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Performa Market Perspective

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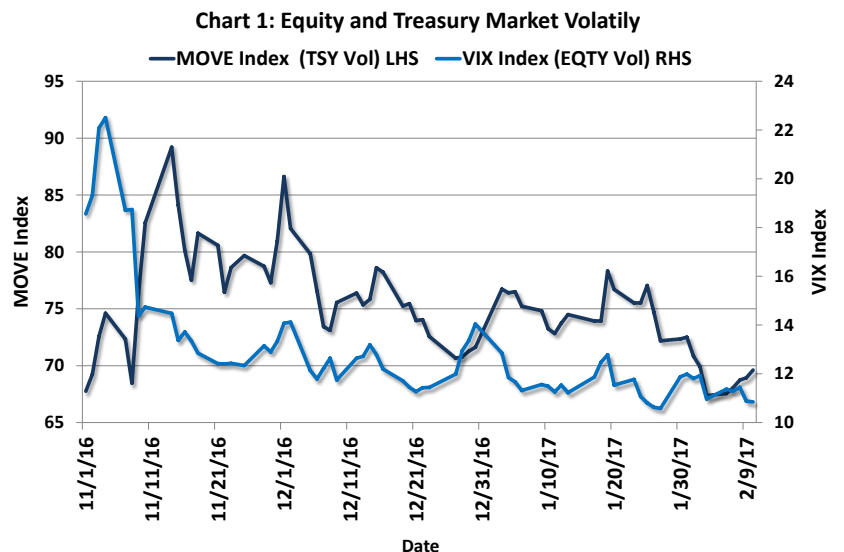
Airline Industry Focus - New Paradigm or Chasing Returns?

The post-election day rally continued well into February, confounding the many pundits crowing about elevated “market uncertainty.” While the president’s messaging medium (Twitter) and tone (abrupt) remain fascinating, his initial flurry of executive orders and laundry list of broad economic and foreign policy changes remain primarily in idea form.

Investors seem to be taking the lack of details in stride. Volatility has actually fallen, which more aptly describes complacency than uncertainty (see Chart 1).

It will take a while before we have clarity on the policy prescriptions that will ultimately come out of Washington. Even so, risk assets continue to rise in anticipation of all the economic perks to come and U.S. equities appear priced to perfection.

Even if Trump meets peoples’ expectations over the near term, a short dip buying opportunity may emerge. However, if the Trump rocket fails to launch – likely sabotaged by a less than enthusiastic Republican legislature – we would expect a greater pull back in risk assets.

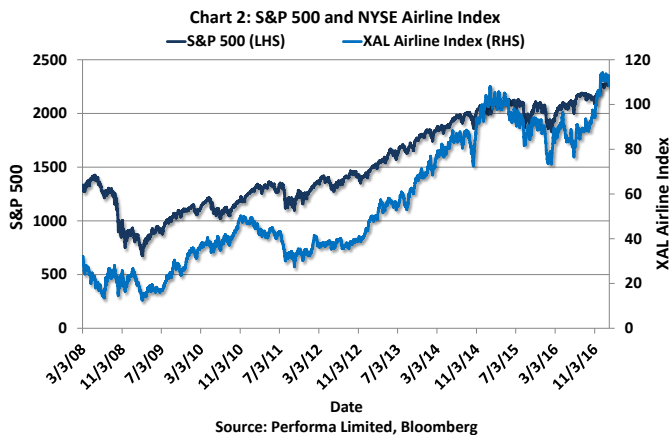


Source: Performa Limited, Bloomberg

Donald's Ban Grounds Airlines?

Late on Friday, January 27th, President Trump signed an executive order limiting incoming travel and immigration from seven countries. The immigration order, or travel ban as many called it, immediately created mass confusion and protests. Which brings us to the subject of this Performa Market Perspective: airline investing.

The U.S. equity market sold off immediately in response to the travel ban only to quickly recover and resume its skyward trajectory. Airline stocks followed suit, but with a bit more volatility. In any event, a sector that has historically performed extremely poorly has been on an impressive multi-year run. Leaving some investors to wonder if the airline industry has shifted to a new paradigm (see Chart 2)?



Just the other day, Berkshire Hathaway revealed it now holds over \$10BN (over 8% of the total market cap) of U.S. domestic airline stocks after initially buying stakes last quarter. Warren Buffet now holds more than \$2BN each of United, Delta, American, and Southwest. We were curious as to what spurred the Oracle of Omaha to let his lieutenants buy so much of an industry he historically hates!

Flash back to 1994 when Warren Buffet said: “There’s no worse business of size that I can think of than the airline business. You’re selling a commodity product with no variable costs. Huge fixed costs. It’s a terrible business. I have an 800 number now which I call if I ever get an urge to buy an airline stock. I say, ‘My name is Warren, I’m an air-aholic,’ and then they talk me down.”

Apparently, Doug Parker, American’s CEO left the Berkshire crew impressed after last March’s JP Morgan airline conference when he said that the industry has a new reality. Hmmm. “New paradigm” you say? Let’s look under the wings. From a top down perspective, massive industry consolidation, lower fuel prices, and more efficient planes are all positives. Those, in theory, address the previous industry struggles with a lack of pricing power, volatile variable costs, and better fixed asset margins. Looking at the past may shed better light on this perceived paradigm shift.

Deregulation & Shareholder Value Erosion

The 1978 Airline Deregulation Act ushered in an era of airline competition as new, low cost carriers entered the market at will. The legacy carriers had a difficult time adjusting as their business models were originally designed around a monopolistic framework. Adjust they did however, and over time, when a startup Icarus strayed too close to the sun, the majors came out swinging.

However, one by one, old and new airlines managed to bankrupt themselves. In the wake of the 9/11 terrorist attacks, all major U.S. carriers filed for bankruptcy – some sooner than others but most by 2006.

10 Largest U.S. Airline Bankruptcies

Carrier	Size	Date
United	\$25.2BN	12/9/2002
American	\$25.1BN	11/29/2011
Delta	\$21.8BN	9/14/2005
Northwest	\$14BN	9/14/2005
US Airways	\$8.3BN	9/12/2004
US Airways	\$8BN	8/11/2002
Continental	\$7.7BN	12/3/1990
Eastern	\$4.0BN	3/9/1989
TWA	\$2.5BN	6/30/1995

Source: Forbes Magazine Online June 12, 2014

These attacks wiped out almost all of the shareholder value for the entire U.S. airline industry. In less than 2½ years, the ARCA/NYSE Airline Index (XAL) fell 78%. Expand the period to include the 2008 credit crisis and the decline reached 90% by early March 2009. For comparison, the S&P 500 declined during the same period (down 35% from 9/10/01 to 3/4/09), but most of that occurred from late 2007 through the March 2009 low.

The only airline that managed to survive 9/11 has been Southwest, the longest running low cost carrier. And while JetBlue is recognized as an airline that people like to fly, if one bought JetBlue shares at the IPO on April 11, 2002, they would still be underwater today.

That Was Then and This is Now...

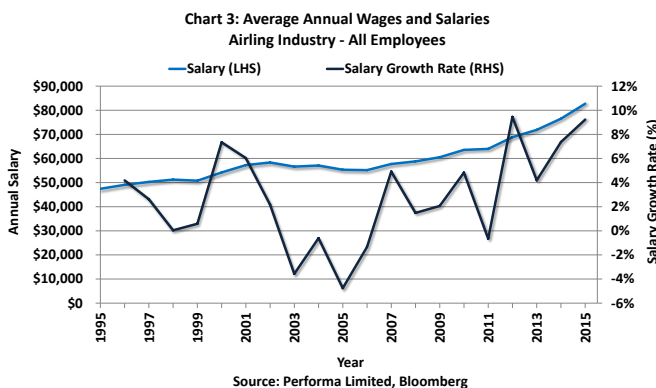
The past decade of impressive performance is clearly what led Doug Parker to suggest the potential of a new paradigm. It has been our experience that all too often a deviation from the trend is immediately tagged as a paradigm shift. New paradigms, while rare, can and do happen. However, this tendency to over label leads to a plethora of false positives.

The general benefits from consolidation, lower jet fuel costs, and better planes have collectively been a tailwind for the industry. However, there are also macro factors at play making it hard to identify exactly what is propelling the airline industry higher. Below we highlight additional themes that have supported the recent run, provide perspective as to why we remain cautious on the sector, and highlight alternative areas to gain exposure to the airline industry.

Bankruptcy and Cost Resets

Since 2001, airlines have significantly cut costs during bankruptcy through renegotiating labor contracts and retiree benefits. Balance sheet and fleet restructuring provided a second round of cost savings.

Today, however, these costs are rising. Average wages per employee fell during 2002-2006, but have been rising dramatically since (see Chart 3).



Additionally, another spike will likely occur after all the labor contract renewals that took place over the past six months kick in. Last year, United went through massive labor negotiations with 80% of their workforce now represented by labor unions. We expect to see more deals in 2017 and while the timing and structure of these negotiations varies by airline, one trend has been consistent; higher wages. These new deals have led to wage gains of over 30% for just three to four year contracts. The employees and their unions have successfully clawed back the cuts that made survival possible years ago.

Finally, borrowing costs are set to rise with interest rates due to tightening monetary policy.

Mergers and Supply

Since the airline industry as a whole had been suffering, regulators turned a blind eye to any anti-trust issues and let the major U.S. carriers merge at will, with only a few minor concessions made by the airlines regarding route or asset disposals. For a while, seat supply was tightly managed and paved the way for industry profitability after 2009.

Unfortunately, all was not as rosy as it seemed. It took a few years for business travel to return to pre-2008 levels, which kept average ticket prices low. Now seat supply is expanding and unit costs are rising, not to mention a lack of merger candidates available domestically.

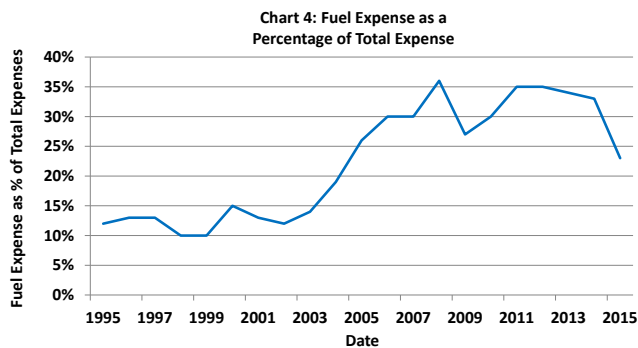
Loyalty Programs & Ancillary Fees

Airline frequent flyer programs are a windfall in many ways. Credit card, hotel, and rental companies purchase unlimited mileage credits at more than face value and airlines can issue as many miles as they want. The airlines also sell their future profits to willing investors. Mileage awards are never fully used and program benefits and trip availability keep eroding. Consumers are wising up but many business flyers are still hooked. The large, one-time program monetization gains may be in the past, but the revenue source will remain healthy for the foreseeable future.

Extra bags, picking a seat, less waiting in line, and even carry-ons are all fair game for additional fees as ticket prices have not kept up with inflation. Airlines rely on ancillary fees more each year. Sadly, this is one area where backlash from customers has little effect and we do not see this trend changing anytime soon.

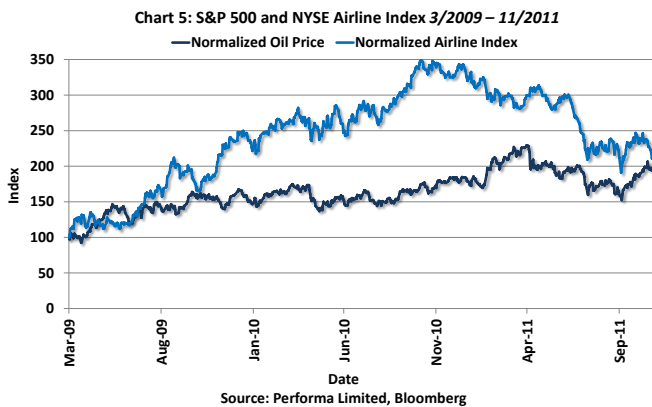
Jet Fuel

Jet fuel is a major airline expenditure (see Chart 4); and both management and investors love cheap gas.



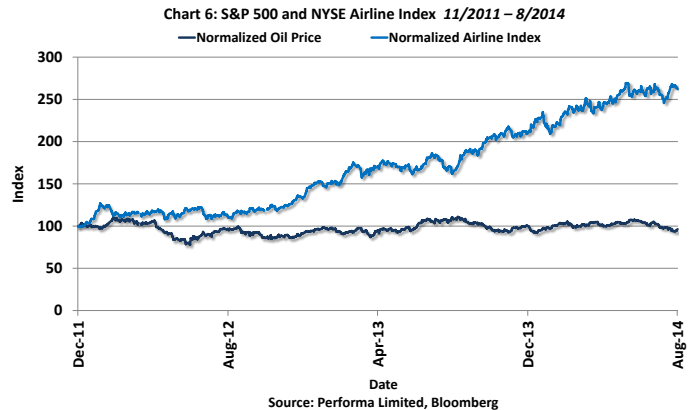
What would normally be an inverse relationship between oil prices and airline stocks became distorted recently. Looking at normalized comparisons between the airline index and oil prices shows three distinct periods since March 2009.

Asset Recovery (3/09-11/11) - For a few years, both oil and airline equities rose in concert (see Chart 5).



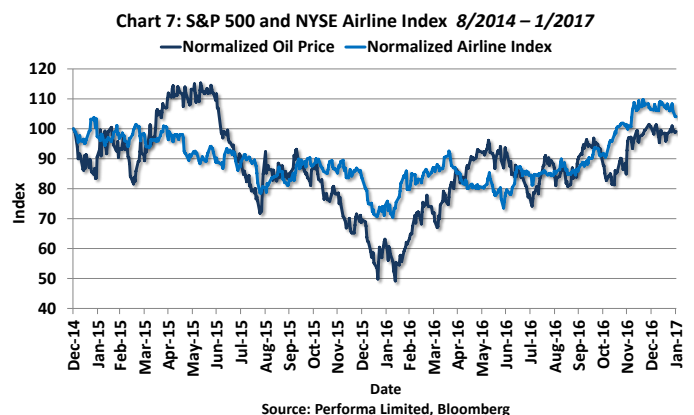
Historically, investors have considered higher jet fuel prices an airline's Kryptonite; not the case during this time period. Instead, during this time period, both rose in tandem, primarily reacting to the recovering stock market and cheap cash from the Federal Reserve.

Oil Stability (11/11-8/14) - Oil prices were range bound around \$100/barrel from November 2011 until the commodity meltdown that began in August 2014 (see Chart 6).



At that point, oil fell precipitously, losing more than half its value in four months. During the same period, the airlines continued their meteoric rise with the XAL index more than tripling by December 31, 2014.

Positive Correlation (12/14-present) - Today oil trades around \$53/barrel – just as it did on December 31, 2014 – and the airline index is only marginally higher. Although market prices have rebounded (after significant volatility) to a level that is close to where they began, market conditions certainly have changed. The inverse relationship between oil and airlines has vanished with both moving in lockstep (see Chart 7). The length of this positively correlated period is surprisingly long (2+ years) and is not explained by good or bad internal hedging programs that delay benefits or additional costs associated with oil price trends.



The last nine years have produced three distinct relationships between oil and airline equity price. The lack of a clear, reliable relationship between the two only makes it more difficult for equity investors.

Immigration Executive Order

Historically, we have been cautious about taking an equity position in airlines. Trying to time jumps onto and off of the airline equity roller coaster is fraught with danger, especially for an industry with sizable exposure to a variety of shocks.

The short-lived market reaction to President Trump's executive order on immigration was undeniably a negative for airlines. But the bigger question is whether or not there will be lingering effects as the order gets kicked around the court system. In general, protectionist type policies usually leave outsiders feeling unwelcomed. On the margin, we expect the negative headlines will lead some foreigners to pick a more welcoming destination. While it's impossible to estimate the exact impact of the president's order on future human behavior, holding all else constant, we expect the order to potentially damage international earnings of domestic carriers which had been the most lucrative portion of most airlines' business models.

Where We Do Invest

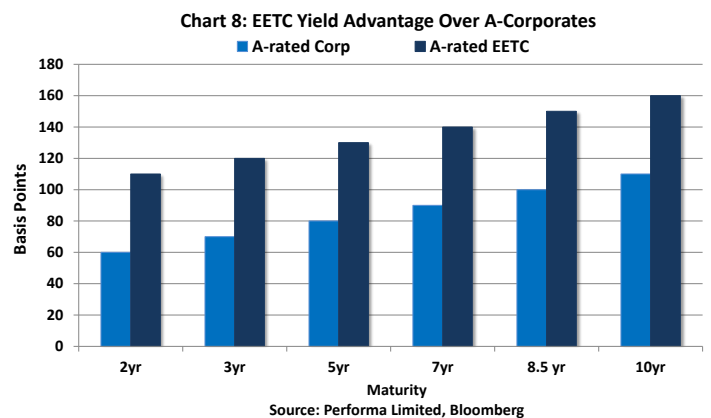
All hope is not lost, as there is an avenue to gain airline industry exposure in a much safer setting. Within a smaller pocket of the bond market, we have been investing in a security type that has long shown the ability to protect principal on the downside during even the most hardened bankruptcy proceedings.

Our preferred sector is the Enhanced Equipment Trust Certificates (EETC) market. Similar to other structured product bonds backed by actual assets, EETCs hold the rights to an airline's specified list of airplanes as collateral. Investors receive interest payments passed through the lease or mortgage on each group of planes.

The EETC market grew after the advent of other securitized assets, such as mortgage pools, and provided the airline industry an effective way to finance purchases starting in the late 1990s.

Principal protection comes from the bankruptcy statutes of U.S. code 1110, which effectively bars airlines from walking away from the leases and mortgages in place on each aircraft within an EETC transaction. These 1110 bond holder rights withstood the wave of airline bankruptcies in the mid-2000s and have serious legal precedence in both the context of airlines as well as commercial real estate.

Although not as liquid as corporate bonds, EETCs offer a yield advantage of 50-75 bps, which on a ratings comparative basis more than makes up the difference (see Chart 8).



Additionally, EETC transactions are structured to pay down principal balances on a regular basis which, in turn, protects the value of the underlying pool of aircraft as they age. As with many securitized bonds, there are senior and junior bonds within each deal with the latter providing additional credit enhancement to the senior tranche.

On a relative value basis, we are including EETC senior bonds in our investment grade fixed income portfolios versus other sub-sectors of the corporate bond market. Our portfolio managers have invested in the EETC market since 2001 across all portions of the credit spectrum and have experience managing through more than half a dozen individual airline bankruptcies.

In a market that is difficult for larger fixed income managers to navigate and not conducive to passive strategies, such as index funds or ETFs, it is one of the niche areas that we have always liked. Since yield is a significant, long-term producer of fixed income performance, the added layers of protection make EETCs a sensible place to invest a small portion of our client capital.

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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 25 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 \$3.68 billion in assets worldwide representing more than 65 captive client relationships as of January 31, 2017. 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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