CapVisor Associates, LLC
Quarterly Newsletter

Winter 2012

Volume 4, Issue 1

Inside this issue:

Our Brave New World by Carl Terzer 1

Economic Review by Richard Litchfield 1

High Yield: An Alternative for Insurance Company Portfolios Part 2 by Tom Krasner 2

"...we expect total returns to be much more in line with overall prevailing yields and possible price decline should yields rise."

Insurance Asset Management

Our Brave New World

(continued on page 3)

By now most of us are familiar with the Federal Reserve's new policy of open and clear communications and we have read of their commitment to keeping interest rates near zero for an extended period of time, perhaps through 2014. It appears that our brave new world will be one of continued economic malaise and low market returns accompanied by historically high levels of volatility.

Since the Fed's announcement, the yield curve has flattened, which happens when long-term Treasuries fall faster than short term Treasuries. Many experts suspect that the flattening is a temporary market reaction and that steepening will occur with continued signs of improvement in the US economy. In any event, a flat yield curve indicates that investors have adjusted their holdings to reflect the continuation and elongation of an "easy money" policy period.

Interest rates and inflation

Thinking back to CapVisor's Fall 2011 newsletter, specifically our article entitled

Economic Review

(continued on page 4)

Fixed income investors enjoyed much higher total returns than expected in 2011 as interest rates fell which produced large price gains. Unfortunately, the corollary is extremely low yields on new investments and elevated call activity from the rush of issuers looking to refinance. The total return of the broad market as represented by the Barclays Aggregate Index was 7.84%. Looking forward, we expect total returns to be much more in line with overall prevailing yields and possible price decline should yields rise. With the yield to worst (akin to yield to maturity) of the broad Aggregate Index at 2.24%, this implies low single digit total returns for 2012.

Economic developments and events in 2011 were extraordinary in nature and far too numerous and complex to do justice with a simple list. A brief summary of what caused such a deep sense of crisis, first in the US in 2008 and now in Europe, must focus on the pervasive utilization of debt by the consumer, business and government sectors at the expense of income or growth-enhancing policies. The long secular trend of increasing leverage has come to an end, and unwinding the over-levered involves sacrifice, resolve and time. We will not fill these pages with dark prognostications or detailed accounts of the weak conditions now prevailing across the developed world --- enough of that was done in 2011! Instead, we hope to convey what we plan to do in light of these circumstances which we trust will calm your worry as you observe market behavior in 2012 and beyond.

Sector performance and current positioning

As with most major bond rallies, Treasuries outpaced nearly all other parts of the high grade bond market, meaning duration-adjusted excess returns of the spread sectors underperformed Treasuries in 2011, primarily during the 3rd quarter. Spread widening is common when Treasury yields plunge (10 year Treasury yields plunged 1.4%) since investors are fleeing higher risk sectors as growth expectations are slashed. Looking ahead, we believe these wider spreads will not persist as investors become acclimated to lower yields in general and find corporate and securitized bonds compelling, thus narrowing spreads as demand once again outpaces supply. Even with the current overweight to corporates, we are looking to add exposure since we believe fundamentals are solid and "yield wins over the long term." As for the securitized sector, we are lukewarm on the outlook and seek to opportunistically add exposure (i.e. during periods when MBS underperform) but ex-

High Yield: An Alternative for Insurance Company Portfolios (Part II)

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.

"…Credit spreads in high yield as of the end of January are 661 basis points. Early in October they exceeded 800 basis points, a traditional threshold for a bullish high yield market."

In our last edition, Mr. Krasner outlined why high yield securities are an attractive alternative to the more traditional insurance company allocations of high-quality fixed income securities, blue-chip equities, and real estate. High yield's low correlation to these asset classes, strong performance and moderate volatility make a case for consideration. He explained that default rates and recovery rates, given economic conditions, play an important role in considering this asset class. And Mr. Krasner left us with this thought…"Prior to investing in high yield, an investor should ask himself whether the current spreads sufficiently compensate him for the expected default risk and the expected recovery should the bond default."

A similar mental calculation applies to the current investment environment. Is today a good time to invest in high yield? The first consideration is the outlook for the economy. During the volatility of the late summer several investment banks were putting the probability of a recession at 40%. Since then, economic news has been mildly positive; and the European sovereign crisis has shown some signs of a solution. Most economists have returned to a consensus of slow economic growth for the U.S. economy. A slow expansion would portend a benign environment for high yield while a double-dip recession would create more headwinds.

I would argue that an investor currently is being sufficiently compensated. Credit spreads in high yield as of the end of January are 66 basis points. Early in October they exceeded 800 basis points, a traditional threshold for a bullish high yield market. Consider Figure 2.

High yield credit spreads have exceeded 800 basis points six times. On each occasion the high yield market posted a non-negative return over the following year and recovered significantly within three years. This historical experience concurs with the expectation of a benign environment for high yield over the next few years.

The current credit spread of 661 basis point factors in a projected 7% default rate. Investors are already pricing in a mild recession. The consensus forecast by investment banks calls for a default rate of between 2% and 4% over the next year. Even the projections under the scenario of a mild recession expect the default rate to peak close to 7%. Only the assumption of a deep recession with a high default rate would argue for a further widening of credit spreads and the poor performance of high yield. These projections already assume a large increase in the default rate from the current default rate of 1% over the last 12 months ended August 31st.

The probability of a mild recession seems much higher than the probability of a deep recession. Leverage has declined since the financial crisis. This decline has two implications. First, a sharp rise in corporate borrowings usually precedes a correction. In contrast, companies are hoarding large amounts of cash on their balance sheets. The low leverage on corporate balance sheets suggests that companies would be well prepared for an economic contraction. As a consequence, companies would not need to reduce leverage this time. Companies have already paid down debt and aggressively refinanced or extended their debt maturities. High yield bond issuance in 2010 broke a record. The amount of high yield debt needing to be refinanced over the next few years is quite manageable.

Low government bond yields should also be supportive of high yield. Investors seeking yield will need to take credit risk. During the summer we saw a flight to quality as fear dominated investor behavior and drove investors to seek safety. As they realize that they cannot stay in low yielding, high quality assets forever and still meet their income requirements, investors should increasingly turn to higher yielding alternatives.

A conservative investor who needs to generate income, such as an insurance company, may ask how to lower the risk of investing in high yield. One alternative is to invest in shorter-maturity high yield bonds. These bonds tend to deliver most of the return of high yield with significantly less volatility. For example, in September 2011, the Barclays High Yield Index declined 3.27%

continued on page 3

High Yield: An Alternative for Insurance Company Portfolios

while the 0-3 Year Sub-Index declined 2.16%. My experience has been that a short-maturity high yield portfolio will deliver about 90% of the return of a normal high yield portfolio with 60% of the volatility. The short-maturity portfolio tends to out-perform during market corrections and under-perform during market expansions. It also performs well during periods of market stability.

The lower volatility largely results from the short maturity. Long duration government and investment grade bonds are more volatile than short duration bonds. The same effect reigns in high yield. Extending the duration of a bond extends the time sensitivity of its cash flows. For a government bond and an investment grade bond most of the time sensitivity is due to changes in interest rates. For a high yield bond, although interest rates play a role, much of the effect derives from the increasing business risk of future time periods. Cash flows in the distant future are less certain and more vulnerable to default risk than cash flows in the near-term.

Short-maturity high yield bonds tend to be seasoned bonds. Companies originally issued these bonds with an 8-10 year term. The bonds now have only a few years remaining until their maturity date. The seasoned nature of these bonds is one of the explanations for their lower volatility. The lower volatility is partially a consequence of a lower default rate. Academic studies of high yield bonds have found that default rates rise for four years after issuance and decline in later years. The reason is intuitive. Like other securities, investment banks are best able to sell new issues when the economy and company fundamentals are the most positive. After issuance, negative surprises often occur. Seasoned bonds have already passed through this default cycle.

Another advantage is the natural liquidity of a short-maturity high yield portfolio. A company does not usually wait until the maturity date of a bond to retire it. Early calls and tenders frequently occur, shortening the effective duration of the portfolio and providing natural liquidity. This refinancing activity can easily transform a two-year duration portfolio into a one-year duration portfolio and cause a large part of the portfolio to turnover annually. For example, a 30-bond portfolio with a one-year effective duration would have two to three bonds called in the average month. Because of the rapid portfolio turnover, a short-maturity portfolio is less sensitive to inflation risk and interest rate movements. The portfolio manager can easily adjust the portfolio to changing market conditions. His biggest challenge may be keeping the portfolio fully invested.

Insurance companies should consider an allocation to high yield. It can complement a traditional allocation to investment grade bonds and blue-chip equities. Shortening the maturity of the high yield portfolio can substantially reduce the volatility of the portfolio without sacrificing a significant amount of the annual return.

Figure 2 High Yield Performance After Spreads Cross 800bp

	Spread to Worst (bp)	3 months	6 months	1 year	3 year
Feb-90	837	5.46%	7.11%	10.33%	73.69%
Sep-90	970	-0.08%	18.42%	36.93%	90.83%
Oct-00	813	3.83%	1.88%	0.00%	29.38%
Jun-01	804	-4.44%	1.14%	0.88%	34.76%
June-02	839	-3.03%	2.43%	19.59%	47.32%
Sept-08	1001	-19.50%	-14.61%	20.35%	48.73%
Average		-2.96%	2.73%	14.68%	54.12%

Our Brave New World

(continued on page 5)

Risk Management and Inflation, many experts are bracing client portfolios for inflation to pick up, not necessarily near term, but certainly as a result of recent Fed policies. As evidence, treasury inflation-protected securities (TIPS) have rallied compared to Treasuries as investors seek protection against these future inflationary pressures over the next decade. As our Fall article indicated, 2011 inflation rates were rather high but projected inflation rates were rather tame, at least in nominal terms. However, it is much more important to view inflation rates in relative terms, specifically with respect to prevailing interest rates. From this perspective, inflation rates

Richard J. Litchfield, CFA
Vice President
MBA Boston University
BS Boston College

Mr. Litchfield is Head of Trading and Portfolio Management for Opus Investment Management. He joined Opus in 1995 and manages numerous P&C insurance portfolios. In addition, Rich maintains primary responsibility for the entire municipal bond sector. Prior to joining Opus, Mr. Litchfield was a fixed income analyst with Keystone Investments.

> "…we like sectors where market inefficiencies exist since different opinions can generate greater opportunities for spread compression and value creation over the long term."

Economic Review

(continued from page 1)

pect to achieve no more than a neutral weighting relative to the index. Taxable municipals represent better value, but supply is light which limits our ability to add significant weighting.

Regardless of low yields, bonds play an important role

With yields so low and prices so high, it may be tempting to consider timing the market and sell bonds. After all, cash won't suffer from price erosion and some equities offer much higher dividend yields as well as upside price potential. Before jumping to that conclusion, consider for a moment the role bonds play for an insurance enterprise. Before you agree, consider the following:

-Leaving aside any regulatory considerations for the moment, fixed income investments are seen as secure and high quality and therefore require less capital than equities or alternatives. Government bonds offer supreme safety (in theory!) due to the taxing authority, while corporate bonds are higher in the capital structure than equities and securitized bonds are just that: backed by some kind of collateral and/or structural features that provide great protection for bondholders.

-Next, consider the income produced by bonds and the wealth-building nature of yield on yield, or compounding. This is the primary motivation for an insurance entity: a predictable, stable earnings stream that can provide reliable results, contrasted with more volatile operating results and/or investment returns from equities and alternatives. With the higher embedded book yields in many insurer's portfolios earnings streams are still quite attractive and offer good protection in the event yields move lower or persist at these levels for longer than anyone expects. Sitting in cash until yields recover could take a number of years and a significant income sacrifice is paid for this maneuver, and of course there's the possibility yields could move still lower due to an escalation of the crisis in Europe.

-As a store of value and a means to protect book value, bond valuations can be expected to linger around par barring any sort of credit blow-up or fraudulence. The stable store of value serves an important function in letting the insurance executive proceed with the business of insurance through any kind of calamity that may ensue.

-Lastly, bonds are more liquid than any other type of investment save cash. Liquidity refers to the ability to turn investments into cash in short order. Even after S&P's downgrade of the US in 2011, the US Treasury market is the deepest, most liquid in the world, and investment grade bonds in general are not far behind. Dealers make markets (bid-ask) in these bonds, central banks own stores of them, banks and other financial institutions rely heavily on them: in short, the fabric of the world's financial system is woven with bonds.

The economy and what we like now

Nine months ago, some in the media were beginning to write about the Fed's imminent rate increase owing to the improvement underway in a variety of economic data. In reality, the observations were nothing more than a cyclical bounce which later came to be severely tested by the Japanese nuclear disaster, the escalation of the European debt crisis and a further drop in real estate values. Due to the tepid nature of the recovery, the Fed has emphatically stated their intention to not raise rates until 2013 at the earliest.

Even with a weak outlook for 2012 GDP, we remain very comfortable maintaining a significant overweight to the credit sector . Since the jarring events of 2008, when CFOs and CEOs worried about rolling overnight commercial paper and money market funds needed a federal backstop, corporate America has reduced leverage, extended the average term of debt, improved productivity and increased margins. There are the extremes that are still struggling, such as banks, and some stories that are clearly more intent on rewarding equity owners than bondholders, but our conservative philosophy will continue to guide our credit selection process. Suffice it to say we are not expecting major shifts out of the credit sector this year.

Another part of the market we find intriguing is the municipal sector, primarily taxable municipals. A year ago, one fairly prominent sell-side analyst was predicting massive defaults and problems in this sector. We disagreed and

Continued on page 5

Economic Review

used the temporary and limited market distortion that resulted to add to positions. We continue to find good values today, albeit lower yielding and fewer in number. Most municipal borrowers are proving their resilience by taking appropriate measures to deal with the tough economy: raising fees/ taxes, cutting services, reducing benefits --- all types of fiscal austerity.

In short, we like sectors where market inefficiencies exist since different opinions can generate greater opportunities for spread compression and value creation over the long term.

Think positive, but be careful what you wish for
The housing market has probably reached its nadir and should begin to show some signs of recovery in 2012. These signs should include modest price appreciation in select markets, growth in new home starts and a deceleration in foreclosure activity. We cite the steady improvement seen in household formations, which foretell home buying since they measure those moving away from home, divorces and other life-changing circumstances requiring a new household being formed. Not all of these will buy a home, but the drop in home prices now makes owning a real option in many markets where renting had the decided advantage.

Another possible source of good news is hidden between the lines of today's news stories regarding Europe's debt crisis: it takes a crisis to force action and that is indeed what we have! With all this talk of crisis, the optimistic among us should be hopeful that reform is coming. Call it what you want --- modify, reconstitute, reorganize, alter, change --- it is what's needed and in more places than we care to admit, but it is coming and that is reason enough for optimism. Canada and Turkey are two prominent examples of countries that have experienced similar conundrums in the last 30 years and have today emerged as pillars (well, columns anyway) of economic prudence.

While we all would like economic growth to achieve greater momentum, a word of caution is worth mentioning: should economic growth surprise to the upside, bond yields will rise sooner than expected and recent price gains will erode. The same goes for Europe's travails: a true "solution" that passes the market's "smell test" would likely cause Treasury yields to bounce higher. However, in light of global fiscal austerity, widespread pessimism on the merits of real estate as an investment, and the overwhelming nature of Europe's crisis, it seems unlikely Treasury yields will rise in an abrupt manner. ***The main message is to consider current bond valuations as somewhat temporary in nature given the grave state of affairs in Europe and treat all unrealized gains as subject to attenuation should the outlook brighten materially.***

Our Brave New World

(continued from page 3)

above 1% may be deemed high; certainly high enough to produce negative real rates of return all the way out the yield curve to 5 year Treasuries. While this situation imperils many fixed income investors, it actually is self-serving for the Government. In addition to the well publicized benefit of nurturing an unsteady economic recovery, it also serves to deflate the government's growing debt problem. In this way, even low nominal inflation rates can act as a current "tax" on investors to help pay down public debt.

Risk Management
The Wall Street Journal recently reported on a pension study by the consultant firm, Mercer, which has applications for insurance companies as well. With near zero short term rates dragging down long-term bond yields, the pension plan deficits of S&P 1500 companies rose more than 50% in 2011. This is attributable to the fact that, similar to insurers, rates at which they have been discounting liabilities have changed from previous assumptions. Fortunately, most insurer's bond portfolios are of shorter duration than pension plan bond portfolios which serves to lessen the detrimental effect somewhat.

Insurers will need to be mindful of duration matching techniques to limit declining bond portfolio market values caused by rising interest rates. Of greatest concern may be the scenario in which interest rates snap back rapidly in response to the long period of suppressed interest rates, rather than gradually increasing over a longer period of time. If and when the economy demonstrates sustained growth and good future prospects for expansion, this risk will be upon us.

Some Solutions for Insurers
With high quality, intermediate bond portfolios producing low yields, insurers must look elsewhere for incremental return. Municipal debt is one of the more obvious candidates for insurer's portfolios. We have not seen, nor do we expect to see, the high profile doomsday credit scenarios that were projected early last year. High yield, particularly short duration strategies discussed in an accompanying article in this newsletter, may be another good source of return with controlled risk exposure. Finally, dividend paying equities continue to receive new allocations, or reallocations from large and mid- cap portfolios, in an effort to boost portfolio yields. S&P's Howard Silverblatt provided some statistical support in a recent article for the dividend-paying stock strategy. His calculations, using the power of compounding, illustrate that $10,000 invested in non-dividend paying stocks in 1979 would be worth around $250,000 in 2010. Had this investor put the same amount into dividend paying stocks and reinvested those dividends, his 2010 balance would be $413,600…he makes his point!