PALISADE
Asset Management, llc

**First Quarter 2011**

# Quarterly Perspectives

**2011 Benchmark Index Returns**

| Index | YTD as of March 31, 2011 |
|---|---|
| S&P 500* | 5.93 |
| DJIA* | 7.07 |
| NASDAQ | 4.83 |
| MSCI EAFE* | 2.67 |
| Barclays Intmd. Govt/Corp | 0.34 |
| Barclays 3 Yr Muni | 0.78 |

*With Dividends Included


**James C. King**
jking@palisadeam.com

**Peter D. Rocca**
procca@palisadeam.com

**Dennis M. Ott**
dott@palisadeam.com

**Steven E. Landberg**
slandberg@palisadeam.com

**E. Thomas Welch**
twelch@palisadeam.com

**Paul J. Kronlokken**
pkronlokken@palisadeam.com

**Jennifer L. Fischer**
jfischer@palisadeam.com

**333 South 7th Street**
**Suite 440**
**Minneapolis, MN 55402**
**Phone: 612-455-2900**
**Fax: 612-455-2909**
www.palisadeam.com


## Market Recap

The first quarter ended on the upside even after digesting the global challenges we faced from the devastating earthquake/tsunami damage in Japan, the continual political unrest throughout the Middle East, and the debt laden European countries. All of the US and International equity markets were positive with the Dow 30 leading the way.

We view this global resiliency along with the increasing U.S. economic growth as positive signs that the economic recovery is continuing. We do however see market volatility throughout the rest of 2011 due to the continuation of global challenges. Although we see stock valuations covering the full range of under to overvalued levels, we continue to like large cap, higher yielding stocks due to their lower valuations and diversified global growth opportunities.

This quarter, we bring you our thoughts and opinions covering three diverse subjects where we question real inflation, we discuss ‘investment discipline’, and we review the challenges that special trusts present. We would be remiss if we did not recognize also that it is Spring, signaling a time for growth and a time for enjoying the outdoors again . . . and for many of us, it signals the beginning of baseball season - Go Twins!

## Inflation – Is It Here Yet?

**Paul J. Kronlokken**

The recently reported CPI showed modest inflation, at only 2.1%. We scratch our heads and wonder how can the rate be this tame with commodity prices soaring, the average consumer wincing when they go to the grocery store or the gas pump, and the Federal Reserve pouring money into the economy? We believe it is because of a lot of the stimulus is not stimulating, yet, and due to the variances in how the CPI is calculated.

As an example, wheat, corn and sugar are nearing or are at historical highs and gas prices have been approaching $4.00 a gallon faster than any of us care to witness. But the real effect has been nominal thus far. All the money that the Federal Reserve has been pouring into the economy was supposed to open our credit markets so homes could be sold and businesses could expand, but these outcomes are occurring slower than anticipated.

So why is inflation ‘only’ at 2.1%? Another part of the answer can be found in the way the CPI is calculated. Over the past few decades, a couple of important changes have occurred to affect how the CPI is calculated. Back in the mid-90s, the CPI calculation changed from including a ‘fixed’ to a ‘variable’ basket of goods. It was believed that as the price of a single item rose, consumers would substitute another cheaper item e.g. eat more hamburger when steak gets too expensive. Thus, the goods in the basket would change as well as the percentage weighting amongst those goods.

Also, over time, the quality and technology improvements of a product are affected. As an example, the average price of an automobile has risen significantly, but because of the improvements in safety and technology, the total price increase is not entirely reflected in the CPI. The CPI also has altered the way certain mathematical calculations are applied. Today there is greater emphasis on the goods with falling prices which has reduced the inflationary influence that rising prices have had on the calculation.

Is the CPI reflective of our real cost of living? Many have argued that the CPI no longer reflects the cost of living, but rather the cost of survival. With that line of thinking, what then is the real cost of living? Some economists using the older CPI calculation method have estimated that the current CPI is understating inflation by as much as 4%; bringing the current rate closer to 6% nearing the highs of the past 25 years. If that is the case, we should definitely begin to see the reported CPI move up.

The *Federal Reserve* however, has already stated that they will not be swayed by this rise in commodity prices, which they view as transitory. Similarly at Palisade, we do not expect to see a tightened monetary policy anytime soon. We see rates most likely moving up, but at a slower speed than many economists believe. In this uncertain inflationary environment, emphasizing high quality stocks at lower to historical valuations, with proven earnings and dividends, is still very much warranted.

## Investment Discipline in Volatile Markets

**Peter D. Rocca**

With the recent increase in equity market volatility, we are once again reminded of the importance of adhering to a disciplined and understandable investment strategy. Too often, market volatility causes investors to abandon their investment management disciplines and forget their basic rules to achieving long term investment success.

We are not stating that how we invest at Palisade is the only way to invest. There are a multitude of successful methods to achieving long term investment success. Our key point is that having a clearly defined method of how to invest in all types of good and bad economic/market periods is the best way to support long term investment success.

Behavioral Finance is "a field of finance that proposes psychology-based theories to explain stock market anomalies". One of the questions that this area of academic discipline tries to understand is, "What causes investors to act irrationally when faced with investment volatility?" We are in no way trained 'financial Psychologists', but our investment experience has given us ample opportunity to watch what human traits are at the basis of this erratic behavior.

It is not a simple explanation, but our simple opinion is that at the root of most poor investment decision making is *emotion*, combined with *inexperience* and *impatience*. Simply stated, *emotion* causes us to over- or under-estimate the facts and it is emotion that is at the root of greed and fear. Combine *emotion* with *inexperience* and it is easy to see how one can lose confidence in their process and adopt the emotions of a larger, reactive and non-disciplined group. Lastly, *impatience* comes from the lack of confidence and can further cause the abandonment of often sound investment disciplines.

We have also seen that the more complicated and difficult to understand strategies are even more difficult to adhere to in volatile market periods. At Palisade, we believe that during both up & down market volatility, the more simplified and understandable an investment process is, the easier it is to stay disciplined when emotions are peaked. We usually see after more extreme volatility (when emotion superseded discipline), that investors take a hard look at their philosophy and processes and often times work towards 'fixing' their previously used investment disciplines.

The data analysis process may be complicated, but we have found that long term investment success comes from sound decision making from disciplines that can navigate both good and bad investment markets. At Palisade, we understand this and also understand that the best way to achieve long term success is to not 'lose as much' in down markets. Our simplified and easily understood investment process protects performance on the downside and just as importantly, allows us to follow our discipline when the emotions of volatile markets run high.

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## The Challenges of Funding Special Family Needs

**E. Thomas Welch, JD**

We are often asked, "What is the most efficient way to fund my grandchildren's education?" A less known, but common solution is a 'Pot' trust that has been around for decades. Due to a Pot trust having multiple beneficiaries, they present both advantages and unique challenges for Trustees and Portfolio Managers. An alternative solution is a 529 plan. They are newer and although simpler to manage, they are limited to what they can fund and what investments can be used.

A common example of a Pot trust is a grandparent establishing and funding one trust for all of their grandchildren. The trustee can distribute funds to any grandchild, usually for specific purposes, such as education, home purchase, or for starting a business. These trusts are most commonly designed for the education needs of grandchildren. A distinct advantage is that Pot trusts offer spending flexibilities, but many unique challenges are created for the trustee, and even more so for the Portfolio Manager.

The initial challenge is caused by the age spread of the grandchildren. If the age range is close and the number constant, the challenge of managing both cash needs and growth needs in tandem is low. However, if there is a large age spread (we have experienced them as large as 20 years), the challenge of treating all grandchildren alike is difficult. The challenge increases when assuring that funds are not overspent on the older grandchildren and thus reducing the amounts available for the younger group, and vice-versa.

To create a portfolio that matches the beneficiary's unique needs, each Pot trust must consider the following:

- When it is likely amount that each grandchild will begin drawing on the portfolio?
- What type and level of education will the grandchildren want?
- If the trust terms allow for usage other than education, will occur, and if so, what are the timing of funding these other needs?

The next challenge is often times more daunting – projecting what the inflation factor for educational costs will be. In the past twenty years (1990–2009), education costs have tripled! Compare that with the CPI and the equity markets which have increased at a far lower percentage and an investment 'growth' challenge emerges for the Portfolio Manager.

With the above challenges in mind, Portfolio Managers must then build a diversified portfolio with the proper asset allocation of liquidity and growth so that the portfolio can withstand downside market shock and does not disrupt the educational and other current and future needs of the beneficiaries.

Recently, many grandparents have switched to using 529 plans for funding their grandchildren's education needs. These portfolios are easier to manage, but have less spending and investment flexibility. 529 plans can only being used for education and do not allow for investing in individual securities, only mutual funds. As 529 plans are separate for each grandchild, they can avoid the 'age spread' challenges, but like Pot trusts, they face the challenges of inflating education costs.

The choice of what type of vehicle to use depends on the specific goals of the grandparents. Whatever choice is made, grandparents should be sure that the Portfolio Manager and Trustee clearly understand their goals for the trust and the accompanying challenges.