, as well as previous time in the service and hospitality industry, makes her a perfect fit to work as the correspondent between Legacy and its clients. Nicole was born in Germany, but raised in Alaska. She has a double major in Criminal Justice and Psychology from the University of Nevada, Reno. She recently relocated to Houston to be close to family.