ALLOCATIONS TO CONCENTRATED EQUITY STRATEGIES

Do not underestimate the importance of individual stock selection.

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The U.S. economy has experienced a steady run of moderate growth over the last 10 years. However, economic cycles don't run on timelines or have expiration dates. During the same period, markets have also experienced periods of financial stress tied to macroeconomic and geopolitical uncertainties, which will likely continue in the future. As investors search for solutions to help meet their risk and return objectives in these uncertain times, we believe concentrated equity portfolios of high-quality issuers offer a compelling approach to achieve long-term investment objectives. Investors should consider incorporating such strategies as a component of their overall equity allocation.

ACTIVE QUALITY VS. PASSIVE QUANTITY

Money continues to flow into passive strategies, and in August 2019, assets in U.S. index-based equity mutual funds and exchange traded funds (ETFs) topped those in active stock funds for the first time.[1] Passively managed index funds and ETFs are attractive because they are the easiest way for investors to broadly diversify their portfolios. However, these funds and other broadly diversified portfolios are agnostic to a key driver of return – the quality of each individual stock included in the underlying index.

Passive index tracking funds (and other vehicles) use broad diversification as a "blunt instrument" to mute the impact of volatility and provide some degree of protection from losses. In theory, diversification promises to temper the impact of one bad apple spoiling the whole bunch by investing in a broad basket of stocks. However, these funds invest in good and bad stocks through all market conditions – no consideration is given to the quality of individual stocks that make up the portfolio. At the same time, capitalization-weighted indices such as the S&P 500® Index and Russell 3000® Index (among others) determine the weighting of positions by size. The biggest (*i.e.*, highest market capitalization) stocks have the largest weighting in the portfolio. As a result, the biggest stocks rather than the highest quality stocks have an outsized impact on overall performance.

We believe the quality of an individual stock – as measured by specific qualitative and quantitative characteristics – is the critical factor for achieving long-term return across multiple business cycles. In seeking the goal of diversification, investors often ignore the importance of owning specific individual companies and may believe all risk can be avoided through diversification. In reality, all portfolios are subject to systematic risk (also referred to as "market risk"), and systematic risk cannot be diversified away.

FINDING QUALITY

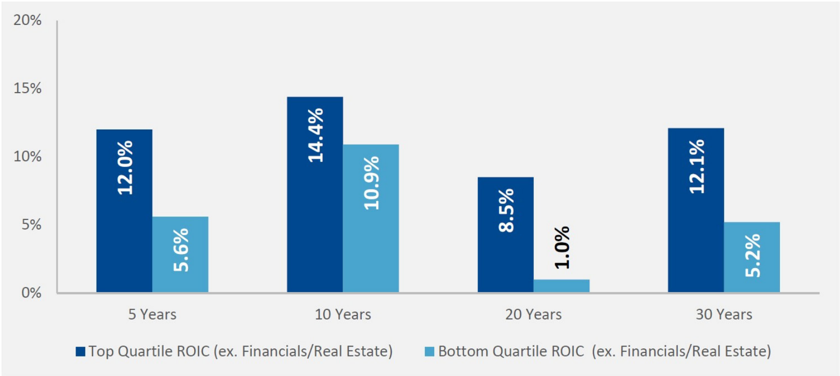
Fundamental research is required to identify high-quality companies that can drive portfolio returns. Analyzing companies is like assembling a jigsaw puzzle. Every piece is important, and the full picture can only be seen when both quantitative metrics and qualitative characteristics are evaluated. This type of evaluation requires experience and discerning skill.

Quantitative Metrics

All fundamental research starts with analysis of a company's financial performance. We believe investors should focus on key performance indicators (KPIs), a subset of financial metrics, that are typically rewarded with higher stock prices and earnings multiples. KPIs that are indicative of quality include sustainable, high return on invested capital (ROIC), strong free cash flow (FCF) generation, and steady and consistent growth in revenue, earnings, and cash flow over a multi-year time frame. We believe these KPIs can directly translate to superior stock performance.

Taking ROIC as an example of how KPIs can be rewarded with superior stock performance, the following is an analysis of all companies in the Russell 1000® Index, which consists of approximately 1,000 of the largest companies in the U.S. equity market and is considered the bellweather index for large-cap investing. This analysis demonstrates that companies with a higher ROIC have outperformed firms with lower ROIC over varying time periods. This outperformance has also been achieved with lower volatility, better risk-adjusted returns, and better downside capture.

Companies with higher ROIC are often more nimble and able to create value throughout business cycles. A highly diversified approach that includes companies with lower ROIC would not reap the performance, volatility, and downside capture benefits that result from limiting a portfolio to companies with higher ROIC.



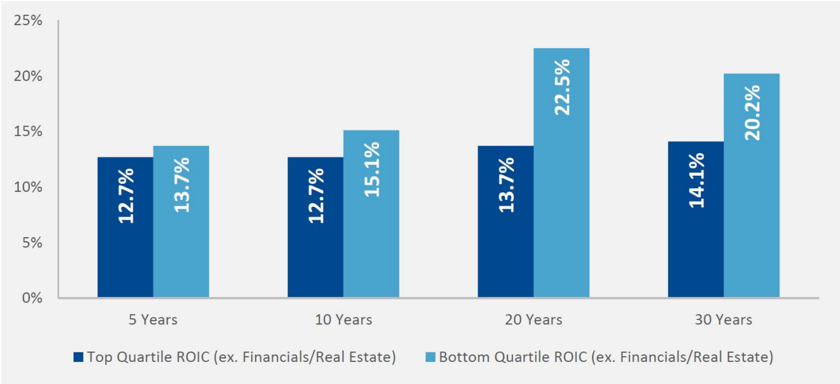
Source: Furey Research Partners and FactSet Research Systems, Inc., as of September 30, 2019.

ANNUALIZED RETURNS: RUSSELL 1000® INDEX BY RETURN ON INVESTED CAPITAL

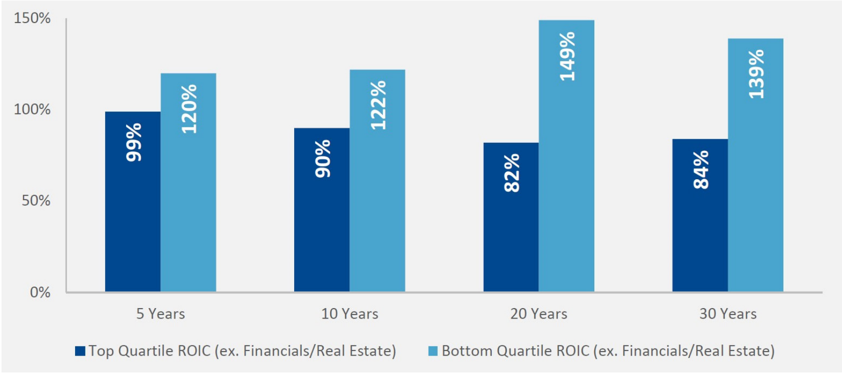
TOP QUARTILE COMPANIES AS MEASURED BY ROIC HAVE OUTPERFORMED THE BOTTOM QUARTILE COMPANIES.

VOLATILITY (ANNUALIZED STANDARD DEVIATION OF MONTHLY RETURNS): RUSSELL 1000® INDEX BY RETURN ON INVESTED CAPITAL

TOP QUARTILE COMPANIES AS MEASURED BY ROIC HAVE LOWER VOLATILITY VERSUS BOTTOM QUARTILE COMPANIES.



Source: Furey Research Partners and FactSet Research Systems, Inc., as of September 30, 2019.



Source: Furey Research Partners and FactSet Research Systems, Inc., as of September 30, 2019.

DOWNSIDE CAPTURE (MONTHLY): RUSSELL 1000® INDEX BY RETURN ON INVESTED CAPITAL

TOP QUARTILE COMPANIES HAVE FAVORABLE DOWNSIDE CAPTURE RATIOS VERSUS BOTTOM QUARTILE COMPANIES.

The Russell 1000® Index represents large- and mid-cap stocks, which typically comprises the majority of holdings in our Focused All Cap Equity strategy.

Note that we exclude financial and real estate companies from this analysis because ROIC is not an applicable quality metric for these types of companies.

Qualitative Assessment

The backbone of any successful business, and critical to its success, is a strong management team and dynamic corporate culture. Management and culture make a real difference but can be difficult to evaluate since so many aspects are intangible and defy strict scientific measurement. Regardless, we believe management and culture should be evaluated using standards and not as an inconclusive sociological study.

The most notable standards we believe management and culture should demonstrate include:

- An ingrained ethos of continuous improvement and talent development;
- Effective strategy deployment and lean operating systems, benefiting growth, margins, and cash flow;
- Repeatable innovation and product vitality driven by the voice of the customer; and
- Disciplined capital deployment with proven results, notably high ROIC.

While there are additional ways to evaluate management and culture, we believe companies exhibiting these standards have a greater ability to generate significant cash and remain competitive, innovative, scalable, and disruption-resistant. As a result, they tend to be more sustainable and perform better than their peers regardless of economic backdrop. A broadly diversified approach will (inevitably) include companies with sub-standard management, and we believe those stocks will have limited long-term success.

A CONCENTRATED APPROACH

Companies that are able to demonstrate both the quantitative and qualitative attributes outlined above can drive portfolio return by systematically compounding shareholder value over time. However, these "compounders" are few and far between. A portfolio consisting exclusively of these types of companies lends itself to a concentrated approach. We also find these compounders typically operate highly diverse businesses with multiple divisions in various end-markets. As a result, a concentrated portfolio consisting of these types of companies has inherent diversification that is not apparent when only focusing on the number of holdings.

A concentrated portfolio has additional benefits, allowing a portfolio manager to limit the portfolio to the highest quality names and build a comprehensive, nuanced, and full picture of each company together with its competitive landscape. Valuable time and intellectual capital is not spent on companies that are not the absolute best ideas but are nonetheless part of portfolios for the sake of diversification, filling out an arbitrary number of target holdings or balancing sector exposures.

"I get more and more convinced that the right method of investment is to put fairly large sums into enterprises which one thinks one knows something about and in the management of which one thoroughly believes. It is a mistake to think one limits one's risk by spreading too much between enterprises about which one knows little and has no reason for special confidence."

- John Maynard Keynes
  British economist known
  as the father of
  Keynesian economics

CONCLUSION

Investing in a select group of distinguished companies with the quality characteristics we outline has the potential to systematically compound return over time, especially during periods of economic uncertainty. Investors should not underestimate the role of individual companies within a portfolio or believe all risk can be avoided through diversification. Instead, investors seeking long-term return should consider allocating some portion of their assets to concentrated strategies that allow individual companies to drive portfolio performance. In doing so, investors should review Palisade's Focused All Cap Equity strategy. This strategy offers investors a thoughtful, active approach for seeking capital appreciation under a variety of market conditions.

DISCOVER THE BENEFITS OF FOCUSED ALL CAP EQUITY

CONTACT US TO LEARN ABOUT THE PALISADE APPROACH

Palisade Capital Management is a privately-held investment management firm that offers a solutions-based approach towards client portfolios. Through our fundamental, research-intensive culture, we have developed traditional and alternative investment strategies that seek to deliver attractive returns aligned with our investors' priorities. Founded in 1995, Palisade's diversified client base includes corporations, public plans, financial institutions, family offices, and individuals.

Palisade's Focused All Cap Equity strategy seeks to achieve attractive long-term performance by investing with high conviction in a portfolio of approximately 20-30 companies that tend to compound shareholder value over the long-term.

We generally invest in companies that consistently generate strong free cash flow and above-average return on invested capital. As important, we focus on companies that have strong track records of disciplined and effective capital deployment for internal growth initiatives and strategic acquisitions. To this end, we conduct rigorous, bottom-up, fundamental research to identify companies with leadership teams possessing outstanding operating talent, augmented by excellent portfolio management expertise.

For more information on Palisade and its Focused All Cap Equity strategy, please contact our institutional services team:

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[1] Gittelsohn, John (September 11, 2019), End of Era: Passive Equity Funds Surpass Active in Epic Shift. Retrieved from https://www.bloomberg.com/news/articles/2019-09-11/passive-u-s-equity-funds-eclipse-active-in-epic-industry-shift

Important Information:

Past performance is no guarantee of future results.

The performance and volatility of the Palisade strategies described herein will be different than those of any index.

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The S&P 500® Index is an unmanaged index that is widely recognized as an indicator of general market performance, based on the market capitalizations of 500 large companies having common stocks listed on the NYSE or NASDAQ. The S&P 500® Index does not have a defined investment objective, nor does it charge fees and expenses.

The Russell 3000® Index is a market capitalization weighted equity index maintained by FTSE Russell that seeks to be a benchmark of the entire U.S. stock market. More specifically, this index encompasses approximately 3,000 of the largest U.S. traded stocks.

The Russell 1000® Index is a market capitalization weighted equity index maintained by FTSE Russell that seeks to be a benchmark of the large-cap segment of the U.S. stock market. More specifically, this index is a subset of the Russell 3000® Index and encompasses approximately 1,000 of the largest U.S. traded stocks.

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