



PALISADE

Fourth Quarter
2011

Asset Management, llc

Quarterly Perspectives

2011 Benchmark Index Returns

Index	December 31, 2011	
	QTR	YTD
S&P 500*	11.82	2.11
DJIA*	12.77	8.37
NASDAQ	7.86	-1.80
Russell 2000*	15.47	-4.18
MSCI EAFE	2.86	-14.82
Barclays Intmded. Govt/Corp	0.84	5.80
Barclays 3 Yr Muni	0.31	3.46

*Dividends Included

James C. King
jking@palisadeam.com

Peter D. Rocca, CIMA
procca@palisadeam.com

Steven E. Landberg, CFA
slandberg@palisadeam.com

Paul J. Kronlokken
pkronlokken@palisadeam.com

Dennis M. Ott, CFA
dott@palisadeam.com

E. Thomas Welch, JD
twelch@palisadeam.com

Jennifer L. Fischer
jfischer@palisadeam.com

333 South 7th Street
Suite 440
Minneapolis, MN 55402
Phone: 612-455-2900

Public Employee Entitlements

By James C. King

The political season is upon us and like winter, we'll be happy when it's over. That said, this political season is about deficits, jobs and taxes. Along the tax debate discussions, we hear the word 'entitlements' frequently used and usually referring mainly to Social Security and Medicare. While the cost of these programs are high and continue to rise, rarely do politicians mention the 'elephant in the room' entitlement – the pension and health care plans at the Federal, State and Local government levels.

With State and Local benefits averaging about 60% higher than the private sector and Federal civilian benefits about 400% higher than the private sector, you would think the politicians would discuss these entitlements. Years ago, public employees were underpaid compared to the private sector and, as a result, were given more generous pension and medical plans. Yet today, not only are the retirement and health care benefit plans very generous for the Federal, State and Local government employees, but on average their salaries are also higher than the average salaries of private sector employees.

Since there are such wide disparities between plans it is difficult to quantify. In fairness, the Government Accounting Standards Board (GASB) is attempting to shed more light on the true cost of benefits, not because of the discrepancy to the private sector benefits, but because of various differences between political subdivisions. In other words, unlike the private sector, at this point not even our government accurately knows what these entitlements costs are – currently, or in the future.

Politicians rarely address these 'other' entitlements, or why government employees should have different plans than those available to the private sector. It is interesting to note that a substantial cause of the European countries current financial difficulties are the government salaries and benefit programs. Yet, we seem to be heading in the same direction with our growing public employee entitlements.

While researching information on this article, we were recently shocked to learn that Congress is given a free pass pertaining to the 'insider trading' laws - a criminal act for anyone else. There is no acceptable logic to explain why our national politicians, who have advanced access to regulations that affect publicly traded companies, be exempt from this law?

Other than the personal affect it would have on them, why is there no move to bring this excess of public employee entitlements in line with the private sector? We are afraid that fewer and fewer political leaders/decision makers, at the Federal level, have private sector work experience. Over the last sixteen administrations, the average private sector experience was at 48.4%. Over the last two administrations, this percentage has dropped precipitously and currently stands at only 8%.

Our point is not to bash the earnings and benefits of public employees, but to bring some light to a rarely discussed and long trend of growing public employee entitlements. This continuous growth strongly impacts our country's budget problems and is reaching a non-fair playing field level vs. employees in the private sector. Of concern to us as Investment Managers is, if left unchecked, the negative effect this unabated entitlement growth will have on the long term economic health of our country.

Weather, Disruptions and Valuations

By Steven E. Landberg, CFA

Recently I had dinner with a gentleman who has traded commodities for over forty years. Our conversation focused on Europe, the fate of the Euro and, as expected, a commodity trader's focus turns to the weather. During 2011, weather may have caused more economic and market disruption than people originally acknowledge. In particular, the March earthquake/tsunami in Japan and more recently the flooding in Thailand may have delayed the strength of the ongoing economic recovery.

Many industries and corporations avoided negative impact from Japan's earthquake, however the auto industry did not; specifically Toyota and Honda. Japanese factories that suffered earthquake damage supply Toyota with 15% of its parts. Fewer parts caused a rippling effect throughout the industry – decreasing production of finished goods and causing factory shutdowns, even in America. Such supply disruption caused Toyota to see their output slump 23% in the first half of the year. As a result of these supply disruptions, General Motors surpassed Toyota as the world's largest auto maker.

When weather events impact the largest auto maker in the world, the resulting economic impact is felt throughout the global economy. A Wikipedia search of 'auto parts' produced a list which totals close to 500 different parts comprising the manufactured components of automobiles. A list this vast provides numerous opportunities for parts supply disruption.

Similarly, the recent flooding in Thailand also had disruptive effects to the technology industry's manufacturing supply chain. The aftermath of these floods appear to be causing a severe shortage of hard drives used broadly in laptops, servers, TV set top boxes, etc. Such shortages could decrease the supply of hard drives by as much as 25% over the final months of 2011. Intel, Apple, Texas Instruments and DuPont have all announced that the floods in Thailand will have an impact on their earnings and the list of affected companies is growing. While finally reporting a recovery in sales during November, Toyota too is concerned about the negative impact to their production caused by the Thailand flooding.

The impact that weather has on commodities is intuitively understood, but the overall impact of weather related disruptions to an industry's manufacturing supply chain may not be readily apparent. It is however clear that due to the weather related disruptions to the auto and technology industries, difficulties have been widely distributed throughout the global economy.

That said, we feel that much of the economic impact is temporary. One has to be careful not to focus only on the *short term* impact towards economic activity caused by weather related disasters. Economic activity reflected by retail sales, the Purchasing Managers Index (PMI) and GDP are going to reflect aberrations due to such events. For example, auto retail sales recovered strongly in September to a month over month positive 4.2% from the -0.8% recorded in August. The resulting rebound in the auto industry could significantly add to year end and first half of 2012 GDP numbers. Without the weather related events, we probably would have seen a smoothing of GDP growth throughout 2011.

At Palisade, we are aware of the impact such events can have in the short term for the economy and on company earnings. We evaluate the impact of these specific tragic events, but our investment focus remains on longer term trends that affect earnings and dividend growth. On a historical basis, our current view is that there are numerous companies selling at reasonable valuations. The highest quality companies are going to survive the immediate storms and, in the long run, should produce attractive returns for their shareholders.

Are ETFs Another Financial Fiasco in the Making?

By Dennis M. Ott, CFA

Last quarter, we featured an article discussing the volatility in the equity markets and cited the popularity of Exchange Traded Funds (ETFs) as being one of the main causes of this volatility. These types of securities may represent up to 40% of the equity market's volume. I would like to expand and discuss the potential risks that could be looming with the accelerating popularity and the greater complexities of ETFs that are now being offered.

At Palisade, we have embraced 'straight-forward' ETFs for providing broader market participation and diversification in a portfolio. For example, we primarily invest in individual large cap U.S. equities and fixed income. Additionally, we may wish to invest in small/mid cap and international equities. This can be accomplished with the purchase of a variety of understandable ETFs that have low costs, strong liquidity, and their performance mirrors a relevant index.

However, the 'Wizards' on Wall Street are continually dreaming up new ETFs which are anything but straight-forward. As we learned with the mortgage debacle, the more exotic the instrument, the greater the probability it will disappoint investors/speculators. Much of the commodity price inflation which has worked its way into the cost of living may be due to the growing number of commodity ETFs. In some of the more exotic ETFs, a reading of the description indicates that the manager may invest in a set of swaps with a financial institution rather than the specific asset described in the name. If that financial institution were to default, severe negative implications could result. Finally, a good deal of the recent market volatility may be attributed to speculators trading ETFs on momentum.

Any time a large amount of money flows into a market that lacks liquidity, price levels adjust upwards until the 'herd' exits. For example, it is estimated that without investors and speculators who have been pouring money into the oil market, using ETFs and other instruments, oil price levels may be a good deal lower.

While we are not generally in favor of more government regulation, we would like to see more oversight in commodity markets and exotic ETFs. Increasing margin requirements or allowing only those which have a genuine economic interest in the commodity to trade in these instruments might avoid financial fiascos later.

To avoid potential problems, we caution investors to emphasize owning only those ETFs which they can easily understand, are liquid, and have low costs.