

Inside This Issue

p.1 Part 1: Under-performing Equity Portfolios: Do I Need a New Stock Portfolio Manager?
By Carl Terzer

p.1 Q2 Economic and Market Review
By Leo J. Dierckman

p. 6 Why Private Credit? Why Now? And Where to Be?
By Josh Paton

p. 9 Upcoming Events

CONNECT WITH CAPVISOR



Part 1: Under-performing Equity Portfolios: Do I Need a New Stock Portfolio Manager?

Maybe but probably not, especially if underperformance has been a more recent problem. However, before we explain why, let's review some important context for our answer.

The importance of choosing the right Benchmark Index for Performance Evaluation is the critical factor. One must ask: Do we have the "best fitting" performance benchmark index for the mandate parameters specified to our manager?

Most insurance companies' Board of Directors evaluate manager performance vs. the assigned benchmark, such as the S&P 500. This kind of assessment is based on "nominal" performance. We like the S&P 500 benchmark index because it is widely-published and, in our opinion, the best broad representation of the US stock market. We also like it because it:

- is constructed by using a

Continued on page 5

Q2 Economic and Market Review

"Houston, we have a problem"

On March 4, 2022, immediately prior to the current rate hiking cycle, the U.S. unemployment rate was 3.8%. After 10 consecutive Federal Open Market Committee (FOMC) rate increases beginning on March 16, 2022, the unemployment rate reported on July 7th 2023 was 3.6%; two tenths of one percent lower than where we started! The FOMC "demand destruction" effort has failed as of this date. Why? We will attempt to address the cause of this prolonged economic resilience with a focus on

corporate capital structures and strong consumer balance sheets.

Why is it taking the FOMC so long to slow down the economy?

We believe a number of reasons factor into the resilient U.S. economy. First, there were high levels of household savings that consumers have been able to draw down to support spending habits. Secondly, most households generally have 30 year fixed rate mortgages already locked in from the previous years'

lower interest rate environment which is making their disposable income less sensitive to current rate hikes. In addition, corporations (both high yield and investment grade) have extended maturities of their loans and paid down revolvers, making them less vulnerable to higher rates. Lastly, capex spending has been focused on intangibles like software and R&D, which are less sensitive to rate hikes rather than large construction efforts to increase capacity that are typically funded with new debt.

Continued on page 2

Q2 Economic and Market Review

Fixed Income Second Quarter Market Performance

Two main concerns hung over markets through most of the second quarter: the debt ceiling and fear of credit tightening in the wake of banking turmoil. By the first week of June, however, with just days to spare, Congress and the President resolved the debt debate by suspending the ceiling until 2025. Meanwhile, surveys and data from the Fed showed lending slowed in the second quarter, but not to the extent of a credit crunch. After lifting the fed funds target 25bps to a top end range of 5.25% in May, the FOMC unanimously voted not to raise rates at the June meeting. It was a hawkish skip, however, as participants telegraphed more hikes this year in their updated forecasts, dot plot, and comments following the meeting.

The U.S. interest rate curve rose and further inverted during the quarter. Yields on all maturities ended the quarter higher, and the 2-year yield increased the most, rising 0.81% during the quarter. The longest dated points on the yield curve were relatively anchored as the yield on the 10-year and 30-year maturities rose by only 0.33% and 0.18%, respectively. Here are highlights on fixed income performance in the quarter.

- The 10-year Treasury yield started the quarter at 3.48% and ended the quarter at 3.81%. Treasury prices fell as yields rose. The 2-year/10-year spread further inverted to -1.06% after beginning the quarter at -0.58%.
- Investment grade and high yield credit experienced mixed results during the quarter. The Bloomberg U.S. Credit index returned -0.3% while the U.S. Corporate High Yield Credit index returned 1.7%. The best performing segments of the U.S. fixed income market were leveraged loans, high yield corporate credit, and high yield municipals. The Bloomberg U.S. Credit Index measures the investment grade, U.S. dollar denominated, fixed-rate, taxable corporate and government-related bond markets. The U.S. High Yield Corporate Bond Index is designed to track the performance of U.S. dollar-denominated, high-yield corporate bonds issued by companies whose country of risk use official G-10 currencies, excluding those countries that are members of the United Nations Eastern European Group (EEG).

Investment Grade Corporate Bond Second Quarter Performance:

The 2-year Treasury yield ended



Leo J. Dierckman (25 years fixed income investment experience) is a Managing Director, Portfolio Manager for Oppenheimer Investment Management LLC. Leo is primarily responsible for management duties for the Insurance accounts and non-investment grade assets. His research responsibilities are for the Healthcare, Homebuilding, and Municipal bond sectors. Prior to joining OIM, he was Vice President, Portfolio Manager for 40186 Advisors, Inc. He was a member of the insurance management team for the Conseco insurance portfolios and non-affiliated insurance clients. He also served as the lead portfolio manager for the 40186 Strategic Income Fund (NYSE:CFD), a publicly traded closed-end mutual fund and the Manager's Convertible Securities Mutual Fund (NASDAQ:MCXYX). He holds a B.S. in Finance from Indiana University.

June at 4.87%, 81 bps higher in the month, and the 10-year Treasury yield ended June at 3.81%, 33 bps higher. The 30-year Treasury yield remained at 3.85%, up 18 bps in the quarter. Also, the Treasury yield curve inversion steepened significantly, as measured by the difference between the 2-year and 10-year yield, and remains well inverted at -106 bps.

Given the drift higher in the yield curve, corporate credit spreads tightened in June. Per the Bloomberg U.S. Credit Index, investment grade corporate credit tightened 14 bps versus comparable U.S. Treasury yields. Corporate credit continues to be

Continued on page 3

Q2 Economic and Market Review

the best performer for fixed income markets in 2023; however, we believe credit selection is paramount in this environment. Going forward, with U.S. economic growth risks tilted to the downside as lending standards tighten and a hawkish Fed still vows to bring inflation under control, we expect the focus will shift toward credit fundamentals and the ability of corporates to navigate this macro uncertainty.

High Yield Bond Sector Second Quarter Performance:

- High yield bonds returned 1.7% for the second quarter on the heels of a strong first quarter return of 3.8%. Year-to-date, high yield has returned 5.4%, comprised of 3.3% from coupon and 2.1% price return. During the second quarter, from a quality perspective, CCCs were the outperformer returning 4.7%, while single-Bs returned 1.8%. BBs underperformed the market at 0.8% as the rise in interest rates at the end of the second quarter impacted this more rate-sensitive rating category. High yield spreads started the quarter at 474 bps and ended at 425 bps, with intra-quarter volatility surprisingly calm. Going forward, we think the up-in-quality trade makes sense and will allow investors to defensively position ahead of a likely recession and increasing

default rates, while continuing to offer relatively attractive all-in yields.

Second Quarter Economic Update

Student Loans:

In October, 37 million borrowers will be required to restart payments on federal student loans following a more than 3.5 year pause instituted in response to the COVID-19 pandemic. The Federal Reserve Bank of New York estimated \$195

“ This new consumer headwind will add to building pressures from higher interest rates and likely slow the economy in the quarters ahead. ”

billion worth of payments were waived from March 2020 through April 2022, or about \$8 billion per month and \$96 billion per year. Based on these figures, and an average marginal propensity to consume of \$0.65 per extra dollar of income as estimated by the Federal Reserve, we expect the resumption of student loan repayments to reduce aggregate demand by about 0.2% of annual GDP.

These recent changes in federal student loan policy will have significant impacts on affected households, but appear to be

only a modest headwind for the broader U.S. economy. This new consumer headwind will add to building pressures from higher interest rates and likely slow the economy in the quarters ahead.

Corporate Earnings and Capital Expenditures:

We continue to forecast moderately lower corporate profits in 2023. Seasonally-adjusted corporate profits peaked in 2022 and have declined modestly since. First quarter 2023 corporate profits were -1.8% lower year-over-year (YoY) and down -4.1% quarter-over-quarter, annualized. For the second quarter of 2023, the consensus estimated YoY earnings decline for the S&P 500 is -7.2%. A weakening growth outlook, higher interest rates, bloated inventories, and stubbornly high wage growth are expected to result in slower sales growth and contracting margins. We expect business investment to decline modestly during the remainder of 2023.

The ISM Manufacturing Index:

After spending most of 2021 at a robust level in the high 50s to low 60s, the ISM Manufacturing Purchasing Manger's Index plummeted throughout 2022, before crossing below 50 in November. Levels above 50 signal expansion while levels below 50 signal contraction, and the ISM declined to a post-pandemic low of 46.0 in June 2023. The ISM Services Index remains solidly in

Continued on page 4

Q2 Economic and Market Review

expansionary territory in 2023. The ISM manufacturing index, also known as the purchasing managers' index (PMI), is a monthly indicator of U.S. economic activity based on a survey of purchasing managers at more than 300 manufacturing firms. It is considered to be a key indicator of the state of the U.S. economy. The survey is conducted by the Institute for Supply Management (ISM).

Gross Domestic Product:

The Street consensus is forecasting the probability of a recession in the next 12 months at 65% as the cumulative impact of unprecedented rate hikes take effect; however, as usual, the timing of said contraction remains a subject of debate. First half 2023 economic performance was better than expected, pushing expectations for a slowdown into late 2023 or first half of 2024. Our updated forecast 2023 real GDP growth is +1.4% for the year, while the Bloomberg consensus expectation is for 1.3% real GDP growth in 2023.

Unemployment:

U.S. labor markets have remained resilient in 2023. However, we have begun to see some early signals of slowing through slightly higher initial jobless claims, reduced job openings and lower trending payrolls. JOLTS job openings are down ~18% from their peak in March 2022 and are on a clear downward trajectory. We forecast the unemployment

rate to rise modestly over the second half of the year before ending somewhere near 4%.

Wages:

Various measures of wage growth have shown gradual deceleration in recent periods, but overall wage growth remains uncomfortably high. The Federal Reserve Bank of Atlanta's Wage Growth Tracker has declined to +6.0% YoY, compared to a peak of +6.7% in the summer of 2022. The Employment Cost Index (ECI), the Fed's preferred measure of wage and benefit inflation, is reported less frequently, on a quarterly basis. The ECI peaked at +5.1% in the second quarter, remained at that level through year-end 2022 and ticked down to 4.8% in the first quarter of 2023. We expect gradual wage deceleration going forward.

Inflation:

During the pandemic, goods inflation picked up as a result of stimulus-enabled online shopping combined with constrained supply chains. As the country reopened, pent-up demand caused experiential spending at restaurants, hotels, and airlines to spike, resulting in goods disinflation and service sector inflation. Now, the service sector is normalizing, and as a result, service sector inflation is moderating. Specifically, ISM services prices paid, a leading indicator for inflation, was 54.1 in June, down from 56.2 the month prior and a peak of 84.5 at year-

end 2021. In other words, goods inflation normalized in 2022, service sector inflation is normalizing in 2023 and, when combined with low and stable inflation expectations, the stage could be set for the Fed to end its rate hike cycle later this year.

Monetary Policy:

U.S. economic growth risks are skewed to the downside with higher real interest rates, tightening credit standards and a hawkish Fed that still vows to bring inflation down to their 2% target. While there have been early signs of a weakening labor market and cooling inflation, employment remains strong and the absolute level of inflation remains high. Accordingly, monetary policy is becoming more restrictive with the Fed hiking 75 bps already this year. The Fed's next meeting is July 26 and a 25 bps hike seems likely. Another 25 bps hike in 2023 is possible after that. □



Part 1: Under-performing Equity Portfolios: Do I Need a New Stock Portfolio Manager?

consistent and disciplined methodology, that of representing the 500 largest US stocks by capitalization. The stocks that are the most likely to be considered by institutional investors and in particular, insurers;

- is a free-floating capitalization-weighted index, meaning members of the benchmark can change over time with changes in their capitalization;
- is “style” agnostic, meaning that it can incorporate both Value and Growth styles, as well as their combination called “Core”;
- represents about 80% of the US stock market or \$33.8 trillion; (as of December 31, 2022);
- has a long track record: 66 years; and
- is the most commonly used measure of “nominal” performance of the market.

Therefore, using the S&P 500 as a benchmark to evaluate US stock performance is common for a “Core” or style-neutral assignment (neither growth nor value oriented). It can also be a good benchmark even if your manager has a Growth or Value tilt as it indicates whether or not the selected “tilt” is a winner.

Conclusion: the S&P 500 is generally the best overall index to measure US stock performance.

What type of vehicle are you using to gain your S&P 500 exposure?

In revisiting your stock portfolio managers’ performance, and assuming that the S&P 500 is the appropriate benchmark, you may find that your manager recently underperformed the benchmark. This is most likely the case whether you are using a mutual fund, an ETF¹ (electronically traded-fund) or a separately managed account (SMA)!

“ The S&P 500 is generally the best overall index to measure US stock performance. ”

The three primary ways of gaining US stock exposure are through Mutual Funds, ETFs or SMAs (separately managed accounts). First, let’s look at the case of mutual fund investors. The S&P SPIVA² study indicates that most stock managers cannot match the S&P 500 performance. Why then not simply invest in an S&P 500-tracking ETF (electronically traded fund)? Well of course, you might wish to. CapVisor makes this suggestion many times to our clients depending on the client circumstances and the market conditions. However, more on that topic shortly - see SMA’s below!

Second, we look at passive exposure for the S&P 500. While there are many mutual funds that are indexed, ETFs gain

similar exposure at a lower cost and are generally preferred. ETFs, most of which are “passive” investments, are designed to track an index such as the S&P 500. As such, they are almost guaranteed to underperform the index over the long term due to fees and trading costs, neither of which are present in benchmark indices. Therefore, we find that ETFs are very useful when:

1. an allocation may be too small to attract premier active managers;
2. looking to gain exposure to an asset class and receive the risk/reward characteristics in the least expensive manner; or
3. seeking to diversify a portfolio inexpensively.

Unfortunately, they are not useful to beat the benchmark over time.

In part 2 of this article, we will explore:

1. Why SMA’s are a good choice for insurers
2. How to find managers that have outperformed and are likely to continue to outperform market indices
3. Understanding and measuring portfolio risk
4. Underperformance in up markets? But what about protection in down markets?

¹ ETF= electronically traded fund, which trades, intra-day like stocks on the stock exchange.

² “SPIVA” stands for “S&P Indices Versus Active,” and it is the name for a regular series of research reports that compare the performances of actively managed funds to appropriate benchmarks.

Why Private Credit? Why Now? And Where to Be?



Josh Paton, CFA
Senior Credit Analyst

Mr. Paton joined the Knights of Columbus in 2019 as a Credit Analyst where he focuses on public and private investment grade Consumer–Cyclical, Consumer Non–Cyclical, Communications and Technology sectors. He

is also involved in helping manage the Knight’s various limited partner commitments to alternative investment funds. Prior to joining the Knights, he held internships at both Amica Insurance and FactSet.

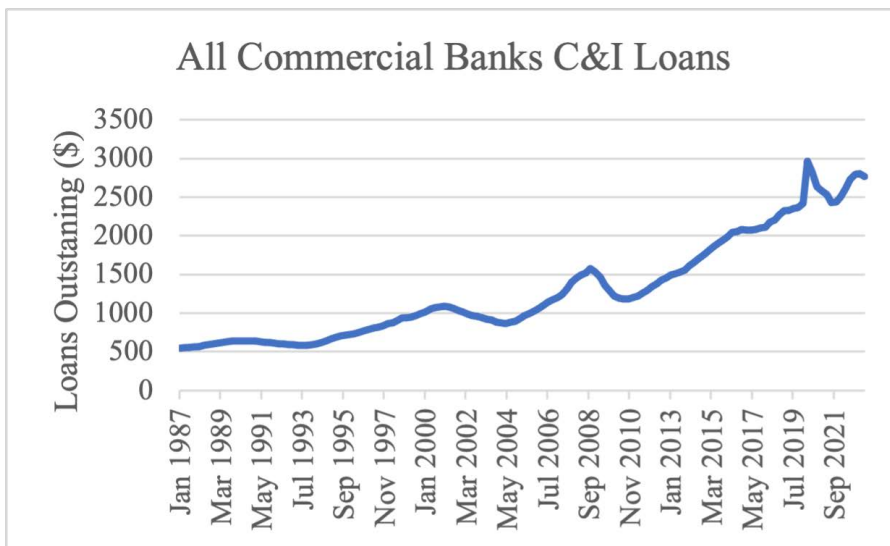
Mr. Paton graduated summa cum laude from Bryant University, in the Honors Program, with a BS in Applied Economics, a BSBA in Finance, and a minor in Applied Statistics. He also received his MBA concentrating in Global Finance from Bryant University and holds the Chartered Financial Analyst (CFA) designation.

Private credit is defined as nontraded loans made to middle-market companies typically used for private equity sponsor-led leveraged buyouts. The borrowers are generally of an equivalent size to those companies found in the Russell 2000 index but, in aggregate, they represent a much larger part of the US economy compared to the Index. Some 200,000 middle market businesses contribute one-third of the U.S. private sector GDP. Typically, revenues range from \$10 million to \$1 billion¹, and firms further break down the market into the Lower Middle Market (LMM) as companies with less than \$25 million of EBITDA, the Middle Market (MM) as companies with between \$25 and \$100 million of EBITDA, and the Upper Middle Market (UMM)

which are companies with greater than \$100 million of EBITDA¹.

Data on private credit is difficult to source, but one way to monitor the growth of the industry is through related data sets. For example, the Federal Reserve tracks Commercial and Industrial (C&I) loans from all commercial banks. While this is not private credit, the characteristics of these underlying loans are like those of private credit, allowing us to reference that data to track the growth of the industry over time. As shown in Figure 1, C&I loans have grown from about \$1.2 trillion in 2010 to approximately \$2.8 trillion as of April of 2023 which represents a period approximate annual growth rate of 6.5%. Private credit has had even more impressive growth as demonstrated by the approximately 25% annual growth in fundraising over the past 5 years for direct lending according to Preqin². This becomes apparent when you look at the breakdown of who is lending in these markets (Figure 2 on page 7) Over time, the share of non-bank lenders has increased significantly which is attributed to growing regulatory scrutiny of banks. Additionally, the demand for this product has increased substantially. According to Preqin, dry powder in the private equity markets sits

Figure 1



Source: Federal Reserve Economic Data

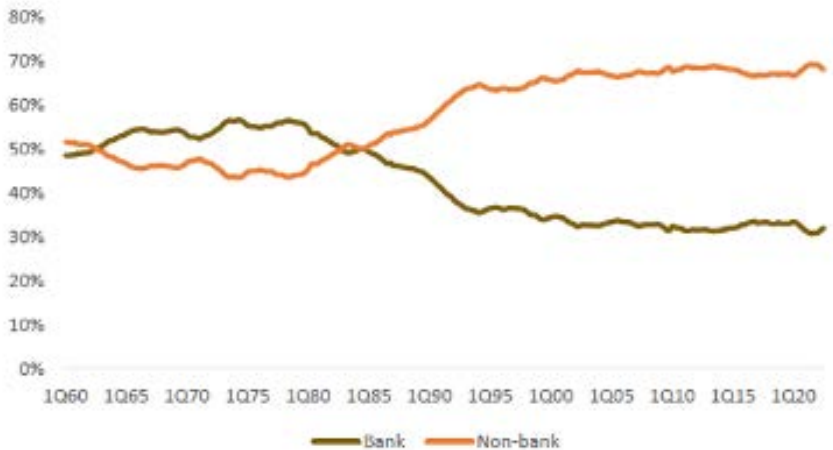
Continued on page 7

Why Private Credit? Why Now? And Where to Be?

at over \$800 billion. With banks unable to meet the associated debt financing needs for this private equity activity, dozens of direct lending firms have sprung up to fill the “capital vacuum.”

This market has changed significantly in the last 12 months. As of Q1 2023, the Cliffwater Direct Lending Index (CDLI) had a yield of 10.95%. In addition to this current yield, part of the return profile comes from original issue discount (OID) and equity invested alongside the sponsor which helps make the return profile today in the low to mid-single digits from high single digits a year ago depending on what part of the capital structure a firm is lending to. There are two reasons for the increase in returns. One is that broader economic weakness has led to tighter underwriting

Figure 2 Lender Mix By Type



Source: Federal Reserve, UBS Global Research

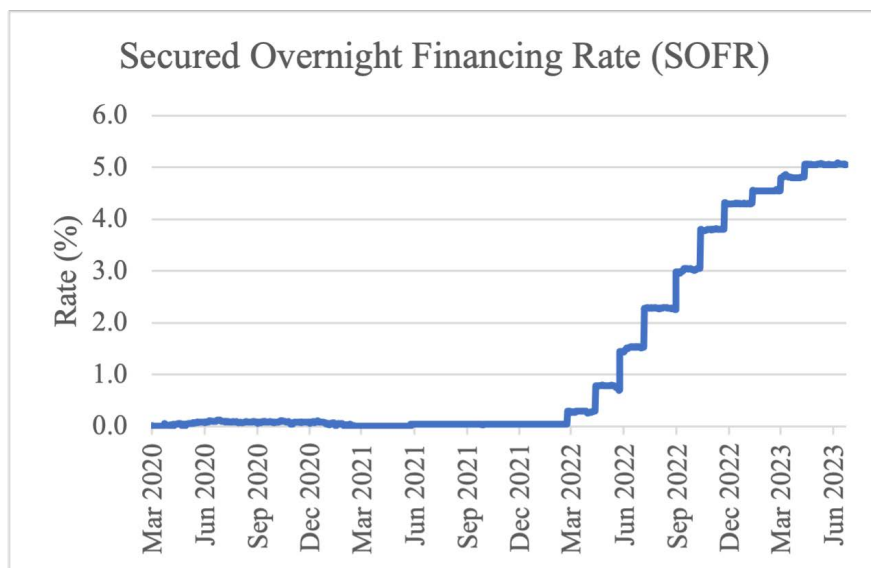
standards, resulting in a lower supply of available debt capital while making that capital more expensive for borrowers through wider spreads. Additionally, base rates have climbed at an

unprecedented pace (Figure 3). These loans are typically structured as a fixed credit spread over a floating reference rate (SOFR). Following the financial crisis and driven by Federal Reserve policy, SOFR was essentially zero, and, in March of 2022, the rate started steadily climbing to around 5% now. This increase in base rates meaningfully increases the total return of these loans and, when paired with wider spreads, it is easier to accomplish the aforementioned higher returns of low to mid-teens.

At the same time, contractual coupon returns have increased for this asset class, and the fundamentals have improved as well. Leverage for newly-inked deals has decreased from what

Continued on page 8

Figure 3



Source: Federal Reserve Economic Data

Why Private Credit? Why Now? And Where to Be?

would have been 6x debt/ EBITDA³ 12 months ago to around 4x debt/EBITDA³ today. These lower leverage levels were driven by the previously discussed macro factors. As debt has become more expensive, private equity sponsors have been forced to write larger equity checks to complete deals and avoid placing undue stress on the portfolio companies' balance sheets. Additionally, during the era of free money and unlimited investor capital, lenders were competing for deal flow which resulted in an era of covenant-light deals. That has changed in recent months as lenders are cracking down and restoring meaningful covenants like leverage levels, minimum liquidity, and scrutinizing EBITDA add-backs. The combination of these lower leverage levels and stronger covenant packages creates an attractive entry point for investors as you receive better structural protections compared to public fixed income while also harvesting the incremental yield from the illiquidity premium.

All of this raises the question: How do I select the right alternative manager? Perhaps the most important answer to that question is the track record, particularly looking at default rates over time. This provides insight into the ability of a manager to select credits that are going to perform and will pay back a loan. One of the ways to do this is to allocate to a manager that lends in the right part of the capital stack. Senior

debt is usually a first lien position that gets paid back first in a bankruptcy scenario and is often secured by a pool of collateral that can be worth more than the original loan. Moving down the capital stack increases returns to compensate an investor for taking a first-loss position. A low loss rate also signifies that a manager has the knowledge and ability to work with a portfolio company to work-out a nonperforming loan. Work-out strategies include asking an equity sponsor to inject more capital, renegotiating document terms to provide a quarter or two of covenant relief, or (worst-case scenario) taking over and operating a portfolio company. An additional consideration is whether or not a manager is adding additional leverage at the portfolio level. Managers will often get secured financing to increase the buying power of fund AUM. While this will amplify returns, it also can amplify losses. In today's environment, adding this type of leverage to a portfolio is not necessary to achieve attractive double-digit returns.

One fund that illustrates some of the above principles is the KOCAA Private Credit Fund^{4,5}, managed by the Audax Group. The Audax Senior Debt team has been investing together since 2007 and has a track record of 0.04% in annualized losses per their team. The Fund currently has 93% of assets allocated to 1st lien secured

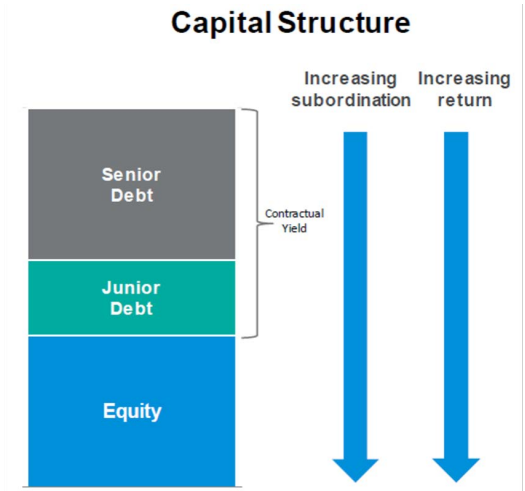


Figure 4 for concept illustration only

debt with a weighted average of 47% loan to value. The Fund is diversified across 210+ borrowers, 100 PE sponsors, and 20 industry groups. One feature of the Fund is the evergreen structure. Private debt funds may have longer lock-up terms with 2-3 year investment periods and 4-6-year harvesting periods. The KOCAA Private Credit is an evergreen structure that has a 1-year lock offers quarterly redemptions. Since inception, the Fund has been benchmarked against the LSTA U.S. Leveraged Loan Index. The manager's relative value proposition of seeking the selection of strong credits in the senior part of the capital stack has led to the low 0.04% annualized losses stated above. This has helped lower the default exposure taken on by Fund Investors, while still allowing them to experience some of the historical middle

Continued on page 9

Why Private Credit? Why Now? And Where to Be?

market benefits at the same time.

¹ According to the National Center for The Middle Market

² An alternate investment data aggregator

³ According to Bloomberg data

⁴ The KoCAA Private Credit Fund relies on a 3(c)(1) exemption. Private Funds that rely on 3(c)(1) exemptions, such as the KOCAA Private Credit Fund, requires initial Accredited Investor Due

Diligence Suitability screening

⁵ All KOCAA Private Credit Fund metrics used are sourced directly from Audax. This information is intended for Institutional Investors only, and suitability is required.

Investing involves risk and you may gain or lose money on your investments. Knights of Columbus Asset Advisors ("KoCAA") is an SEC registered investment adviser.

KoCAA's status as a Registered Investment Adviser does not imply a certain level of skill or training. For additional information visit KoCAA.com or write to kofcfunds@kofcassetadvisors.org. This information is intended for current or prospective investors in the U.S. only.

Upcoming Events



1. Carl Terzer and Travis Terzer are attending the Bermuda Captive Conference from September 11-13.

2. CapVisor is exhibiting at the NAMIC Annual Convention from September 17-20 in National Harbor, Maryland. Carl Terzer and Travis Terzer will be in attendance. We hope to see you there!

3. The SCCIA Annual Executive Educational Conference is in Charleston, South Carolina from September 26-28. Carl Terzer is speaking in the session, "Captives' Financial Strength" on Wednesday, September 27 at 2:30 p.m.

4. On October 18 and 19, Travis Terzer will be in Wilmington, Delaware for the DCIA Fall Forum. Travis is speaking in a session entitled, "Captive Insurance Investment Considerations in a Volatile Market" on Thursday, October 19 at 8:45 a.m.

5. Carl Terzer is speaking on investments at EIS' Member's Program Advisory Committee

Meetings from October 23-26 at the Charleston Harbor Resort in South Carolina.

6. Carl Terzer and Travis Terzer look forward to seeing you at the TCIA Annual Conference in Nashville, Tennessee from November 5-7.

7. The CIC-DC Annual Conference is in Washington, DC on November 8 and 9. Carl Terzer is moderating the session, "Some Old and New Ideas for Success in Captive Investing" on Thursday, November 9 at 10:00 a.m. We hope you stop by!

8. Carl Terzer is attending the NRRRA National Conference in Chicago, Illinois from November 13-15. We hope you stop by Carl's speaking session, "The Macro Economy" on Monday, November 13 at 2:00 p.m.

9. The Cayman Captive Forum is from November 28-30. Carl Terzer and Travis Terzer

will be in attendance.



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

Click here to connect with CapVisor!



We share interesting investment information, research and strategy advice, and announcements.

This publication is provided by CapVisor Associates, LLC ("CapVisor") and is intended for sophisticated institutional investors solely for informational purposes. The information contained herein is provided with the understanding that the authors and publishers are not herein engaged in rendering legal, accounting, tax, or investment advice nor does information constitute an offer to sell or a solicitation to buy securities or investment products. Any reference to tax or legal matters is not intended to be used, and may not be used, for the purpose of avoiding penalties under the US Internal Revenue Code or for promotion, marketing or recommendation to third parties. This information has been obtained from sources believed to be reliable that are available upon request. Any opinions expressed are subject to change without notice and do not necessarily reflect the opinions of CapVisor Associates, LLC. Unauthorized use or distribution without prior written permission of CapVisor is prohibited.

Past performance is no guarantee of future returns. © CapVisor Associates, LLC 2023. All rights reserved.

CapVisor Associates, LLC
P.O. Box 1084 Gainesville, GA 30503
(973) 665-6370
Email us at:
info@capvisorassociates.com

