Inside This Issue

Feeling Market Pain?

The first three quarters of 2022 have been a period for the record books! With US stocks and investment grade bonds down, investors who thought they were diversified are rightfully confused and concerned.

From the world of personal investing/wealth management or retirement investing, most people know of the magical asset class diversification formula of 60% equities and 40% bonds. This asset allocation mix, while not typically appropriate for insurers, normally provides market value and return stability: asset class diversification in its simplest form. As you can see from the chart on page 3, a 60/40 portfolio has an average annualized return of about 9% over the nearly last 100 years.

Since the stock and bond markets have very low to slightly inverse correlations to one another, investors historically got a smoother

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Q3 Economic and Market Review

Well, we now have three quarters of 2022 in the books and it was quite a month and a quarter. We ended the 2nd quarter with the 10-Year Treasury yielding 3.02% and three months later, this yield climbed to 3.83%[1]. This change in yield also needs to be taken into context of the 1.51% yield on the 10-year at the start of 2022. The equity market has been a challenging place this year. Year-to-date, through September 30th, the S&P 500 was down 23.9%, with 4.9% of that decline occurring in the third quarter, while the month of September saw the index decline more than 9%[2].

We are looking at the potential for stagflation, and we may already be there, because inflation continues to remain high with the headline Consumer Price Inflation (CPI) standing at 8.3%[3] and, when factoring out food and energy, inflation is growing at 6.3%[4]. Durable Goods Orders declined last month and, this morning, the ISM Manufacturing Index declined to 50.9[5]. While it is true that any reading above 50 connotes growth, we are growing at a very decelerating rate as this index stood at 56.1 just four months ago and has declined in each subsequent month. There are other statistics that also show slowing, but my point is that we are still seeing high inflation and economic activity appears to be slowing. What may be delaying the declining growth part of this equation is the continued strength of the consumer due to the tight labor market. At their last reading, unemployment stood at 3.7% and underemployment was 7.0%, still quite low, albeit slightly higher than just a few months ago[6].

Regular readers know that both my thinking about the economy, and the economy itself, is informed by behavioral finance in that psychological influences can and do influence economic activity. For example, the combination of higher interest rates (driven by inflation expectations) and a general concern about economic activity has dramatically slowed the housing market. We went from an environment where people were lining up at open houses and writing letters to sellers in order to position themselves to be the preferred bidder, to homes now sitting on the market and price decreases beginning to occur. I appreciate that a primary culprit of the housing slowdown is the increased cost to the buyer due to higher interest rates. At the same time, the market has had a wholesale change that I believe supersedes a simple interest rate explanation.

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Q3 Economic and Market Review

Tony Minopoli, President & CIO of Knights of Columbus Asset Advisors

Tony joined the Knights of Columbus in 2005 and is responsible for the day to day management of the Knight's General Account investment portfolio and mutual fund strategies. Tony is also responsible for overseeing the internal investment staff and the fixed income and preferred stock investment strategy.

So, we now sit at the end of September and the S&P 500 has returned -23.9% and the bond market, as measured by the Bloomberg Aggregate Bond Index, returned -14.6%. Calculating a simple 60/40 blend of these returns results in a combined return of -20.2% for the first nine months of the year. I have had several discussions with clients around the benefits of diversification, or more specifically the fact that diversification has not really helped this year.

The capital markets are being heavily impacted on a number of fronts. First, we have interest rates rapidly climbing as the Federal Reserve (Fed) and other central banks are attempting to fight off inflation. This has taken the wind out of the sales for stocks. At the same time, we cannot forget that some of the inflation that we are experiencing is due to domestic oil drilling policies of the current administration. This coupled with the Russia/Ukraine war and Russia severely limiting gas flow to Europe has caused the price of energy to move materially higher this year. As recession fears have started and China continues to fiddle with Covid lockdowns, we have witnessed a decline in energy prices, so the Organization of the Petroleum Exporting Countries (OPEC) is deciding on a production cut to maintain loft prices. It's a lot more cost effective for the Saudis to run a golf league with $100 per barrel oil than it is with $60 per barrel oil, but you get the idea.

With all this said, we remain focused on building diversified portfolios because the next moves for the market will likely be uncertain as well as uneven. The ability to take a step back and determine long term goals will be far more beneficial than attempting to decide if we have reached a market bottom. As I have written about on several occasions, the world seemed pretty dark in March of 2009 as we were in what seemed like an interminable recession, and then the markets healed. In April of 2020, it seemed like the world was changed forever due to Covid and then the markets and the economy recovered.

> **"The ability to take a step back and determine long term goals will be far more beneficial than attempting to decide if we have reached a market bottom."**

As a young man, while interning at Evaluation Associates, one of the asset management firms that had been hired to manage assets for some of our clients made a strong market call. The manager, properly, was concerned about the excesses they saw in the market and promptly moved most of their portfolios to cash in September of 1987, just in time to miss the October market crash. Interestingly enough, my firm terminated this manager in early 1988 because they became so spooked by the market, they did not see the rebound and were unable to rebuild their portfolios. I do not know what happened to this company, but it struck me that the leaders of my company were able to recognize that this manager had become so gripped by all that was wrong, that they simply could not find even a shred of optimism.

I relay this story only to highlight those times of market stress and/or investor stress, are often the worst times to make major decisions. I fight the same issues that most individual investors fight, the desire for safety and security in uneven times. My inclination is always to fight these concerns and focus on the fundamentals of my asset allocation structure and remain positioned to participate in a wide array of market environments. It is not easy, but it is likely the wisest stance.

[1] Source: Bloomberg, as of September 30, 2022
[2] Source: Bloomberg
[3] Source: Bloomberg, as of August 31, 2022
[4] Source: Bloomberg, as of August 31, 2022
[5] Source: Bloomberg, as of September 30, 2022
[6] Source: Bloomberg, as of August 31, 2022

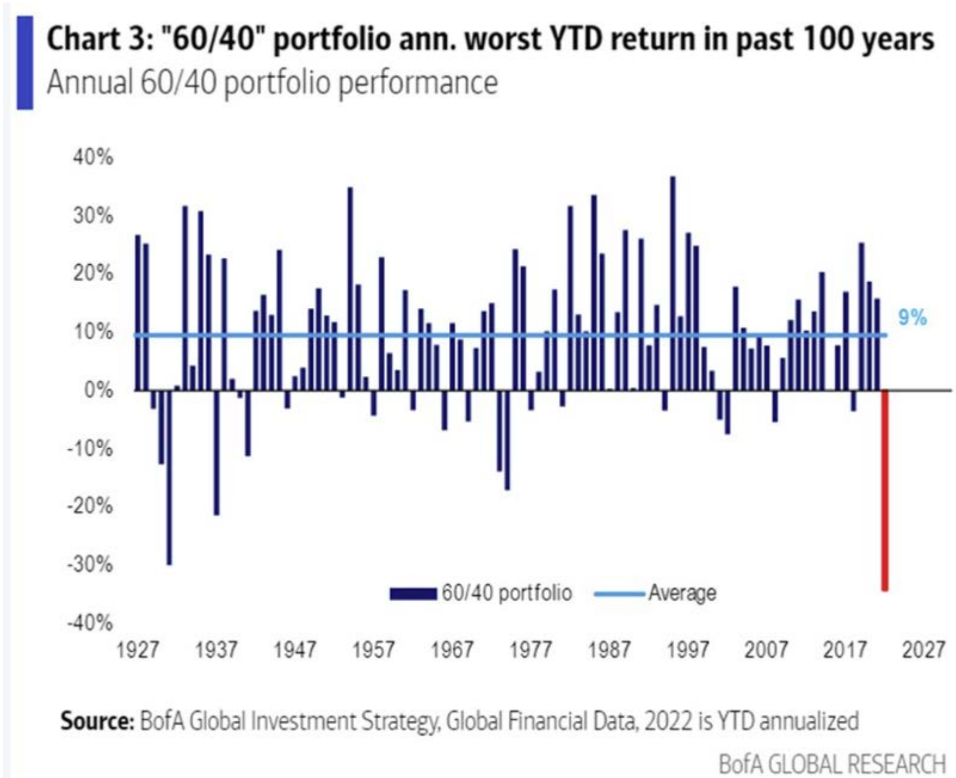
Feeling Market Pain?

ride when either asset class was up or down. And, then came 2022!

Over the past several additions of our newsletters, our readers have heard us lament about the extensive monetary and fiscal policy distortions that were built into the US securities markets since the 2008 Great Recession. Since 2008 and until very recently, monetary policy conducted by the Fed held rates at historical lows, mostly near 0%. In addition, the FED bought government securities to provide additional liquidity during the 2008 crisis and more recently again during COVID. In 2020, the liquidity was exacerbated by fiscal policies which deferred student loans and rental payments, extended unemployment benefits and provided PPP loans and other forms of " free money". In combination, these unprecedented actions were intended to forestall a deep recession and to ease the economy back on course. As the saying goes, no good deed goes unpunished! Of course, tinkering with normal economic and market forces and cycles usually has unintended consequences. One can easily see how the extent of these consequences distorted the current markets. Specifically, the normal interplay of the stock and bond markets is currently completely broken. All of the meddling since 2008 had the cumulative effect of producing this year's double whammy.

The double whammy with a bit of historical perspective

For US Bonds*, you'd have to go back to 1931 when bonds were down -15.68% to find a year this deeply negative in performance! US Investment grade bonds, as measured by the Bloomberg Aggregate Index, are down 14.61% through 9/30/22.



Since 1928, when market records began, the average annualized total return for US investment grade bonds has been about 7% per annum. There has been only 14 years that bonds have produced a calendar year negative return. The *average* down year over that time span produced a -3.48% annualized return.

> "The normal interplay of the stock and bond markets is currently completely broken. All of the meddling since 2008 had the cumulative effect of producing this year's double whammy."

For US Stocks*, as measured by the S&P 500 (including dividends), the average return since 1928 through 2021 was 11.82%. From 2009, the first full year of the monetary and fiscal policy market manipulation, through year-end 2021, the average annual return was a super bullish 16.36% per annum: about 27% above its average historical return.

Year to date though Q3 2022, U.S. stocks across virtually all indices moved down in lockstep:

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Large Cap – S&P 500 = -23.87%

Mid Cap – Russell Midcap = -24.27%

Small Cap - Russell 2000 = -25.10%

Unfortunately, in very volatile markets or calamitous situations, it is not unusual to see normal historical asset class relationships disrupted and move towards correlations of 1.

To put all this in perspective, and help highlight the case that diversification does not always smooths out returns, the chart directly below tells the sad and highly anomalous story of 2022.

We have broken the near 100-year record for the worst performance of the stock and bond market portfolio combination.

This year's horrible investment grade bond performance as measured by the Bloomberg Aggregate (AGG) has dragged down annualized results over the last 10 years through September 30, 22 to a dismal return of .86% through September 30, 2022. Performance results for the last 15 years is not much better at a total return of 2.74% per annum.

The chart below approximates the 10-year performance of the Bloomberg Aggregate using the ETF AGG. The price return is in the blue shaded area and the red line includes dividend income (interest).

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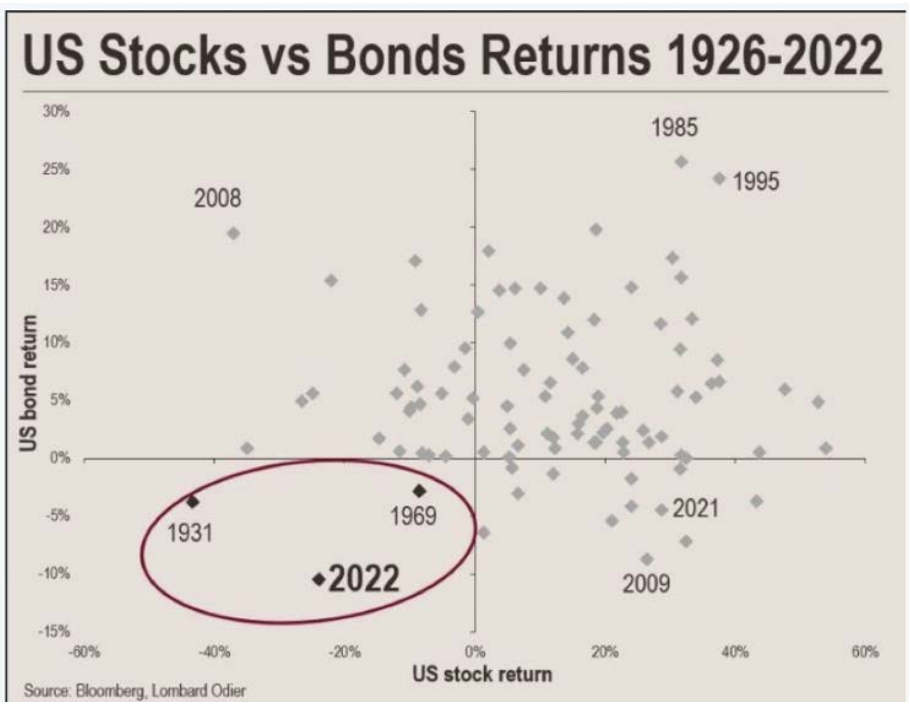

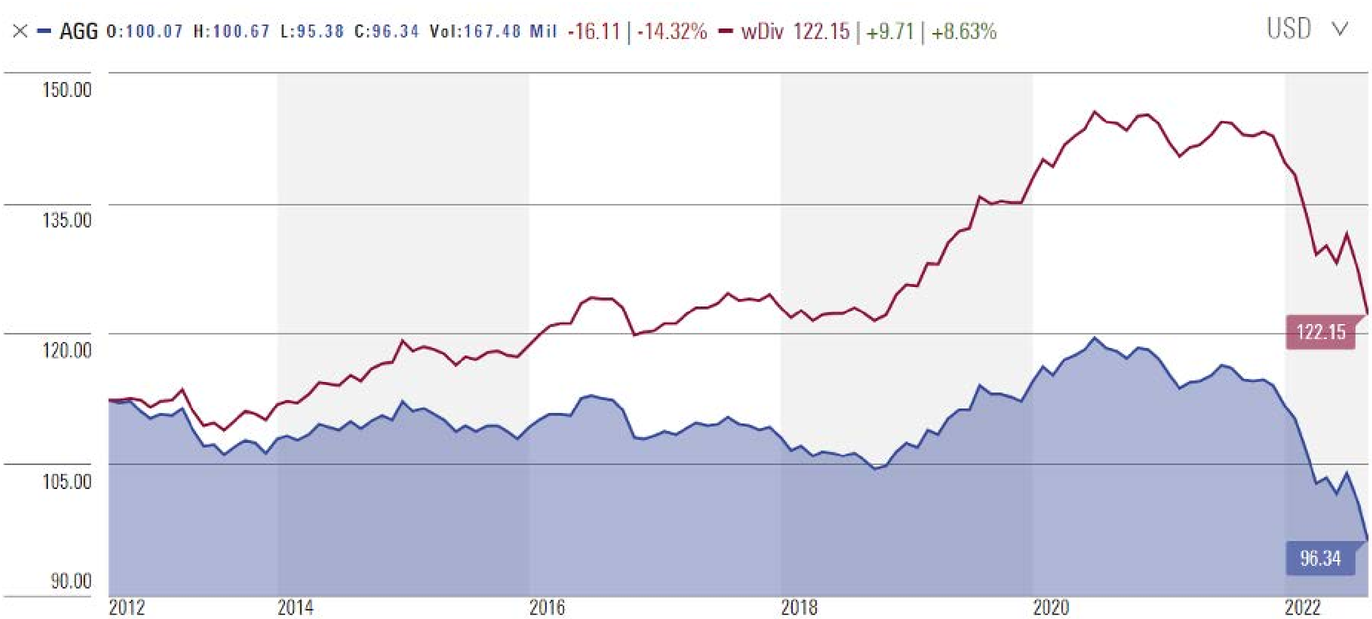

Source: Morningstar

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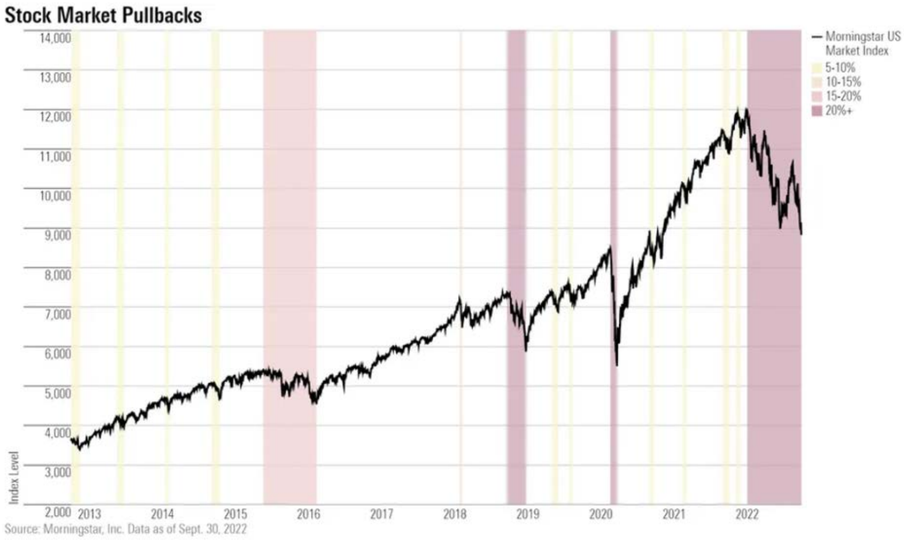

Source: Morningstar (10/17/22)

Quarterly Market Performance Barometer

	Performance %		
U.S. Equities	Q3 2022	Q2 2022	2022 YTD
U.S. Market	-4.58	-16.85	-24.88
Value	-6.60	-9.44	-13.43
Growth	-3.84	-25.33	-36.79
Dividend Composite	-5.64	-9.58	-15.45
Wide Moat Composite	-6.69	-16.99	-27.61
Global Equities			
Developed Markets ex-US	-9.17	-14.90	-26.70
Emerging Markets	-9.81	-11.59	-24.98
Fixed Income			
U.S. Core Bond	-4.83	-4.50	-14.57
U.S. Treasury Bond	-4.53	-3.65	-13.07
U.S. High Yield Bond	-0.68	-9.90	-14.57
TIPS	-5.55	-6.25	-13.61
10+ Year Treasury Bond	-10.28	-11.58	-29.00

Source: Morningstar Direct, Morningstar Indexes. Data as of September 30, 2022.

The chart on the top left shows the S&P 500 results for the last 10 years.

This year's miserable results through 3Q, a longer and more severe pullback than any in the last 10 years, has brought the 10-year and 15-year annualized Large Cap stock returns down to 9.55% and 5.86% respectively.

Nowhere to Hide!

The asset class return chart on the bottom left shows that stocks and bonds, domestic and international, could produce positive returns this year.

With an 8+% inflation rate and insurers future claims obligations inflating at a similar pace, these numbers could spell trouble. Investment portfolios heading downward and future obligations heading up, means extreme financial pressures unless things change. Fear not…they will.

Conclusions

Looking forward, we expect continued volatility for the next few quarters until the Fed demonstrates progress in its fight against inflation. Bonds will suffer a bit more as interest rates continue to rise but less so since we believe that most of the rate increases are factored in already. Somewhat oddly, the intermediate part of the bond yield curve appears to be the best risk/ return location. Bonds are likely to resume more normal patterns once the Fed's rate increasing cycle nears an end.

Equity markets will likely be more affected by the length and depth of

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the expected recession in 2023. Global socio-political events (Ukraine/Russia, China, North Korea, etc.) and consumer sentiment will also need to be factored into an equity outlook, but any impact is impossible to predict from where we sit today. I would not suggest bailing out on growth stock allocations since they are likely to be the largest beneficiary upon market recovery.

However, if you are considering putting new money into the equity markets, James Paulsen, the Leuthold Group's chief investment strategist offers an interesting idea. He found that when a key part of the U.S. bond market shrugs off new Federal Reserve interest rate hikes or tough talk on inflation, it's probably time to buy stocks.

Looking at the relationship between the 10-year Treasury and the S&P 500, he found five periods since the mid-1980s when the benchmark 10-year Treasury yield peaked. In his analysis, Figure 1 below, we can see that when the 10-year Treasury yield peaked around July 2 (green Line), the equity market surged within 4 weeks, around August 2 (blue line), notwithstanding the continuation of the Fed rate rise cycle until October 2 (red Line). We'll keep an eye on this pattern to hopefully signal an entry point for 2022 for those with cash on the sidelines- see figure 2 below.

If prudent strategic asset allocation decisions have been executed, stay the course as research data projecting future asset behaviors demonstrates accuracy due to mean reversion, and the expected results tend to come in fairly close to estimates over the long (strategic) time horizon.

The best course of action when the outlook is this uncertain, is to sit tight and try to ride it out. Trying to time market entry to put new money to work may make some sense, however, "Timing the market" has empirically been proven to be a fool's game.

This is evidenced by how far off market predictions have been from the Wall Street taking heads. Following is an excerpt from a 1/31/22 NY Times article:

"Many Wall Street strategists are predicting that the market will end 2022 higher. David Kostin, the chief U.S. stock market strategist at Goldman Sachs, for instance, predicts that the market will finish the year up 15 percent from where it closed on Friday."

While he may not be wrong, his prediction looks highly unlikely at this

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Figure 1

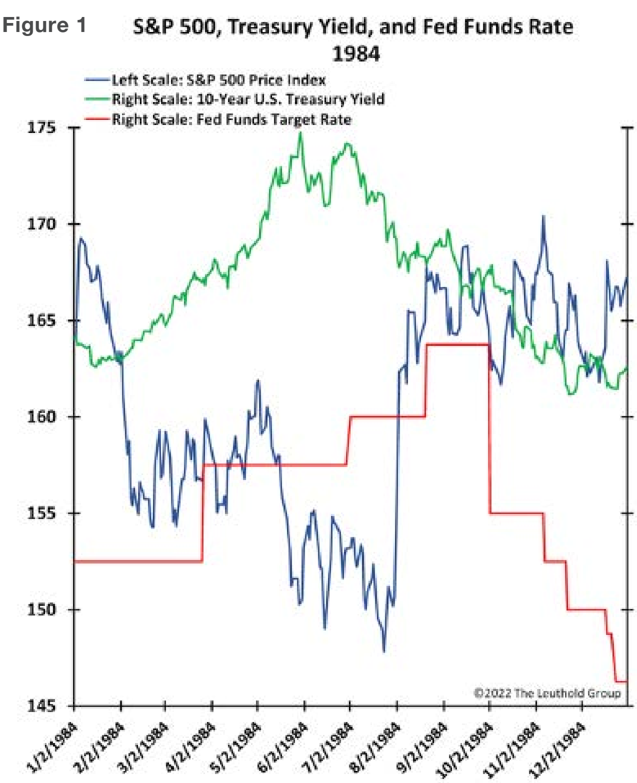
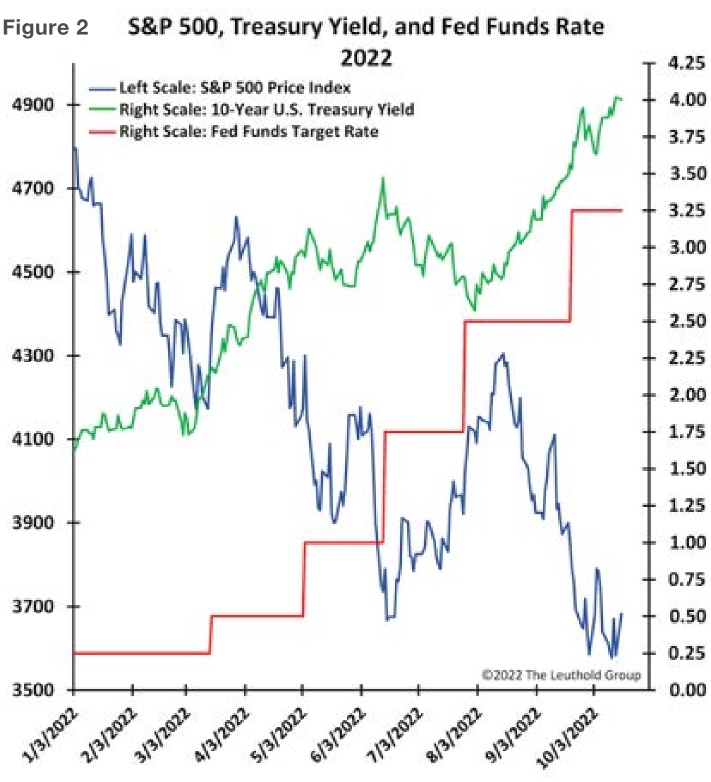


Figure 2



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time.

Tactical improvements during market turmoil are few and far between. We have been advocating asset classes, such as some Alternatives (ALTS), that have low correlations, sometimes zero or inverse correlations, to public securities markets which can benefit an overall portfolio in good times and bad. In our opinion, allocations of 3-10% are the most insurers should venture into the non-public markets and therefore may only tweak up returns at the margins.

Insurers should remind themselves that unless regulatory, accounting and claims or surplus pressures are intolerable, they should limit their damage by staying the course. The markets will invariably recover and continue their historical upward march. Focus on the long term and the rewards will come. ☐

Data Source: https://www.stern.nyu.edu/~adamodar/pc/datasets/histretSP.xls

2023 Asset Class Projections - Quiz Yourself!

As a reader of CapVisor Newsletters and our other investment-related materials, you will recall Strategic Asset Allocation (SAA) is the most important decision an insurer makes regarding their investment program, accounting for more than 90% of their investment results over the long term. Therefore, our Strategic Asset Allocation Optimization work is based upon optimizing portfolio's risk/return characteristics over a 5 to 10-year forward-looking period. Why? Simply because insurers, and quite frankly almost all successful investors, plan for the long run. Our actuarially built model, updated annually, typically uses forward looking projection for asset class behaviors, specifically, JP Morgan Long Term Capital Markets Assumptions (LTCMA).

After a very anomalous year in the markets, we have set up a "fun fact test" with correct answers based upon JP Morgan's LTCMA for 2023. These LTCMAs define "risk" as expected volatility and project both expected risk and expected returns over the strategic time horizon.

Quiz yourself! Which asset class:

1. Has higher expected returns: US Core (Agg) Bonds or US Intermediate Government Credit (IGC) Bonds?
2. Has higher Volatility/Risk: US Core (Agg) Bonds or US Intermediate Government Credit (IGC) Bonds?
3. Has higher risk level but higher expected returns: US Large Cap or US Small Cap?
4. Has similar risk levels but higher returns: US Small Cap or Emerging Market equities?
5. Has a higher risk level: Long Term Treasuries or diversified High Yield Bonds?
6. Has lower risk and higher return expectations: Japanese equities or US Small Cap stocks?
7. Offers higher expected returns at the same risk level: High Yield Bonds or US REITS?
8. Has higher expected returns at lower risk levels: US Minimum Volitility Factor Equity* or US Large Cap Equities?
9. Has expected lower risk and higher returns: Gold or TIPS?
10. Has similar returns with lower risk levels: Direct Lending** or US Large Cap stocks?

*Defensive equity portfolios
**An alternative (ALTs) Investment in privately-negotiated corporate debt in which lenders, other than banks, make loans to companies without intermediaries such as an investment bank, a broker or a private equity firm.

Answers on page 8

Upcoming Events

1. The TCIA annual conference will be taking place in Nashville on November 15th-17th. Carl Terzer will be speaking about strategies to maximize your captive investment plan in an uncertain economy. The session is on Wednesday at 1pm.

2. CapVisor will be attending the Cayman Captive Forum on November 29th - December 1st. We look forward to seeing you there.

3. Travis Terzer will be at the World Captive Forum in Miami from February 1st-3rd. We hope you stop by booth #8 to visit with Travis.

4. The CICA International Conference will be held in Rancho Mirage, CA from March 5th - 7th. Carl Terzer and Travis Terzer will both be attending.

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

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2023 Asset Class Projections - Answer Key

Correct answers in red

1. Has higher expected returns: **US Core (Agg) Bonds** or US Intermediate Government Credit (IGC) Bonds?
2. Has higher Volatility/Risk: **US Core (Agg) Bonds** or US Intermediate Government Credit (IGC) Bonds?
3. Has higher risk level but higher expected returns: US Large Cap or **US Small Cap?**
4. Has similar risk levels but higher returns: US Small Cap or **Emerging Market** equities?
5. Has a higher risk level: **Long Term Treasuries** or diversified High Yield Bonds?
6. Has lower risk and higher return expectations: **Japanese equities** or US Small Cap stocks?
7. Offers higher expected returns at the same risk level: **High Yield Bonds** or US REITS?
8. Has higher expected returns at lower risk levels: **US Minimum Volatility Factor Equity*** or US Large Cap Equities?
9. Has expected lower risk and higher returns: Gold or **TIPS?**
10. Has similar returns with lower risk levels: **Direct Lending**** or US Large Cap stocks?

Scored correctly = 7+ "Wizard" (we'll take your resume) ; 3-6 "Savvy Investor" (and probably very interested in our new SAA model's results) ; less than 2 = "lousy guesser" ;)

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