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Monthly Market Perspective

October 1, 2015

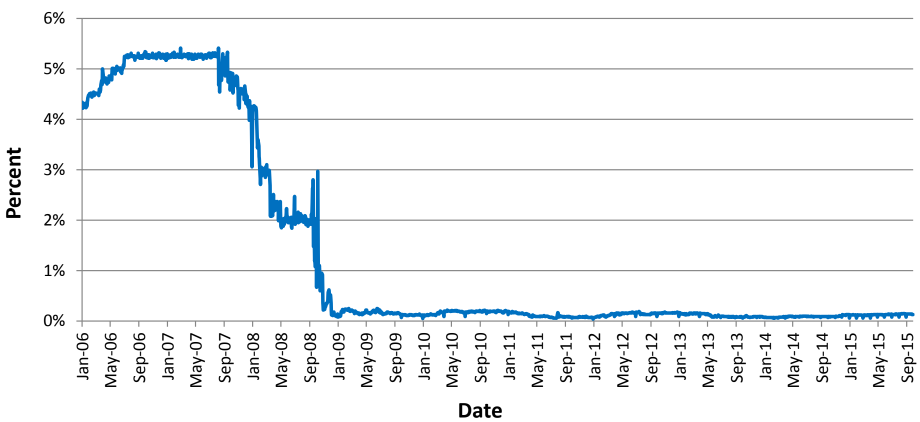
Performa is an independent, employee-owned investment management firm, founded in 1992. We combine more than 20 years of experience in the captive industry with the institutional expertise of our investment team to provide our clients with tailored investment solutions.

Monthly Spotlight: Is this a Case of Bad Parenting or Just a Failure to Communicate?

On multiple occasions over the last few years, the threat of tighter monetary policy has resulted in significant market volatility. Nine months ago we equated the previous global market reactions to those of a child's supermarket tantrum. We now wonder where the adult supervision went and if global central bankers have succumbed to bad parenting?

Back in August, we believed that the U.S. economic backdrop and strengthening labor market gave the Federal Reserve what they needed to raise short-term interest rates for the first time since 2006 (see Chart 1 below). At their September 17th FOMC meeting, however, the Fed decided to defer a decision until their late October meeting and perhaps even December.

Chart 1: Federal Funds Effective Rate



Source: Bloomberg, Performa Limited U.S.

IN THIS ISSUE

While there was considerable debate within the Fed's conference room with hawkish members pushing for a September rate hike, the doves won out. In their post meeting statement, the Fed cited global economic growth concerns (translation: China) and recent financial developments (translation: another market tantrum) for their rationale in standing pat. Dennis Lockhart (a voting member) summed up the change of heart as "prudent risk management around recent and current market volatility." The FOMC's inaction two weeks ago brings their credibility to a tipping point. We outline our concerns below.

First, basing monetary policy on global events looks increasingly like mission creep. The Fed has two explicit mandates – helping the economy achieve full employment and keeping inflation in check. Being aware of the global economic landscape is certainly in the job description of a voting Fed member. However, managing domestic monetary policy to assist foreign countries and markets is clearly NOT the role the institution is designed to play.

Second, Dennis Lockhart's market based explanation acknowledges an inability to say "enough is enough" to the irresponsible investors the Fed supposedly supervises (bad parenting).

Third, the FOMC accidentally brought into question the strength of the U.S. economy causing a negative reaction from many market participants. The blunder sent Fed members scrambling to backtrack on their statement and reassure the public that the U.S. economy is indeed still in good shape and a rate increase is certainly coming soon. The latest miscue has rattled markets and worked only to increase volatility. Can you say unintended consequences?

Lastly, and on a lengthier basis, the Fed's poor economic forecasting record, coupled with their inability to hold politicians accountable for doing their part on the fiscal side of the U.S. growth equation, points to an already growing list of those willing to tune out the Fed.

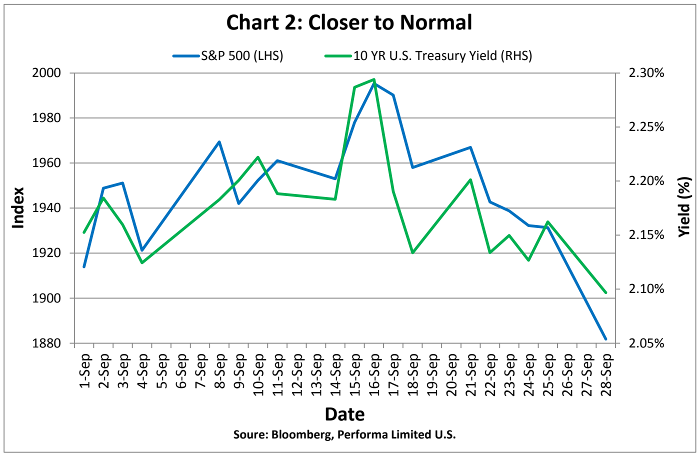
We firmly believe that all central banks should be independent and the Fed has increasingly come under partisan fire in Congress. Fed members, however, need to cut back on the hubris and mission creep to focus on their core function: managing monetary policy for the United States. With each passing misstep within a communique, press conference or economic forecast, the probability of a policy mistake today (if it has not happened already) rises almost exponentially.

We are less than enamored with the Fed's strategy of setting policy and then using rhetoric to reverse course. It appears market participants are growing impatient as well.

Is There a Silver Lining?

By the end of September, the market reaction to the Fed's September meeting had markedly deviated from the multi-year pattern with equity prices lower and bond prices higher (see Chart 2 below).

Previously, during the quantitative easing era, the logic had been simple and perverse. Any negative news (economic, political, financial or otherwise) should ultimately lead to further monetary stimulus from central banks, thus justifying increasing equity



and home prices. The trade was easy – supercharged front running based on bad news. All investors had to do was buy on negative headlines and then wait until the stimulus program was announced to book their profits. Meanwhile, the one constant was the lack of fundamental investment research.

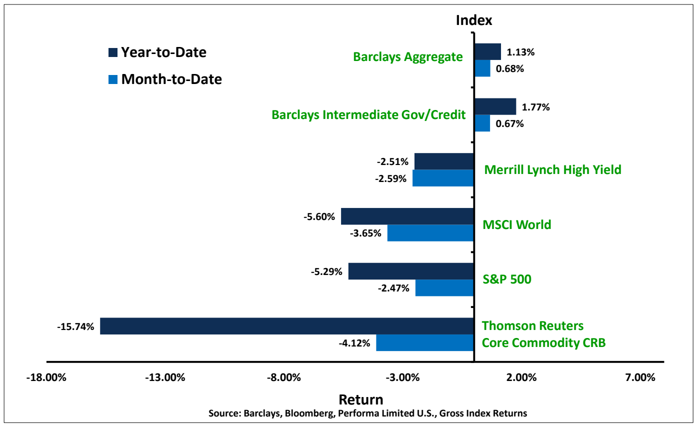
The current reaction potentially indicates a saner market. Any growth problems outside of the U.S. are certainly bad for emerging market equities and profit margins for some multinationals, but not something that will derail U.S. growth. Going back to fundamental analysis will reveal those investments that can withstand gradual increases in short-term rates. The herd should no longer be rewarded with excessive stimulus every time it decides to throw a tantrum.

Whether or not the market figures out the right direction based on old methodologies, there are larger, social effects that may provide some kindling as well. We only point out the following as a description of the landscape as opposed to jumping on a soapbox. It really should not surprise investors that Bernie Sanders and Donald Trump are doing well in the political polls. Bernie, the self-proclaimed Socialist (Democratic) Junior Senator from Vermont, has a cult following with his "Occupy Wall Street" grass roots pied piper show while the Donald waxes poetically about his disdain for hedge fund managers and lobbyists.

We are approaching an inflection point and the stakes are surely high for both sides. The Fed knows it should raise interest rates, but remains troubled by the prospect of finding out the true implications of the last seven years of easy money policy. Meanwhile, the market seems to be telling the Fed "hike already or we will make it worse."

Asset Class Overview

Macro volatility dominated market sentiment throughout September. Ongoing global economic growth concerns, continued commodity price declines, a waffling Federal Reserve, and company specific news from VW and Glencore all weighed on risk markets last month. Global and domestic equity markets suffered steep declines and continued underperformance in the energy sector weighed on the high yield market. As risk assets fell from favor, investors turned to money market and high quality bond funds. The Barclays Aggregate Index, a measure of the broad investment grade bond universe, returned 0.68% for the month (1.13% year-to-date).



Looking ahead to the fourth quarter, markets will be focused on China, commodity markets, corporate earnings season (starting October 8th), two FOMC meetings (October 28th and December 16th), third quarter economic growth figures as well as the prospect of a looming U.S. government shutdown come December, to list a few.

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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 $2.9 billion in assets worldwide representing more than 50 clients. 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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