PALISADE
Asset Management, llc

Quarterly Perspectives

First Quarter 2014

Palisade Panorama – Sierra Nevadas, CA

2013 Benchmark Index Returns

Dec 31, 2013

INDEX	DEC	YTD
S&P 500	2.53	32.39
DJIA	3.23	29.57
NASDAQ	2.94	40.12
Russell 2000	1.97	38.82
MSCI EAFE*	1.41	19.43
Barclays Intermediate Govt/Corp	-0.63	-0.86
Barclays 3 Yr Muni	0.00	1.32

Dividends included for all equity indices
**Dividends not 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.*
Sources: Interactive Data Corporation

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Expectations for an Eventful 2014

By Peter D. Rocca, CIMA

The growth in the 2013 U.S. equity markets marks a memorable year. 2013 saw its share of event driven volatility, but less than what we have come to expect over the last five years. Also noteworthy, just days before the Budget Conference Committee's December 13th deadline, two lawmakers, Rep. Paul Ryan (R-WI) and Sen. Patty Murray (D-WA), spearheaded a two year budget deal, finding a way to keep the government running past the January 15th current continuing resolution date. Although the budget issues are far from being resolved, this budget extension was encouraging amidst all of the partisan politics.

Major issues will continue to be a focus for Congress in 2014 which, in our opinion, will bring both continued fiscal uncertainty and potential market volatility. Budget differences between the parties remain. Congress will continue to debate the debt limit, which may not be addressed until the middle of the year after there is a better understanding of government tax receipts. Choices still need to be made surrounding tax reform, but this most likely won't be addressed until after mid-term elections. Lastly, it is our opinion that U.S. taxpayers won't fully understand the effect of recent tax increases until their taxes are filed. Investors have enjoyed strong equity growth, but this positive feeling may erode after taxes are paid.

After such a strong year of growth, how will the U.S. equity markets respond in 2014? When compared on an historical basis, are current equity valuations overpriced? Will we see continued organic earnings per share growth? Read on as these questions are discussed by Palisade Investment Managers Paul Kronlokken and Dennis Ott. Also in this Newsletter, Tom Welch reviews the tax changes on trusts, an important issue for many of our clients.

"My stocks are all going up again. Is that a bad sign?"

By Helen E. Hokinson, originally published 06/17/1937

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Differing Valuation Signals

By Paul J. Kronlokken, CAIA

With 2013 being recorded as one of the better performing years in the past several decades, questions of overvaluation have become common among investors. A recent Nobel Laureate, Robert Shiller, has sounded the warning bell and some popular Wall Street strategists are calling for varying degrees of market corrections. To analyze these varying opinions, we decided to complete our own research on the current valuations, and share our results with you.

At Palisade, we have always focused our earnings research on reported earnings after extraordinary items (operating earnings), rather than on future estimated earnings. We do this because using the past four quarters of actual earnings helps us to avoid analyst's erroneous assumptions, bias, and/or wishful thinking. Looking to the popular *S&P 500 Index* as our market proxy, the current annual adjusted trailing earnings are at $109 per share. With the index of 1,828, this places the current price to earnings (P/E) ratio at a multiple of 16.7x.

In analyzing the past twenty years of P/E data, Chart 1 below shows the highest P/E occurred in 1999 with a multiple of 30.4x. The lowest P/E multiple was in 2009 at 10.7x. The median P/E for this same period was at 17.0x. Using the *Dow Jones Industrials Index* data, the findings are very similar. 15.3x is the current P/E, while 26.9x was the high in 1999, and 11.6x was the low in 2009, with the median at 18.0x.

For the same twenty year period, we looked at two other valuation statistics and found our "mid-range" valuation findings were similar. In Chart 2, we compared historical Price to Cash Flow ratios (P/CF). In Chart 3 we compared historical Price to Book Value ratios (P/B) to today's valuations.

Although the past year's 30% growth move in equity prices is something we pay close attention to, we feel the markets are neither cheap nor expensive at the current levels. As my partner Dennis Ott comments in his article, some financial engineering has occurred, but even so, valuations are in the median range of where they have been historically. In our opinion, selectively there is room for equity prices to move higher and still be far below historical high valuations.

So what is an investor to do? We continue to look for pockets of individual stock value (e.g. energy sector) and add to positions when appropriate. All the while, we continue to keep an eye on the market's momentum.

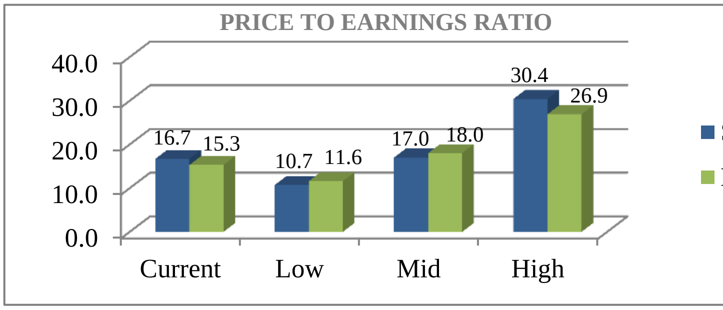

Chart 1

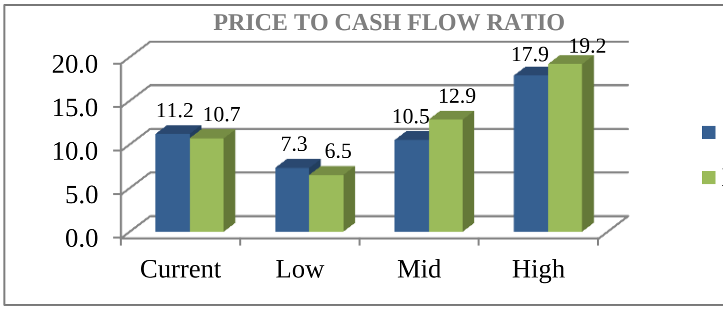

Chart 2

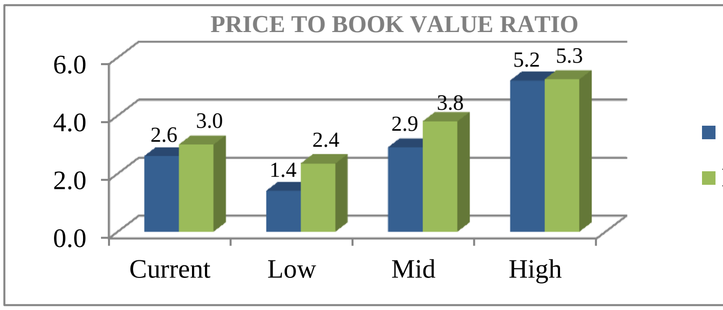

Chart 3

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The Changing Corporate Balance Sheets

By Dennis M. Ott, CFA

Over the last 6 months, there have been an increasing number of articles written in the financial press on stock buy backs and corporate "financial engineering." To research this, we conducted our own small study of fourteen mega-cap U.S. Corporations and reviewed a number of important quantitative statistics. The results we found are interesting.

Our study measured sales and operating income growth, earnings per share growth, the change in long-term debt, and the change in shares outstanding. Our study period was from 2006 to 2012. Although stock buy backs and financial engineering have affected all sizes of corporations, we chose mega-cap stocks because one or more of these companies appear in nearly all institutional and individual equity portfolios. We define "mega-cap" as a company with an equity market capitalization of over $100 billion. Our results measured from a point-to-point percentage change and represent averages for these fourteen mega-cap companies.

Over this time period, sales grew 40% and operating income 37%. Longer term debt increased a little less than 300%, while earnings per share, 54%. Shares outstanding decreased about 10%. The growth in longer term debt could be concerning, were it not for current very low interest rates. It makes excellent financial sense to borrow at 3% or 4% when most corporations are able to earn between 12% and 20% returns on investments. Additionally, interest expense is deductible for tax purposes. We surmise that many of these companies have sold debt to build a "war chest" of cash for opportunistic purchases of other companies and/or their own stock. Much of this cash still rests on the balance sheets as cash reserves have grown to record levels.

The fact that earnings per share have shown greater growth than operating income, points to some financial engineering by the fourteen companies. Since earnings per share are the result of earnings divided by shares outstanding, managements are able to meet growth targets when the denominator decreases faster than the numerator. Separately, most companies compensate top management with generous stock options or stock grants. A percentage of the share repurchases are done to support these options. Stock repurchase obscures the dilution which might otherwise occur.

The Federal Reserve's very low interest rate policy coupled with some financial engineering has also been quite helpful in pushing equity prices higher. Our concern lies with the length of time that these two positive factors may continue. As my partner, Paul Kronlokken discusses in his article, stocks are fairly valued at this time. Our comfort level will increase more as we begin to see a greater level of organic growth.

Reduced Tax Bite for Trusts with Tailored Portfolios

By E. Thomas Welch, J.D.

We are being asked by our clients, who are grantors, trustees and/or beneficiaries of irrevocable trusts, how the new tax law changes are going to affect their trusts, including the new *Affordable Care Act* (ACA), better known as the Obamacare tax. The quick answer is that trusts are being treated less kindly under the new current tax law.

Trust "net income" retained by the trust reaches the highest federal tax bracket of 39.6% quickly at only $11,950. Additionally, a certain amount of that net income may be subject to the new ACA tax. There may also be a State of Minnesota tax with a rate as high as 9.85%. Distributions to beneficiaries can lower the net income of a trust to arrive below $11,950 and push the tax affect, both regular tax and ACA tax, out to the beneficiaries.

However, this low hurdle to reach the highest federal tax bracket may not be nearly as onerous for many trusts. For most trusts where we manage the investments, the main income sources are dividends, tax exempt income from municipal bonds, and capital gains (almost always retained in the trust).

Here are the factors that mitigate the tax effect:

- Dividends - Taxed at a 20% maximum rate, but based on one's income, can be subject to the ACA tax of 3.8%, reaching a maximum rate of about 24%.
- Municipal Bond Interest - Not subject to regular federal income tax, or the ACA tax.
- Capital Gains - Taxed at a 20% maximum rate, but like dividends, are subject to the ACA tax, and also reach a maximum rate of about 24%.

As most of the trusts we manage at Palisade have longer time horizons, we invest the majority in stocks. We find this allocation to be favorable for a couple of reasons. First, stocks grow more over time. Secondly, stock dividend income and realized capital gains retained in the trust, and not distributed to the beneficiaries, are taxed at a much more favorable maximum rate (20% - 24%) than the highest federal tax rate of 39.6%. Municipal bonds held in trusts continue to enjoy federal tax exemption, including exemption from the ACA tax.

In many accounts where we have realized capital gains, our tailored portfolios allow us to harvest losses, if any, to offset or mitigate the effect of the realized capital gains and the ACA tax. This is one of the many advantages a tailored portfolio of stocks and bonds can have over a mutual fund portfolio. When mutual funds are held in trust accounts, a trustee cannot control the taxable gains taken by the fund manager. Often a trustee has little or no accurate knowledge of the gains in the mutual fund that will be passed on to the trust until well into the fourth quarter of the year. This results in having a very limited time frame for any meaningful trust tax planning.

Welcome to the newer world of trust income taxation! We have not touched on the tax issues on taxable interest, passive versus active income from partnerships, LLCs, rental properties, and other forms of income retained in a trust, most of which result in higher tax to the trust on retained income. As investment managers of trusts, we are aware of the new tax planning issues in trust portfolios. We are always sensitive to the potential for higher taxes and even more so now as we enter into 2014.