PALISADE
Asset Management, llc

Quarterly Perspectives

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The Palisades – Hudson River, NY

Equities vs. Bonds and Expanding U.S. Debt

By James C. King, CEO

Over the last several months, the equity markets have had a steady upward bias; a continuation of what we have seen for this entire year. However, the equity markets are now beginning to feel like they are treading water, waiting for the presidential election to provide clarification on where they should go from here. Even with the growth of the U.S. equity markets, we still feel that owning equities presents a continued growth opportunity for investors.

The equity valuations of the higher quality ranked companies do not have us concerned. These equities that make up most of our investment universe are definitely in the lower percentage of their historic valuation ranges. In particular, the health care and industrials sectors are historically inexpensive with valuations at or near 25-year lows. We believe this is due to the uncertainty that surrounds health care legislation, defense spending, and the strength of the continued growth in the emerging markets. Additionally, our research shows that dividend payouts of these companies are increasing, while dividends, as an overall percentage of company earnings, are low.

In contrast to these lower equity valuations, bond valuations are at unprecedented highs due to the Federal Reserve intervening to keep interest rates at artificially low levels. When looking at the current bond market, I am reminded of what bond yields looked like back in 1976, where a 10-year Treasury note was yielding 8% when issued. Similar to today, the yield was at a low compared to where yields were to rise to. As yields rose, these 8% bonds dropped to as low as half of their issue price prior to maturing in 1986! While investors received their money back if they waited the ten years to maturity, the *interest rate risk* and the *opportunity cost* of continuing to hold that bond were significant. Compare this to today's 1.80% 10-year Treasury note with inflation looming in our future, and we see holding equities for yield as a viable yield option over bonds.

Expanding U.S. Debt

I recently read an article by a moderate think tank comparing our government's percentage of GDP spending to the percentage of GDP spending in Spain. Going back to 1938, our U.S. government's spending at all levels was at about 15% of GDP. By 2010, U.S. spending had grown to over 36% of GDP. Today, Spain's spending levels are very similar to the U.S., and both of our total debt/GDP ratios are quite high; ours is 103% vs. Spain's at 68%. As we all know, Spain's government is on the brink of bankruptcy. As stock investors, the thought of our U.S. debt continuing to rise is concerning to us.

Simply put, if the U.S. is to avoid the fate of Spain we need to reduce the percent of government spending and/or increase revenues. Reducing government spending is pretty straightforward. How we accomplish this reduction is the challenging part that our politicians face. Increasing government revenue comes from increasing tax revenues paid by companies and individuals. There are two ways this increase can be accomplished- tax rates can be raised, and/or tax revenues increase from expanding economic activity.

As an investment management firm focusing on growing our client's investment portfolios, we support economic legislation that stimulates growth in business, increases economic activity, and develops an increase in tax revenues. Working towards a balanced budget is a challenging task, but essential for the health of our economy. Read on as my partner Peter Rocca expands upon this further.

Thank you for allowing us to share our thoughts with you. Enjoy your fall season!

2012 Benchmark Index Returns

(September 30, 2012)

INDEX	**SEPT**	**YTD**
S&P 500*	6.35	16.44
DJIA*	5.05	12.17
NASDAQ	6.17	19.62
Russell 2000*	5.25	14.23
MSCI EAFE**	6.14	6.95
Barclays Intermediate Govt/Corp	1.40	3.53
Barclays 3 Yr Muni	0.59	1.88

**Dividends included*
***The MSCI EAFE Index is a free float-adjusted market capitalization index that is designed to measure the equity market performance of developed markets, excluding the US & Canada*

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"Fiscal Cliff" and Excess Regulations

By Peter D. Rocca, CIMA®

At Palisade, we try to avoid discussing politics with our clients or in our quarterly newsletter articles. We hold varying opinions, but we believe our mandate to our clients is to help them invest and manage their money in the most efficient and effective way we know. This rule makes for managing our daily emotions much easier in a business environment which has more than enough daily volatility to go around.

Rather than predict what economic outcomes will occur based on who we elect as our next President and members of Congress, we want to summarize, and comment on the "Fiscal Cliff" – the large and looming combination of year-end tax increases due to the likelihood of tax cuts reverting to the higher pre-Bush levels <u>and</u> decreases to government spending.

Year-end Tax Increases:

- Expanding the number of taxpayers subject to the higher Alternative Minimum Tax (AMT)
- Capital gains tax rates increasing from 15% to 20%
- Long-term dividend tax rate increasing from 15% up to ordinary income tax rates
- Federal tax rates at all tax brackets increasing by 3.0-4.6% to rates not seen since 2001
- Payroll taxes for employees on Social Security increasing by an average of 2%
- The Estate "death tax" expanding, as it reverts back from $5 million to an only $1million tax qualifying level

Key Decreases in Government Spending:

- Unemployment benefits for some three million Americans will be cut off
- The Pentagon will start 2013 with a $55 billion budget cut
- Federal payments to doctors who treat patients using Medicare will be reduced by about a third

As Jim King highlighted in his article, we are concerned about the expanding U.S. budget deficit. We are even more concerned that these "Fiscal Cliff" changes are too big for our fragile economic recovery to absorb all at once. If nothing is done to alter these changes, the bipartisan Congressional Budget Office is predicting that our U.S. economy will revert back into a recession. As a financial management firm concerned with the long term strength of the U.S. economy, the growth of publicly traded companies, and for the best financial interest of our clients, we support a more gradual fiscal management solution; a solution that reduces the amount of changes in the "Fiscal Cliff".

Additionally, while we understand the reasons that have created the increased amount of government regulation placed on our financial industry and corporations, we feel that we have gone from a pre-2008 under-regulated environment to over-regulation that has a stifling effect on increased economic activity. Again, as investment managers we are in favor of more effective regulation that curbs excessive greed and improper financial behavior, but supports overall business growth.

Whichever candidate wins, we hope that party politics are set aside and they lead our country out of the economic difficulties we are facing. We need our President to lead Congress through bipartisan supported change, for the best long term economic interest of our country. This is a challenging, but in our opinion, an achievable outcome.

ROBO Investing!

By Paul J. Kronlokken, CAIA

Palisade has been fortunate over the past several months to gain new accounts from a few large local investment organizations. For a variety of reasons, these clients were uncomfortable with their previous investment situation and wanted to change to a new investment manager. When reviewing these new accounts, we were alarmed at the multitude of securities these accounts held. We also noted that when these investment portfolios were being constructed, there was limited regard for the tax ramifications that occurred when changes were made.

Generally speaking, all of these new accounts held 25-30 individual stocks plus an additional 20-30 mutual funds/ETFs (Exchange-Traded Funds). The portion of assets invested in individual stocks was generally in higher quality companies, with some similarity to what we invest in for our clients. What is worrisome however, are the remaining investments in the excessive quantity, of often overlapping, and over-diversified group of funds.

We analyzed these funds and discovered that the combined funds owned thousands of securities. We would not expect the previous investment manager to know the details of what the client held amongst these funds as it is nearly impossible to track and understand the multitude of different securities.

After further investigation with one client, we found that systematic selling of long term holdings of good quality stocks had occurred to purchase their model of stock and fund portfolios. When further inquiries were made, the prior investment manager could not provide detailed reasons for the changes that created large amounts of capital gains, nor could they describe exactly what the client currently owned. The client sarcastically surmised that it seemed as if a robot had taken over the trading of their accounts.

We also noted that at the different investment organizations that the investment mix of funds was quite similar. We doubt that the same collection of funds were the best mix for matching to the different client's needs. From this, we surmise that the same type of robotic investing is taking place at the other large investment organizations.

Recently, the U.S. investment Money Flow reports have shown a trend of billions of dollars a month flowing into ETFs; many of the same ETFs that we saw in the above referenced client's portfolios. We do not dislike funds, we just want to make sure that we first understand them, and that they appropriately diversify and compliment the other securities in a portfolio. We strongly doubt that clients of the organizations that practice this ROBO investing really understand what securities they own.

At Palisade we focus on completing detailed research on securities to understand and support our disciplined investment strategies. By doing so, we can thoughtfully customize each client's portfolios to match their specific investment needs. Additionally, by keeping our security holdings to a manageable quantity, we find that our clients understand what securities they own and why they own them.