

# Palisade Investment Advisors, llc

## Quarterly Comments

**PALISADE**

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Most segments of the financial markets did not perform well this quarter. The Dow hit a new, recent high of 10,941 in early March and ended the quarter at 10,504, down nearly 2%. The S&P 500 and the International equity markets both acted in a similar manner. From a performance standpoint, bonds had little change. However, the spread between the 10 year treasury and the Fed Funds rate narrowed. We have seen an increasing demand on short term borrowing which has increased short term yields, and limited demand for longer term funds.

There were a number of things working against the equity markets this quarter. We continue to deal with the high price of oil, rising short term interest rates and more accounting shenanigans with the focus on American International Group and MBIA. Additionally, there has been the continued negative movement of what we call the three Ds'; Debt (government and consumer), deficit and the dollar. While these broad economic indicators have little short term effect, we believe they will continue to weigh on the markets performance through the balance of the year. Although not widely forecast, we think the dollar will be stronger than anticipated through the balance of the year.

Over the near term, the market will be influenced by first quarter earnings announcements during April. We expect earnings will be up in the 8% to 10% year-over-year quarterly comparisons versus about 20% in the fourth quarter of 2004. While this still represents good growth, decelerating growth rates tend to inhibit market prospects. For 2005, we still are expecting the market to grow in the range of 5% to 8%.

Historically, the second and third quarters have been the poorest (the fourth quarter is the best and the first quarter is second), thus the market adages; sell in May and go away! One caveat, if any of the market adages or axioms ever work – never believe them again.

### 2004 Benchmark Index Returns

Index	1st Qtr 2005
S&P 500*	-2.13
DJIA*	-1.86
NASDAQ	-8.10
MSCI EAFE	-1.26
Lehman Int.	-0.87
Govt/Corp	
Lehman	-0.75
3 Yr Muni	

\*With Dividends

## A Perspective on Hedge Funds

By Jim King

Today there is a great affinity for alternative investments. Most are institutionally dominated and include real estate, private equity, venture capital and hedge funds. Interestingly, only about half of the largest institutions invest in hedge funds. The State of Minnesota has about 17% of their investments in alternatives, however, does not invest in hedge funds. Hedge funds come in all sizes and shapes. They vary from equities, bonds, currencies, commodities both leveraged and non-leveraged to a baffling array of strategies. It is estimated that there are between 6,000 to 7,000 of these funds in existence today. One of the main reasons for their proliferation is that, for the most part, they are unregulated and have little disclosure on their holdings or activities.

I have been in the investment management business over 30 years and can state with a high degree of certainty that there are not 6,000 to 7,000 good money managers in the world! I would speculate that there may be 3,000 to 3,500 competent managers with perhaps as many as 500 great managers that are actively managing money. Keep in mind that this group would be spread through the ranks of private asset management companies, mutual funds, and institutions such as banks and insurance companies as well as hedge funds. This is not to say that all hedge funds are poorly managed, but I would speculate that a significant percentage would fall in this category.

One fundamental disagreement we have with this asset category is that it is a form of gambling rather than investing. We believe investing is the buying of a company that dominates its industry, sells a better product or service than its competitors, has a strong financial position and is ethically and legally responsible. Investing in a company means participating in earnings and dividends growth over a long period of time. Alternatively, we would invest in the debt of this type of company to accomplish portfolio income objectives. Most hedge funds have no economic objective except gambling to make a profit for the principals and secondly for the investor. Alan Greenspan, Chairman of the Fed, has suggested that hedge funds do supply liquidity to the market, however, we think that is a very soft argument since many of the funds move in the same direction at the same time.

Although most hedge funds involve considerable risk, the inherent differences between them probably preclude a wide spread implosion, however, one sectors' damage may diminish the funding for the group as a whole. We suspect that there will be a bad ending to some hedge funds in the future or to quote an investment axiom, "markets always move in the direction that embarrasses the greatest number of people."

## Reading the Body Language

By Paul Kenworthy

In evaluating companies which we consider owning, we often try to recognize when a company is being run for the benefit of a small group or even an individual within the company. If the company doesn't show respect for its customers, employees or shareholders, we question its ability to be a productive long term investment for our clients.

Before buying any company for our Opportunistic All Cap Equity strategy, we review executive compensation, and avoid investing in companies that pay excessive amounts to their executives. We do not want to own a company where a disproportionate amount is "taken off the top", to the detriment of shareholders.

Some of the more common industries which are often undeserving of repeat customers can be banking, financial services, investments (mutual funds) and telecommunication. When banks want more revenue they may simply increase their artificial fees, such as overdraft fees and ATM charges, which today have little relationship to cost. As we have all experienced, telecommunications companies often have a myriad of fees and charges, many of which are hidden and confusing.

Can businesses that have all kinds of "traps" for their customers really expect customer loyalty? More importantly, can they remain in business long term? We think that over the long term, consumers are smart and always figure out where the real value of services lie. If real value is not provided by companies, customer loyalty evaporates as does shareholder value.

It is our belief that companies who can provide quality service and fairly priced products will be rewarded with investor and customer loyalty – and result in productive long term investments. We like companies built for the long run that take care of the customer, and in turn, the shareholders.