Monthly Market Perspective

February 9, 2015

Performa is an independent, employee-owned investment management firm, founded in 1992. We combine over 20 years of experience in the captive industry with the institutional expertise of our investment team to provide our clients with tailored investment solutions.

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A Fool and His Money are Soon Parted

Common sense dictates that when lending money, it's best to demand more from those whose prospects are riskiest. Whether it is a car loan lender evaluating the rate differentials between a family with excellent credit and a low FICO score borrower, or investors comparing the bond yields of a triple A corporation versus a High Yield issuer: the credit curve is decidedly upward sloping and poor credits pay more.

Nevertheless, like everything else that seems rooted in long-standing rationality, there are moments of hysteria, weakness, and belief that this time will be different.

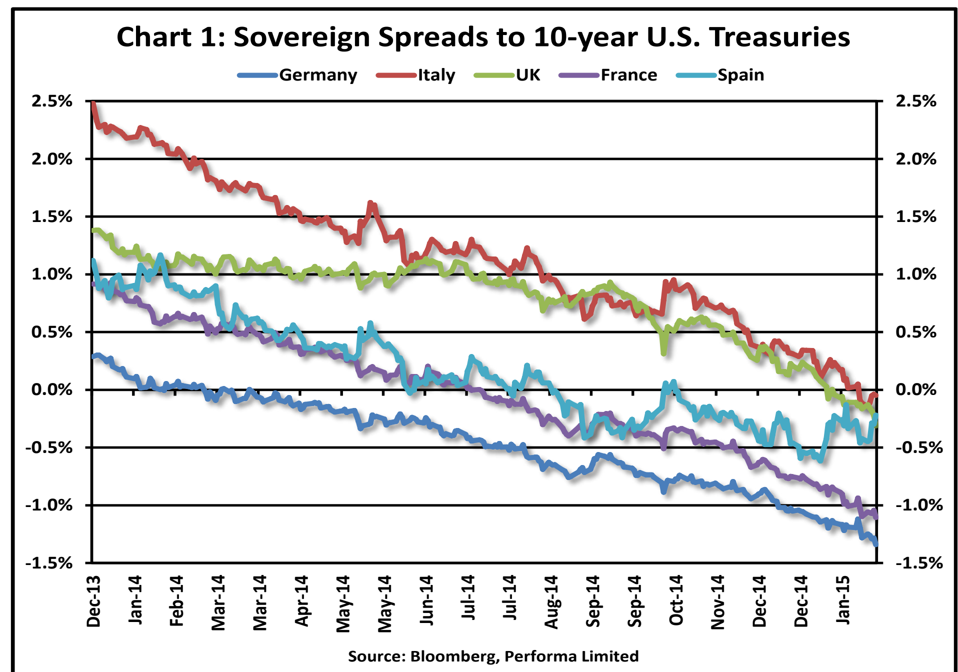
It appears to us that large swaths of global government bond investors feel that the usual norms are off the table. Highlighting the current Bond market perversion are several economically challenged countries, such as Spain (23.7% unemployment) and Italy (12.8% unemployment), followed by their larger, and only somewhat less challenged neighbors in France. These three current market darlings can borrow money in the bond markets less expensively than the United States of America (5.7% unemployment), whose economy is fundamentally sounder and not part of the Euro Bloc currency mess (see Chart 1 for yield spreads).

The current relationship may be fascinating, but it is fraught with potential disaster for the bondholders in those European countries, and it portends risks to those owning U.S. Treasuries. Perhaps William Shakespeare was partially right when Hamlet said, "Never a borrower or a lender be." It is certainly better to be the borrower in this environment!

What a Long, Strange Trip It's Been...Since 2008

The European Central Bank (ECB) launched its much anticipated bond pur-

chase program in January, and after cleverly shaping market expectations, has managed to impress the market with both the size and scope of the program. In anticipation of the announcement, investors indiscriminately bought Eurozone sovereign bonds, sending yields to record lows. Buying assets under the greater fool assumption (someone will pay a higher price later) is hardly a trade rationale but is somewhat time-tested, as the pattern has worked since the U.S. Federal Reserve initiated three Quantitative Easing (QE) programs over the past six years. What is concerning today is that after the ECB announcement, bonds yields broke the pattern and fell further.



Musical Chairs

As sovereign yields around the Eurozone mindlessly wander lower, we wonder once the buying stops, who will be left without a chair? Perhaps it will be the private sector investors who are currently falling all over themselves to buy low-rated sovereign debt that trades extremely rich to much higher quality assets. On the other hand, it could quite possibly be the same public institutions currently creating said skewed market relationships that end up sitting on the floor.

Central bank policies have broken one of the best allocation systems in the world – the financial markets – and at some point, the house will come tumbling down. As Europe deals with a lagging regional economy and the public backlash that bred the new anti-austerity Greek government, we put higher odds on Central Bankers taking losses than the private sector. Either way, the U.S. bond market has been collateral damage and a correction in European yields should allow U.S. rates to find a higher, more fundamentally correct range.

The Macro View

U.S. economic momentum did not meet expectations, as it slowed somewhat in the 4th quarter, rising 2.6% as compared to higher numbers over the previous two quarters. Corporate investment, net exports, and an expected pullback in government spending detracted from growth. On the bright side, consumer confidence reached fresh cycle highs, as personal consumption enjoyed tailwinds from significantly lower gas prices. The labor market continued to improve, which we see as a strong factor towards further expansion in 2015.

On the other side of the pond, the U.K. economy grew by 2.7% in 2014, marking the strongest year of expansion since 2007. British consumption continues to be a bright spot, as their unemployment rate declined to a new multi-year low. While economic risks in the Eurozone remain skewed to the downside, there are some signs of life. Improving business, investor, and consumer sentiment in addition to firming retail sales are all encouraging signs.

Economic data out of China has recently been stable now that the era of double-digit growth is over. Chinese

Performa Preliminary Intermediate Fixed Income Composite Performance *

	Jan	YTD
Performa Gross	1.17%	1.17%
Performa Net *	1.15%	1.15%
BarCap US Int. Gov't/Credit	1.66%	1.66%

Market Returns

Equities	**Jan**	**YTD**
S&P 500	-3.00%	-3.00%
FTSE World	-1.65%	-1.65%
Fixed Income		
BarCap Treasury	2.59%	2.59%
ML High Yield Cash	0.68%	0.68%
BarCap Aggregate	2.10%	2.10%

* The investment management fee for the Performa Intermediate Fixed Income Composite is 0.30% per annum. Please see the last page for important performance disclosures.

authorities had been looking for economic growth in the 7.5% area and economic growth for 2014 was 7.3%.

GLOBAL MONETARY POLICY

After much anticipation, the ECB finally announced its bond purchase program in January. While purchases will not start until March, the size and open-ended nature more than satisfied market expectations. The Swiss National Bank sent shock waves throughout currency markets with a surprise decision to remove a currency cap that kept the Euro/Franc exchange rate at 1.20. Several other Nordic central banks took a more accommodative stance as well, while the Federal Reserve is slowly inching closer to policy normalization.

FIXED INCOME MARKETS

Elections in Greece, the ECB QE announcement, surprise counter reactions by non-Euro Central Banks, falling oil prices, and deflation concerns all helped create a volatile month for bond markets. The Merrill Lynch Option Volatility Estimate Index, a measure of bond market volatility, spiked in the first week of January and remained elevated throughout the month. For January, the Barclays Capital Aggregate Index, a measure of the broad investment-grade bond market, returned 2.10% as the yield on U.S. 10-year Treasuries fell by 53 basis points.

Credit

The Credit market continued its weak relative trend as January ended with spreads another seven basis points wider, causing 44 bps of underperformance compared to duration-matched Treasuries. However, absolute returns reached nearly 3% as government bond yields fell. The market also had to contend with the divergent forces of lower commodity prices on producers against the potential benefits for consumers and companies that cater to them.

- Full 2014 earnings season for the S&P 500 is at the half way mark. Notable developments include reduced guidance, spending and earnings power out of the commodity players, as well as a rash of multinationals claiming that the strong dollar has undercut profits. Understandably, underperforming sectors for the month include metals & mining and energy/oil.
- New issuance was around $100 billion, which was lower than the monthly rates seen in 2014. We saw heavy supply from financials, on the heels of generally solid earnings results. We expect industrials to potentially tap the market in February as earnings announcements begin in earnest.
- We remain overweight credit focused on high-quality corporate issuers as a substitute for Treasuries and U.S. Agencies in this low yield environment.

Structured Products

The Structured Product market began the year with positive returns, but was unable to match the torrid rally in the U.S. Treasury market. New bond supply

was healthy but secondary trading was strained - a trend we expect to continue in 2015. Overall, investor demand remains solid but has turned cautious as all eyes are on the Federal Reserve.

ABS - The Asset Backed market held up well in January and investors still like high-quality, short offerings as a cash alternative. There are still some pockets of fairly priced, esoteric collateral that provide decent bond yields and we have followed the strategy as well.

CMBS - The Commercial Real Estate Mortgage market was softer in January but put in a good fight against similar maturity Treasuries. Yield spreads are still drifting at the wider end of the range seen in 2014. New bond supply was robust but choppy. Some deals were well received and traded stronger while others needed price concessions to clear as investors became pickier with the underlying collateral. The sector continues to offer solid risk adjusted return potential in our view, especially with high-quality, shorter maturity opportunities.

MBS - The Residential Mortgage market could not keep up with Treasuries and was the laggard in the Structured Product market in January. Persistent low interest rates have kept refinancing rates elevated and market volatility has sent buyers to the sideline. While the yield spread to Treasuries can make sense in a low rate environment, we feel that the macro volatility is still too high for us to embrace Agency Mortgages at this point.

High Yield

Oil prices found a bottom in January and so too did the energy sector of the High Yield market. The market was able to digest the announcement of the ECB's bond purchase programs and potential disruptive Greece election result with limited problems. With total High Yield market rates north of 6.5%, the sector saw generous inflows in January.

The Performa High Yield composite lagged the benchmark in January returning 0.39% (.30% net) for the month versus the benchmark return of 0.68%.

The High Yield markets return was dominated by the positive move in U.S. Treasuries, the market as a whole still remains on the inexpensive side relative to other fixed income markets. Positive security selection in the cable and retail sectors was offset by our cash position and several names in the metals, transportation, and finance sectors.

EQUITIES

Despite a sizable equity selloff in January, the S&P 500 Index (-3.00%) is still within 5% of its record high from last month. Equity markets seemed to rhythmically sway between big gains or losses on an almost daily basis. Political uncertainty in the Eurozone, tepid global economic data, shifting global monetary policy, and the economic impact of lower oil prices all contributed to the volatility.

While the U.S. economy is still the envy of most other countries, there are some decidedly stretched valuations in certain areas of the market, and the very long, six-year stock market rally is heightening investors' concerns.

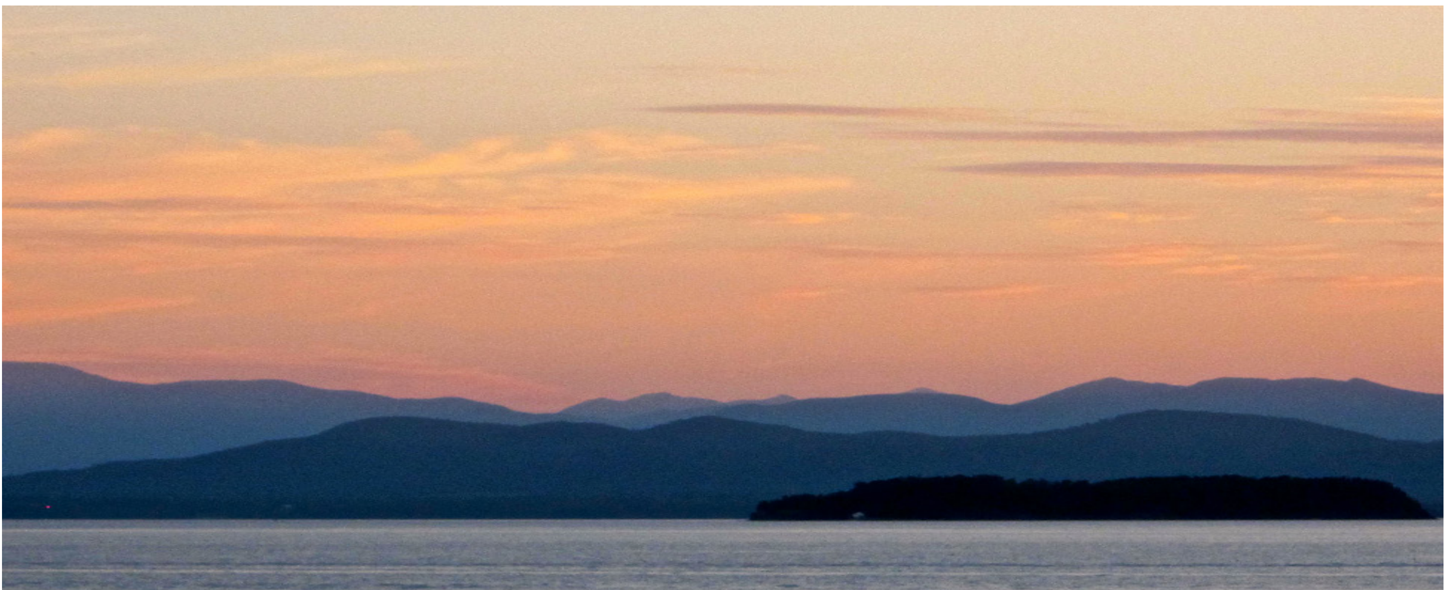
While lower gasoline prices should be a positive economic catalyst due to increased consumer spending, cutbacks in energy related production, and capital expenditures will weigh on short-term growth numbers. Finding the right balancing act remains tricky, but historically low bond yields still provide a tailwind for equity markets.

ASSET ALLOCATION

After a relatively calm year in 2014, a wave of volatility crashed over financial markets in the first month of the new year. Throughout the month, global interest rates moved lower, equity markets oscillated feverously between gains and losses, and commodity prices continued their steep decline. Potentially disruptive elections in Greece, the announcement of the ECB's bond purchase program, and meandering global economic data gave market participants plenty to chew on in January.

Our view is that the move lower in U.S. Treasury rates is largely attributable to international developments, and any clarity coming out of Europe could work to send U.S. rates higher. Thus, we maintain a shorter than index duration in our fixed income strategies to insulate our clients from potentially severe capital losses. With the spread to government bonds at wider levels we find the core of the High Yield market more attractive than in 2014. We favor overweighting credit exposure at the expense of interest rate risk.

International equity markets outperformed domestic markets thanks to the ECB's announcement of a full blown QE program and relatively stable oil prices. While there is still a haze over Europe we think there remain ample opportunities abroad on a case-by-case basis in equity markets.



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Our capabilities include asset allocation and active fixed income management through diversified mutual funds or separate account portfolios. With offices in the world's largest captive domiciles, including Bermuda, Vermont and South Carolina, we are focused on delivering customized solutions to meet the unique investment objectives and liquidity requirements of our investors.

We are 100% employee-owned and currently manage over $2 billion in assets worldwide. Our Investment Philosophy is value driven and long-term in nature. Whether approaching asset allocation or fixed income, our ability to be nimble, contrarian and decisive sets us apart from our peers and promotes capital preservation.

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