The Palisades – Hudson River, NY

A Perspective on Risk in Today's Equity Markets

By Peter D. Rocca, CIMA

When reading the multitude of investment market predictions, I am always amazed at the disparity of these predictions. At the extremes, there are those who believe we will see the current S&P values going below the lows in March of 2009, and others who believe that this market will continue to strongly move upwards for two or three more years. This is all rather confusing to most investors. At Palisade, we counsel our clients to pay less attention to these predictions and instead focus on their long term goals and put short term market risk into an appropriate perspective.

To best evaluate these short term disparities of opinions, we look beyond all of this predictive "noise" and analyze in detail the valuations of the equities that make up our monitored universe. In a separate article, Jim King discusses how we analyze security valuations. I want to focus on how we view investment risk, as it relates to our clients, on a few different levels.

From the client's perspective, finding a broad definition of "investment risk" is difficult with so many specific types of risks related to investments: inflation risk, interest rate risk, credit risk, valuation risk, timing risk, and volatility/comfort level risk. Finally, we uncovered a definition that accurately describes the key investment risk that our client's face: "*The chance that an investment's actual return will be different than expected*." We agree that the most important risk from our client's perspective is clearly not meeting their investment expectations.

As Investment Managers, our role is to address daily the above mentioned investment specific risks so as to best manage our client's investment expectations. Additionally, we need to ensure that our client's expectations are realistic and that we have a clear plan to meet those expectations.

As you would expect, the most common client expectation is to grow their assets through the investment strategies that we manage. We know, and our clients do as well, that investing in equities can be volatile. We know that equities are at times undervalued and at other times overvalued; however, we can't control these valuation levels. Unless our clients have a short term need to spend their investments, their assets are positioned to withstand this volatility so as to best achieve the desired long term growth.

So where is the risk in the current equity markets? Current equity valuations are not as low as they were, but they still represent the greatest opportunity to achieve long term growth. With money market funds paying little interest, and overbought bonds providing low yields, what better investment option is there? All of this risk discussion boils down to the fact that for our clients expecting long term growth, the real risk of meeting expectations in today's equity markets is not that they <u>are</u> invested, but just the opposite, the real risk lies with NOT being invested at all.

2013 Benchmark Index Returns

July 31, 2013

INDEX	JULY	YTD
S&P 500*	5.09	19.62
DJIA*	4.18	20.06
NASDAQ	6.56	20.10
Russell 2000*	7.00	23.97
MSCI EAFE**	5.24	7.53
Barclays Intermediate Govt/Corp	0.31	-1.15
Barclays 3 Yr Muni	0.37	0.33

**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*

James C. King
Principal, CEO & Portfolio Manager

Peter D. Rocca, CIMA
Principal, Business Development & Client Relationship

Steven E. Landberg, CFA
Principal, Portfolio Manager & Client Relationship

Paul J. Kronlokken, CAIA
Principal, Portfolio Manager & Client Relationship

Dennis M. Ott, CFA
Principal, Portfolio Manager & Client Relationship

E. Thomas Welch, JD
Principal & Business Development Manager

Jennifer L. Fischer
Principal, CFO & CCO

Is the Stock Market Overvalued?

By James C. King, CEO

Lately, we have heard much discussion of how the equity market indexes are at all-time high levels and that the timing of owning and/or, adding to equities is not good. It is important not to get fixated on these new index highs for a couple of reasons. First, "new highs" have less meaning when inflation and valuations are factored into the discussion. Second, in viewing current valuations in the context of historical valuations, we feel equities are reasonably valued.

At Palisade, we spend a great deal of time analyzing both individual company and equity market valuations. To truly assess if equity valuations are high, our focus is to understand current valuations in the context of historical valuations. Chart 1 below shows the comparison of the current vs. historical price earnings (P/E) values of a diverse group of large cap individual companies. For most of these companies, current P/E values are below the historical median P/E values.

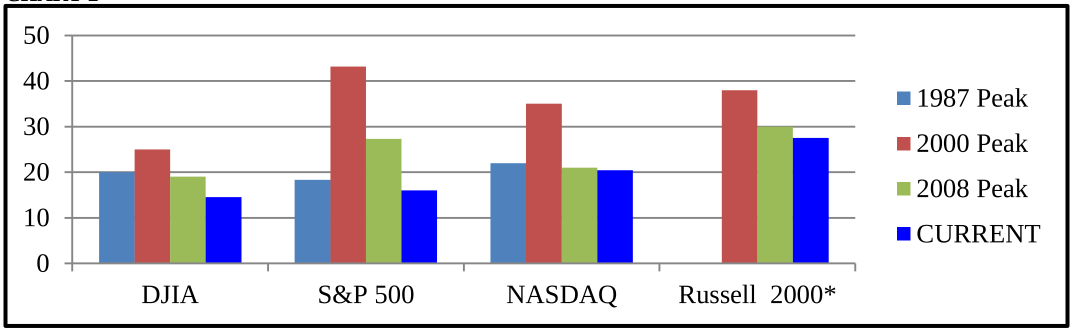
CHART 1

INDIVIDUAL EQUITIES	SECTOR	CURRENT P/E[1]	HISTORICAL P/E RANGE[2]			CURRENT P/E as % of MEDIAN P/E
			MEDIAN	LOW	HIGH[3]	
Chevron	Energy	10.3	12.5	5.6	30.5	82%
General Mills	Consumer Staples	19.6	17.6	13.0	25.9	111%
IBM	Technology	12.0	16.3	9.6	76.8	74%
MMM	Industrials	18.4	18.9	8.8	28.7	97%
Target	Consumer Discretion	15.2	18.5	9.5	34.5	82%
UnitedHealth	Healthcare	13.9	20.3	6.6	35.4	68%

To Note:
[1]Current P/E ratios are based on stock prices as of 08/06/13.
[2]Historical P/E ratios are based on the past twenty year period, 1993-2013.
[3]High P/Es generally did not occur during market cycle peaks.
Data source – Baseline, Inc.

On a broader scale, when understanding the P/E values of the current equity indexes vs. the last three U.S. equity index peaks, the current equity index P/E values also appear to be reasonably valued as shown in Chart 2 below. It is also important to remember that not all equity indexes are valued the same. Depending on the types of equities owned (large, small, etc.), P/E values can vary widely.

CHART 2



To Note:
**The Russell 2000 (small cap) Index P/E data is not available for the 1987 market peak.*
Actual Market Peaks occurred on 08/25/1987; 03/24/2000; 10/19/2007
Data source – Baseline, Inc.

In comparison to the current bond market's valuation that is selling at near all-time highs, the equity markets, especially the larger cap stocks of the DJIA and the S&P 500, look relatively inexpensive and less risky. With the S&P 500 index dividend yield at around 2.4% vs. the 10 Year Treasury Note currently yielding 2.5%, owning equities continues to be compelling in spite of the equity indexes selling at a "new high".

Based upon the P/E values of the different equity indexes, it is our feeling that the overall equity markets are reasonably valued; especially the larger cap indexes. Predicting near term equity market movement is difficult and although valuations are reasonable, we are realistic in our belief that to insure the continuation of the upward movement, the economy needs to continue to expand, even if modestly.

The Great Rotation Revisited

By Steven E. Landberg, CFA

In our last quarterly newsletter, we addressed the highly anticipated "Great Rotation" that called for investors to exit bond funds en masse and invest their proceeds into equity funds. At that time, our analysis concluded that such a great rotation was not occurring and that all the hype was, well, simply hype. What our research suggests now is that the Great Rotation cycle appears to be a three-step, not a two-step process: bond mutual funds are sold with the proceeds reallocated to cash; then eventually, the cash is invested in equities and equity mutual funds.

Today, many of those that called for the Great Rotation have changed their views. Bank of America, for one, recently downgraded their call for a "Great Rotation" to now simply a "Mini Rotation". On the other hand, Ed Yardeni (Dr. Ed's Blog, July 16, 2013) correctly refers to what has recently occurred as a "Great Liquidation". Of late, investors have liquidated (sold) their bond mutual funds and placed the proceeds in cash rather than rotating them into equity mutual funds. This liquidation out of bonds and into cash is supported by the recent Investment Company Institute (ICI) data which showed $66.7 billion exiting bond mutual funds during a recent five week period. During this same five week period, only $0.3 billion flowed into equity mutual funds, which further substantiates the rotation of bond funds into cash, not stock funds.

Will investors eventually move their cash, as well as rotate their bond allocation into equities? At present, we are not sure when this movement will happen, but we are starting to see certain market dynamics that will begin to finally support this reallocation. We believe the real impetus for this rotation will depend on short term interest rates. If short term rates continue to remain at historic low levels, investors seeking some type of return on their investable funds will feel more pressure to reallocate to equities. This migration will also be spurred along due to a recent increase in long term interest rates. The rise in long term interest rates caused many bond funds to lose value in the last quarter bringing negative returns year-to-date. As investors are reviewing their quarterly statements, they are realizing that bond funds are not the safe haven they perceived them to be. Combining that realization along with the equity markets continuing to steadily perform, we feel that investors will soon begin to reallocate their bonds/cash into equities.

Perhaps over the next few quarters, we will see the Great Rotation that we have heard so much about. Keep your eyes peeled everyone.

Palisade's High Quality Investment Strategies

Palisade Asset Management, LLC is dedicated to investing in disciplined equity and fixed income strategies. We employ a customized investment allocation process that integrates an optimum combination of investment strategies for each client. Our strategies consist of the following:

High Quality Growth
Large Cap Equity

- Invest in high quality, large cap, growth stocks that pay dividends
- Majority of stocks ranked "A+" or "A" by Standard & Poor's
- Invest to participate in strong earnings and dividend growth
- Build portfolios with relative concentration; owning a maximum of 30 stocks
- Utilize a proprietary valuation modeling system

Core Growth
Multi Cap Equity

- Invest in high quality, growth stocks
- Diversified across 40-50 stocks; $1 billion market cap or greater
- Portfolio has an emphasis on owning high quality Midwest companies
- Investing to participate in strong earnings growth
- Flexible portfolio construction to match client specific needs

Tax & Tax-Exempt
High Quality Fixed Income

- Investment discipline stresses attaining superior relative yields
- Utilizes a more conservative management strategy
- Strong economic, market, and credit quality analysis to minimize security risk
- Maturity structure based on yield curve shape/slope, or directed by cash flow needs
- Portfolios customized to meet specific client needs