OCTOBER 2023

MARKET PERSPECTIVE

INSIGHTS & REVIEW FROM PERFORMA'S INVESTMENT TEAM

CASH TO BONDS

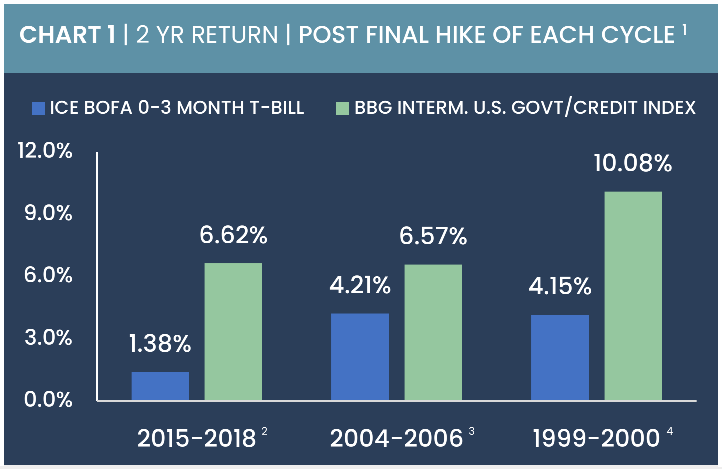
Given the current macro landscape, we wanted to discuss why we believe now is a good time for captive owners to consider extending cash holdings to longer maturities via bond strategies. Before doing so, however, we want to be clear that this is not necessarily a fit for all captive programs. For example, it is prudent to maintain cash balances to cover near-term obligations, support very short-tail liabilities or for programs with high liquidity needs. Additionally, a captive's investment portfolio may support collateral arrangements (trusts or LOCs) with restrictive guidelines or a captive may be constrained by limited excess collateral – both of which require shorter duration mandates. In those scenarios, a cash/money market strategy remains the better fit, even though there will be a lower long-term return potential. Fortunately, cash/money market strategies are still benefitting from the current higher interest rate environment.

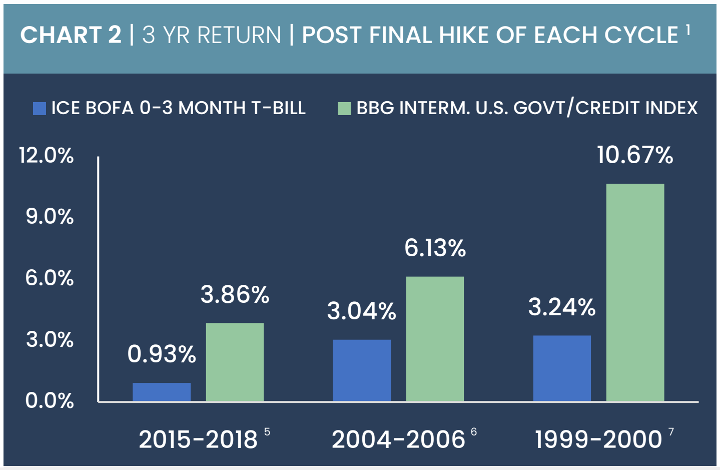
For those who can move excess cash further out the maturity spectrum, we believe the current trend towards higher rates out the maturity spectrum will present an opportunity to increase portfolio duration risk (interest rate exposure) given a favorable risk/return profile and an overall slowing of economic activity. Doing so would lock in yields not seen in decades while allowing for greater potential price appreciation when interest rates/yields move lower (and bond prices move higher).

When it comes to fixed income investing, a general rule of thumb is to carry less interest rate risk (short duration) in a rising rate environment and carry more interest rate risk (long duration) in a falling rate environment. Of course, the hard part is identifying the tipping point in interest rate cycles.

The question of how much interest rate risk to carry in fixed income portfolios is of particular importance today as the Federal Reserve has begun to slow the pace of interest rate hikes. Moreover, with cash rates at 20-year highs and the U.S. Treasury curve inverted (short term yields higher than long term yields) a common question that we have been fielding is: Why not just leave assets in a money market fund, the yield is higher and interest rate risk lower?

The short answer is that when the interest rate cycle turns, and rates move lower, investors are better off owning more duration/interest rate risk (not less) despite the yield give up. History shows that after the Fed delivers the final hike of a tightening cycle, it is beneficial to move out the maturity spectrum; locking in elevated yields and capitalizing on price appreciation as interest rates/yields move lower (bond prices up), *see chart 1 and 2 below.*





SOURCE: BLOOMBERG, EVESTMENT, PERFORMA. [1] REPRESENTS ANNUALIZED RETURNS 2 YRS (CHART 1) & 3 YRS (CHART 2) FROM THE END OF EACH FED TIGHTENING CYCLE. [2] REPRESENTS THE 2 YR RETURN AS OF 12/31/2020. [3] REPRESENTS THE 2 YR RETURN AS OF 6/30/2008. [4] REPRESENTS THE 2 YEAR RETURN AS OF 5/31/2002. [5] REPRESENTS THE 3 YR RETURNS AS OF 12/31/2021. [6] REPRESENTS THE 3YR RETURN AS OF 6/30/2009. [7] REPRESENTS THE 3 YR RETURN AS OF 5/31/2003.

Additionally, fixed income investors also need to consider how the rate environment might be different when they receive principal and/or coupon payments. When it comes to the reinvestment of principal and/or coupon payments, investors want to avoid getting money back at the wrong time, i.e. minimize reinvestment at lower rates. In a scenario where rates head lower (bond prices higher), owning longer duration bonds allows for capital appreciation while reducing the amount of money to put to work at lower rates (lower reinvestment risk).

Without question, parking capital in cash has been a smart move as of late, however, the rate cycle will turn. Around that moment, investors will gravitate towards longer duration bonds to increase their potential for price appreciation and minimize reinvestment risk. Those who sit in cash will be forced to invest large percentages of their portfolio at lower and lower cash/money market rates without the benefit of much price appreciation from having duration in the portfolio via owning longer maturity bonds.

One final note, trying to time markets and finding the exact point when rates turn is almost impossible, which is why we think it is prudent to start adding duration when and where possible in preparation for when rates stabilize and eventually move lower. For investors who are cashflow positive, being able to leg into longer duration fixed income positions as rates rise is undoubtably an enviable position. Meanwhile, for those who already have an allocation to longer maturity bonds, have weathered the storm of higher rates and handled the subsequent unrealized losses over the past 18-24 months — those strategies are already well-positioned to benefit from a higher yield environment and price appreciation when the cycle turns.

ABOUT PERFORMA

Combining our extensive knowledge of the insurance industry with the institutional expertise of our investment team, Performa has been managing assets on behalf of captive and other insurance clients for 30 years. Our capabilities include asset allocation, active fixed income and equity management through diversified mutual funds, ETFs (exchange traded funds) and 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 clients. We are 100% employee-owned and have $5.91 billion in captive assets under management and advisement as of July 31, 2023. 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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