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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.

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More than a month into the second half of 2016, macro factors continue to dominate financial market sentiment. In previous Market Perspectives we have discussed the recent trend amongst investors to almost exclusively fixate on the macro issue du jour, while ignoring fundamental analysis. Hidden amid the daily news clutter surrounding the upcoming U.S. election and Brexit fallout, second quarter corporate earnings season was in full swing during July.

By July 31st, over half of the companies in the S&P 500 (many of them investment grade bond issuers) had reported their quarterly financial results. In aggregate, while not terribly inspirational, earnings have been more encouraging than the dire consensus expectations.

Over the past few years, the themes and trends of corporate earnings releases for companies within the investment grade universe have been remarkably consistent. Top line revenue growth has been subdued, while margins have remained decent and balance sheets have slowly rebuilt higher leverage ratios. Several of those conditions are not traditionally thought of a constructive for investment grade credit and are consistent

with typical late credit cycle behavior. However, in an environment where the business cycle has been elongated due to worldwide monetary policy largesse, corporate fundamentals remain resilient. While we continue to look for any significant deterioration in investment grade corporate balance sheets, we have yet to see the canary in the coal mine that would cause us to greatly reduce our allocation to the sector. Additional positive factors (such as record amounts of cash on hand, disciplined financial policies combined, and solid market technicals) keep credit a compelling story, particularly compared to owning U.S. Treasury bonds.

According to the most recent JP Morgan JULI Index, 1st quarter 2016 revenue was down 9.5% over last year's results. As expected, this decrease was led by a severe downturn in the commodity based sectors. While non-energy sector revenue was not hurt as much, 9 of 17 sectors still experienced declines.

Margins for the quarter, on the other hand, were resilient and came in flat at 29% on average; cost cutting in the energy sector helped. While margins have expanded steadily since the financial crisis, it has been a result of depressed wages, modest hiring, and conservative capital expenditure plans. At this juncture, the low hanging fruit has been picked and recent quarters show these factors diminishing in relevance.

Companies have been able to keep stockholders happy by throwing bags of money their way through financial engineering as opposed to strong corporate revenue growth. Issuing debt for mergers and acquisitions, buyback programs, and larger dividends have increased debt ratios but at inexpensive levels. Total debt for the quarter rose by 13% (year-over-year) highlighted by massive increases from Apple (funding share buybacks) and Microsoft (funding the $26 billion LinkedIn purchase). This year, the increased debt levels continue to be primarily related to large M&A and a limited number of transactions. Despite these concerning numbers, overall leverage metrics, the foundation for credit analysis, have been surprisingly resilient. While gross leverage (debt/earnings before interest payments, taxes & depreciation) has increased from 2 times to 2.85 times over the past six years, record levels of cash (over $1 trillion) sits on corporate balance sheets and acts as a large buffer.

Still, higher leverage combined with diminishing refinancing benefits has resulted in declining interest coverage. This ratio is now back to levels close to those experienced prior to the credit crisis. However, the cash on hand back in 2007-2008 was small compared to the hoard today.

While some of these deteriorating fundamentals are signs to watch closely, the technical picture remains solid for investment grade corporate bonds. Despite historically low absolute yields, the sector

still enjoys a 1.4% higher average yield premium to equivalent U.S. Treasuries. With this average yield advantage, credit is still miles away from being considered expensive, as compared to the 0.50% - 0.75% premium experienced last decade. Additionally, international buyers continue to view the relative yield of U.S. corporates as attractive compared to their own markets and have been active buyers of new issue debt.

To be sure, investor demand for corporate bonds has been so persistent over the last year that not even a record level of new deals have sated it. Should interest rates increase, effectively squeezing deal economics, the technical picture for credit should further improve. In a higher rate environment the new issue market would likely slow, the decrease in supply would help support the market. Furthermore, when financial markets exhibit short bursts of volatility, mergers stop and supply dries up temporarily as well.

Overall, despite the tendency amongst investors to focus almost exclusively on macro uncertainty, we continue to watch corporate fundamentals closely. While some metrics are concerning we remain constructive on the sector. Absolute yields, while at historically low levels, are compelling relative to other opportunities and corporate balance sheets have proven quite resilient in the face of continued headwinds.

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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, 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 over $3.17 billion in assets worldwide representing more than 65 captive client relationships as of July 31, 2016. 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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