PERFORMA

Investment Solutions For Captives

Monthly Market Perspective

November 7, 2016

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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Monthly Spotlight

A Little Action in the Front-End

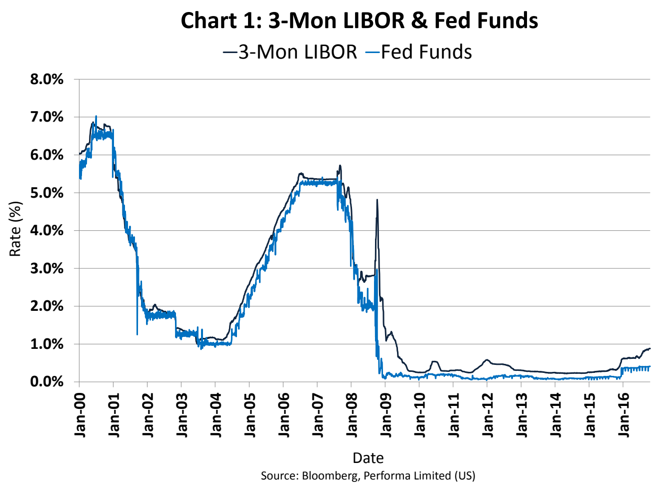
We have previously discussed using a barbell strategy to manage the yield curve exposure within fixed income portfolios. In practice, this means that instead of holding bonds proportionally across the yield curve, we concentrated on the edges with less exposure in the middle, thus resembling a barbell. Specifically, we have paired longer, fixed-rate bonds with floating-rate bonds in multiple subsectors of the investment grade bond market.

Given today’s low rate environment and the gradual shift toward tighter U.S. monetary policy, we remain cognizant of the impact higher interest rates can have on high-quality bond portfolios. To that end, floating-rate securities are quite appealing with attractive yields and minimal interest rate risk.

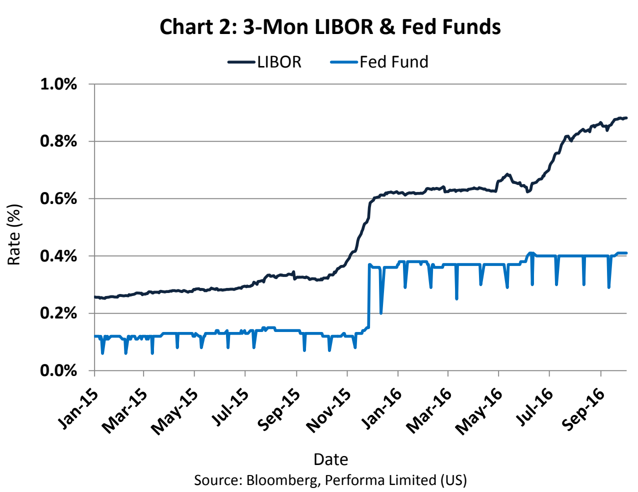
This month we provide an update on our barbell strategy in light of the recent spike in the London Interbank Offered Rate (LIBOR). The move higher in LIBOR has benefited our floating-rate bonds nicely, contributing positively to overall performance.

What's Up with LIBOR?

LIBOR is a benchmark short-term interest rate that represents the rate at which banks lend U.S. dollars to each other. Since LIBOR and the Federal Funds rate are close substitutes (i.e. that is banks and financial institutions can borrow in either market with relative ease) they track each other closely over time (see Chart 1), but diverge during periods of financial stress.



Over the past four months, LIBOR rates have increased while the Fed Funds rate has remained stable (see Chart 2).



So does the move higher in LIBOR signal market distress? No. U.S. money market reform that kicked in on October 14th, 2016 drove a wedge between the LIBOR and the Fed Funds rate.

In the wake of the 2008 financial crisis, regulators took steps aimed at preventing mass redemptions from institutional prime money market funds during periods of extreme financial stress. The reforms (floating NAV, liquidity fees, and redemption gates) created incentives for investors to reallocate capital away from traditional prime funds and into government funds. As a result, leading up to the October implementation date, demand for short-term LIBOR-linked assets fell dramatically as money poured into short-term debt obligations backed by the U.S. government. LIBOR decoupled from the Federal Funds rate and drifted higher, benefiting our clients' portfolios as the coupon on the floating-rate bonds reset at higher levels.

What is a Floating-Rate Bond?

Unlike traditional fixed-rate securities, the coupon on floating-rate bonds changes during the life of the security. The coupon rate is calculated by adding a predetermined spread to a base index, and generally resets monthly or quarterly, depending on any movement in the base index. As the underlying interest rate drifts higher, the coupon of a floater will reset higher, and as the underlying interest rate moves lower, so too will the coupon. So in this sense, the coupon of floating-rate bonds "floats" with prevailing market rates.

Back to LIBOR..

Looking back at Chart 2, one can see that after the Federal Reserve hiked interest rates in December 2015, 3-month LIBOR shifted higher, but was relatively stable, trading at roughly 0.63% for the first half of 2016. In July, as the date for U.S. money market reform approached, investor appetite for short-term assets began to shift. Demand for short-term LIBOR-linked assets waned and LIBOR increased. Higher LIBOR rates resulted in higher coupons for our floaters, increasing the overall yield on client portfolios, and contributing positively to performance.

While our original thesis for owning floaters was not based on large-scale U.S. money market reform, it has since allowed us to keep the strategy in place and fortified our rational. Admittedly, the pace of interest rate hikes has been frustratingly slow (as we have written about extensively) during this cycle. However, given the current low rate environment and a Federal Reserve that is in the process of preparing the markets for a likely rate hike in December, we believe that the biggest risk to bond investors today continues to be higher interest rates. Protecting our clients' capital from higher rates, while not all that flashy, is the prudent course of action for long-run success given today's asymmetric bond market risks.

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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 $3.46 billion in assets worldwide representing more than 65 captive client relationships as of September 30, 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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