PERFORMA

Investment Solutions For Captives

Monthly Market Perspective

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

Monthly Spotlight

After last month's sell-off, sentiment in the global markets has increasingly become one-sided as each piece of news and data is shrouded in pessimism. It is not our role to argue with the consensus as no one person or institution has control over the dialogue. Instead, our job is to explain to our clients what issues perplex investors and whether short-term sentiment has enough legs (or not) to become a longer-term trend and how best to position portfolios for either a continuation or a reversal.

To date, 2016 has seen a continuation of the major themes that have been in place since the oil market began its freefall in the summer of 2014 (See chart below).

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The drumbeat of declines in commodity prices, Chinese economic growth and Emerging Market currencies have hit the equity and non-government debt markets squarely between the eyes. Unfortunately, the markets have exclusively taken a negative view of all incoming touch points after we entered a new global monetary transition period in December.

Transition phases, in science and investing, are bumpy and nerve racking. The U.S. is tightening monetary policy while other countries are lagging or even providing additional stimulus. Further easing adds fuel to the volatility, but no clarity or trend. We have long believed that most central banks ran out of powder a few years ago and the market's reaction to the Bank of Japan cutting interest rates in January was almost repudiation. However, whether this transition period lasts six months or two years, it will be defined by the range that has been in place since the 2008-2009 credit crisis. Thus providing opportunities to find inflection points.

What will it take to turn the consensus view? A good part may just simply be a change in money flows. As long as investors (small and large), keep selling riskier assets and reallocating the proceeds to cash or short term bonds, the price action itself dominates the conversation. "If there is selling, it must be bad!" Momentum in both directions is a powerful market driver, but not a fundamental one. It breeds the buy high/sell low stories that have become so common over the years.

For those with a longer-term perspective, there is no doubt that selling expensive assets and dialing back risk in frothy markets are prudent courses of action. Yet momentum selling without a plan for reentry (however long the horizon may be), has left many investors behind when sentiment shifts and it turns out that no existential crisis existed in the first place.

So is the world at an existential crisis point yet again? In the U.S., we were certainly in crisis during 1929 and 2008. Other countries and regions have had their own moments since the Dutch went crazy for Tulips in the 1630's. It's hard for us to see one now - at least on the economic front. Surely, global economic growth has been a slow slog for years, but it's hard to make a crisis out of a snail, unless of course, it's a snail swarm of biblical proportions like the locusts in Exodus 10.

In our view, we think there are two, much larger themes in place that have exacerbated market volatility and constrained economic growth - impatience and inflexibility.

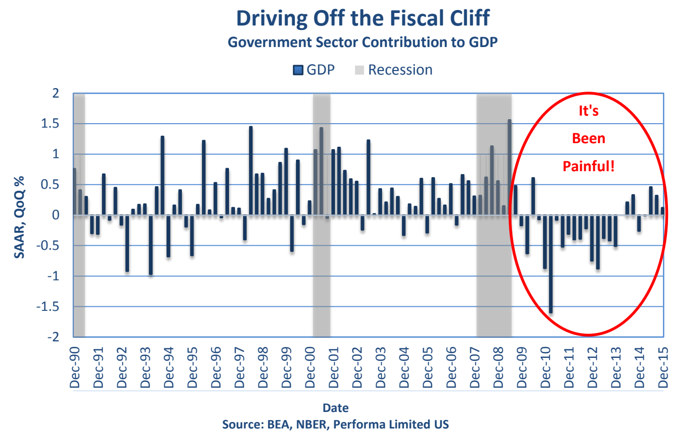
For example, investor impatience with the prolonged, unnatural state of artificial monetary policy has bred contempt. While this is positive in some respects, it is profoundly negative in others. The positive comes from the burgeoning realization that voodoo quantitative easing programs act as short-term stabilizers, but not drivers of long-term economic activity. In other words, the investing community has decided to reject Central Bankers' drug dealing role and gone cold turkey. This is definitely a welcome change, although withdrawal is always painful (volatile).

The negative side of impatience has been the disregard for asset valuations and indiscriminate yield buying over the past seven years. This has provided investors with a false sense of security as prices rise and then the nasty realization for many that they may not fully understand what they have been buying as prices fall. Yield grabbing in unfamiliar markets is not a long-term investing tenet. Conversely, for core investors picking up cheap assets as unfamiliar, crossover buyers give up certainly is. Those opportunities are beginning to appear in various places such as portions of the high yield market, small cap equities and select emerging market countries.

It is hard to stand back and look at the big picture as rocks fall down into the valley, but one thought that we keep coming back to is plotting where we are in the current economic cycle and how it affects portfolios. We understand the markets' impatience, but we also believe that we are in a cycle that is significantly longer than the typical boom/bust/recovery timeframe from the last thirty years. While not quite a dog's life where each human year is worth seven, we see the current cycle lasting ten to twelve years. The fits and starts seen over the past seven years may, at each point, have appeared to be the end, but really have been just parts of the broader range.

The second area behind our thinking is inflexibility, manifested in the sea of change in governance in many countries and regions since 2008. The inability to compromise, the all or none policy vote and the reactionary policy implementation all adds up to bifurcating the world into haves and have nots. Those countries who end up as supplicants to those with the dictatorial power to control their economic fate.

The disconnect between standard policy responses and the austerity fight in the developed world led to monetary policy string pushing and fiscal policy abdication by countless governing bodies across the globe. Had European and U.S. politicians added fiscal stimulus firepower to the monetary policy sparks earlier on this decade, the probability of escaping a moribund global growth path would have been much greater. Instead, the Germans led the push for economically damaging austerity rules within the region when many European countries were economically more fragile. In the U.S., the Tea Party co-opted the conservative agenda resulting in a paralyzed congress and killed any prospective common sense fiscal prescriptions (see "Driving Over the Fiscal Cliff" chart).



Even the rigid U.S. Dodd-Frank and European Basel III banking regulations have created negative unintended consequences. We do not think that lowered world financial market liquidity and little increase in access to credit for consumers and smaller businesses were what the original reactionary policy makers had in mind.

Compromise is the foundation of democratic unions. The last seven years of autocracy has not been a productive response to the original crisis. While passionate stands have been taken in certain countries during this time period, we may be closer to resuming inclusion, compromise and normal political decision making than at any point during this cycle. Any potential political breakup of the European Union should create a centrist push. Politics in the U.S. need to move away from the outer fringes as well. Campaigns for party nominations usually work the fringes with the winners moving more centric as the general election approaches. Each of the leading Republican candidates swears to be a Ronald Reagan disciple, but it is unclear if they know what that really means as they continue to pander to small blocks of voters. Reagan was an inclusionary leader; elected by both mainstream Republicans as well as a sizeable block of Reagan Democrats. Pragmatism needs to replace the uncompromising Tea Party vitriol. Perhaps John McCain can put the genie back in the bottle.

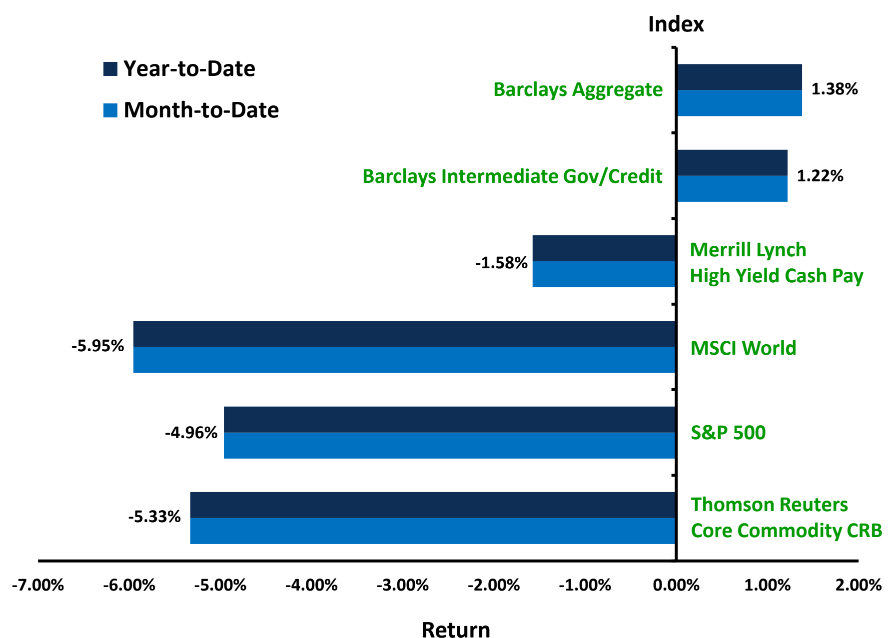
Long-term thinking may be beneficial, but one may ask, how does it relate to the here and now? For us, it means that the mini cycles are there to help in the decision making process for when to employ new cash into the markets versus waiting for a better day. Over the past seventeen Januaries, negative equity returns have occurred ten times. Of those ten down months, only four years saw a continuation through year-end. This does not necessarily mean that we believe 2016 will see a reversal, but that it's possible. It's more important to deduce the extent to which a January swoon has merit as a potential indicator for the remainder of the year. We do not expect oil prices below $30/barrel and the value of local, inaccessible Chinese equity markets to be the main, direct factors influencing returns in 2016, despite being the most hyped in the press.

Instead, we are relying on our fundamental analysis to spotlight opportunities. While some market indicators may be flashing yellow or red, there are pockets closer to green. We have begun to deploy some of the cash stored up in various strategies coming into year-end, as individual names or sub-sectors show extremes in quality valuations. If momentum investing causes an artificial divide, we think the gulf has widened considerably recently. And for our clients that continue to see positive flows into their portfolios, simple dollar cost averaging has always been a favorable method.

For those investors that have given up, there are others that will meet them armed with research, fortitude and patience – we always strive to be part of the latter group. That starts with never taking for granted our ability to act with confidence because of the understanding and trust our clients have shown as we help them navigate this current seven year odyssey.

Asset Class Overview

It was a painful start to the year for risk assets and non-government debt markets amid global growth concerns and further pressure on commodity prices. The MSCI World Index, a measure of developed world equity markets, returned negative 5.95% for the month as the index fell to multi-year lows. U.S. equity markets faired only marginally better. After staging a late month rally the S&P 500 ended the month off the lows, but still down 4.96%. The high yield bond market managed to outperform equities with the Merrill Lynch US Cash Pay High Yield Index returning negative 1.58%. Investment grade fixed income benefited from a general flight-to-quality. The Barclays Aggregate Index, a measure of the broad investment grade bond universe, returned a positive 1.38% in January.



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ABOUT PERFORMA

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Our capabilities include asset allocation, active fixed income and equity 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 $2.8 billion in assets worldwide representing more than 50 clients. Our investment philosophy is value driven and long-term in nature. Whether approaching asset allocation, fixed income or equities, our ability to be nimble, contrarian and decisive sets us apart from our peers and promotes capital preservation.

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