

SUPPLEMENT: PALISADE YEAR IN REVIEW AND THE FUTURE OF ENERGY

The two most significant developments for Palisade unitholders in 2014 were the payment of special distributions in all of our Funds and the impact of declining oil prices on the portfolios in the second half of the year.

Significant special distributions were paid in all of our Funds: \$1,000 in the Limited Partnership, \$1,150 in the Capital Fund in March of 2014 (each representing approximately 25% of the Fund assets) and \$0.80 per unit in the Vantage Fund in December of 2014 (Vantage unit holders received total distributions of \$1.36 during 2014). Special distributions have been made after periods of unit value appreciation and they will continue to be a key component of returns in Palisade's future. Recent share price weakness in the energy sector has created investment opportunities for patient investors; our approach is to invest in downturns and harvest during rising price environments.

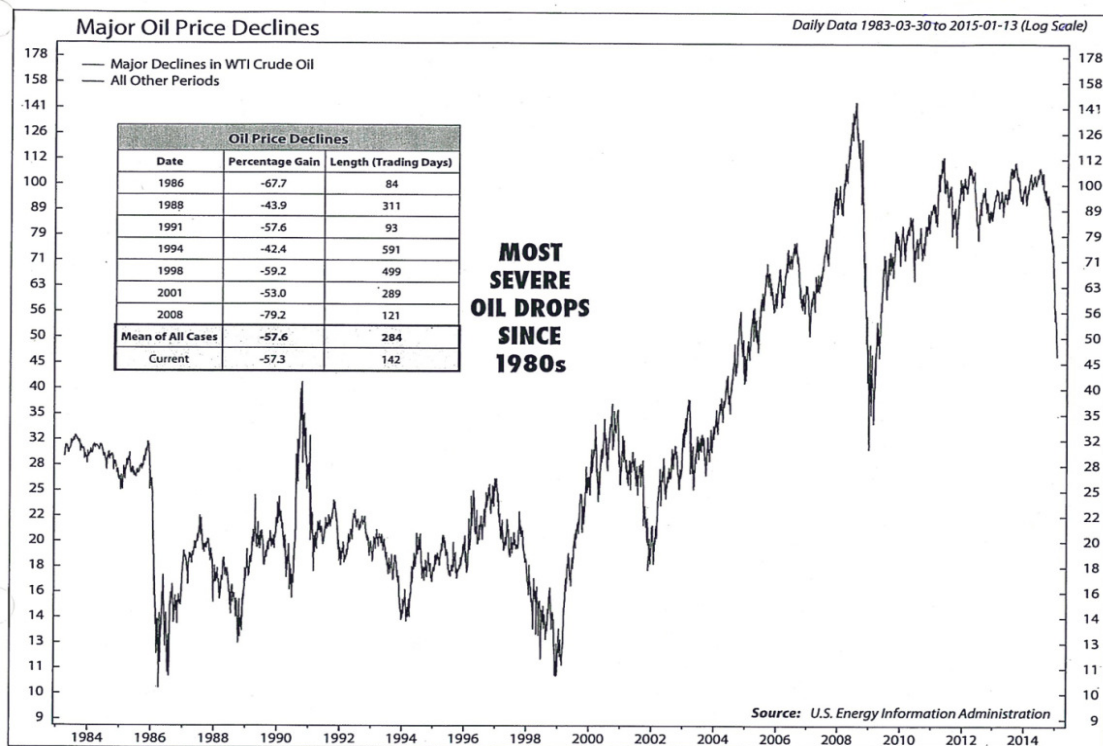
The year was marked by strong performance in the first half of the year followed by weak results in the second half. This is best illustrated by breaking down our performance in calendar quarters.

	Q1	Q2	Q3	Q4
Palisade Capital Fund	5.2%	9.9%	-5.8%	-17.0%
Palisade Limited Partnership	5.3%	10.0%	-5.9%	-16.9%
Palisade Vantage Fund	5.6%	10.0%	-3.8%	-8.9%

The primary reason for weakness in the Palisade unit values in the second half of the year was due to the collapse of world oil prices. The relative outperformance of our Vantage Fund to the Capital Fund and Limited Partnership in 2014 reflects broader diversification resulting in a lower weighting of energy investments in Vantage compared to the other two funds. Given its importance to our results, this report focuses on recent developments in the oil market. We compare this decline to previous down cycles and describe key variables that will influence the oil market going forward. We also provide information on Palisade's recent investment activities and some guidelines for interpreting our results.

Over our sixteen year history, Palisade unit values have been exposed to several events which have caused a short-term decline in our unit values including the credit crisis of 2008-2009, the 9/11 terrorist attacks and the tech wreck in 2000. We have also experienced numerous oil price reversals since Palisade's inception. In 2000, oil prices declined 50%, in 2006 they went down 33%, in 2008 they declined 77%, in 2011 they declined 30% and in 2012 they were down 27%. The current oil price decline took WTI prices from a June 2014 peak of \$107 to a recent January 2015 low of \$44; a decline of 59% (only time will tell whether the ultimate bottom was set in January).

This current price collapse would be classified as one of six major price declines since 1985, the last one having taken place in 2008-2009. The illustration below shows in both graphical form and numerically the percentage change of these pullbacks (note that these exclude the previously mentioned price declines in 2011 and 2012). So far this price collapse is on par with the mean percentage decline of the previous six major price drops.



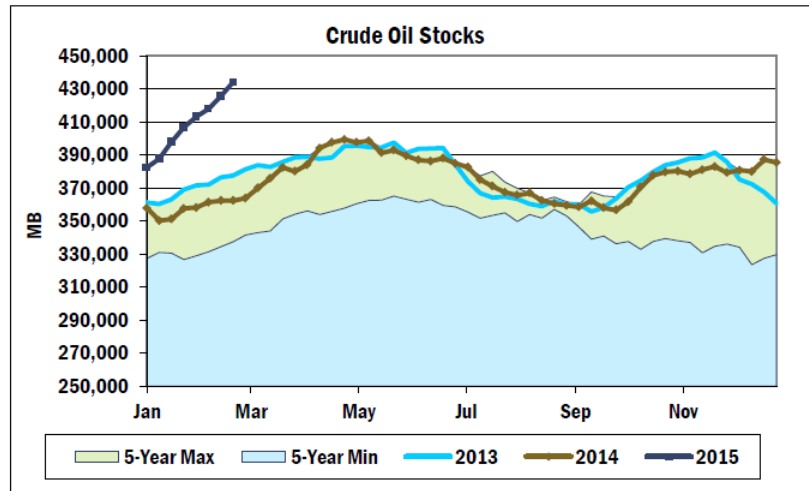
In our third quarter supplement, written prior to the November OPEC meeting, we acknowledged the possibility of a Kingdom of Saudi Arabia (“KSA”) led oil price war and the difficulty of understanding the motivations of the Kingdom. At the time we believed that a price war was not the most likely outcome; this was based on our assessment of the fiscal needs of KSA. We also noted that oil markets were not as oversupplied in percentage terms as they have been in previous periods when price war strategies were pursued. This fact remains true today¹. Nevertheless, we misjudged the willingness of the KSA to shake up the market in an attempt to take back market share. Their recent tactics represent the introduction of a new set of facts that are very important to the future price of oil.

Oil is an exceptionally volatile commodity; understanding why is integral to successful investment in the sector. Economists refer to changes in a product’s supply and demand dynamics to price as “elasticity”. Products where price changes impact either supply or demand quickly are considered to be relatively “price elastic” while products where supplies or demand are not impacted quickly by changes in price are referred to as “price inelastic”. Crude is particularly volatile because both supply and demand are very inelastic to price changes in the short-term. Oil is a necessity, so demand is relatively insensitive to rising prices. Conversely, during periods of declining price consumption habits are slow to change, thereby muting demand increases. On the supply side, energy projects typically have long lead times and once projects are on stream there is little incentive to take them off the market because development costs have already been spent. Supply inelasticity is also due to the fact that much of the world’s oil volumes are either inside the OPEC cartel or controlled by state-owned enterprises. By their very nature, cartels and state run companies are often less sensitive to price signals. In an inelastic market such as oil, relatively small supply/demand imbalances can have a dramatic impact on price because they can take more time to resolve.

The inelasticity of oil as it relates to supply is currently weighing heavily on the market and frankly for good reason. It is most visible in the significant inventory builds in North America. North American inventories for crude oil products sit at eighty year highs and are expected to continue to build for at least several more weeks. The chart below

¹ To illustrate, in February of 2015 Kuwait’s oil minister went on record stating that the market was oversupplied by 1.8 million barrels a day. The worldwide oil market is over 90 million barrels a day so his estimate represents oversupplies of approximately 2%.

illustrates current U.S. crude oil inventories relative to the last five years². Ongoing production increases, set in motion before oil prices fell, have caused storage facilities to get very full. This trend can be extrapolated, rightly or wrongly, to a picture of no storage space left a few months from now, and this is spooking the market. It has also caused some energy traders who are otherwise longer-term bullish to try to time their entry when the inventory picture becomes clearer. In any event it will take time to clear storage to normal levels and until this occurs price increases will likely be dampened.



However, in the longer-term, oil supply and demand do show some elasticity to price. It takes time for demand response to manifest itself but it is starting to show up now in, for example, gasoline consumption and large vehicle sales. The past era of fuel efficiency was driven by high gasoline prices. Now we have cheaper fuel and it's likely to stimulate demand over the medium and long term. In the meantime, the world still needs lots of new supply to meet growing demand, and the cancellation or deferral of investment today in large scale projects with long term supply potential will likely have a dramatic effect in a few years. This has been the case in the past and it has led to large upswings in price. Supplies are required regardless of price and the industry requires long lead times to deliver them.

The current oil quote of approximately \$50 per barrel may be characterized as a "tug of war" between price bearish record inventory builds and longer-term more bullish market rebalancing brought on by increasing demand and lower supplies caused by reduced investment today. The market is also minimally pricing in lower probability events such as political decisions or geopolitical occurrences that could rebalance the market quickly. The more time that passes, the more likely these rebalancing events are likely to occur. This is why we think that investing in energy stocks through this trough period is the correct course of action.

We refer readers back to the chart of the previous six major price collapses. Today many forecasters like to discuss the shape of an oil price recovery. Some believe that the recovery will be a "U" shape (i.e. a long and gradual recovery period) others believe it to be an "L" (i.e. no recovery) while others think it will be a "V" shape (i.e. sharp recovery). Note that in the past the recovery periods have always been a sharp "V". If history is any indication we think the recovery, when it occurs, will be a "V"; entirely consistent with its short-term inelastic nature. Below is a table of the one year returns after crude oil bottomed in the six prior price collapses since 1985³.

² Courtesy of Peters and Co. Limited.

³ The recent peak was set about 180 trading days ago on June 20th 2014.

Chart of Major Oil Corrections since 1980...

Interesting to see where this right-sizing shapes up...

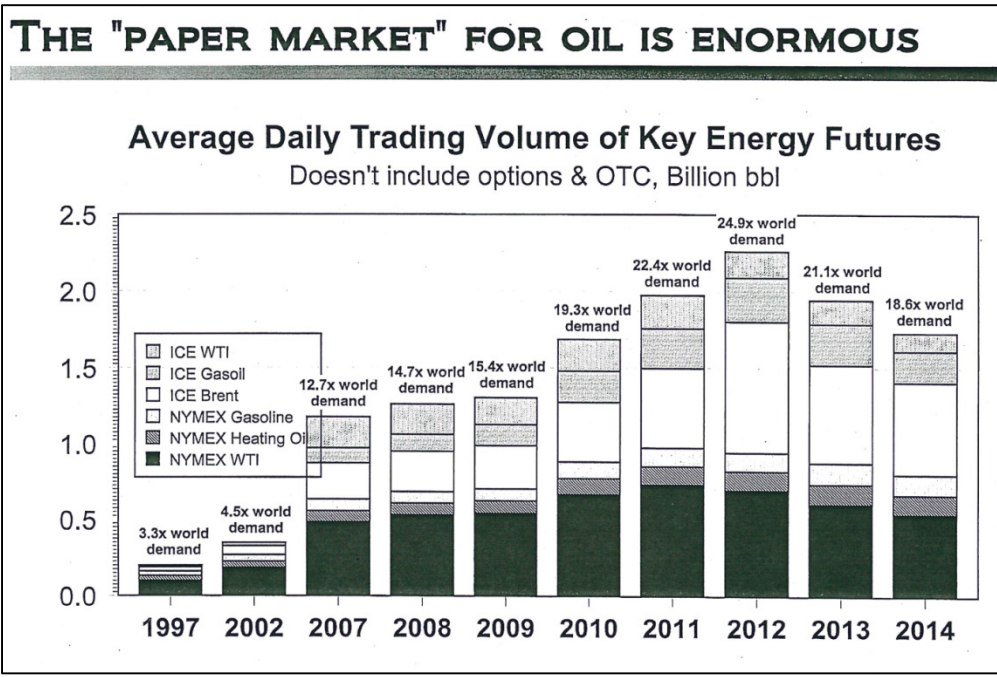
Major Oil Corrections Since 1980				
Date	Event	% Change in Oil Price	Length of Oil Price Decline (in trading days)	% Increase in Oil Price 1 Year Post-Low
1986	Saudi Market Share War	-67.2%	82	79.0%
1988	Oil Glut	-43.7%	295	58.4%
1991	Global Recession / End of Gulf War	-57.2%	90	5.4%
1998	Asian Crisis	-59.6%	484	134.5%
2001	Global Recession	-53.1%	290	46.2%
2008	Great Recession	-78.4%	119	134.8%
Average		-59.9%	227	76.4%
Current		-57.2%	141	?

While past cycles provide us with some guideposts it is useful to think about the unique features of this particular cycle. We identify three major ones: (1) the impact of financial instruments, (2) shale oil and industry efficiencies, and (3) the fiscal needs of oil producing nations.

The chart below shows that the amount of “paper barrels” traded on financial markets has been approximately 20 times that of the physical demand for crude oil⁴. The “financialization” of commodity markets, influenced by plentiful money and stimulative monetary policy, have had a dramatic effect on the volatility of the oil price. The supply and demand for “paper barrels” has perhaps been more influential on volatility of price than the supply and demand for real barrels. Hedging and speculative activity, driven in part by the storage market and prompted by forward market considerations continues to have a bearing on North American pricing⁵. The impact of the “financialization” of crude oil markets will serve to magnify moves both up and down in the price of crude; think of it as a market on steroids. We believe it will become common to see \$5 to \$10 swings in crude oil prices in time frames measured by days, not months. For investors with a longer-term orientation such as us, it means paying less attention to daily headlines and near-term volatility.

⁴ The chart created by Cornerstone Analytics.

⁵ For example oil markets are currently in contango, meaning forward prices are higher than near-month prices, creating arbitrage opportunities for storing oil in facilities and tankers for delivery at higher prices.



Most of the recent volume growth for crude oil in North America has come from shale oil. Shale oil development has unique characteristics when compared to older conventional crude deposits. Shale oil drilling can be prolific and highly repeatable (akin to a “manufacturing process”); supplies are relatively quick to develop and tie in, but in order to be sustainable shale oil production requires massive ongoing reinvestment due to immediate and substantial production decline rates. Two key questions are whether shale oil will change the inelasticity of supplies and what additional efficiencies can be found which will bring down overall development costs. Both of these questions will only be answered by the passage of time.

In this downturn the speed and depth of capital expenditure reductions by energy companies has been stunning. It confirms that the price required to support the type of unconventional reserves being drilled today is very high (ballpark \$75-\$80 per barrel). It also confirms that the North American E&P industry got over-inflated with plentiful cheap money from public and private markets. This money served to finance the huge ramp up in production, much of which was marginal at \$100/bbl crude and will be destroyed at current prices. The music has stopped on this which will be constructive to price longer-term.

Industry will undoubtedly get more efficient, with weak players and poor investors being smacked out of the game. The industry got fat and it is now being trimmed. Cost inflation on the service and supply side is being reversed. Recently, headlines were made by Canadian Natural Resources CEO Steve Laut when he went to Fort McMurray and directly confronted industry about “made in Fort McMurray pricing”. This is just one shot across the bow in an industry that is in a serious fight for survival. Ultimately these moves and others will ensure that the strong will get stronger. A more efficient industry means that we will likely see a lower ceiling price for crude oil in the intermediate term, much as we have seen in the natural gas industry in recent years.

Earlier in this report we noted that during the fourth quarter of 2014, Saudi Arabia shook the oil market with a change in their pricing strategy. We think some facts about the KSA are highly pertinent to this cycle. According to Helima Croft of RBC Capital Markets, in 2014 the Saudi government ran a deficit of \$14.4 billion dollars despite Brent prices averaging \$99.50 per barrel for the year, exceeding their official spending targets by 28.7% last year. Ms. Croft also notes that the KSA’s 2015 budget projects a deficit of \$38.6 billion. She states that Saudi Arabia typically overspends their budget forecasts by at least 25% per annum and their budget does not include allocations for defense expenditures despite the fact that it accounts for about 35% of government spending (official government spending

excluding defense was forecasted to be \$230 billion in 2015). The KSA has financial reserves of approximately \$736 billion to cover budgetary shortfalls but Ms. Croft's analysis indicates that they will be drawing down their reserve fairly rapidly in a low oil price environment.

While the KSA has the capacity to wage a price war for a period of time the benefits of such a strategy erode with time. We draw an analogy to a union on strike; they are drawing on their "strike fund" to obtain concessions in the future. These concessions ultimately need to exceed what they are giving up in the near term. The more they draw down resources to support their strategy the more they will need to make up in the future or their strategy will have failed. The KSA is stronger than most of its OPEC members and some concessions from weaker members are likely. Regardless of this, we believe the KSA will ultimately wish to pursue a strategy that provides higher revenues for them in the future than they are receiving today.

The KSA's strategy will have been successful in one very important respect. They have reintroduced price risk in the investment decision-making process of energy companies and investors around the world. Prices were relatively stable for two years prior to the price collapse. The KSA would have observed that price stability did not serve their purpose, it only encouraged consistent supply growth, some developed by their geopolitical enemies, and for which they were the only player prepared to act as swing supplier. Reintroducing price volatility will mean that higher returns will be required by the industry when investment decisions are being made, thereby slowing development of future supplies.

Many other OPEC nations are basket cases. With the price collapse, some are bordering on "failed state" status. Libyan production, which was partially responsible for the over supplied markets last year, is being taken off the market due to civil war conditions. Growth in Iraqi production, considered a near certainty last year, is now a question mark due to ISIS militancy in the country. In Nigeria elections have been postponed, raising further questions about that nation's stability.

Ample oil supplies have pushed geopolitical risk in the global oil industry to the back pages of the financial press. One day something could happen that shocks the oil quote, reminding the market just how small the supply/demand imbalance is, and how higher prices are required to keep the oil flowing from new high volume sources (oil sands, deep water, shale oil, arctic, etc.). We believe it is unlikely that many of the world's hotspots will get back to previous production highs with limited access to capital, little local expertise, and many western companies will be unwilling to invest in less stable parts of the world when there are large unconventional reserves to be captured in safer jurisdictions. Very long term we take our clues from Exxon Mobil. In its *Outlook for Energy: A View to 2040* Exxon states that North America is destined to become energy self-sufficient and a net exporter to the rest of the world. Exxon sees that North America is the place to be investing now that tight oil and gas have been unlocked with technology. At Palisade we believe that this will not happen in a \$50 oil world and investing in well run energy companies in North America, particularly during periods of price retrenchment, is where you want to be in the coming years.

Several members of the Palisade team have had personal experience with all six of the major price declines since the mid- 1980's. In these periods we learned that the best course of action was to invest through the downturns, not get too caught up in the noise of daily price fluctuation, and to wait patiently for the upturn. We see little reason why this course of action is not appropriate this time. We have been adding to our core investments and will continue to do so. In the Limited Partnership and Capital Fund we have moved from roughly a 15% cash weight in the second quarter of 2014 to a 6% cash weight currently. We expect to invest much of our remaining cash balances in the coming months. It has often been said that the "cure for low oil prices is low oil prices" and we believe this remains true.

With respect to our future performance it is important for our investors to understand that we are diversified across energy sub-sectors (i.e. large cap E&P, intermediate E&P, small E&P, service companies and infrastructure). We very carefully monitor our investment weighting to each sub-sector. Sub-sector investment allocation means that different

components of our portfolio react in different ways and at different times to oil price volatility. For example through this downturn our larger energy companies went down less than the oil price; the 60% oil price decline on balance impacted our larger energy companies' share prices by less than 30%, peak to current trough. On the other hand, smaller energy companies and service companies were highly correlated in percentage share price drops to the oil price decline. These companies, on balance, would have declined approximately 60% or more. Importantly, we expect the reverse to take place on an oil price recovery; our senior companies will not move up as much as the oil price, while our service and smaller E&P's are expected to go up more in line with an oil price recovery. Sub-sector price dynamics impact the timing and magnitude of our performance relative to energy indices. The more frequently quoted energy indices, such as the ones we reference in our reports, are weighted more heavily to larger entities. It would not surprise us if we underperformed these indices initially and then outperformed them later in a price recovery.

We can't know with certainty the timing and extent of a future recovery in oil prices. However we know the world runs on energy and we believe it will require ever more of it in the future. We believe downside volatility creates opportunity. Buy low and sell high is the classic investment mantra that many do not act on when the opportunities present themselves. We will and we look forward to reporting to you on our progress in future quarters.