Bermuda

South Carolina

Vermont

Monthly Market Perspective

April 3, 2015

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.

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Monthly Spotlight: Not All High Yield Bonds are Created Equal

High yield bonds – debt issued by corporations carrying a rating below investment grade – can provide equity like returns with lower volatility, while having less interest rate risk than more traditional fixed income investments. In general, high yield bonds offer a generous yield advantage over Treasuries and investment grade corporates, while providing diversification benefits to a well-constructed portfolio.

To start, think of the high yield market as having three parts broken down by credit quality: BB's, B's, and everything else.

Double B's (BB's) - One notch below investment grade, BB's are the highest rated part of the high yield market. BB's offer an income advantage over investment grade bonds, but have more interest rate risk than the rest of the sector.

Single B's (B's) - B's provide a yield advantage over BB's, to compensate investors for increased credit risk, while having less interest rate risk – a positive in a rising interest rate environment.

Everything Else - Companies rated CCC and below are often in a distressed situation, acting more like equities. The subsector has minimal interest rate risk, but that comes at the expense of higher price volatility and default rates.

Since 2012, client dependent, Performa has maintained an allocation to the high yield sector via the Performa High Yield Fund as a way to boost client income, while decreasing overall portfolio volatility. Going forward, as equity markets bounce around all-time highs, an allocation to high yield will play an important role in a well-diversified portfolio. That said, not all high yield bonds are created equal, and just having high yield exposure won't be enough. Positioning within the sector will be a key factor in determining overall performance.

The Sweet Spot

Performa's view is that B's are currently the sweet spot of the high yield market, offering good risk adjusted value. In a macro environment of diverging monetary policy and modest economic growth B's are an attractive investment. The subsector offers a significant income advantage over BB's (see Chart 1), while having dramatically less interest rates risk as measured by duration (see Chart 2).

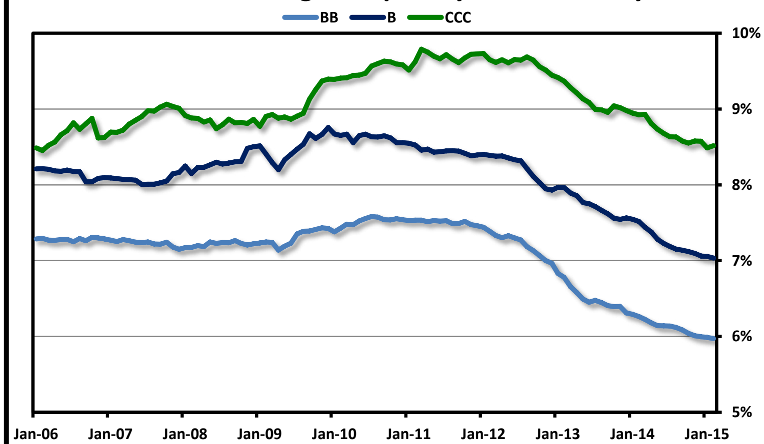
Secondarily, solid companies with strong fundamentals can be found within the B subsector. Some companies simply don't care about being investment grade and are perfectly happy carrying a B rating. Just as some businesses need to issue large amounts of debt and thus require an investment grade rating, others, usually smaller companies, have no such need. As such, some B issuers are overlooked and offer attractive investment opportunities.

Tying It All Together

Over time high yield returns have generally outpaced investment grade fixed income markets (the exception being during economic downturns) while frequently matching or outpacing equities (see Chart 3).

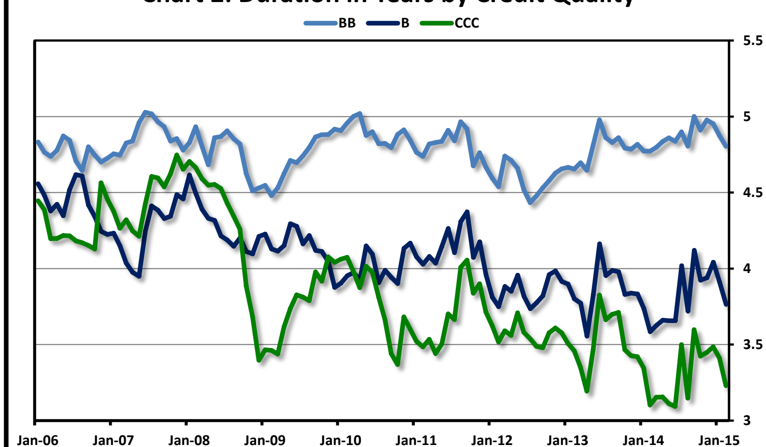
The unique risk/return profile of the high yield market makes it a valuable addition to a well-constructed portfolio. Going forward an allocation to the sector, tilted toward B's, can offer portfolio diversification benefits, while boosting overall returns without adding an unwanted amount of interest rate risk.

Chart 1: Average Coupon by Credit Quality



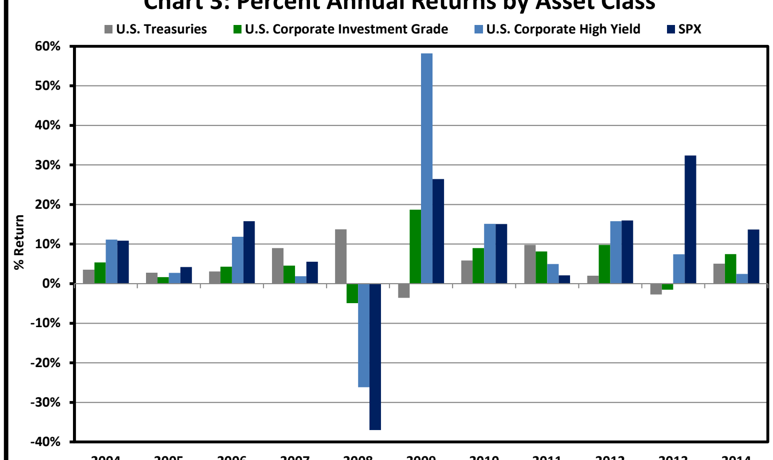
Source: Barclays, Performa Limited U.S.

Chart 2: Duration in Years by Credit Quality



Source: Barclays, Performa Limited U.S.

Chart 3: Percent Annual Returns by Asset Class



Source: Bloomberg, Barclays, Performa Limited U.S.

The Macro View

U.S. economic growth appears to have slowed in the first quarter as a strong U.S. dollar, labor disputes at West Coast ports, and harsh winter weather all weighed on activity. In contrast, the strength of the U.S. labor market continues to impress, and should support growth going forward. Coupled with improving labor markets, low gas prices and elevated equity markets have the U.S. consumer feeling quite optimistic – a positive signal as the U.S. economy emerges from a long, cold winter.

Eurozone economic activity is hardly raging, but we remain encouraged by the signals we're receiving. Further improvement in labor markets, low energy prices, and growing consumer demand all suggest that better economic growth lies ahead. Meanwhile in the United Kingdom, fourth quarter growth was unexpectedly revised higher to 3.0%, the fastest pace of year-over-year growth at any point during the current expansion. More timely economic indicators suggest a continued firming in activity, with consumer confidence at a 12 year high.

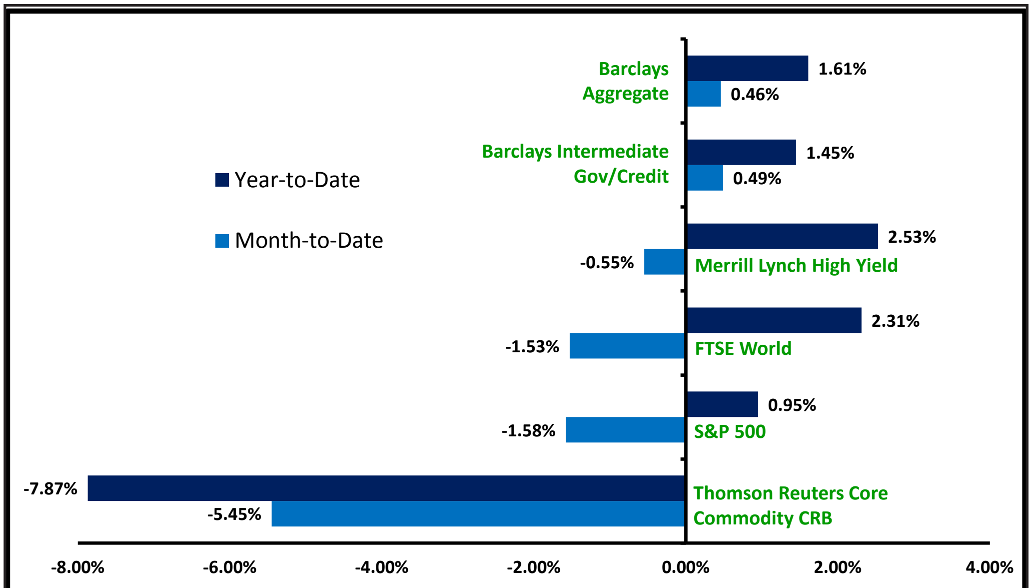
The economic story out of China continues to be one of slowing growth. Chinese officials have acknowledged that activity is slowing, but reiterated that they will provide the stimulus necessary to defend a 7.0% growth rate.

Global Monetary Policy

By historical standards, global monetary policy remains extremely supportive. The European Central Bank began its bond purchase program in March, sending Eurozone sovereign to historic lows. In the U.S., as expected, the FOMC dropped the word "patient" from their March statement as they contemplate 2015 interest rate hikes. Meanwhile, the Public Bank of China signaled it has scope to stimulate its slowing economy.

Asset Class Overview

Investors favored certainty and security in March as investment grade bonds recouped some of February's losses, while equity and high yield markets slumped. The Barclays Capital Aggregate Index, a measure of the broad investment grade bond market, returned 0.46% for the month pushing year-to-date returns north of 1.5%. Meanwhile, the lack of demand for risk assets sent both domestic and global equity markets lower. For the year, the FTSE World Index has returned a solid 2.31%, outperforming the S&P 500 by 1.36%. Global equities, however, were not able to keep pace with high yield returns, which topped 2.50% for the first quarter of 2015.



Source: Barclays, Bloomberg, Performa Limited U.S., Gross Index Returns

The Markets

Credit

The credit market quickly reversed last month's positive tone as mixed economic data, lower Treasury yields, as well as a wave of corporate issuance weighed on spreads. The spread between credit and U.S. Treasuries widened in March, as corporate bond yields are now 1.25% higher than their benchmark. For the year, credit has returned 2.16%, resulting in 0.17% of excess return over comparable Treasuries.

- The primary market was active in early March with over $31 billion of origination on the second trading day, and more than a $100 billion in the first 2 weeks of the month. In total, the primary market supplied $140 billion in new issuance to the corporate market relative to $128 billion posted in March of last year.
- Unfortunately for credit markets, the aggressive pace of issuance in early March coincided with a reversal of rates and a selloff in equity markets. By mid-month, however, credit markets had settled down and were largely unchanged during the last 2 weeks of the month.
- News flows specific to credit were light, especially as we entered a quiet period leading up to first quarter earnings season. Alcoa unofficially kicks off earnings season on April 8th followed by financials and money center banks closer to mid-month. Early preannouncements point to headline risks centered on currency concerns, commodity declines, and struggling top line growth.
- We remain overweight credit as a substitute for Treasuries and U.S. Agencies in this low yield environment. We continue to reduce overall duration of the corporate portfolio targeting floating rate paper while opportunistically adding longer bullet maturities in order to maintain yield.

Structured Products

The Structured Product market was quite active during March. All subsectors experienced positive absolute return for the month, but the Agency Backed Mortgage market was unable to keep up with their U.S. Treasury hedges. Consequently, the relative underperformance of the Agency Backed Mortgage market created a drag for the overall Structured Product universe, as measured within the Barclays Aggregate Index.

ABS - We saw an active new issue calendar early in March and secondary trading remained robust for most of the month in the Asset Backed market. Supply was easily digested and demand for short duration bonds was quite robust, as credit spreads tightened meaningfully throughout the month. One interesting area of focus has been the container market. Several container bonds issued in 2013 are approaching their call date. The market is watching to see if borrowers call existing bonds and refinance to an extended date, possibly taking out more debt in the process. Or, if they forego the call option and let the bonds run to maturity. Either way this should give investors a pulse on the shipping space and overall global demand.

CMBS - Commercial Real Estate was active in the primary and secondary space. For most of the month the sector traded well and demand was healthy. Despite a pullback at the end of the month/quarter, the sector managed to outperform comparable Treasuries in March. We continue to feel there is solid risk adjusted relative return in the sector, but are vigilant on the real risk of diminished liquidity. Diligence in credit work and the ability and willingness to hold an asset to maturity are crucial.

MBS - The Mortgage market, and specifically Agency Backed Mortgage bonds have traded directionally. When interest rates rise, the sector tends to outperform as investors prefer the yield advantage over Treasuries. When the interest rates drop, mortgages underperform as investors shy away from lower all in yields and fret over the potential for increasing mortgage prepay speeds as borrowers refinance existing loans in a lower rate environment. We remain wary of the sector due to the volatility inherent therein.

High Yield

The High Yield market posted modest losses in March as oil prices retested January lows and the energy sector gave back some of the February gains. The Merrill Lynch Cash Pay High Yield Index returned negative 0.55% in March, but with a year-to-date return of 2.53% the sector was a top performing asset class in the first quarter.

For the month, Performa High Yield investors had a negative 0.43% return, outpacing the benchmark by 12 basis points. The outperformance was attributable to positive security selection in the healthcare sector and an underweight to energy issuers. The portfolio continues to hold a large cash position which also helped performance in a falling market. We continue to look for opportunities to redeploy cash, specifically in undervalued energy names and misunderstood credits in other sectors.

Equities

March was another volatile month for equities, bouncing between big gains and big losses with regularity. For the month the S&P 500 was down 1.58%, leaving the index up 0.95% in the first quarter. While the U.S. economy is stronger than most, the dollar rally has negatively impacted our own multinational companies' profitability and hence their stock market outlook. Some fiscal reports emanate mixed signals and bring into question corporate profitability for the remainder of 2015. With first quarter earnings reports about to begin, earnings and revenue growth will be closely examined in conjunction with individual stock and equity market valuations.

As the long bull market in equities continues, each and every move up seems more arduous and met with less investor enthusiasm. Shifting U.S. monetary policy, nuclear negotiations with Iran, oil price fluctuations, and choppy trends in U.S. consumer spending have made it difficult for equities to sustain new highs. Looking ahead, we will closely monitor consumer spending as an indicator of future corporate profitability and stock market appreciation.

We are cautious but hopeful for sustainable economic growth and continue our research, identifying undervalued and underperforming equity assets that offer above average appreciation potential.

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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 over 20 years.

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 $2.8 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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