Monthly Market Perspective

November 10, 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

OUT WITH THE OLD, IN WITH THE NEW

We decided to detour from our usual financial market-specific commentary this month and discuss the state of the U.S. consumer in the wake of the 2008 financial crisis. Specifically, we wanted to examine the implication of consumer habits in respect to future economic growth and share our findings with you. If there is one behavioral pattern we believe stands out the most, it's the abrupt reactions to a swift change in financial conditions.

Individual and group spending habits typically shift quickly when confronted with significant financial shocks: old spending habits die and new trends emerge. Faced with rapidly increasing prices in highly inflationary environments, consumers stampede to the nearest store to spend their money before its purchasing power erodes. In today's world, Zimbabweans or Argentinians bear witness to expected patterns, furiously buying anything not nailed down. Conversely, declining prices and deflation creates hoarders. The parsimonious habits resulting from the Great Depression created generations of long-term frugal savers.

Now, more than six years after the height of the financial crisis, one thing is clear: the pain is ingrained. You may not want to bring back those memories, but think about how your own spending patterns have changed from the middle of the last decade.

Today, people are saving more, and credit card debt has fallen from favor. Homes are no longer veritable ATM machines. Home ownership rates have fallen significantly in six years, and renting is the more popular housing option – especially for the current generation that is considered in the prime "first time home-buyer" demographic. These are stark contrasts to the consumer

Performa Preliminary Intermediate Fixed Income Composite Performance *

	Oct	YTD
Performa Gross	0.39%	2.60%
Performa Net *	0.36%	2.35%
BarCap US Int. Gov't/Credit	0.70%	2.94%

Market Retuns

Equities	**Oct**	**YTD**
S&P 500	2.44%	10.99%
FTSE World	0.63%	4.84%
Fixed Income		
BarCap Treasury	0.97%	4.07%
ML High Yield Cash	1.16%	4.73%
BarCap Aggregate	0.98%	5.12%

* 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.

trends prevalent until 2008 and suggest a more realistic, less levered consumer. By all measures, this current recovery has been frustratingly slower than those in the past. The aforementioned shift in consumer habits encompasses a large piece of the puzzle.

While a modest pickup in credit card debt would signal both growing consumer confidence and support faster economic growth, economies fueled by untenable debt loads (public or private) do not create long-term, sustainable growth. In fact, it is typically the backbone of bubbles.

Certainly current economic growth in the U.S. is not what it what once was, but the period of comparison is always relevant. Just because the last decade or two remain visible in the rear view mirror, activity in that period does not deserve 100% relevancy and focus for analysis purely from proximity. Looking back over the last 200 years, the current economic growth rate is actually in an acceptable range. Moreover, a healthier consumer is much more positive over the long run than a recovery fueled by borrowing.

THE MACRO VIEW

Economic activity in the U.S. grew at a sturdy rate of 3.5% in the third quarter, following a very healthy 4.6% rate in second quarter. Third quarter growth came in stronger than expected, as government spending and net exports supported the headline number. Looking forward, job creation in the U.S. remains on pace for the best annual performance since 1999, and the recent drop in gas prices will put a little extra money into consumer's pockets heading into the holiday season.

The Eurozone economy continues to suffer from high levels of unemployment as large disparities across member countries highlights the "haves" and the "have nots." With core inflation stuck well below the ECB's target of 2.0%, and downside risks to the economy mounting, the ECB is surely feeling the pressure to provide more accommodation. Compared to other developed economies, growth in the U.K. looks relatively healthy, expanding by 0.7% in the third quarter according to preliminary estimates. However, the latest reading of year-over-year inflation plunged to a 5-year low, raising some eyebrows heading into the fourth quarter.

China continues to be a source of ample uncertainty in the global economic puzzle. With home prices falling throughout the country and year-to-date growth running slightly below the government's stated target of 7.5%. Some pundits are now speculating that Chinese officials might lower their target growth rate to 7.0% for 2015.

GLOBAL MONETARY POLICY

The U.S. central bank has officially passed the "bond purchase" torch to its central bank counterparts overseas. In late October, the Federal Reserve voted 9-1 to end their bond purchase program, citing a healthier labor market and sufficient underlying strength in the U.S. economy. Meanwhile, Japan's central bank, the BOJ, recently voted to increase the size of its program. While mounting economic concerns in the Eurozone have increased pressure on the ECB to expand their bond purchase program to include sovereign bonds and perhaps other fixed income markets.

FIXED INCOME MARKETS

As with other global financial markets, October 15th was a historical day in terms of volatility and price movements in the bond markets. At one point, 10-year U.S. Treasuries yields were over 1/3% lower than the night before - only to reverse course quickly that afternoon. Absolute market panic like this leads to shakeouts, as some investors (primarily leveraged hedge funds and momentum players) have not been able to survive the month due to the large price swings. That said, the effect may be cathartic, as long-term investors will represent a larger percentage of the markets and bring a calming effect. Moving markets away from easy money central bank policies is not a straight line process, and it continues to cause periodic market spasms. It is important to look further out and not get wrapped up in the hysteria, as short term positioning will invariably put an investor on the wrong side of sudden, performance eroding move.

Credit

The investment grade corporate bond markets struggled in October. Overall, global market volatility, as well as the glut of 3rd quarter earnings announcements, weighed on investors. Opposing central bank monetary policy between the U.S. (ending QEIII) and Europe (rumored corporate bond buying by the ECB) also created uncertainty. The credit index yield relative to U.S. Treasuries ended the month five basis points wider at +112 bps (underperforming by almost 0.25%). For 2014, the sector's excess return sits at positive 0.75%.

- Over 2/3rds of the S&P 500 reported earnings in October. The trend shows marginal revenue growth driven domestically while foreign receipts were hurt by Eurozone weakness. Earnings growth came primarily from equity friendly behavior, as bottom line operating income and margin expansion remain subdued. Our analysis continues to focus on increasing debt loads at companies issuing new bonds purely due to historically low overall rates and a very accommodative market.
- New bond issuance was down a bit from September's massive calendar. A few issuers were spooked mid-month and pulled deals, while others took it in stride. We believe the primary market will be healthy for remainder of the year. Supply from recent mergers and acquisitions along with company's insatiable desire to take advantage of the current interest rate environment will be met with continued investor interest.

Structured Products

Structured Product sectors could not keep up with the mid-month whipsaw market action in U.S. Treasuries. By month's end, Structured Product returns were positive, but slightly lagged equivalent maturity government bonds primarily due to Residential Mortgages. Other sub-sectors fared better.

ABS - Asset Backed Securities managed to outperform their Treasury counterparts with a combination of contained supply and good two-way, secondary market flows. Lower credit quality bonds did lag the market recovery after October 15th, but the senior level of bonds made up for it.

CMBS - Commercial Mortgage Backed Securities recovered nicely after the mid-month volatility to outperform duration matched Treasuries. Supply was light and well received, whether from new transactions or otherwise. Liquidity, on the other hand, showed signs of serious weakness (and potentially a foreshadowing) as the gap between bids and offers widened dramatically and broker/dealers backed away from bidding. Chalk it up to yet another sign of eroding structural market liquidity. We are also watching to see if there will be any spillover of U.S. bank selling pressure resulting from the just completed European Bank stress tests. We're committed to short, high quality (floating rate if possible) bonds to mitigate some of these risks while adding marginal yield to portfolios.

MBS - Residential Mortgages could not find a buyer in early October, but rallied into November. The market still slightly underperformed Treasuries on the month. The end of the Federal Reserve's quantitative easing has less of an impact as cash flows from their existing holdings will be re-invested in MBS. Mortgages will perform well if the Treasury yield curve flattens (longer bonds outperforming shorter issues). The Fed remains the major buyer, which still creates valuation and volatility problems in our view.

High Yield

Despite finishing the month with a modestly positive return, the high yield market experienced a meaningful cycle in October.

The Bank of America Merrill Lynch High Yield Cash Pay index was down more than 1% by the 15th as rumors abounded that hedge funds were experiencing losses on Fannie Mae and Freddie Mac positions and the negative sentiment in the equity market was spilling over into high yield. In addition, energy related bonds underperformed as oil prices slid to $80 per barrel. Sentiment turned around with the announcement of additional monetary stimulus from the European Central Bank and the index returned + 1.16% for the month.

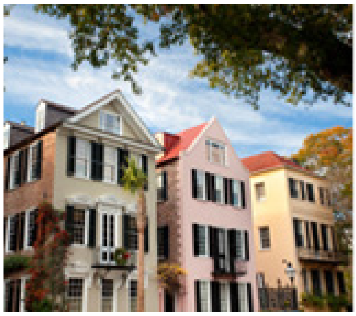
The Performa High Yield Composite return lagged the index primarily due to its high cash position and exposure in the energy sector. The plunge in oil prices and overall lower market liquidity hit energy names across the high yield sector particularly hard. On a fundamental basis, we look for recovery in the sector as volatility abates. Partially offsetting the negative factors were favorable security selection in the mining, food and finance sectors and an overweight to cable television names.

We continue to believe that the market is susceptible to spillover effects from other factors, but that corporate fundamentals still provide solid footing.

EQUITIES

Volatility returned to global financial markets during the month of October, and equity markets were no exception. Concerns about global growth lead the S&P 500 sharply lower during first half of the month, before reversing course and reaching new record highs by month-end. Compared to international markets, we continue to believe that at current valuations domestic equity markets offer little relative value.

ASSET ALLOCATION



We remain committed to our current overall asset allocation strategy. Client portfolios are neutral to slightly underweight global equity exposure, while we are allocating new dollars to income producing strategies with lower interest rate risk. In an environment where we feel risk is not being adequately rewarded, our short-term goal remains preserving our client's capital. To that end, all of our fixed income strategies have a shorter-than-index duration, favoring high yield securities relative to investment grade bonds.

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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 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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