Monthly Spotlight: Where is the Gym?

The Results

For the first 7 months of 2014, the barbell strategy has worked well within our clients' fixed income portfolios. As anticipated, the unhinging of the front-end of the U.S. bond market occurred and interest rates from 2 to 5 years increased. However, the dramatic decline in rates at the long-end of the curve has been the topic most discussed. 30-year bonds have fallen 0.75% since January making them the best fixed income performers while 10-year treasury yields have fallen over 0.5% YTD (from 3% at the end of 2013). This twisting of the curve has led most broad market bond indexes to post positive YTD returns at the high end of our entire 2014 forecast.

Under normal circumstances, this market behavior and a shorter portfolio stance would yield underperformance. However, the barbell strategy offset this and allowed for generally the same returns as the client benchmarks, with roughly just 2/3 of the interest rate exposure. The upshot is that with a shift in valuations, the front-end of the market looks better valued than the long-end – the opposite of our view in January! **Performa client portfolios now have the added benefit of being better positioned to hang onto these gains than their respective indexes if rates increase across the board or longer bonds reverse course and underperform.**

It's the Left Side of the Barbell that Makes it Work

For floating rate note exposure, we chose corporate and commercial real estate mortgage bonds (CMBS). While corporate bond floaters are easy to evaluate from a credit perspective, CMBS ones are not. To find the right floating rate CMBS bonds, we draw upon our investment team's expertise and nearly 20 years of experience in managing these securities. CMBS floating rate securities are typically smaller, as well as backed by fewer properties, than in a typical CMBS transaction. Many times the underlying buildings are in a transition period, for instance hotel properties going through partial renovations or rebranding. Other examples are properties that have just finished construction completion or are near completion and are not yet fully leased. These types of loans require research on similar assets and more of a projection on growth and future cash flow while having less historical data to use as a model for said growth. This dynamic demands higher protection for the bond buyer to offset the marginal increase in risk.

We believe that the commercial mortgage market will remain in its current, healthy state at least well into 2016. The 2014 environment allows us to capture excellent incremental yield through new floating rate deals. Many building owners have been moving steadily through their transition periods as they find a more receptive mortgage market and refinance. In total, these bonds provide a shield against rising interest rates as well as the potential to perform well as the economy and the commercial real estate and mortgage markets continue to heal from 2008.

- Jason Golder, Portfolio Manager—CMBS

The Macro View

United States

The U.S. economy expanded by 4.0% from April to June, according to the first reading of 2nd quarter growth. This rebound in economic activity was much stronger than expected, with solid gains across all major areas except for exports. Even a slight plateau in housing sector data does not dampen our encouragement from labor market improvements and rising consumer and business sentiment.

International

The U.K. economy grew during the 2nd quarter, extending the run of consecutive quarterly gains to six. Britain's labor market improved as well, with unemployment falling to 6.5% in July. Inflation also retreated towards the Bank of England's 2.0% target. Meanwhile, the Eurozone economy remains vulnerable to shocks from the Ukrainian unrest via trade sanctions on Russia and natural gas flows.

China's manufacturing sector expanded at a moderate pace in July with 2nd quarter growth slightly beating market expectations at 7.5%. This bodes well for emerging market economies reliant on commodity sales to China. While the first half of 2014 has been better than expected, China's economy is still trying to find its footing away from sustained government stimulus intervention.

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The Macro View Continued

Global Monetary Policy

The turning tide of global monetary policy continues at a glacial pace. Any further monetary easing from the European Central Bank (ECB) is not likely until next quarter, if at all. Meanwhile, the U.S. Federal Reserve's July meeting produced little new information about the future timing of interest rate hikes. The Fed and the Bank of England are the clear front-runners to normalizing monetary policy after the 2008 crisis, as we continue to expect the ECB to lag during the current cycle.

The Markets

Fixed Income

Increasing tensions in Gaza and Ukraine kept U.S. 10-year yields at the low end of their recent range for most of July. However, higher Q2 economic growth pushed 10-year yields north of 2.55% by month-end. The Barclays Aggregate Index, a measure of the broad investment grade bond market, returned negative 0.25% for the month (3.66% YTD).

Corporate Bonds

July was a relatively tame month for the credit market, as yields versus U.S. Treasuries were mostly unchanged. The sector produced 7 basis points of excess return for the month (167 for 2014).

- Investors focused on 2nd quarter corporate earnings season during July, which wraps up by late August. Volatility in all risk markets increased towards month-end with intensifying tensions in the Middle East and Russia/Ukraine. Even with the anxiety, corporate yields remained close to their post 2008 tight levels.
- New bond issuance slowed in July (<$60 billion) given the record amount of supply in June combined with earnings announcements and the typically summer drop in liquidity. Financial names were the dominant issuers during the month, taking advantage of stable markets, low rates, and solid earnings reports.
- We continue to watch the very robust mergers & acquisitions (M&A) market as the count and size of 2014 deals is well above expectations. We continue to think the accommodative credit markets and low overall interest rates are playing a significant part in the economics of these transactions. These large transitions inherently build into a pipeline for new supply, which may weigh on secondary market prices. If investors balk or interest rates increase, this could end.
- Our overweight to corporate bonds exposure has decreased since the beginning of the year both in terms of dollars spent as well as on a duration-adjusted basis as a large part of our barbell strategy described at the front of this piece.

Structured Product

The Structured Product market underperformed equivalent U.S. Treasuries by 43 basis points for July according to the Barclays Aggregate Index. Diving deeper, sub-sector and credit quality bucket returns were off kilter as compared to other fixed income sectors. (see next page)

Performa Preliminary Intermediate Fixed Income Composite Performance *

	July	YTD
Performa Gross	-0.15%	2.04%
Performa Net *	-0.17%	1.87%
BarCap US Int. Gov't/Credit	-0.22%	2.03%

Market Returns

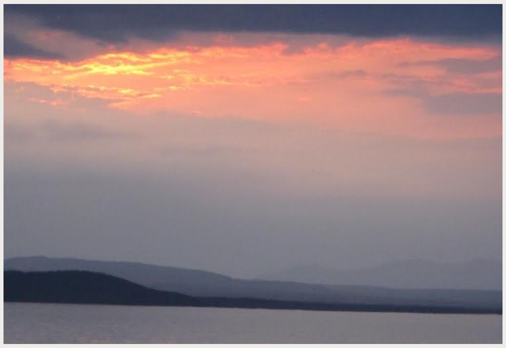
Equities	July	YTD
S&P 500	-1.38%	5.62%
FTSE World	-1.38%	5.12%
Fixed Income		
BarCap Treasury	-0.16%	2.55%
ML High Yield Cash	-1.33%	4.15%
BarCap Aggregate	-0.25%	3.66%

* 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.

The Markets (continued)

Structured Product (continued)

To wit, while high yield bonds (below) had a poor month, structured product bonds with low credit ratings actually posted positive returns as demand dynamics were a mirror opposite of high yield.



- **ABS** — The Asset Backed Security market was orderly and subdued for July. While new issuance felt heavy at times and yields to U.S. Treasuries rose slightly, this sub-sector held in well. We continue to look for shorter bonds with less interest rate sensitivity.
- **CMBS** — Most portions of the Commercial Mortgage market remained well bid for the month. New issuance and a rash of secondary market selling from hedge funds limited the upside. Most selling concentrated on older, lower credit quality securities. By month-end, supply had been absorbed and returns were a function of higher interest rates. Please see the front of this piece for a more detailed explanation of our CMBS floating rate posture.
- **RMBS** — Residential Mortgage bonds were the worst performing sector in the Barclays Aggregate Index and U.S. Agency guaranteed securities have now only matched equivalent U.S. Treasuries returns for all of 2014. High new mortgage origination and demand from the Fed's buying program could not match investors' selling pressure. We continue to avoid the sector amidst the volatility.

High Yield

After 10 consecutive monthly gains, the BAML High Yield Cash Pay Index declined -1.33% in July, leaving returns at +4.15% YTD. Headline risk increased, as a new round of articles appeared that questioned the valuation of the market and quality of new issuance. Investor consensus is that July's sell-off was technical in nature as mutual and exchange traded high yield funds sold indiscriminately into a less liquid, summer market to fund redemptions (like summer '13). Valuations are certainly now more attractive but we remain defensive in our High Yield strategies and hold significant cash balances.

Performa's High Yield Composite continued to outpace the index— 24 basis points (before fees) better than the index in July and +1.07% (gross of fees) YTD. The outperformance came from the portfolio's defensive cash position and lower interest rate sensitivity than the index. We continue to focus on the middle tier of High Yield credits while avoiding low-yielding, high quality bonds that are highly correlated to moves in the U.S. Treasury market. We remain underweight the lowest quality sector while waiting to buy bonds should volatility and more forced fund sales bring an overshoot on the downside.

Equities

After reaching new record highs intra month, equity markets fell by month-end. The main factors were stronger economic data, which, like last summer, brought fears of the impending end of the easy money punch bowl as well as geopolitical tensions. Most major indices ended July with returns between negative 1% to negative 1.5%. We continue to believe that domestic equity markets are fully valued.

Asset Allocation

Our overall stance has client asset allocation portfolios at neutral to slightly underweight global equity exposure as new cash is spent in market neutral and income producing strategies with lower interest rate risk. The short-term goal is to protect 2014 positive portfolio returns from short term volatility. Within the fixed income allocations, we hold a shorter-than-index duration, as well as prefer an overall underweight to Investment Grade bonds in favor the high yield on a relative basis.

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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 Ber-muda, 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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