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Insurance Asset Management

Inside This Issue

The State of the US Economy- What Are We to Believe?

Our country's leadership and media have made common knowledge of the fact that Governmental action along with Fed Policy of "easy money", encompassing several quantitative easing programs coupled with historically low interest rates, may have averted a prolonged and deep depression as a result of the 2008 financial calamity. We know that the Government has produced job growth resulting in an unemployment rate currently at about 5.3%. We know that we have experienced a slow but steady recovery spanning 6 years and positioning the US for a bright and prosperous future as we continue on this successful upward glide path.

Unfortunately, we also know that real median household income is at 1989 levels, real unemployment is more likely in the 10- 15% range when

Continued on page 6

Economic Review

In the first three months of the year interest rates fell to almost historical lows, the U.S. Dollar strengthened, commodity prices declined, and transitory factors reduced domestic growth culminating in positive returns for fixed income investors. During the past three months the 10 year Treasury yield rose 50 basis points, the U.S. Dollar weakened, the price of oil stabilized, and U.S. economic data pointed to a nice rebound in second quarter GDP. As a result, fixed income investors lost 1.68% during the quarter (Barclays U.S. Bond Aggregate Index) reversing the gains made in the first quarter of the year. How quickly trends can reverse! However, there remains a somber tone to the markets as struggles with Greece still prevail, Puerto Rico continues to be challenged by a heavy debt-load, and sizable turbulence is being experienced in the Chinese equity markets.

U.S. economic data points to a rebound

With the winter weather and west coast port closings a thing of the past, U.S. economic data is beating consensus expectations. After a minor setback, job growth has returned to adding 200,000 positions per month. Manufacturing data is also showing signs of improvement and consumer confidence is approaching an 8 year high. Nascent wage inflation, something highly sought after, is appearing in the Employment Cost Index and in other wage reports. Examining the myriad of small business surveys also points to growing optimism regarding the U.S. expansion which, noteworthy, is now in its sixth year. Still, there is much debate, both outside and within, on when the Federal Reserve will increase rates for the first time since the Financial Crisis began. Probabilities favor a September lift-off, but this is not set in stone and could be delayed until 2016 – not an unpopular thesis. From a global perspective, growth expectations are slightly moderating with relative strength in the developed markets (led by the U.S.) offset by weakening in the emerging markets (led by China). A clear demonstration of this dynamic is

Continued on page 2

Mr. Piel joined Opus Investment Management in 2007 as a portfolio manager. In his current capacity, he leads the Investment Grade Core, Short Broad Market, and TIPS strategies at Opus. Mr. Piel partners with a variety of account types, including pension funds and insurance companies. Previously, Mr. Piel was employed with Genworth Financial as an asset liability analyst within their Institutional Markets Group.

"Heading into the second half of the year, market expectations are for a gradual increase in rates by the Federal Reserve, low steady growth, and limited inflation which, on paper, are a healthy backdrop for fixed income."

Economic Review

Exhibit 1 Source: National Federation of Independent Business

the diverging central bank policy around the globe. The U.S. and U.K. are contemplating rate hikes, while China is cutting rates to avoid asset bubbles, especially in their real estate market. Europe is somewhere in the middle as quantitative easing and negative deposit rates have appeared to provide a boost to growth, but absolute levels are still very low and the situation in Greece is certainly a wildcard.

Surveys of small business owners indicate continued confidence in economic recovery

Less liquidity, more volatility

A growing concern within the fixed income industry is the lack of liquidity, specifically in the corporate bond market. Much has been written about how recent financial regulation has reduced the amount of inventory that banks hold to promote market liquidity due to the capital charges they would incur, however this is not the only driver behind growing illiquidity. Corporations have taken advantage of the low yielding environment by issuing record amounts of debt. In fact, this year is on pace to be the fourth consecutive year of record corporate bond supply. As a result of the low yield environment, the size of the corporate bond sector has exploded since the Financial Crisis in terms of amount outstanding and number of issues. According to Barclays Index data, on December 31, 2000 the size of the corporate bond market was $1.25T. It took 10 years for the market to double in size, but only an additional 5 years to triple!

Mitigating this market dynamic has been the

Economic Review

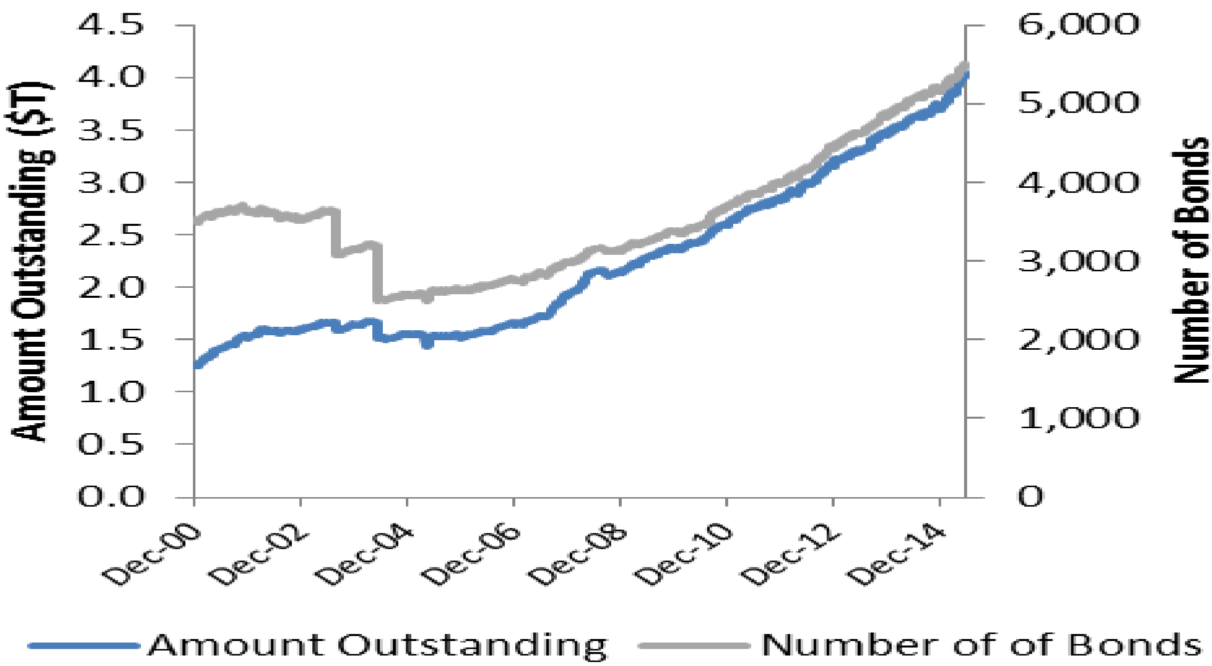


Exhibit 2: Growth of U.S. investment grade corporate market contributing to liquidity concerns

Source: Barclays, Opus

voracious demand for yield as the economic outlook improved causing spreads to tighten and bond prices to rise. Currently, spreads are somewhat meager compared to the last five years and if the Fed begins to raise rates, will the same demand exist to support bond prices? Glimpses of what the future may hold can be seen today when spreads meaningfully rise on takeover speculation, downgrade concerns, or leveraging transactions without an actual transaction occurring. This illiquidity will be more of a burden for the large fixed income shops that may have to contend with negative retail fund flows, but all investors should expect more volatility as a product of supply growth and smaller bank balance sheets.

Closing comments

Heading into the second half of the year, market expectations are for a gradual increase in rates by the Federal Reserve, low steady growth, and limited inflation which, on paper, are a healthy backdrop for fixed income. Concurrently, investors will have to contend with the Greek saga, Puerto Rico, Chinese market turmoil, and the possible first rate hike, all of which have the potential to derail market sentiment. Additionally, the quality of corporate balance sheets has peaked with some measures deteriorating to levels last seen during the Financial Crisis. Where does this leave us? A cautious approach to risk is justified given fair valuations and an economic backdrop susceptible to a mistake in political policy. Focusing on efficient use of risk will allow us the flexibility to capitalize on opportunities in the future when they appear.

Diversification and Hedge Funds

Tom Krasner, CFA is Co-Founder and Principal of Concise Capital Management, LP, which manages short-duration, smaller issue high yield bond separate accounts and a hedge fund. Mr. Krasner has spent over 20 years in fixed income, distressed debt and high yield bonds, including extensive experience in corporate restructurings and workouts. Mr. Krasner holds a B.A. in Economics/ Mathematical Sciences and a M.A. in Economics from Rice University.

Maria Laura Balcazar is pursuing a B.A. in Financial Economics at Columbia University in the city of New York. She has also worked as an analyst at Concise Capital Management, LP, a hedge fund in Miami, Florida.

"…looking at the cross-correlation of assets is key. This allows investors to get an idea of how diversified they are and points them towards options that would lead to the greatest reduction in volatility…"

In today's elevated equity market environment—stocks are hitting all-time highs— diversification is key. Many financial advisors are adapting their client's portfolios to protect them against a possible market correction. The question is *how* to diversify.

Cash is a great safety net in volatile times, but it's a diversifier with a negative "real" return. The opportunity cost of cash is the interest that could be made elsewhere or the profit that could be made off a good investment. In fact, the real value of cash is consistently decreasing because of inflation. Most insurers keep 5-15% of their assets in cash, as insurance in case of an unforeseen claims or operating expenses, because of its high liquidity. While this level is too high for be considered "efficient" cash management, in our low interest rate environment opportunity cost to hold cash is lower than under normalized interest rate environments. Another benefit of cash is that Investment managers can take advantage of low prices by investing the cash when the market is down rather than having to wait for prices to rise again in order to avoid unrealized losses. This practice of holding some extra cash is often referred to as "keeping some powder dry". The issue then, is timing the deployment of that cash.

In a perfect world, we would all buy low and sell high, but experience shows the practical impossibility of timing markets. Some insurers hold excess cash for long periods of time and invest when they believe the market is cheap, only to see it drop even lower. This type of investor would then lose money on his investment *plus* the interest he could have been making on it.

Besides cash, traditional wisdom suggests allocating 20-25% of the portfolio in equity and 75-80% in debt. This model, a "back of the napkin" approach to asset allocation, can offer reasonable returns while maintaining a conservative long-term risk profile. Most insurers, however, fear losing a dollar they already own more than they desire making an additional dollar. This conservative, risk-averse mentality leads some to reduce volatility even further by investing in lower correlation, alternative assets such as leveraged loans, emerging markets, and distressed bonds among others.

When seeking diversification beyond the 75/25 or 80/20 portfolios, looking at the cross-correlation of assets is key. This allows investors to get an idea of how diversified they are and points them towards options that would lead to the greatest reduction in volatility given the assets they already hold. Distressed bonds (Caa rating) and leveraged loans, for example, have small negative correlations with government bonds, but they have relatively high correlations (0.53 and 0.43 respectively) with the S&P 500. Meanwhile, aggregate bonds and government bonds have low correlations with the S&P 500 (0.16 and 0.02).

Negative correlations are desirable because when one asset class goes down, the other goes up, so instead of losing money on both assets at different ratios, you lose on one and gain on the other—significantly reducing total losses.

Another tool to facilitate diversification, subject to possible regulatory constraints that may apply to many insurers, is investment in liquid alternatives or hedge funds. Liquid alternatives resemble a fund of funds in a mutual

Exhibit II: Portfolio Returns by Asset Type, 2005-2015

	Stocks	Bonds	25/75	Hedge Funds
Compound Return	9.30%	5.90%	6.75%	8.70%
2008	-37.00%	5.40%	-5.20%	-19.00%
Worst Drawdown	-51.00%	-5.20%	-16.65%	-20.50%
2013	32.40%	-2.00%	6.60%	9.40%

Sources: AQR- "Hedge Funds: The (Somewhat Tepid) Defense" 24 October 2014, and Concise Capital Management

Diversification and Hedge Funds

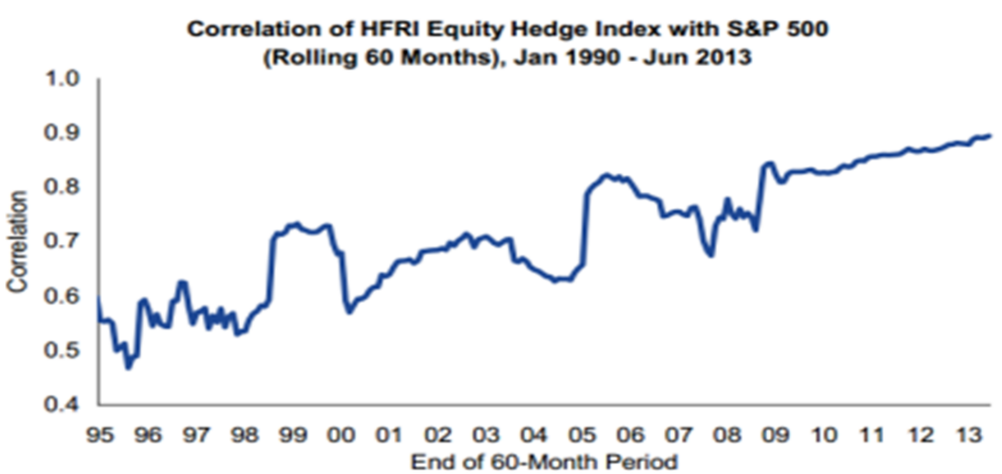
fund format. In other words, they make hedge funds available to retail investors. The benefit of these investment vehicles is that they offer potential economic value that would not be found in standard portfolios. Their unconventional nature makes asset valuation difficult but simultaneously allows competent managers to profit from market inefficiencies. Stock and bonds in smaller companies, for example, may be under-followed and therefore have pricing errors (the company may be more or less valuable than what the stock price indicates). Experienced and attentive managers can then identify and take advantage of the inefficiencies. Many hedge funds capitalize on such mispricing and other arbitrage opportunities.

Furthermore, their ability to engage in derivative trading and to exploit market inefficiencies allows them to hedge against market conditions, giving them a correlation with stocks like those in the S&P 500 between zero and one. Though they may not always offer excess return, they can reduce volatility. The lower this correlation, also known as beta, the more diversification they offer. Beta explains why hedge funds underperformed in 2014 and suffered losses in the 2008 crisis (though by a smaller percentage).

Hedge funds have lower volatility than some of the other risk-asset classes typically found in insurance company portfolios (see Exhibit II), but they also have lower long-term compound returns— the old trade-off. These sorts of comparisons are difficult, however, because of the variety of hedge fund strategies available - directional, arbitrage, event-driven, etc. Instead of picking between stocks, bonds, and hedge funds, one should build a portfolio that hedges away risk that an investor already bears by incorporating hedge funds. Integrated portfolios build alternatives into each asset class and choose these alternatives based on their correlation with pre-existing assets. The variety of strategies available allows investors to weigh their options and choose their own optimal strategy.

A few of the more popular strategies include Short Bias, Equity Hedge, Event driven and Macro. The two strategies with the lowest correlations with the S&P 500, are the Dedicated Short Bias (DSB) and the Global Macro (GM), but these are also the ones with the lowest annualized returns in the past 60 months: -11.93% and 1.86% respectively. GM funds aim to profit from trends in the global economy but have high volatility because they use leverage and derivatives to heighten the effect of market movement. DSB funds focus in the short sales of securities they believe are over-valued. Their low correlation with the S&P 500, however, comes at a price. Losses for short-only positions are potentially unlimited since prices can theoretically rise infinitely. It is pivotal that investors consider the benefits and risks of each strategy and match them with their desired results.

One thing to keep in mind is that mutual funds and hedge funds have received a lot of criticism as of late for essentially being over priced indices because of their heavy fee structures and high correlation with the S&P 500. This trend is even more concerning given that the correlation has risen steadily since 1996 (See Exhibit IV). A key tool for determining the likelihood that a given fund will outperform the benchmark, as well as the extent of active management, is the Active Share, a tool invented by Martjn Cremers and Antti Petajisto of the Yale School of Management in 2006. It is the percentage of stock or bond holdings in a portfolio that differ from the benchmark index. The lower the active share, the more the hedge fund's portfolio matches the benchmark and the higher the correlation between the two. A high correlation, in turn, lowers a fund's probability of outperforming the benchmark. Besides strategy, the percent of Active Share is an important measurement to keep in mind when choosing a hedge fund or alternate investment vehicle.



Source: Pragmatic Capitalism-"So Much for Non-correlation in Hedge Funds" Cullen Roche—12 July 2013

Continued on page 8

The State of the US Economy- What Are We to Believe?

"Are retail sales the canary in the coal mine? Is it doom and gloom or a robust market …"

accounting for the significantly reduced workforce and high level of part-time or under-employed. We read that young people are unable to buy a home and are renting in record numbers, in part because they are debt ridden with more than $1 trillion in outstanding student loans. We also read that most middle-aged Americans have not saved sufficiently for retirement at a time when social security is nearing its insolvency target date. With this gloomy backdrop the media is reporting a sudden rise in popularity of what would normally be considered "fringe" candidates, e.g. Trump and Sanders. How could this not be an indictment of the politically-driven economic storyline?

Certainly nearly every period of time has conflicting signals and data concerning the strength or weakness of the economy and the markets. Perhaps through all the information and misinformation, we can reflect on one undeniable truth that has had a low profile in the public discussion and, for the most part, has been absent in the media. It is well known that the US is a domestic consumer driven economy. In fact, consumer spending accounts for 70% of GDP. So, how about retail sales? What do they tell us is really going on?

At the time of this writing, monthly retail sales were recently released by the US Government. This data was accompanied by the release of quarterly results by four of the biggest US department store chains. This Government data indicated that year-over-year retail sales increased 2.4%. General merchandise sales fell 0.5% in July, with Department store sales dropping by 0.8%. Sales at the largest retailers have barely budged in the last year, with overall sales up a measly 0.3%. While it is not news that bricks and mortar retailers have been losing ground to internet retail sales, the overall government figures are somewhat alarming.

One might ask why this 2.4% growth number is not more robust for an economy that is supposedly in its sixth year of economic expansion with a tight labor market as indicated by the advertised 5.3% unemployment rate. Many of Wall Street's pundits also predicted that the crash in oil prices would provide a windfall in retail sales and increase general consumption levels as sav-

The State of the US Economy- What Are We to Believe?

ings at the pump created extra "spending money". So why then aren't retail sales booming?

Information Management
Main-stream media such as CNBC, Bloomberg, The Wall Street Journal reported the government retail sales figure in a manner consistent with their mission of reinforcing the message of economic recovery and confidence in the future. While this is understandable, since we recognize the importance consumer sentiment in shaping our economic reality, information should not be created to distort opinions nor reality. Unfortunately, the reality is that retail sales growth is at the exact same levels as when recession hit in 2008 and 2001.

While this doesn't mean that a recession is imminent, it most certainly is not a comforting comparison. Perhaps worse, is the fact that when excluding the subprime debt fueled auto sales, retail sales only grew by 1.3% in the last year.

So, how else can these retail sales figures help to gauge our true economic progress? A look at the historical data on the Census Bureau website indicates that GDP has risen by 22% since 2007. General merchandise sales were $48.4 billion in July 2007 and reported at 56.1 billion in July 2015. Over this eight year period that represents a 15.9% - not bad, right? Even the more questionable data coming from the BLS CPI apparently confirms this statistic with a very similar increase in GDP of 14.5% over this period. That means that REAL retail sales at the nation's biggest retailers has been virtually flat for the last eight years. Is that indicative of an economic recovery?

It is pretty hard to get excited about any positive economic news knowing that this progress may only be attributable to the fact that our economy is on the "Juice". That is, a Fed who has pumped $3 trillion into the banking system while still keeping interest rates at 0%. What happens when the business cycle inevitably rolls back into the next official recession, unemployment soars, and consumers really stop spending? Our financial foundation to deal with those conditions has been considerably weakened. Critics of the government's policies and the Fed's unprecedented market manipulation contend that any "recovery' is nothing but a fraud built upon mounds of subprime auto debt, subprime student loan debt, corporate stock buybacks, and Fed financed bubbles in stocks, real estate, and bond markets. Are retail sales the canary in the coal mine? Is it doom and gloom or a robust market and US economy guided by the Fed and US Governmental policies? As the markets are posed to react to the Fed's interest rates increases and the US stock market waivers under pressure of faltering Euro and Asian economies, the answer cannot be too far down the road. Fasten your seat belts.

CapVisor Associates, LLC

CapVisor Associates,

219 Main St. #693
Chatham, NJ 07928

Phone: 973-665-6370

E-mail:

carl.terzer@

capvisorassociates.com

We are on the web at
www.capvisorassociates.com

Niche hedge funds with a high active share ranging from 90% to 100% of the portfolio are preferred. Specialized asset class focus, like high-yield bonds in smaller, under-followed companies might be a preferred approach for insurers. Beyond offering diversification, such niche hedge funds specialize in strategies that can mitigate risk and enhance returns. Typically a niche focus, like on smaller-cap businesses, allows investment managers to find more Alpha by exploiting market inefficiencies more readily.

Furthermore, Managers may be able to hedge using the Russell 2000 ETF, for this type of strategy, due to the significant correlation with the high yield portfolio, especially in down markets. It is this ability to hedge and deviate from the market, besides inherent diversification, that is enticing financial advisors to invest in alternatives to protect clients from a possible market correction in the face of increasing volatility and global uncertainty.

Niche strategies like these are available to accredited investors through hedge funds and to retail investors through liquid alternatives. The perfect combination of diverse strategy, strategic approach, and available liquidity for each portfolio can be found in the many funds available.

Upcoming Events

Carl will be in attendance at the **16th Annual SCCIA Executive Educational Conference** at The Historic Mills House, in Charleston, SC From September 21-23, 2015 and hopes to see you there!

CapVisor Associates will be exhibiting at **NAMIC's 120th Annual Convention** at the Manchester Grand Hyatt in San Diego, CA from September 27-30th. Please stop by **booth 807** and say hi to Carl!

Carl will be back at **The SIIA National Conference & Expo** October 18-20th Marriott Marquis in downtown Washington DC . If you would like to arrange for a private meeting with Carl please contact us at carl.terzer@capvisorassociates.com

Carl will remain in DC for the **CIC-DC Annual Conference** also being held at the Marriott Marquis in downtown DC from October 20-21st. Hopefully Carl will see you at one of these fall conference .

Carl E. Terzer
Principal
Editor in Chief
CapVisor Associates, LLC