SUPPLEMENT: DEALING WITH ADVERSE MARKET CONDITIONS

2015 has been a challenging year for our Funds, largely driven by the underperformance of energy. This supplement explains some of the key factors that have made this year difficult, discusses how we have managed through this challenging period, and states how we will behave as we transition our business in the years ahead.

A CHALLENGING YEAR FOR ENERGY

A number of events have taken place over the past year that combined resulted in the perfect storm for energy investors:

1. Crude oil began a precipitous fall in early Q3 2014 and the decline accelerated as the market began to fret over slowing global demand (led by China) and growing supply largely due to the explosive growth of North American tight/shale oil. OPEC's decision to leave production levels unchanged at their November meeting further rattled the oil markets. The lingering supply/demand imbalance and record inventory levels have continued to weigh on oil prices, resulting in a sharply lower share prices for energy companies.
2. There has been an overarching "short Canada" trade on for some time. Initially it was largely related to the weak outlook for the commodity-backed Canadian dollar but it has extended to concern over the health of the Canadian housing market as well as consumer debt levels.
3. The unexpected NDP victory in the May 2015 Alberta elections added further uncertainty to the energy landscape in Alberta which led to a net capital outflow from the Canadian energy sector. The issue of a change in the royalty regime has created additional uncertainty in the market.
4. The global 'green' movement has gained momentum. In certain facets of the energy business this may be impacting the flow of capital. We believe that Canada is and will continue to be a leader when it comes to balancing the extraction of hydrocarbons and the environment, but it will come with an added cost.

In order to understand the specifics of today's situation and the impact to Palisade it is worth reviewing each of the Palisade Fund offerings. Currently, Palisade offers clients exposure to two fund mandates: (1) a diversified energy mandate (the Palisade Capital Limited Partnership and Palisade Capital Fund); and (2) a diversified total return fund (the Palisade Vantage Fund).

The diversified energy portfolios consist of six major components: (1) large capitalization, exploration and production ("E&P") and integrated companies; (2) intermediate size energy E&P companies; (3) energy infrastructure companies; (4) small capitalization E&P companies; (5) oilfield services companies, and (6) diversified investments, primarily in blue chip companies in a host of different industries.

Our diversified total return fund, the Palisade Vantage Fund, is invested in a broader spectrum of industries with energy making up a smaller – but not insignificant – component of the overall portfolio. The portfolio today consists of companies in a wide range of industries (some of which are also represented in the Palisade Capital Limited Partnership and Palisade Capital Fund); including financial services, real estate, utilities, energy infrastructure, E&P and oilfield services, renewable energy, power and other diversified businesses. Each of the investments in the fund pays a dividend, interest or distribution which the fund in turn passes through to investors.

Throughout the history of Palisade, different components of the portfolios have been emphasized or de-emphasized depending on our outlook for and the risks in the individual sub-sectors. In addition, the funds carry varying amounts of cash balances which today sit at the higher end of historic ranges.

At the end of Q3 2015 the unit values for our two energy funds, the Palisade Capital Limited Partnership ("PCLP") and Palisade Capital Fund ("PCF") were down 19.5% and 20.1% respectively for the year. The broad energy market as represented by the S&P/TSX Capped Energy Index was down 24.7% over this same period while the broader markets as represented by the S&P/TSX Composite Total Return Index (including dividends and the reinvestment of such dividends) was down 7.0%. At the end of the third quarter, the Palisade Vantage Fund ("PVF") was down 13.5%[1]. Energy was the primary drag on performance across all our Funds.

In Palisade Capital's seventeen and a half years we have experienced a number of difficult periods, each one unique in the cause, effects, magnitude and duration. For a variety of reasons, the current downturn in energy has been one of the deepest and most complex that we have experienced in our careers. We have lived through challenging periods; in previous periods they all reversed and in many cases there were large share price increases off the bottom. We believe that we are in the bottoming phase, the length of which we cannot know for certain. Patience is important as this bear market runs its course.

OUR APPROACH AND ACTIONS

In the context of our portfolios, we take comfort from a number of elements in particular: (1) our core holdings are entities that have been screened to meet all of the criteria we feel are essential for survivability through down cycles; (2) we believe that these companies will be the 'go-to' names when sentiment and capital return to the sector; (3) we are not overly exposed to any one investment; (4) our energy portfolios are invested across a broad spectrum of the energy sector; and (5) we maintain an element of diversifying investments and cash to help smooth volatility.

So, how do we deal with such market uncertainty at Palisade?

1. We take a long term view – when putting capital to work we think of the decision as a long term investment in a company with premium assets, a team we believe will deliver in a segment of the industry we feel has attractive upside;
2. We exercise patience and take comfort that our core investments are resilient;
3. We manage our cash balances and the various component weightings of the portfolios in the context of the market and the risks – we tend to use periods of weakness to strengthen our hand and periods of strength to harvest gains;
4. We remain nimble and consistent with our approach – we use a disciplined set of investment criteria for each investment which we believe improves the odds of success in the long term; and
5. We don't put our business at risk with aggressive investment practices or being too concentrated in any single investment.

With these tenets in mind, here is a summary of the major actions we have taken in the portfolios in 2014 and so far in 2015:

1. After strong results in 2013 and the first quarter of 2014, we elected to take some profits in our portfolios, raising our cash balances in the process. Consistent with our guiding principle to be responsible and respectful to our clients, we elected to make special distributions of $1,000 per unit from the PCLP and $1,150 per unit from the PCF. At the time, these distributions represented approximately 25% of the capital in each fund. This approach is unconventional in the fund management business but we think it is important to do from time to time as it affords each investor the opportunity to review their asset allocation in a tax efficient manner. Some investors reinvested their distribution, some put their distribution into our PVF, while others decided not to reinvest their distribution.

[1] We provide comparative references to the above indices to establish relative performance yardsticks for each of the Palisade Funds. The data is provided for general reference purposes and should not be construed as directly comparable to the content of each Fund.

2. As a result of new subscriptions as well as some further selling into strength, we entered the third quarter of 2014 with approximately 14% cash in the PCLP and PCF; high by our historical standards and levels we would consider to be defensive. Due to its mandate, the PVF was more fully invested, albeit in a more diversified portfolio with less energy concentration. As the energy market began to roll over we remained patient and began trickling some capital back into a few of our top ideas in the fall, leaving the PCLP and PCF with cash balances of approximately 10% at year-end. With the benefit of hindsight we were too early in redeploying this capital.
3. We entered 2015 with a view to moving towards a more "fully invested" position over a six month timeframe believing that the energy sector was bottoming; our cash balances in the PCLP and PCF bottomed at 6% to 7%. However, we altered course in May when the NDP were voted into power in the Alberta elections and crude oil surpluses remained more resilient than we anticipated. We reduced our exposure to certain Alberta-based companies that we thought were most at risk to potential changes in government policies. These sales proved to be the right decision and by mid-year 2015 we had raised our cash balances back to 18% and 17% in the PCLP and PCF respectively. To a lesser degree we took similar actions in the Vantage Fund. This strategy mitigated some losses, as the energy sector softened considerably from the end of June, with the TSX Capped Energy Index sliding 15% between then and November 20th.
4. In August, facing the uncertainty and risks related to the federal election and global energy markets; we decided to make another special distribution of approximately 15% of the capital of each fund in the PCLP and PCF ($325 per unit and $375 per unit respectively). Although we believed then that the energy markets were in a long-term bottoming process this distribution was designed to further provide our clients with a tax efficient way to manage their energy weightings. We felt the distribution would allow investors the ability to withstand a protracted downturn with their remaining investment, an ability that we think is important during this part of the cycle.
5. Throughout this period, we have been actively focused on high-grading the portfolios by doing some capital rotations, making certain that we own what we consider to be the best quality companies in their respective sub-sectors and that the individual sub-sector weights are appropriate given industry fundamentals. Until fundamentals start to shift and the risks come back in line with the commensurate potential reward, we anticipate maintaining slightly higher than normal cash balances across our funds.

We have acted and will continue to act as conditions change through this very challenging period for energy.

LOOKING FORWARD

Our belief is that most of the damage from this commodity price downturn is behind us. However, we also have to be prepared for a longer and more volatile troughing period, one lasting perhaps another few quarters. The recent downturn has been almost a year and a half in duration, a long period by historical standards. As with all downturns, there are self-correcting factors that take hold in energy markets: capital spending cuts lead to tighter supply/demand fundamentals, mergers and acquisition activity pick up often eliminating barrels and spending from the system, and investors begin to fear missing the turn and want back in when liquidity is at its lowest. All of these factors ultimately exert upward pressure on stock prices.

Capital has been withdrawn from the energy system in record amounts and ultimately this will bring the supply/demand equation back in balance. According to one industry source, 2016 capital expenditures from the sixty largest U.S. companies will be down over 20% from 2015 levels and down 50% from 2014 levels, from $144 billion to $70 billion.

If history is any guide, the bounce off the bottom could be dramatic. However, a catalyst of sorts will be required to generate renewed enthusiasm for the sector. This could take the form of (1) accelerating North American production declines; (2) an event – weather or otherwise – that causes crude oil and/or natural gas inventories to drop faster than expected; (3) a positive final investment decision ("FID") on one or more west coast LNG projects; (4) geopolitically-triggered supply disruptions; (5) a change in policy from key OPEC producers; or (6) any number of other reasons or events that cannot be accurately predicted by anyone.

As we have stated previously, due to our long-term focus tough periods don't deter us, if anything they make us work harder. Our experience tells us that the only way to generate significant returns in an investment portfolio through the cycles is to own high-quality investments that are allowed appropriate time frames within which to appreciate.

THE FUTURE FOR PALISADE

In order to be successful at what we do, we are required to run our business in a way that best suits our skills and investment outlook. To quote Warren Buffett: "Only buy something that you'd be perfectly happy to hold if the market shut down for 10 years". As with Buffett, we take a long-term approach with the companies we choose to invest in. We will occasionally trade around peaks and troughs through cycles but we are not interested in dramatically turning over our portfolios. We know there will be periods when the market will not look at certain investments favourably. We also know that at times our investee companies are going to face challenging industry conditions. In aggregate though we believe we have chosen our investments carefully. We are prepared to ride through periods of negative market sentiment because overall we believe we own good companies run by aligned and experienced teams.

As we look to the future, the purpose of our business remains to responsibly grow the per unit values of our Funds. Our objective is to deliver long-term compounded growth rates that will lead to acceptable increases in our clients' wealth over time. What we care most about is creating value for our clients in a responsible manner.

As we have communicated in recent supplements and at our AGM in the spring, Palisade has been going through a transition in terms of its key people. Importantly, while individual roles and leadership are changing, our cornerstone and guiding principles are not. We will continue to adhere to our steadfast core principles: (1) our clients' interests will always come first; (2) we will maintain our strong "partnership" relationship (alignment of interests) with our clients; and (3) we will continue to provide our clients with choice. The transition steps we are undertaking are entirely guided by such principles.

For personal reasons, certain members of Palisade's senior management have indicated that they plan to dial back their work time commitment. Day-to-day management responsibility has been transitioning over the past several years and is now largely complete. Continuity of top-tier investment professionals has always been a management priority and the April 2015 addition of John McAleer (as a sub-advisor initially for regulatory reasons, and ultimately as a partner in our business) is another example of this priority. Considerable attention has been dedicated to "get it right" with client interests at the forefront. We are extremely pleased by the quality of the individuals that have been attracted to Palisade and this gives us strong confidence in our future. All the pieces are now in place for a seamless transition.

With such transition in mind, we thought it would be useful to refer back to our Q3 2005 supplement entitled "The Plan for Palisade", written 10 years ago to the quarter. While the industry fundamentals were different then, what is important is that the key elements of our business have not changed over that entire timeframe. ***We assure you that they will remain the same for the next decade.***

In that report we stated that "clarity of purpose is of paramount importance to us and that we think there is tremendous merit in simplicity". This, among other reasons, is a driver for the restructuring of the PCLP and PCF. In that report we also highlighted four key strategic imperatives for our business that are as relevant today as they were then. What we have accomplished to date and intend to do in the future can be captured in those strategic imperatives, which are outlined below:

1. Develop and manage funds that we are interested in owning ourselves – serving our investors' needs really means running a business that makes sense for our own capital and then asking outside investors whether our Funds suit their specific needs (the goal is to remain large and aligned investors in each of our Funds);
2. Run a business that we can be proud of and that offers unique advantages to our clients;
3. Make the best investment decisions possible in our Funds in order to deliver on our primary purpose which is to responsibly grow the per unit values of our Funds; and
4. Strengthen our company, for the benefit of our unitholders, by continually addressing our challenges and opportunities.

ACTION PLAN

We conclude with some specific action items that, while different today than they were 10 years ago, are derived from the above imperatives.

1. Restructure the PCLP and PCF – this move will result in one fund instead of two, it will allow us to be more efficient from an operations perspective, its units will be more widely accepted among investment dealers, and it will reduce costs associated with running two pools;
2. Outsource fund administration for this new fund – this will improve client reporting capabilities, streamline our closing procedures, and will allow for an automatic Dividend Reinvestment Plan ("DRIP"); our plan is to migrate the PVF to this model later in 2016;
3. Visit with every Palisade client in the coming months to review our fund restructuring and management succession plans;
4. Work daily on our investment capabilities with a focus on our funds – reviewing existing investments, monitoring portfolio risk and looking for new opportunities;
5. Continue to work on effective communication – keeping our clients well-informed on developments in their investment holdings is of paramount importance; and
6. Stay focused on what has made us successful over 17 years – keeping our Funds manageable, emphasizing personal relationships with our clients, preserving our office chemistry, investing with discipline, and always operating our business prudently through the recognition and mitigation of relevant risks.

Specifics with respect to our fund restructuring will be forthcoming in the next few weeks and we intend to follow up with each investor personally thereafter. We look forward to reporting to you in the future.