CapVisor Associates, LLC

Inside This Issue

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Part 2: Exploring Investment Vehicles and Evaluating Manager Performance

With active mutual funds and low-cost passive ETFs underperforming, what options are left?

SMAs: a good choice for institutional investors

In short, properly analyzed SMAs can be the answer. CapVisor's Informa /PSN database of over 3,000 active managers with GIPS[3] compliant "composites", or separately managed accounts, indicates that most SMA's also fail to consistently beat the S&P 500 index.

As you can see in the chart on page 6, the S&P 500 benchmark ranks in the 33 percentile for 3 years and the 26th percentile for 5 years. While this represents strong performance for the index relative to active SMA managers, it is also encouraging that top quartile managers can outperform the index. Using analytic tools such as the PSN database, clients can source the best risk-adjusted active managers. In addition, SMA's allow client preferences regarding risk/volatility levels to be customized to meet their investment policy.

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Q2 Economic and Market Review

The Economy

The U.S. economy has been resilient this year. Measured by its output, the gross domestic product (GDP) increased 2.6% in 3Q 2023, greater than the 2.0% increase in 1Q 2023.

This growth rate is impressive considering the increase in interest rates over the past year. The Federal Reserve continues to maintain a restrictive monetary policy in

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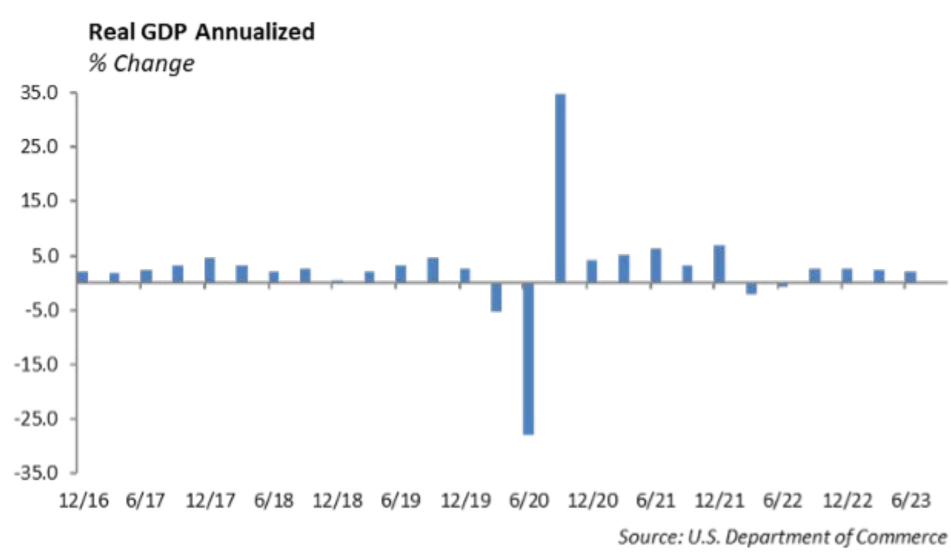
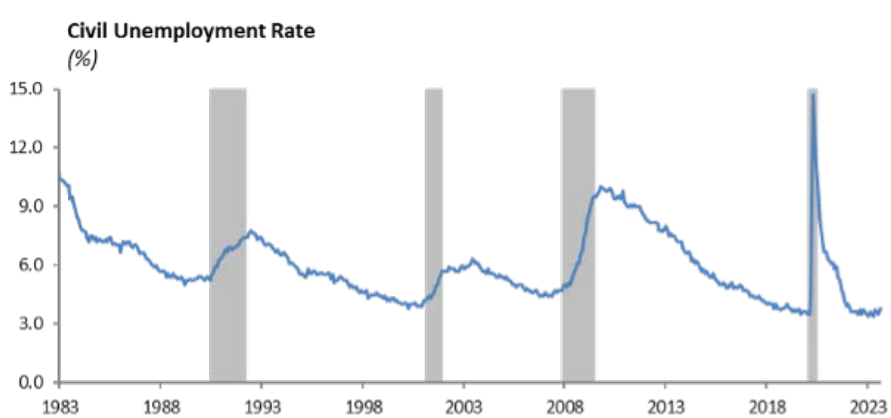


Q2 Economic and Market Review

Greg Hahn: Prior to forming Winthrop Capital Management, Greg was the Chief Investment Officer and Senior Portfolio Manager for Oppenheimer Asset Management and its subsidiary, Oppenheimer Investment Management. Greg also served as the Chief Investment Officer and Senior Portfolio Manager with Conseco Capital Management (40|86 Advisors). Greg was President and Trustee of the 40|86 Series Trust and the 40|86 Strategic Income Fund. Also, Greg had responsibility for the $1.2 billion real estate and private equity portfolio.



Shaded areas represent recessions. *Source: Bureau of Labor Statistics*

an effort to shift aggregate demand lower and reduce the rate of inflation.

While the Fed continues a restrictive monetary policy, the federal government continues to maintain a budget deficit of more than $1 trillion. As a result, a stimulative fiscal policy is working to counteract the effects of restrictive monetary policy.

The labor market remains strong. Employers added 1.6 million jobs through 3Q 2023, and the unemployment rate is running at 3.8% in September as reported by the Bureau of Labor Statistics. The labor force participation rate increased from 60.1% in April 2020 to 62.8% in September 2023.

For the second half of 2023, we expect deterioration in the health of the consumer sector. An increase in corporate layoffs is beginning to erode the strength in employment. The consumer savings rate has slipped to 3.9%, while domestic household and credit card debt reported by the Federal Reserve has increased to over $1 trillion. At the same time, the requirement to pay interest on student loan debt was reinstated on October 1st. Similarly, higher interest rates on auto loans and home mortgages are acting to slow economic growth.

Employment data, including the non-farm payrolls and the ADP jobs report, have supported the robust economic growth, and have exceeded market expectations. This sustained strength in the labor market, in the face of rising short-term interest rates, suggests the need for additional monetary tightening.

The current level of employment growth matches trend line growth and illustrates the economy shedding the long-term effects of the pandemic. However, the size of the labor pool, measured by the labor force participation rate, has been slower to recover as workers opted for retirement or simply left their jobs.

The seasonally adjusted average hours worked per week was 34.4 hours in September, significantly lower than the 35-

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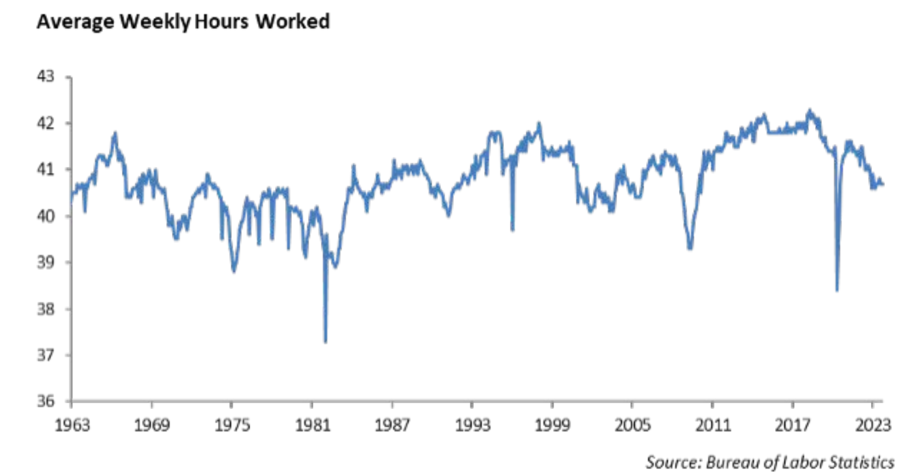
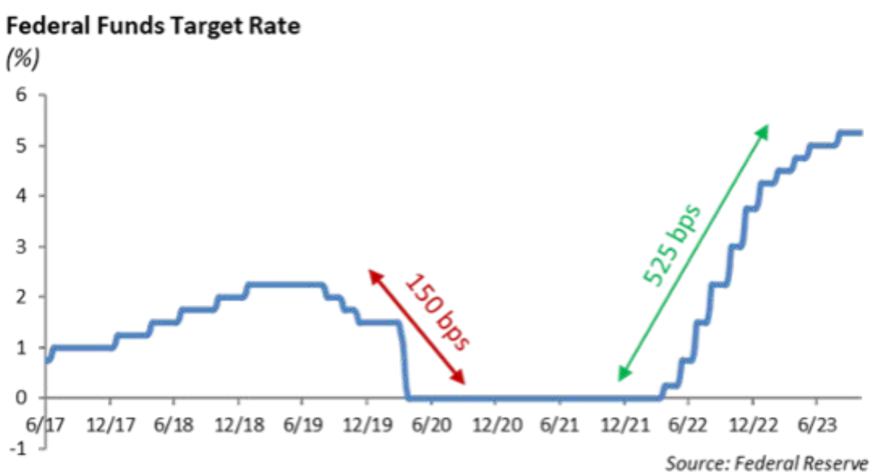
Q2 Economic and Market Review





hour peak measured in January 2021. There also remains a shortage of labor in certain industries.

As a result, the notion that the Fed has "more work to do" is slightly flawed and we expect the recent increase in treasury yields to reverse its course in the first half of 2024.

Monetary Policy

The key driver to the Federal Reserve's monetary policy this year will be the direction and pace of inflation. The Fed has tightened monetary conditions over the past two years by increasing the Fed Funds rate 525 basis points in an effort to shift aggregate demand lower. However, stimulative fiscal policy, expressed through large deficit spending, has helped support continued strong economic data.

After a historic increase in short-term interest rates over the past two years, the Fed paused its tightening program in May. It takes time for the higher interest rates to work through the economy and we expect the Fed to take a "wait-and-see" approach to determine if further tightening is warranted.

The inflation rate, as measured by the CPI, has fallen from its levels in 2022 to 3.7% for September. While we expect inflation to continue to decline, it will take more time and further tightening to reach the 2% inflation target

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established by the Fed.

We expect the Federal Reserve will likely need to increase the Fed Funds rate again in 4Q 2023 given the positive economic data. Fiscal deficits, typically near 3%, have been running over 10% the past four years. We believe this is unsustainable to maintain stability in the economy and capital markets. Until domestic fiscal spending is under control, we expect to stay above 3%.

Valuations Shift in Equity Market

The S&P 500 declined -3.3% during the third quarter of 2023. Rising global interest rates, concerns over a rebound in inflation, and the potential for an economic slowdown weighed on the domestic equity market. In addition, with growing concerns in the housing market and mortgage rates hitting 7.5%, consumer confidence hit a 4-month low. Student loan payments restarting in October added additional pressure on the consumer.

During the quarter, the Energy sector was by far the best-performing sector which benefited from higher oil prices. The communication services sector finished second, increasing by 2.8% led by Alphabet (GOOG/L) and Meta (META). Real estate and utilities, on the other hand, trailed with quarterly decreases of -9.7% and -10.1%, respectively. Both sectors were negatively impacted by higher interest rates.

On a year-to-date basis, communication services (+39.4%), technology (+33.8%), and consumer discretionary (+25.7%) are the best performing sectors within the S&P 500. The U.S. market, measured by the S&P 500, performed better than the MSCI EAFE index by a slight margin, with support from the strength of the US dollar. In emerging markets, all three market regions showed minor decreases this quarter. EMEA dropped -1.8%, Emerging Asia declined -2.2%, and Latin America lost -2.7%. We believe the AI frenzy has led to extended valuations in the market, as the Nasdaq has risen 27.1% year-to-date. Tech stocks, including Microsoft, Tesla, Meta, and Alphabet, have benefited from an AI premium this year.

We expect the performance of the defensive sectors, which include health care, utilities, and consumer staples, to perform better than the broad market given current valuations. Historically, these sectors outperform in recessionary environments. The growth sectors are still trading more expensive relative to the index, with valuation of technology stocks averaging 31x earnings and consumer discretionary stocks at 29x earnings.

As of the end of the third quarter, the S&P was at the 4288 level and trading at 21x earnings. We believe the market remains overvalued, providing minimal upside from current levels and a tough fourth quarter ahead.

Opportunities in Fixed Income

As long as the rate of inflation is declining, we expect interest rates to stabilize, and the bond market becoming less reactive to the Fed's next anticipated move. With a stable monetary policy, we would expect lower volatility to

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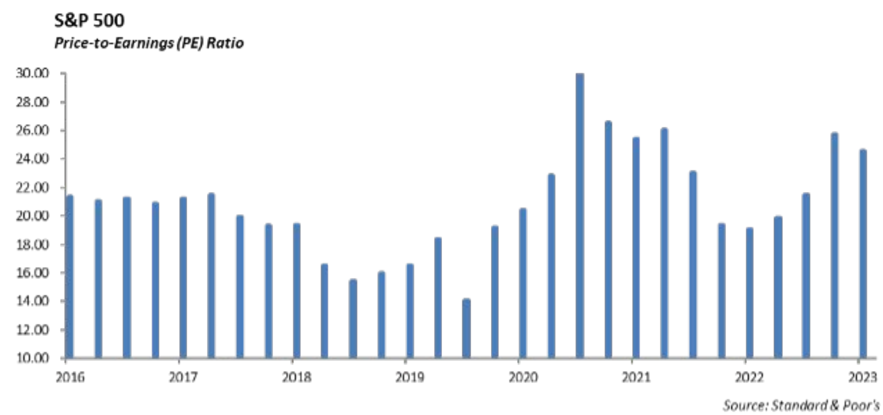
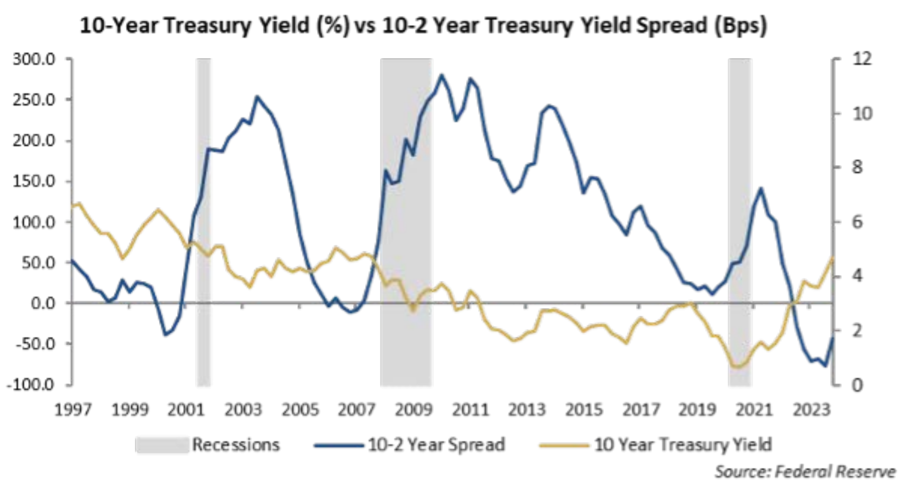
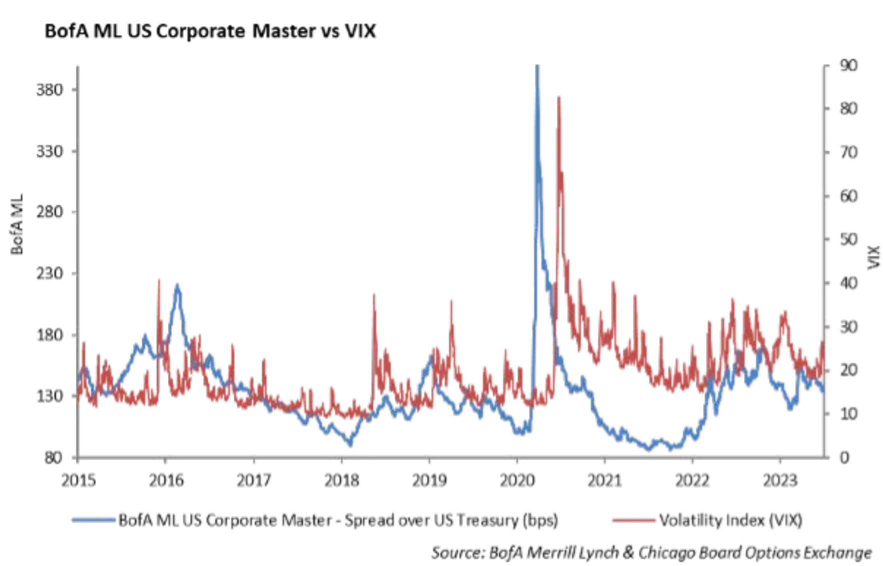






create investment opportunities across the fixed income markets, given the elevated level of interest rates across the curve.

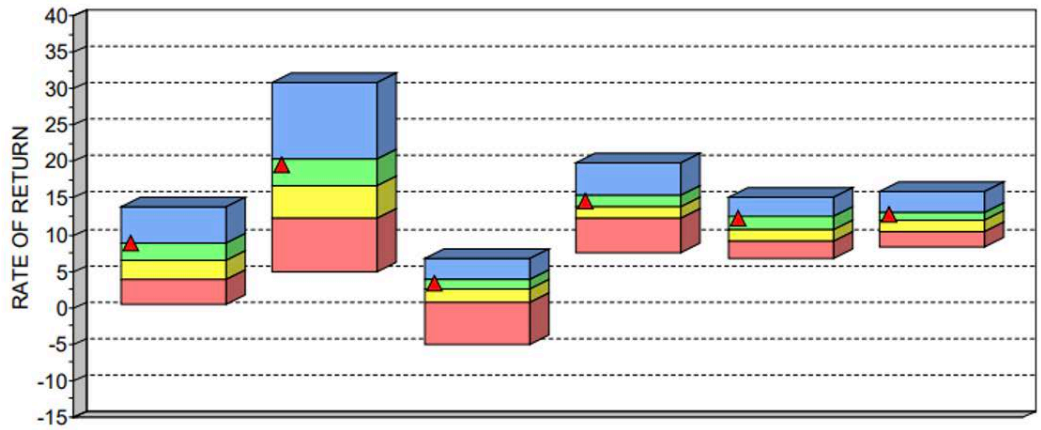
Investors have not experienced this level of the inversion in the yield curve, as well as the length of time the curve has remained inverted, in over 30 years. We expect the yield curve to remain inverted through the second half of the year until slowing economic growth and a lower rate of inflation provides cover for the Fed to lower short-term rates.

Currently, 5-year BBB rated corporate bonds are yielding above 6.00% and similar maturity high yield BB rated corporate bonds are yielding over 6.50%. With the yield on the 10-year US Treasury at its highest level since October 2007 and credit spreads trading at their widest levels in the past five years, we are seeing more buying opportunities in the fixed income market.

Structured securities remain one of the cheapest sectors in the fixed income market. The CLO market has experienced spread widening this past year; however, credit quality has remained strong. At the same time, underlying deterioration in the collateral supporting CMBS has forced spreads wider over the past year. Refinancing and credit risk in commercial real estate is causing pain in both loans and securitized markets. ☐

Part 2: Exploring Investment Vehicles and Evaluating Manager Performance

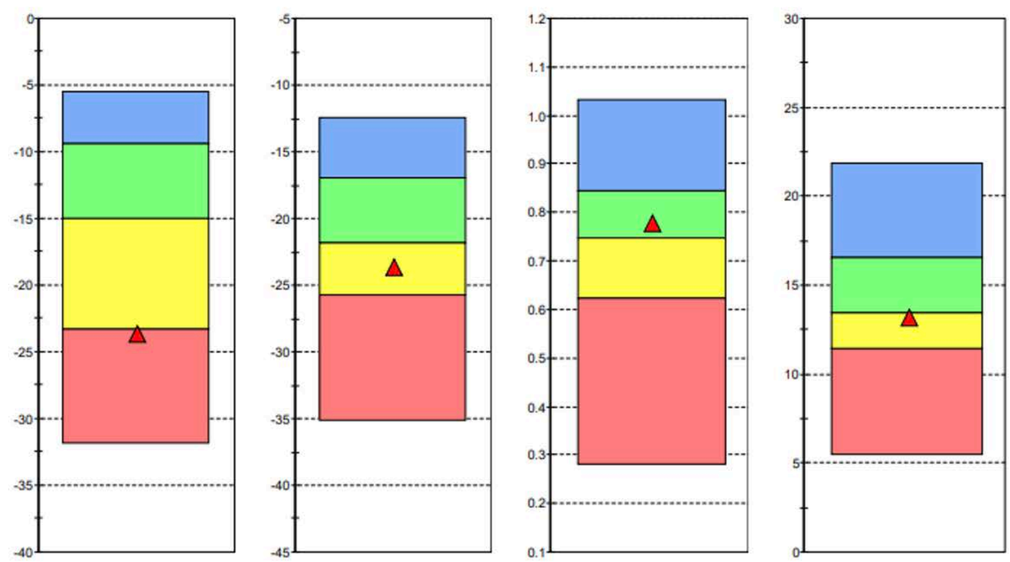
Quartile Ranking Bar - PSN Large Cap - Periods Ending June 30, 2023



	Latest Quarter	1 Year	2 Years	3 Years	5 Years	10 Years
HIGH (0.05)	13.86	30.71	6.71	19.96	15.18	15.79
FIRST QUARTILE	8.90	20.48	3.77	15.47	12.40	13.05
MEDIAN	6.43	16.64	2.58	13.91	10.79	11.92
THIRD QUARTILE	3.98	12.19	0.64	12.36	9.12	10.28
LOW (0.95)	0.46	4.82	-5.14	7.51	6.78	8.37
MEAN	6.68	16.81	2.19	13.81	10.82	11.87
VALID COUNT	664	664	659	644	625	561

	Latest Quarter		1 Year		2 Years		3 Years		5 Years		10 Years	
	VALUE	RANK	VALUE	RANK	VALUE	RANK	VALUE	RANK	VALUE	RANK	VALUE	RANK
Standard & Poor's 500	8.74	27	19.59	31	3.39	33	14.60	36	12.31	26	12.86	29

Multi-Statistic Quartile Ranking Bar - PSN Large Cap - June 30, 2020 to June 30, 2023



	Avg Ddown%	Max Ddown%	Sharpe Ratio Samp	Treynor Ratio
HIGH (0.05)	-5.72	-12.72	1.03	21.70
FIRST QUART	-9.60	-17.20	0.84	16.33
MEDIAN	-15.19	-22.13	0.74	13.29
THIRD QUART	-23.54	-26.01	0.62	11.24
LOW (0.95)	-32.11	-35.33	0.27	5.26
MEAN	-16.58	-22.19	0.72	13.69
VALID COUNT	644	644	644	644

	VALUE	RANK	VALUE	RANK	VALUE	RANK	VALUE	RANK
Standard & Poor's 500	-23.87	76	-23.87	60	0.77	40	13.01	54

Part 2: Exploring Investment Vehicles and Evaluating Manager Performance

As you can see from the chart on page 6, where SMA's can really excel is in protecting principle: that is, they can offer better risk controls. Over the very volatile 3-year period, the S&P 500 index was a 4th quartile performer in average drawdown, or the average amount the portfolio's market value dipped during down quarters. It faired only slightly better with 60% of SMA's beating it in maximum drawdown. The risk-adjusted statistic of Sharpe and Traynor ratios also show that nearly 50% of active SMA managers can beat the index on a risk-adjusted basis.

In summary, risk mitigation and downside protection offered by diversified SMA portfolios and managed by professional managers generally did significantly better than the index. Extreme volatility is the enemy for institutional investors.

<u>Why all the underperformance of the S&P 500?</u>
Remember the FAANG[4] (plus Microsoft) stocks that helped power the 13-year bull market run prior to the pandemic? The disproportionate weighting of these mega cap stocks drove the S&P 500 returns. Most of the remaining 495 stocks in the index, with some exceptions of course, detracted from index performance.

The top graph on the right illustrates this weighting phenomenon. We can see that the top stocks, by capitalization weighting, has increased recently to the highest percentages in the last 40 years. This has amplified their impact on S&P 500 index performance.

Looking at two of the most widely-held stocks, Apple and Microsoft, we can see in the bottom graph that their combined presence, in the 500 index, was about 13%.

Of course, a concentrated portfolio of the popular FAANG stocks did great …until it didn't! Professional investment managers would not construct a portfolio without sufficient diversification in the number of companies, nor would they allow for high levels of industry segments, in this

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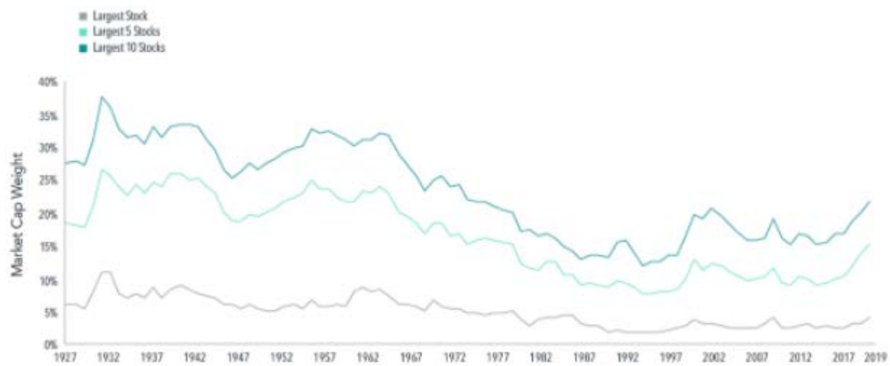
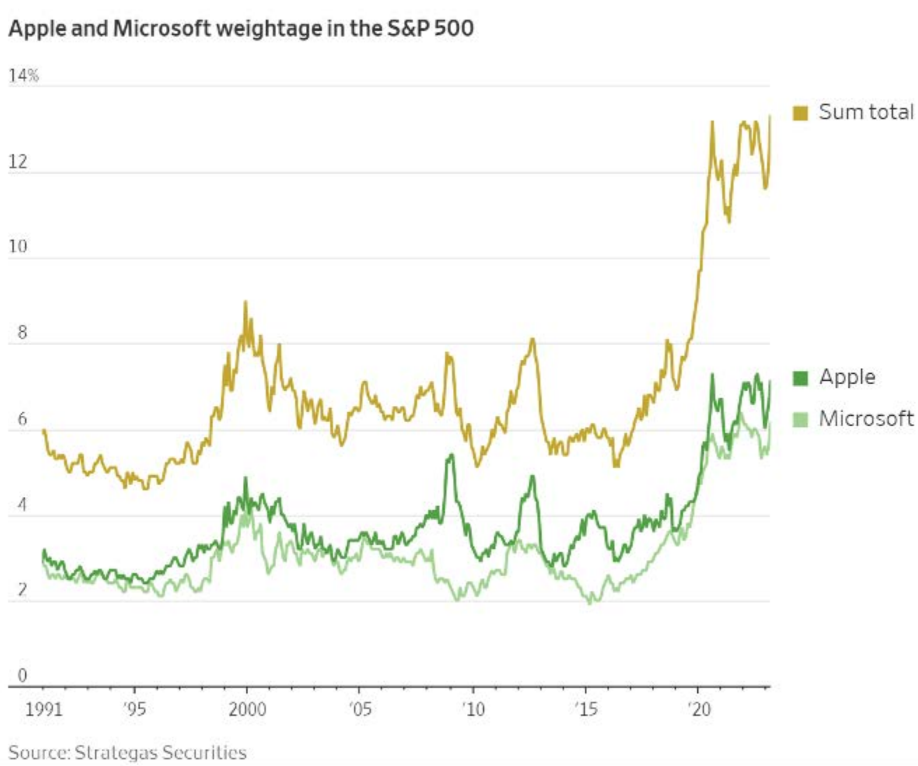


Source: The Evidence-Based Investor



Part 2: Exploring Investment Vehicles and Evaluating Manager Performance

case IT. Even concentrated professionally-managed portfolios typically contain at least 40 different stocks. Why? Holding large positions in so few stocks carries enormous risks as one can see below in the steep performance drop of the FAAG stocks in 2022, when tech stocks were particularly punished.

The chart below shows how the tech-heavy FAANG stocks performed resulting in the pandemic-caused market crash in 2022. Focusing further, the top chart on the right shows the performance of FAANG stocks against the diversified NASDAQ and S&P 500 indexes during the market debacle of 2022.

Fast-forward to the current market scenario and we see that the constituents of the top capitalized stocks has changed a bit. This group now includes Apple, Microsoft, Alphabet (Google), Amazon, and Nivida. Much like the original FAANG stocks, this group of heavyweights drove the market returns this year, particularly in the first quarter.

Once again, the bottom chart below shows that to have kept up with the S&P 500 index return, one would have needed a heavy concentration in those few mega cap stocks.

How useful are benchmark indexes in evaluating manager performance?

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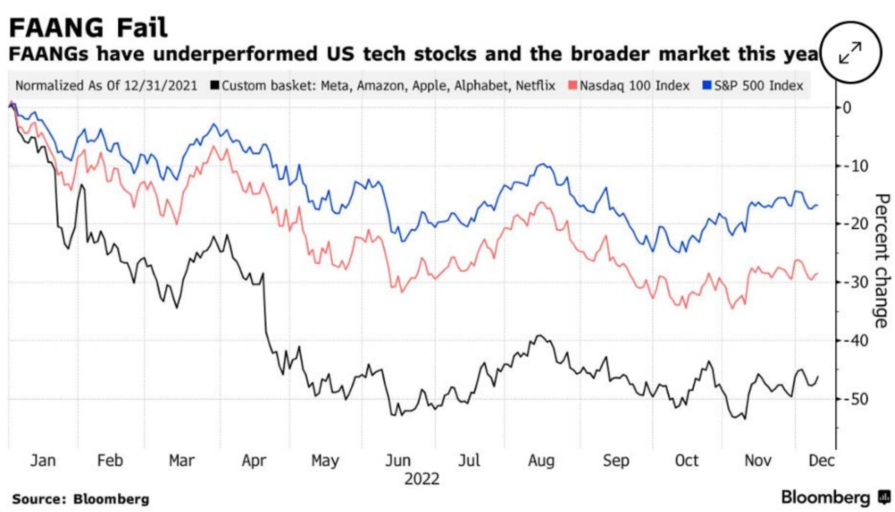

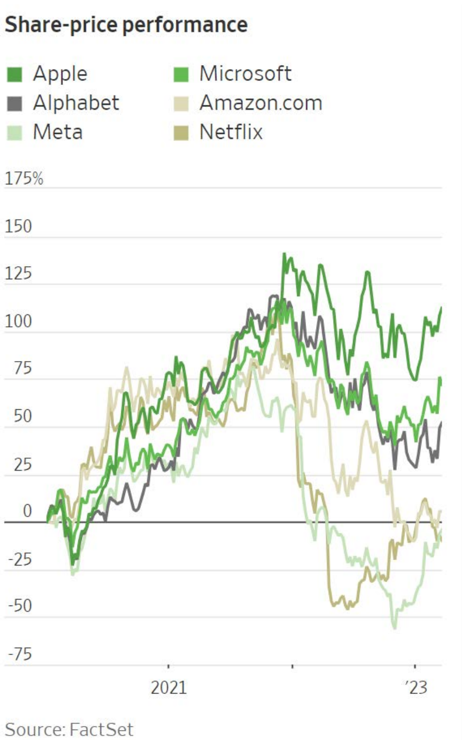

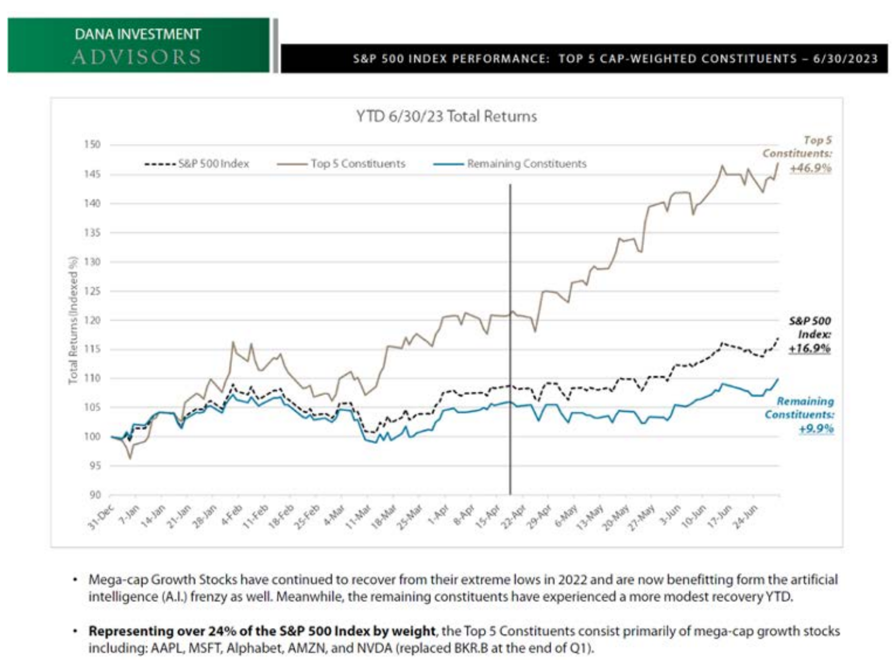

Part 2: Exploring Investment Vehicles and Evaluating Manager Performance

First, observers must take care to avoid two big assumptions that are typically made:

1. **The manager is managing the portfolio within the allowable parameters of the benchmark index selected. That is, they are NOT using techniques or asset classes that are not allowed in the index.**
2. **That the index is a proper fit, i.e. the best index available, for the way the portfolio is managed.**

Stocks:

The PSN manager database contains 257 investment management firms that have 465 strategies that use the S&P 500 as their benchmark. Without filtering the return sets for "cheats", managers using techniques or asset classes that are not allowed in the index, we find that 44% of the active SMA managers beat the benchmark over a three year period ending 3/31/23. Therefore, judging your manager's skill simply based on whether or not they beat the benchmark may not be useful.

It is fine to keep the S&P 500 as your benchmark index but to properly assess manager performance one must also incorporate "risk" into their evaluation of a manager's performance. Rather than simply looking at nominal performance, the manager's return vs. the index return, risk-aware management assessments should be measuring the manager's "risk-adjusted" return. Why? It is easy to see that any manager can beat the index, over a period of time, simply by taking more risk than the index. In our preceding examples, a risky portfolio of Mega-cap stocks outperformed until it crashed and burned. Institutional investors, and in particular insurance companies, should strive for consistent, predictable, and reputable results - not a swing for the fences approach.

"It is fine to keep the S&P 500 as your benchmark index but to properly assess manager performance one must also incorporate "risk" into their evaluation of a manager's performance."

Beating a benchmark index in down markets is at least as important as beating it in up markets; perhaps more important for smaller insurers or those with lower surplus.

Bonds:

This is an entirely different ball game! The PSN manager database contains 205 investment management firms that have 382 strategies that use the Bloomberg Aggregate as their benchmark. Without filtering the return sets for "cheats" those managers using techniques or asset classes that are not allowed in the index, we find that 97% of active SMA managers beat the benchmark over a three year period ending 3/31/23. Therefore, judging your manager's skill based on whether or not they beat the benchmark is not useful.

How to find good managers

No investment manager will always outperform their benchmark index unless, of course, the benchmark index is not properly selected, or the manager simply takes more risk than the benchmark. Over time, risk and returns are inversely related. A "skilled" manager can beat the benchmark fairly consistently with the same amount of risk as the benchmark. He/she may also beat the benchmark periodically using less risk than the benchmark. How to find such a manager? Manager performance databases, such as PSN, allow a knowledgeable user to identify skilled managers – those that provide consistently superior returns. Professionals can "risk-adjust" manager returns using Modern Portfolio Theory (MPT) statistics that, in general terms, analyze performance in terms of how much return the manager generated per unit of risk as compared to the benchmark.

The most important factors in assessing a manager's performance are the clients' objectives and risk tolerances. For example, a very conservative investor, one who puts a high priority on principal preservation, may be quite happy with a

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manager who slightly underperforms the benchmark in up markets but significantly outperforms the benchmark in down markets. A more aggressive investor may want a manager that swings for the fences, but insurers or other institutional investors seldom fit that category.

<u>The Bottom Line</u>

1. **Periodic underperformance to the benchmark is not necessarily an indicator of poor portfolio management.**
2. **Risk-adjusted returns, not nominal returns vs the benchmark, are the determinant of manager “skill”.**
3. **Prudent, risk-aware portfolio managers would not and should not hold securities in the concentrated positions required to have produced returns similar to those recently produced by indices like the S&P 500.**
4. **That being said, a well-diversified “Core” portfolio, managed by a skilled manager, should be expected to provide principal protection in down markets and better risk-adjusted returns throughout market cycles and over time.**

[3] GIPS- Compliant - Global Investment Performance Standards (GIPS) are a set of voluntary standards used by investment managers throughout the world to ensure the full disclosure and fair representation of their investment performance. The goal of the standards is to make it possible for investors to compare one firm’s performance against that of another firm. Source: Investopedia

[4] FAANG stocks include Facebook (now Meta), Amazon, Apple, Netflix and Google.

[5] Manager performance databases, such as Informa’s PSN or eVestment, provide thousands of investment managers’ returns along with Modern Portfolio Theory statistics. Knowledgeable users can then use the MPT statistics to risk-adjust returns and rank managers by skill.

Doug Classen, Senior Vice President Dana Investment Advisors. Doug Classen joined Dana Investment Advisors in September of 1994 and is currently a Senior Vice President. Doug graduated from Wheaton College with a Bachelor of Arts in Economics in 1977. He is responsible for sales activities with Institutions, Consultants and Advisors.

Carl Terzer is the Founder and Principal of CapVisor Associates, LLC. He brings more than 32 years of insurance asset management experience to the task of correlating clients’ investment strategy with their business objectives, risk tolerance, liability structure and accounting and regulatory environments. His expertise encompasses investment plan design, strategic asset allocation and tactical portfolio optimization and manager search/evaluation and after tax, risk adjusted performance analysis.

Debunking the Maturity Wall Myth in US High Yield

- **High yield refinancing needs will begin to increase from 2025**
- **Some believe this “maturity wall” will widen spreads**
- **Average annual issuance since 2009 has been larger than any year of the “wall”**

One mystery of the current cycle is that high yield spreads (yield premiums to US treasuries) have stayed narrow. Some argue that a “maturity wall” is bearing down on the high yield market. The

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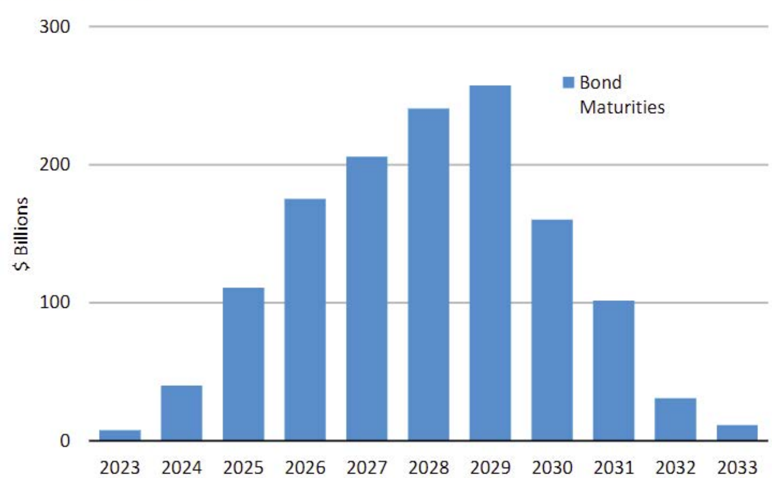
Figure 1: High yield bond maturities



Source: BAML, Concise Capital as of 9/30/2023

Debunking the Maturity Wall Myth in US High Yield

"maturity wall" idea has arisen previously as a threat to high yield, US treasuries, and emerging market debt. It is the boogeyman that has never managed to crawl out from under the bed. There is no precedent for a technical condition, like impending maturities, to catalyze a selloff in any bond market.

The US high yield market, as currently constituted, has $1.36 trillion in bonds outstanding. Maturities are small until 2025. From then through 2029, the bulk of the market will need to be refinanced. The buildup up in maturities from 2025-2029 is the "maturity wall" referred to above. Is it realistic to believe the need to refinance this wall of debt will cause spreads to widen sharply? In a word, no.

Severe spread widening in high yield bonds has been associated with economically driven crises in the credit markets. Sometimes, those crises originate in the high yield market, as in 2000-2002, with the overbuilding of internet infrastructure, and in 2015-2016, when a plunge in oil prices sent many junk-rated energy companies into distress. Sometimes, they originate in other markets and high yield becomes collateral damage. Examples include bouts of spread widening triggered by the Asia crisis (1998), the European sovereign crisis (2011) and the Covid-19 sell-off (2020). A technicality, like the need to refinance, triggered none of these crises. Maturities in 2025 represent 9.8% of the high yield market or about $130 billion, an amount smaller than this year's meager new issuance. Refinancing such an amount should not be a problem. The first year of recovery from the GFC, 2009, saw $150 billion issued.

Excluding 2020-2021, annual issuance since 2010 has averaged $256 billion per year. In the end, the wall is likely to be a mirage in the desert, something hovering just beyond the horizon, never to see the light of day. ☐

Tom Krasner, CFA has spent over 25 years in fixed income, distressed debt and high yield bonds. He has extensive experience in corporate restructurings, credit analysis, portfolio management, and workouts. Prior to co-founding Concise Capital with Mr. Koach, Mr. Krasner was Executive VP at Harch Capital Management. Previously, Mr. Krasner was a Principal and Portfolio Manager at Riverside Capital Advisers.

Upcoming Events

1. CapVisor is exhibiting at the CICA 2024 International Conference from March 10-12. Carl Terzer and Travis Terzer look forward to seeing you in Scottsdale.

Click here to connect with CapVisor on LinkedIn! We share interesting investment information, research and strategy advice, and announcements.

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