PALISADE Asset Management, llc

First Quarter 2012

Quarterly Perspectives

2012 Benchmark Index Returns

Index	FEB	YTD
	February 29, 2012	
S&P 500*	4.32	9.00
DJIA*	2.74	6.47
NASDAQ	5.44	13.89
Russell 2000*	2.39	9.63
MSCI EAFE	5.44	10.98
Barclays Intmded. Govt/Corp	-0.05	0.97
Barclays 3 Yr Muni	0.36	0.93

*Dividends Included

2012 Growth or 2011 Repeated?

By Paul J. Kronlokken, CAIA

By most measures, the U.S. stock market in 2012 has started off on the right foot. Through the end of February, the popular indexes are all nicely positive, with the S&P 500 up 9.0%, the Dow Jones Industrials up 6.4%, and NASDAQ Composite up 13.9%. Thus far in 2012, the three leading sectors have been Technology, Financials, and Consumer Discretionary up 15.3%, 13.2%, and 10.6% respectively. The three worst performing sectors have been Utilities, Telecommunications, and Consumer Staples at -3.7%,-0.4% and +1.7% respectively.

The leaders have been the more economic sensitive sectors while the laggards are the conservative/ defensive sectors. So far, the economic optimism in 2012 has accelerated these sectors at a faster rate than the indexes. Although the markets are flirting with what the popular press calls “a new high since…”, some parts of the market are not signaling as robust of a recovery. Middle East tensions appear to be rising once again and the European economy is still at risk as it continues to address the numerous sovereign debt issues. Crude oil has rallied significantly above $100 per barrel. Other commodities as well have started to rally, signaling pressure on inflation.

Similarly in 2011, the U.S. stock market started out with the more economic sensitive sectors performing well and oil rallying, but once worries of unrest in Libya hit the markets in February 2011, the conservative/defensive sectors started to look all the more attractive. These same sectors then outperformed for the remainder of the year.

Could 2012 turn out to be just another repeat of 2011? No one really knows for sure. The equity indexes have had large positive moves to begin this year, yet the global challenges still exist. Because of this, near term the more defensive sectors may prove beneficial. However, looking out to the rest of this year and beyond, the economy and markets seem to have ‘legs’, so more growth/less defensive sectors (companies) should outperform.

Financial Repression

By Dennis M. Ott, CFA

Today, investors who are trying to achieve a return from fixed income investments are likely to feel depressed and unknowingly, they are feeling ‘repressed’ too. With interest rates at an all-time low, it is easy to understand why yield-seeking fixed income investors might feel depressed. ‘Repressed’ has now become a financial term, although more accurately, the term is “financial repression.”

Historically, the phenomenon of holding interest rates below inflation is a tool which originated in the 1940’s and 1950’s. Economists labeled this rate manipulation “financial repression.” During this period, the Federal Reserve Bank was fearful that after the Second World War, our domestic economy would slump into another Depression. Between 1948 and 1951, the Federal Reserve stood ready to purchase any and all Treasury bonds at around a 1% yield. This was substantially below the rate of inflation which was running close to 4%. War time rationing caused a backlog in the demand for most goods and services and when price controls were eliminated, inflation accelerated. Today, the same financial repression is being employed to aid our U.S. recovery following a very serious recession.

While I did not personally experience this earlier period of financial repression, senior colleagues of mine at First Trust Company of St. Paul (my employer just after graduate school) did. They often shared with me that during this period trust beneficiaries complained that income generated from bonds was insufficient. They requested that the managers/trustees invest more in equities, which at that time had higher dividend yields than bond yields. This variance forced managers to change their asset mix by emphasizing more equities than bonds. Looking back, this allocation change proved to be the correct investment strategy.

Today, we have a similar environment where high quality fixed income investments yield less than a diversified portfolio of high quality dividend paying stocks. While history does not always repeat itself, this illustration is worth bearing in mind when choosing an investment allocation and compares favorably to our strategy of strongly emphasizing stocks over bonds.

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Alternative Investments in Trust Accounts (Part I of II)

By E. Thomas Welch, JD

Of late, there has been an increasing amount of discussion related to using "Alternative Investments" (AI) in fiduciary (trust) accounts. As we manage portfolios for a number of fiduciary accounts, we decided to spotlight this trendy class of investments based on both our firsthand experience and our ongoing analysis of AI. As this asset class is quite broad, we will address this subject matter in this and the next quarterly newsletter. From the perspective of a trustee, we will define the AI asset class, discuss fees, and review the importance of general risk management.

<u>What is an AI?</u> Most managers and promoters of AI define this class as any investment other than the three main asset classes of stocks, bonds or cash/cash equivalents. As you can surmise, this common definition of AI opens up an extremely broad spectrum of investment choices. As many of you know, a more common name for most AI are 'hedge funds'. We are not sure why AI are being used more prevalently now in trust accounts following the high level of risk and poor performance that so many hedge funds recently experienced. We all learned in the debacle of 2008-2009, that most of these investment strategies were anything but 'hedged'. In addition to the more common AI strategies that we discuss below, this asset class also includes less common investments in personal loans, airplanes, trains, and can even include Saguaro cacti (this author is writing from Arizona).

<u>What are the more common types of AI?</u> The ones that we hear about and review the most are 'long-short' equity strategies, private equity, venture capital, commodities (gold, silver, corn etc.), real estate, and currencies. We question how the long-short strategies are included as AI as these portfolios hold mostly long and/or short positions in publicly traded stocks. Hmmm, could this be because the manager receives higher fees when operated as a hedge fund? Although the above strategies are the most common, we have seen AI portfolios that owned a regional airline, train cars for leasing, or ocean-going tankers. As of yet, however we have not seen any Saguaro investments.

<u>What are the fees and internals costs of AI products?</u> It is commonly known that the fees charged for AI are generally much higher than fees by more traditional long only, stock and bond investment managers. A common AI fee structure has the manager receiving a 1-2% annual base fee plus a 20% share of profits of returns above a selected growth index ('success fee'). We have also seen some hedge funds that do not tie this 20% to out-performing an index and net out even higher fees. For less liquid more esoteric AI strategies, the success fee is often times eliminated. Additionally, there are varying ranges of internal expenses that AI have. The expense % variance is great and depends on the structure of the investment entity, but can range from ½ % up to 2% annually. We have found that expenses are the least clearly communicated, so we instruct our clients to understand these cost details prior to making any AI.

<u>How does a trustee manage the risk of owning AI?</u> If trustees were to think about directly shorting stocks, they would be concerned with the unlimited liability that could occur if they were wrong on the direction of the shorted stocks. Additionally, if trustees were to buy commodity futures contracts, they would be concerned about the leverage factor and higher levels of risk. If they bought real estate, they would be concerned about the leverage and negative cash flow effect on the trust account. These risk factors make holding AI directly in trust accounts almost impossible.

However, the vast majority of AI strategies are held within an entity wrapper such as an LLC or LLP which then presents a shield to limit the unlimited liability to the AI investor/trustee. Although the entity wrapper may protect the investor/trustee from unlimited liability, the underlying risks of the investment are still present. These partnerships can buy and sell almost anything and are allowed to create high leverage within the entity. They also have limited liquidity, and charge high fees and expenses at the entity level. Thus, this entity wrapper seems to allow the trustees to do indirectly what they cannot or would not do directly, but in no way does this eliminate the investment risk.

As you can see, there are many layers of complexity in a trustee's true understanding the of the AI asset class. In next quarter's Palisade Newsletter, we will continue this discussion and delve into other issues such as - specific risks within different AI entities, liquidity, performance and the myth of negative correlation preached by nearly all AI marketers.

PALISADE NEWS – Publications Recognition

Firm News:
Palisade Asset Management was ranked #26 in the U.S. in the category of "Emerging Registered Investment Advisors (RIAs)" by *Financial Planning* magazine in their January 2012 edition, and the only Minnesota firm to receive this distinction. The Emerging RIAs were measured by their annual growth in assets under management.

Investment News:
In the February 2012 edition of the *Emerging Manager Monthly Newsletter* (Vol. VII, Issue 2) Palisade's *High Quality Growth* equity strategy performance was recognized as one of the top U.S. firms for the 2011 4th quarter and the entire year's performance when compared to the Russell 1000 Growth Index.