Key Themes For 2015

January 8, 2014

Performa is an independent, employee-owned investment management firm, founded in 1992. We combine over 20 years of experience in the captive industry with the institutional expertise of our investment team to provide our clients with tailored investment solutions.

IN THIS ISSUE

The Power of the Pump!

The halving of oil prices over the last six months has produced significant uncertainty in the outlook for global economies in 2015. The push and pull between the benefits of lower gasoline prices versus cuts in oil industry investment and starkly lower government revenues in some countries will play out well beyond the new year. Our view is that cheaper oil will likely keep inflation in check slightly longer than otherwise thought, as companies will find it less expensive to produce and ship their goods while supporting personal consumption. Of course, not all of the cost savings will pass to consumers, but when coupled with the additional money from spending less at the gas station, consumer spending should see tailwinds – especially in the U.S.

Countries dependent on oil production revenue will be the flash points in 2015. Russia, Venezuela, and others are facing significant budget deficits and cuts in services that could provide the spark for an Arab Spring; citizen backlash reminiscient from a few years ago. The focus will be on the relative containment of such pressures and any spillover effect.

While it's easy to focus on the negative implications of lower oil prices, especially given ongoing deflationary concerns, we see some risk that markets underestimate the positive growth implications of lower oil prices.

Geopolitics and Political Uncertainty Continues

In the year ahead, geopolitics and political uncertainty will likely persist. Financial markets will pay close attention to a Russian economy reeling from lower oil revenue and western economic sanctions. Layer on continued instability in Eastern Ukraine and there is plenty of room for an adverse geopolitical shock that could effect financial markets.

Performa Preliminary Intermediate Fixed Income Composite Performance *

	Dec	YTD
Performa Gross	-0.22%	2.83%
Performa Net *	-0.24%	2.53%
BarCap US Int. Gov't/Credit	-0.32%	3.13%

Market Returns

Equities	**Dec**	**YTD**
S&P 500	-0.26%	13.7%
FTSE World	-1.82%	4.77%
Fixed Income		
BarCap Treasury	0.14%	5.05%
ML High Yield Cash	-1.48%	2.45%
BarCap Aggregate	0.09%	5.97%

* 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.

Meanwhile, Greece is back in the headlines after announcing the need for a snap election scheduled for January 25th. The rise of the left-wing, anti-austerity Syriza party in Greece mirrors similar political movements in other European periphery countries. While the European Central Bank president, Mario Draghi, may have saved the day in 2012 when he promised to keep the European currency intact, 2015 has an outside chance of finally seeing a member state drop from the currency union.

Easy Money

Away from the U.S., global monetary policy will remain extremely accommodative in 2015. While the U.S. Federal Reserve is on track for beginning interest rate hikes by mid-2015, we point out that the Fed is happy to lag the current business cycle, especially if inflation remains below their 2% target. Needless to say, the messaging will have to be tight (which has not always been the case), leaving ample room for a policy mistake.

In general, we expect all developed market central banks to continue with pro-growth policies as global economic growth rates diverge. In the year ahead, we believe the U.S. economy will continue to outpace its peers, while the Euro area will face significant economic headwinds, and China will likely slow further.

Watch Out for Crowded Trades

Sure, while crowded trades can be profitable, it is imperative to be aware of when they become one-sided. Once sentiment shifts, the exit door typically shrinks rapidly in face of the stampede. Looking ahead to 2015 and beyond, we point out two themes that warrant attention: The first is the sharp rise in the value of the U.S. dollar against many other currencies, and the second is the continued outperformance of long U.S. Government bonds – the flattening of the U.S. Treasury curve.

While we don't necessarily disagree with the underlying rational behind either trade, the extremes will signal when investors have overstayed their welcome. Yes, the curve flattener was a winner in 2014, but at what point does the market realize that it owns really expensive and very long interest rate risk when the economy is humming along – the positioning usually taken as a precursor to a recession and not in an environment such as today's. In other words, keep a careful eye on currency markets and the long-end yield grab.

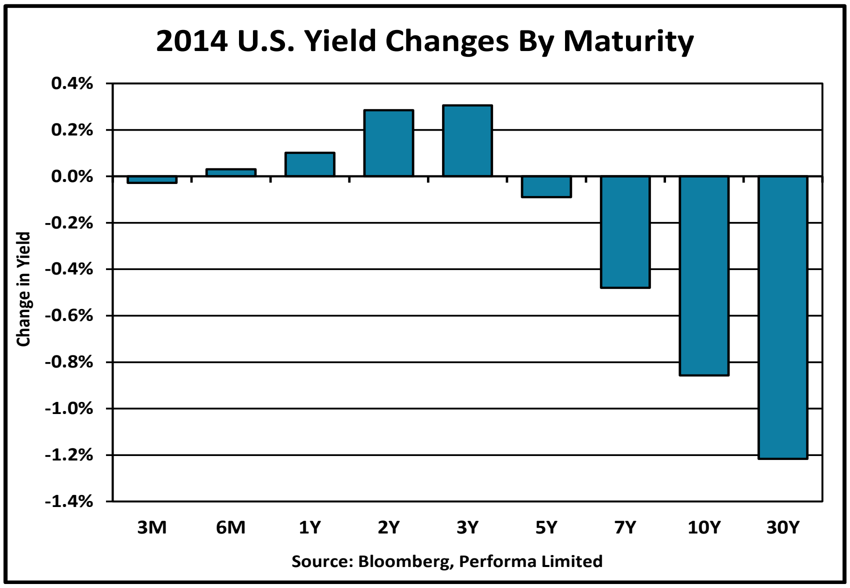
Risks in 2015

Markets have a way of punishing complacency, and we expect nothing different in the new year. As global financial markets have become less liquid due to ongoing regulatory capital and trading constraints, 2015 could be significantly more volatile than the last four years in the face of any new shocks.

Specifically, a loss of investor confidence in central bankers would certainly provide a catalyst for an increase in volatility. As of now markets continue to have faith in the ability of unconventional monetary policies, such as bond purchases, to avoid deflation and support growth. That said, the main tool this decade has been the ability of central bankers to convince markets participants that "talk" is truth. Confidence can be a difficult foundation to build upon.

FIXED INCOME MARKETS

Divergence and disparity were the main themes in the fixed income markets in 2014. As U.S. economic and labor growth separated from the pack, rising U.S. interest rates were cuffed by falling currencies and rates in other countries. The spread between U.S. Treasuries and German Bunds continued to widen during the year, as growth in the Eurozone's strongest economy (Germany) began to evaporate and inflation fell back towards zero. Used to being the leader, the U.S. bond market was unable to free itself of the heavy external factors – a position that has many domestic investors uncomfortable.



The U.S. market also found disparity between shorter rates (5-years and in) and longer maturities. The yield curve flattened as low global inflation drove rates 10-years and longer, lower throughout the year, while monetary policy changes raised 2 and 3-year rates and kept 5-years close to their levels from December 2013.

While these themes may continue into 2015, there is much less room for profitability, especially at the extreme long-end of the market, as 30-year Treasuries have halved their additional yield (to slightly above 1%) over 5-year Treasuries over the last 12 months.

Credit

Investment Grade Corporates performed steadily for the better part of 2014, until oil prices plunged, causing significant underperformance in the energy sector. Credit returned +7.53% in 2014, but as such slightly underperformed U.S. Treasuries. In 2015, we expect the macro environment to remain supportive of credit, while security selection will be at a premium. We expect shareholder friendly activity to continue, such as share repurchases, dividend increase, and mergers. Avoiding security specific risk will be paramount.

With the Federal Reserve poised to increase interest rates in 2015, credit markets will likely have to navigate higher short-term rates. In general, we believe a rising rate environment is supportive of credit as more traditional buyers, such as insurance companies and pension funds, will step in and put money to work at higher all in yields. That said, the lack of liquidity in risk markets coupled with the potential for a negative market reaction to the reversal of the Fed's accommodative stance could produce a temporary spike in volatility.

Structured Products

The Structured Product market performed well in 2014, outpacing equivalent U.S. Treasuries by almost 1/2% according to the Barclays Aggregate Index. This outperformance came despite heavy supply and mixed sentiment, as investors looked to add incremental yield in this low rate environment. Market liquidity continued to be an issue, as it evaporated during periods of volatility. We expect this to continue in the year ahead.

As we move into 2015, the general themes of 2014 should continue, and volatility could increase as the potential for rising short term interest rates will keep investors on their toes. We continue to favor short duration investments and the flexibility they provide.

ABS - The Asset Backed Security sector had a nice year, and is primed for another solid year in 2015. Within the sector, we like a barbell strategy, holding shorter credit card and auto bonds as a cash proxy, while selectively adding slightly riskier assets such as shipping container or subprime auto loan backed securities to boost portfolio yield. We must remain vigilant as another year of increased supply and decreased liquidity could put pressure on prices.

CMBS - Commercial Real Estate bonds were the top Structured Product performer for 2014, beating equivalent Treasury returns by 1%. Throughout the year investors migrated to CMBS as a source of relative value, a trend we think could continue in 2015, given current valuations. Heading into the new year we continue to overweight the sector, primarily in shorter, high quality bonds.

MBS - Mortgage Backed Securities also had a solid year in 2014, producing 40 basis points of excess return. In the year ahead we expect the supply/demand technical to remain positive – limited new supply and reinvestment by the Fed. However, we maintain our underweight and look to be more tactical given historically tight spreads, continued Fed intervention, and better relative value found in other sectors.

High Yield

After a very strong start to the year, the High Yield market suffered as oil prices plunged into year-end. The Performa High Yield composite's gross 2014 return of 2.77%, outpaced the Merrill High Yield Cash Pay Index by over 30 basis points. In 2015, we believe the High Yield market will remain volatile until we get clarity on oil prices. We currently hold a larger than normal cash position providing us the ability to opportunistically add names with strong fundamentals that have fallen victim to the broader selloff in the energy sector.

EQUITIES

As revelers rang in the new year, U.S. stock markets registered their sixth consecutive annual gain. During 2014, the S&P 500 Index rose 13.7% while other, broader measures rose roughly half that. With so many positive catalysts (compared with the rest of the world), the U.S. economy and its equity markets still look like the leaders in the clubhouse. While the outright level of U.S. stock markets are not as cheap as a year ago, there are certainly individual stocks that remain compelling and the market as a whole should perform reasonably well.

The continued strength of the U.S. dollar and the U.S. economy's world-leading position should continue its draw for foreign investors, widening the valuation gap between domestic and international markets. The problems in Europe and Asia offer a greater number of opportunities (from a value perspective) than in the U.S., as many good companies have seen their share prices suffer due to external factors. As usual, the geopolitical and economic risks posed make finding the entry point most vexing.

So, where do we go from here? We expect modestly positive 2015 U.S. equity returns but with higher volatility. Even under the best economic circumstances, stock markets correct and serve as a healthy reminder to manage investment risk carefully, especially after the dramatic market increase of the past 6 years. Our analytical focus is to find undervalued companies exhibiting strong growth characteristics and growing dividends. Together, these serve to enhance portfolio appreciation while mitigating associated market risk. "Careful" is our operative word this year.

ASSET ALLOCATION

In the new year, a macro environment consisting of moderate growth, low inflation and generally accommodative global monetary policy should eventually soothe investor anxiety resulting from plunging oil prices. Such an environment should support risk assets in 2015, barring an adverse, exogenous shock that could derail global growth and lead us to reevaluate our positioning.

While many investors (incented by perceived lower volatility and higher coupon payments) are parking dollars in the long-end of the fixed income market, we think this view is short sighted and will prove to be a losing trade, over the long-run. We continue to maintain a shorter-than-index duration, insulating our clients from rising interest rates and the associated price declines.

Client portfolios remain neutral to slightly underweight global equity exposure, as the valuation gap between domestic and international markets grows. Looking ahead, if the ECB is successful in stemming price declines and we gain some clarity on the economic front, investor confidence will likely rise and European markets could enjoy a rally much like the one witnessed in the U.S. over the last few years. To that end, we are allocating new dollars to income producing strategies with lower interest rate risk, and looking for opportunities to deploy dry powder when they present themselves.

Our focus continues to be providing our clients with a well diversified portfolio, across uncorrelated asset classes, where are primary goal is capital preservation, in the context of client-specific needs.

CONTRIBUTORS

Editor:	**Scott Mildrum, MS, Economic & Macro Strategist**	
Contributors:	**Key Themes For 2015:**	David Kilborn, CFA, CIO, Scott Mildrum, MS
	Sectors:	Jason Golder—Structured Products (ABS, CMBS, RMBS)
		Scott McIntyre, CFA—Investment Grade Corporate Bonds
		David Kilborn, CFA—Equities & High Yield

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 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.

CONTACT US

Relationship Management
Hugh Barit
Chairman & CEO
(441) 295-6754
hbarit@performa.bm
25 Church Street, 2nd Floor
Hamilton HM12, Bermuda

Portfolio Management
David T. Kilborn, CFA
CIO & President
(843) 297-4130
dkilborn@performausa.com
14 North Adgers Wharf
Charleston, SC 29401

Relationship Management
John James
Captive and Consultant Relations Mgr
(802) 540-1752
jjames@performausa.com
3 Main Street Suite 215
Burlington, VT 05401