September 9, 2014

PERFORMA MARKET PERSPECTIVE

Asset Management for Captives — Getting the Institutional Structure a Captive Deserves

Investing captive insurance assets began in the offshore, High Net Worth market. Large multi-national banks ruled the landscape, armed with wealth advisors and bundled financial solutions from letters of credit facilities to investment services and beyond.

The captive industry has changed significantly and captive owners today want unbundled solutions to access the best providers in each area. Unfortunately, the evolution of investment management for small to middle market and start-up captives and RRG's has not kept pace. Why?

For one, the 2008 credit crisis still harbors bad memories and the cleanup has eroded returns. Cash offers nothing and bonds have little left. Many new and smaller captives continue to wait for higher yields or are hesitant to stick their toes into other assets. The loss of many letter of credit providers has hurt as well.

The investment management marketplace provides a second reason. The old, offshore captive investing method mirrored asset allocation models for wealthy individuals. Today, there is no doubt that captive insurers are institutional customers and not retail. The problem is that many captives fail minimum portfolio size requirements at large investment management firms. As a result, cost effective management for the unique needs of captives is lacking. Effectively blocked, captives end up with the default choice of the original banks and financial advisors that still cater to them.

The right service providers are those that possess a deep understanding of a captive's business goals, life cycle and industry. Applying that standard to investment managers leads to active collaboration. This ensures a baseline of success for the captive's balance sheet and an institutional-grade portfolio tailored to specific goals and multi-pronged requirements.

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.

Diversification and asset allocation remain the biggest determination of a captive portfolio's long-term success. Hiding premiums in cash is not risk free. Inflation costs dearly in the absence of returns. Preserving capital is primary but Treasury bonds offer "return-free-risk" if not managed properly. Generating consistent, positive returns & reliable income streams remain important. Rising interest rate fears and aversion to riskier assets will subside if your captive's portfolio is a) managed on an active basis ; b) well diversified within each market segment and by prudent exposure to different markets that move independently; and c) structured to harness liquidity when its needed most.

Captives must anchor their portfolio with bonds, but obtaining an actively managed, diversified bond portfolio is difficult with limited options available. Investing through a broker's "wrap program" or having an advisor or trust department build a portfolio of individual securities, both have pitfalls.



In This Issue

Asset Management for Captives (Continued)

No one wants an expensive, generically built portfolio that has no regard for the objectives of the captive and sacrifices liquidity and diversification. Captives should demand institutional quality portfolios that meet their needs with fees lower than those charged to retail investors.

The bond market rewards large, institutional investors (pension funds, etc.). Since bonds trade by appointment, transparency is limited and big investors reap higher liquidity and volume transaction discounts. This bias against individual and smaller investors reduces returns and portfolio flexibility. Having to sell small positions into a volatile market when faced with a liquidity event creates permanent impairments on a captives' balance sheet.

The creation of the bond index ETFs (Exchange Traded Funds) with NAIC 1 ratings (a prerequisite in many states for obtaining the best capital treatment by regulators) is intriguing. However, these ETF's still have drawbacks. They are passively managed, index products built for a wide audience. Even the low fee funds (and many are not), guarantee returns below the index with no captive insurer's objectives or capital preservation in mind.

From Performa's perspective, we feel smaller captive insurers need a better way to invest in an institutional, actively managed setting with a philosophy and investing process that understands the needs of the industry. Captives deserve an equal footing with larger, institutional bond investors to garner the same efficiencies and economies of scale that were previously elusive. The answer is an actively managed, NAIC 1 rated vehicle where regulators will allow a look through to the underlying bonds. That day has come, so get ready to unleash the power of your captive's balance sheet.

The Macro View

United States

The U.S. economy expanded by 4.2% from April to June, as indicated by the second release of 2nd quarter growth. This rebound in economic activity is stronger than previously anticipated, and could be revised even higher given what we've seen in subsequently released data. Despite the disappointing August employment report, we remain encouraged about 3rd quarter growth prospects. Positive signals from the consumer, manufacturing and service sectors all suggest the August employment report was more likely an abnormality than the start of a new trend.

International

The Eurozone economy failed to grow during the 2nd quarter, and recent economic data provides little hope for a quick turnaround in the quarters to come. Ongoing geopolitical tension in Eastern Ukraine has only added uncertainty to an already vulnerable recovery. Meanwhile, the economic recovery in the U.K. remains on more solid footing as the unemployment rate fell for the fifth consecutive month to 6.4%, the lowest since 2008. A Scottish independence referendum, which will take place on September 18th, will likely have the markets attention in the weeks to come.

Economic indicators received during the month of August highlighted the fragility of China's current economic recovery. Government stimulus remains the crucial crutch to an economy that is not healthy enough to stand on its own two feet.

Global Monetary Policy

"Divergent" is the best word to describe current global monetary policy. August's disappointing employment report will likely prolong the Federal Reserve's (FED) "wait and see" stance. We note this is despite significant and faster than expected progress made on both parts of the FED's dual mandate. Across the pond, continued improvement in Britain's labor market has the Bank of England contemplating tightening policy. Meanwhile, persistently low price inflation and fears of further declines has the European Central Bank (ECB) moving in the opposite direction. Just last week, the ECB voted to lower interest rates and reiterated that they remain prepared to provide further accommodation if necessary.

Performa Preliminary Intermediate Fixed Income Composite Performance *

	Aug	YTD
Performa Gross	0.46%	2.51%
Performa Net *	0.44%	2.31%
BarCap US Int. Gov't/Credit	0.70%	2.74%

Market Returns

Equities	Aug	YTD
S&P 500	4.00%	9.88%
FTSE World	2.32%	7.55%
Fixed Income		
BarCap Treasury	1.05%	3.63%
ML High Yield Cash	1.53%	5.74%
BarCap Aggregate	1.10%	4.81%

* 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.

The Markets

Fixed Income

Government bond markets rallied (yields fell) in August in both a flight-to-quality directly resulting from the tug of war over Ukraine and activity in the Middle East, as well as an anticipated monetary policy announcement from the European Central Bank. Five and ten year U.S. Treasury yields fell 0.10% and 0.20%, respectively, with an even greater fall in core European yields. The Barclays Capital Aggregate Index, a measure of the broad investment-grade bond market, returned over 1% for the month with longer maturity bonds being the biggest winners.

Corporate Bonds

Despite continued geopolitical unrest, the credit markets were supported by solid U.S. economic data and the conclusion of a benign 2nd quarter earnings season. The credit index yield edged a few basis points higher in August, lagging U.S. Treasury returns by 8 basis points. Corporate bonds have still outperformed equivalent Treasuries by over 1.6% year-to-date.

- Second quarter earnings season wrap up: Familiar trends - modestly improving revenue and earnings generation offset by increasing payouts to shareholders via dividends. Ultimately, we see marginally deteriorating credit metrics but not enough to cause us concern at present.
- The new issue market was slow and behind the 2013 pace. Barring a pickup in volatility going into September, we expect a very active primary calendar post the Labor Day holiday. Interest rates at their 2014 lows coupled with a recent wave of mergers and acquisitions; we expect the bond market to accommodate a slew of new deals.
- Our overweight to corporate bonds exposure has decreased since the beginning of the year both in terms of dollars spent, as well as on a duration-adjusted basis, as a large part of our barbell strategy.

Structured Product

As with corporate bonds, the overall flight-to-quality rally in the government bond markets left the sector a bit behind. Since investors focused their attention elsewhere over the summer, we like the upside potential for structured product and look for a fall reversal as interest picks up with more attractive yields and spreads versus other sectors.

- **ABS** — The Asset Backed Securities market was quiet in both new issuance and secondary trading. Prices for the more esoteric subsectors took a breather after a sizable run-up the past few months. We were not alone in sticking with more conservative areas of credit card and high quality borrower auto loan receivables - especially shorter bonds as a substitute for cash.
- **CMBS** — The Commercial Mortgage Backed Securities market underperformed in August. The primary culprits were heavy new issuance, investor selling and low month-end liquidity.

The Markets (continued)

Structured Product (continued)

- **CMBS** — New deal lending standards have declined recently along with less favorable, higher leverage ratios. We expect a pickup in new issue activity in September, however if supply is too robust, it could induce another bout of indigestion, especially for lower quality bonds. We still like top-tier credit quality bonds less than five years in maturity.
- **RMBS** — The Residential Mortgage Backed-Security market was unable to keep up with the Treasury rally in August and now has underperformed Treasuries for all of 2014. The Mortgage market has been neutered with a declining buyer base outside of the Federal Reserve. Future mortgage performance will purely be a function of the next move in interest rates. While we would expect outperformance should rates rise, the sector's volatility and declining liquidity make it a less efficient play.

High Yield

High Yield bonds recovered from the July selloff and the BofA Merrill Lynch High Yield Cash Pay Index rose +1.53%. As yields approached 6% around August 1st, mutual fund flows quickly turned positive, as the July's negative market move in high yield was largely technical. While expected, the recovery was stronger and quicker than anticipated. By the end of August, U.S. Treasury rates had fallen along with average yields spreads in the High Yield market (-0.25% of tightening) leaving the High Yield Index yield below 5.5%.

Performa's High Yield strategy lagged the benchmark return by approximately 25 basis points as we have been holding a large cash position in anticipation of higher yields. Some of that cash was put to work in August.

The strategy benefited from positive security selection from bonds in the diversified manufacturing and financial sectors and by avoiding Harrah's casino bonds. A few names in the mining, energy and retail space offset some of the positive factors, but the cash drag was the primary culprit.

Equities

Foreign market returns had a mixed August. Asian and periphery European indices fell, but the major markets in Germany, France and Britain were positive. Even so the regions relative return was well behind that of U.S. markets. The S&P 500 shrugged off the flight-to-quality to post a solid 3.77% gain. Technology shares rebounded, as did smaller and midsized companies, to post better returns than the S&P 500, but they both still lag on a year-to-date basis.

We are on the record as favoring foreign stock holdings, versus those in the U.S., from a valuation perspective and still hold that stance even though the geopolitical turbulence has not produced the returns we were looking for.

Asset Allocation

Central Banks around the world are on diverging paths. Britain & the U.S. are reversing easy money policies implemented since 2008, but the European Central Bank and Japan remain on the easing path. Equity markets are susceptible to bouts of volatility during the tightening phase of monetary policy and geopolitical concerns will also contribute. We remain optimistic on the U.S. economy, but feel that markets where returns are typically the highest need a breather before warranting an overweight in client portfolios. Therefore, we maintain our conservative stance of investing new cash in market neutral and capital preservation strategies in the short term.

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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 Ber-muda, 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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