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Insurance Asset Management

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2014….A Rough Start

2014 greeted fixed income investors with expectations for a continuance of the Fed's anchoring of short term interest rates at current historical lows. With no apparent inflationary threats and unemployment and the overall economy still slowly improving, interest rate pressures should remain muted throughout the year except perhaps for mild reactions to predictable but sustained tapering of the current QE program. Bond investors welcome a transparent policy regime, guided carefully by the Fed's new dovish Chair, Janet Yellen. We can compare this to the shock treatment the market went through in 2013 when insurance company portfolios were punished in response to the announced "taper" of the Fed's Quantitative Easing (QE) program back in May with many portfolios experiencing negative annualized returns for the year.

2014 greeted equity investors with a stock swoon which was somewhat unexpected since year-end 2013 market predictions indicated sustained growth of the US economy and an accompanying slow but steady climb of US equity markets over the year. The predicted 5-7% consensus rate of return for this year certainly signaled a new, slower phase to the torrid bull market of 2013, but did not prepare many for the set-backs witnessed early in

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Economic Review

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Ahoy! We may finally have smoother waters ahead. The economy should pick up steam during 2014, the noise out of Washington D.C. should decline, and inflation should remain benign. As we enter 2014, we see more tailwinds than headwinds for the U.S. economy and we have positioned client portfolios for modestly increasing interest rates.

2014 Tailwinds:

- Lower fiscal drag and improved confidence – the budget deal in December reduces the impact of scheduled 2014 budget cuts and with Congress likely on the sidelines due to mid- term elections, business and consumer confidence should improve
- Continued support from the Fed – despite all the QE taper talk, monetary stimulus will continue for most of 2014
- Continued improvement in housing and auto markets – see further details below
- Potential for increased consumer spending – the rate of consumer deleveraging appears to be declining and the wealth effect from higher equity and home prices should allow for increases in discretionary spending
- Lessening fears of a tail-risk event – concerns about a hard landing in China are subsiding while European economies are starting to show modest improvements

2014 Headwinds:

- Rising interest rates – but not enough to derail recovery in the housing and auto markets
- Potential expiration of emergency extended unemployment benefits for 1.3 million people

As is tradition with our fourth quarter commentary, we will recap 2013 and provide an economic outlook for 2014.

U.S. Economy:

We are forecasting improved earnings growth and business investment in 2014, strengthening as the year progresses. We expect first quarter earnings growth to be in the +4%

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Leo J. Dierckman (20 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 High Yield, Bank Loan and Core Plus composites in addition to his research responsibilities for the Healthcare, Homebuilding, and Municipal bond sectors. Prior to joining OIM, he was Vice President, Portfolio Manager for 40|86 Advisors, Inc. While at 40|86 Advisors, Leo served as the lead portfolio manager for the 40|86 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.

Economic Review

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area and reach low double digit growth by the fourth quarter (resulting in high single digit growth for the year). On the capital expenditure side, we anticipate mid-to-high single digit growth with a continued focus on cost and productivity improvements vs. capacity expansion for most industries. Gross Domestic Product: For 2013, we anticipated a slow start to the year due to the fiscal cliff, followed by improved second half growth, resulting in full year real GDP growth in the range of 2.0% - 2.25%. Our outlook was right on target. Third quarter GDP growth was a robust 4.1% and we anticipate fourth quarter GDP will end up close to 3.0%, resulting in 2.0% growth for the year. The private sector reported GDP growth of 3.5% for 2013, but increased taxes and reduced government spending reduced GDP by 1.5%. Moving forward to 2014, we anticipate less volatility and annual GDP growth in the 3-3.25% range. Similar to 2013, we anticipate that the latter half of 2014 will be somewhat stronger than the first half. Unemployment: We expected the unemployment rate to remain elevated during 2013, at 7.2% or higher. The most recent reading was 7.0%. We anticipate further declines during 2014 due to continued moderate job growth and the expiration of extended unemployment benefits for 1.3 million people. We believe many of these folks will permanently exit the labor force, with those near retirement age "making it official" and transitioning to social security benefits. We do not anticipate job growth to be robust enough to generate significant wage inflation. We forecast a 2014 year end unemployment rate of 6.3%. During the fourth quarter, the Federal Reserve Bank of Philadelphia released a white paper on the causes of decline in the labor force participation rate. They report "the decline in the participation rate since the first quarter of 2012 is entirely accounted for by increases in nonparticipation due to retirement. This implies that the decline in the unemployment rate since 2012 is not due to more discouraged workers dropping out of the labor force." There are other interesting facts within the report regarding the status of the unemployed. The following is a link to the report if you're interested in learning more: http://www.phil.frb.org/research-and- data/publications/special-reports.cfm Inflation: We anticipated that Core CPI would remain near 2.0% during 2013. It actually trended lower than we expected, with the most recent reading at 1.7%. For 2014, we expect continued low inflation with modest increases possible due to improved economic growth, the Fed's determination to ensure recovery and lower than perceived labor-market slack as discussed above. Medical cost inflation of 2.2% experienced in 2013 (a 50-year low!) will likely remain at historic lows in 2014. Monetary Policy: For 2013, we anticipated a continuance of the Fed's accommodative stance but with a reduction in the Treasury/MBS buying program in the latter part of the year (which indeed occurred). For 2014, we anticipate continued tapering with QE3 completed during the fourth quarter. We expect the federal funds target rate will remain in the 0.0 - 0.25% range the entire year with indications of a possible rate move during the first half of 2015. We believe the Fed will signal intentions to stop reinvesting interest and principal from maturing investments in 2015, allowing its balance sheet to shrink for the first time since 2008.

QUARTERLY COMMENTARY 4TH QUARTER 2013

Interest Rates:

For 2013, we anticipated a slow rise in the 10-year Treasury yield, trading in a range of 1.85% to 2.35% and ending the year at the higher end of that range. During 2013, the 10-year Treasury yield reached a calendar year low of 1.63% (May 2nd), a high of 3.03% (December 31st) with an average of 2.34% for the year. For 2014, we anticipate a narrower trading range of 2.75%- 3.75% and a calendar year average of approximately 3.35%, suggesting that the 10-year Treasury will likely be trading near 3.75% as we approach year end. Housing and Autos: For 2014, we expect new housing construction starts (including apartment units) to be between 1.1 and 1.2 million units, or an approximate 20.0% increase over 2013. Modestly higher interest rates will reduce the pace of existing home price increases to the mid-to-low single digits as

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Economic Review

compared to double digit improvements in most major markets in 2013. Auto sales (as measured by the seasonally adjusted annualized rate per Bloomberg) reached 15.3 million units in December 2013, higher than the 9.0 million units sold in the depths of the recession in 2009 but still below pre-recession sales above 16.0 million. We anticipate car sales to approach or exceed their pre- recession rate in 2014.

Fixed Income Markets: 2014 Outlook Investment Grade:

As discussed earlier, we believe the U.S. economy will continue to progress in 2014 leading to modestly higher interest rates. That said, our investment strategy for 2014 will be very similar to how we managed the portfolios in 2013. We must keep the portfolios invested in short-to-intermediate maturities to keep duration below our benchmarks' duration. In addition, we continue to favor the opportunities corporate credit offers. Relative value in corporate securities is still attractive as they provide a yield advantage over other fixed income asset classes, most notably Treasury and agency securities. Corporate fundamentals remain firmly intact with strong balance sheets, stable debt levels, and low leverage. High Yield: We continue to like U.S. domestic High Yield investments based on sound, fundamental credit research. The default rate finished 2013 at an all-time low of approximately 1.0%, well below the historic average of 4%. We expect defaults to remain well below average again in 2014. We will remain focused on finding solid single-B and higher quality "need based" triple-C companies to add to our portfolio. As compared to the MLHY Index II, we will maintain our overweight to single-B and triple-C credits and underweight to interest rate-sensitive double-B credits. While duration management has not historically been a focal point for our High Yield portfolios, as spreads have continued to tighten over the past 12-18 months, sensitivity to the Treasury yield curve has increased. We plan to maintain slightly shorter portfolio duration than the benchmark duration of approximately 4.25 years. This criterion will remain secondary in the credit selection process. We are, and will remain, a credit driven investment shop, doing what we do best- selecting fundamentally sound companies offering bond yields with excellent relative value for our clients.

Capital Markets and 2013 Performance

The taxable fixed income market in 2013 witnessed a dramatic rise in interest rates after the Fed signaled they might taper their QE program in reaction to stronger economic growth. The yield on the 10-year Treasury note rose 127 basis points in 2013 to end the year at 3.03%. The Barclays Capital U.S. Aggregate Index returned -2.02% for the year. All investment grade sectors produced negative returns; however, mortgage and corporate securities were the best performers at -1.41% and -1.53%, respectively. Treasury securities logged the worst performance in 2013 with a return of - 2.75%. As expected during a rise in interest rates, short maturity bonds performed better than long maturities by a substantial margin. Among the broad corporate classes, financials were once again the top performers over industrials and utilities. Returns were far better in High Yield in 2013. The High Yield performance as measured by the Bank of America/Merrill Lynch High Yield Master II Index returned 7.425% for the year easily outperforming investment grade once again. Most importantly, we are very pleased to report that for 2013 all of our composites outperformed their respective indices.

"For 2014, we anticipate continued tapering with QE3 completed during the fourth quarter. We expect the federal funds target rate will remain in the 0.0 - 0.25% range the entire year with indications of a possible rate move during the first half of 2015. "

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Insurance Companies and Municipal Bonds

Getting Reacquainted with an Old Friend in Tough Times

Tom Dalpiaz has over 30 years of experience in various aspects of the municipal bond business. Currently, he is a Managing Director at Granite Springs Asset Management where he manages bond portfolios for individual clients and financial advisors. Mr. Dalpiaz has managed bond portfolios at Advisors Asset Management, Neuberger Berman, Sage Capital Management, and Weiss, Peck & Greer. Before managing bond portfolios, Mr. Dalpiaz was a municipal bond credit analyst at Weiss, Peck & Greer, Merrill Lynch, and The Bank of New York. Mr. Dalpiaz has had a series of bond articles published in *Forbes* and is author of "Managing Municipal Bond Portfolios For High Net Worth Investors", a chapter found in *The Handbook of Municipal Bonds*, part of the Fabozzi series of investment books. Mr. Dalpiaz has been a guest speaker at numerous investment conferences, including Bloomberg Cities & Debt Briefing and NAPFA. He has been quoted in the *Wall Street Journal, Barron's*, and *Bloomberg* and has appeared on *Bloomberg Television* and *Fox Business News*. Mr. Dalpiaz has an MBA in Finance and a BA in History, both from Hofstra University. He also holds Series 7, 24, 63, and 65 FINRA licenses.

Municipal bonds traditionally have been one of the key "tools in the kit" for insurance companies to consider for their investment portfolios. A brief list of municipal bond positives helps to explain the important role they perform for insurance companies. These positives include the near full exemption of muni bond interest income from taxation, a long term record of safety from default second only to Treasury bonds, and a market whose breadth and diversity allow for remarkable customization when balancing return, risk, and liquidity needs. Insurance companies can benefit from an inefficient muni bond market that cries out to be exploited by an experienced traditional bond picker "looking under every rock" for value.

We recall, however, in the past five years several intense time periods when investors became quite anxious about the municipal bond market as a whole: the financial crisis of late 2008, the fallout from Meredith Whitney's misguided pronouncements in late 2010, and the Detroit and Puerto Rico credit concerns since last summer. In each case, there was a quick impulse to paint the entire muni bond market with a single negative broad brush. Spreads widened, normal market functions became bumpier, and higher yields prevailed. In each case, it also turned out to be an attractive opportunity for informed investors. The resilience of the municipal bond market has proven to be one of the more astonishing features throughout these challenging time periods.

We believe insurance companies should take a fresh look at municipal bonds at the current time. We are not suggesting that municipal bonds are uniquely attractive right now or that total returns for munis in 2014 will battle other asset classes at the top of the rankings. We understand the consensus view for higher interest rates in 2014 and we believe this year will be a challenging one for bonds. We do suggest, however, that investment grade/intermediate maturity municipal bonds can continue to fulfill investment needs for insurance companies even in a challenging interest rate environment. We do suggest there is complexity at work that needs to be considered particularly in the tough environment many expect this year.

Here are some current measures of municipal bond attractiveness for insurance companies to consider:

10-year *High Grade* Municipal bond yields as a percentage of 10-year Treasury bond yields: **106%** (compared to an average ratio of 97% for the past ten years).

10-year *Single A rated* Municipal bond yields as a percentage of 10-year Treasury bond yields: **137%** (compared to an average ratio of 122% for the past ten years).

10-year *Single A rated Municipal* bond yields as a percentage of 10-year *Single A rated Corporate Industrial* bond yields: **105%** (compared to an average ratio of 100% for the past five years and 103% for the past year).

10-year *Single A rated Municipal* bond yields as a percentage of 10-year *Single A rated Corporate Utility* bond yields: **107%** (compared to an average ratio of 97% for the past five years and 103% for the past year).

(Source: Bloomberg)

As insurance companies form judgments on where interest rates might go this year, we suggest analyzing the forces at work on *both* sides of the equation. This perspective of countervailing forces is a helpful reminder for those who make simple assumptions about where interest rates might go: they are often confounded by the actual complexity at work.

The forces at work that could help push interest rates *upward* are fairly well known at this point. The Fed has begun to reduce its monetary accommodation by starting its long-awaited taper. The removal of this artificial support of bond prices should allow natural forces in the bond markets to re-assert themselves and break free

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Insurance Companies and Municipal Bonds

Getting Reacquainted with an Old Friend in Tough Times

from the "manufactured" low levels of the recent past. To the extent there is continued positive economic news, the bias for rates will be higher. A strong equity market could be a force for a re-allocation from bonds to stocks; sizable bond selling could be a source of downward pressure on bond prices and result in rising rates. Lastly, we are likely at the point of the broad cycle that suggests the 31 year period of generally falling interest rates we had been experiencing up until May 2013 is behind us.

However, in 2014, we feel insurance companies will be well-served to recognize the forces working on the *other* side of the equation:

While the Federal Reserve has begun to reduce its purchases of U.S. Government securities, it has also made very clear it expects to maintain the target for the Fed Funds Rate at near zero percent for an extended period, perhaps as long as the end of 2015. Bond markets often reflect forward thinking and can lead the Fed at times but a zero percent Fed Funds Rate as long as it is maintained will likely act as a restraint on rising rates.

Inflation just doesn't seem to be making any meaningful headway as shown by a variety of measures. The conditions that usually surround an inflationary push also don't seem evident: businesses do *not* have pricing power, labor is *not* creating a wage/price push, there are *no* capacity constraints in a variety of industries, we are *not* near full employment, and the demand for products and services is *not* near being frothy.

There is still a reasonable probability that economic growth going forward may be stuck in a relatively modest, long-term growth range of one to three percent. Perhaps the broader forces of an aging population, a slower pace of household formation, and the development of a sharing economy will dampen demand and create a more gradual rise in interest rates.

The supply of new issues in the municipal bond market has not kept up with maturing bonds so that the amount of all muni bonds outstanding has actually been reduced in each of the past three years. This slightly shrinking municipal bond market may create relative scarcity. Coupled with the realization that municipal bonds remain one of the very few games in town to avoid high tax rates, the shrinking muni market could provide positive fundamentals for municipal bonds relative to other choices.

The credit concerns in the municipal bond market that helped to widen spreads and push yields up in 2013 may lessen in 2014. The Detroit story is now a known quantity, common knowledge even to the casual observer of the muni bond market. While a smaller number of muni bond issuers still face difficult budgetary challenges, the overwhelming majority of issuers should continue to experience gradual improvement in housing values, revenue collections, pension reform, and debt/expenditure control. The credit quality wildcard for the muni market in 2014 will be Puerto Rico. If the Commonwealth can demonstrate market access and work through its current challenges, a large lingering credit concern would be removed for the market.

Intermediate municipal bonds have tended to exhibit less volatility than other fixed income alternatives (note the May 2013 through December 2013 period). Investment grade/intermediate maturity municipal bonds are still dominated by buy-and-hold retail investors and tend not to be used as trading vehicles as much as other fixed income classes.

In this tug-of-war we've just described, our judgment is that interest rates will trend higher but that there is enough power in a variety of countervailing forces to moderate that rise. The trends particular to the municipal bond market add to the possibilities of a more gradual, muted rise in rates in the intermediate maturity range (3 to 12 years) of that sector.

Experienced bond professionals understand that the movement of interest rates and how they affect specific bond values can vary widely. They understand it is not very helpful to talk about one monolithic "Bond Market" and how it will react to rising rates. How well an insurance company weathers possible rising rates depends on the particular sectors, maturities, and bond structures that the insurance company holds within the diverse bond universe. Municipal bonds can still work for insurance companies in 2014. More than ever, it is a time for insurance companies to know what they own and to seek expertise in building and managing a portfolio with the sectors, maturities, and bond structures appropriate to their investment needs.

Don't give up the bond ship in 2014. Navigate wisely instead.

"This slightly shrinking municipal bond market may create relative scarcity. Coupled with the realization that municipal bonds remain one of the very few games in town to avoid high tax rates, the shrinking muni market could provide positive fundamentals for municipal bonds relative to other choices. "

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2014….A Rough Start

this first quarter. Of course, and as always, there were also some market "bears" warning of the imminent pop of the "Bubble" that was fueled by the Fed's juicing of the market. They warned of a 10-25% correction and many sited valid market valuation methodologies as proof. Eventually the bears will be correct.

This somewhat surprising dip in the US stock market, primarily in response to turmoil in the emerging markets, certainly was distressing following on a banner year in 2013. Was this signaling the end of the bull? Fortunately and unfortunately, what goes up must come down and then it usually goes back up again. It is all a matter of timing. To this point, the US stock market, as measured by the S&P 500, has since made up most of the ground lost by the time of this writing as seen in Figure 1 .

However, this dip increased uncertainty surrounding the ongoing direction of US Equity markets and more recent economic data has cast doubts on the steady continuance of a US economic recovery that typified year-end sentiment. Fading confidence coupled with the recent increased market volatility created the somewhat predictable knee-jerk investor response: a temporary flight from equities into safe havens. Figure 2 on the next page shows a similar knee jerk reaction in the bond market to the announcement of Fed taperings.

With mixed information, investors are left to speculate whether or not the bull market in US stocks has merely downshifted into its final phase and will resume its march upwards, albeit at a slower rate than last year, or whether more carnage is in store for investors this year.

In evaluating these alternatives courses, we must keep in mind that the stock market is supposed to be a predictor of future economic vitality or more specifically, market values should be reflective of future corporate cash flows. Therefore the stock market should not be expected to move in tandem with current economic news. Even though we see the markets react to current news, this "immediate" relationship is tenuous and tends to be self-correcting. Such adjustments are usually short-lived as compared to the real changes in drivers of future value for example, long-term economic potential, demographics, geopolitics and other interactions of global economies.

What makes the markets especially uneasy is the fact that normal market drivers have been replaced by aggressive monetary policy. The resulting market distortions are hard to measure and outcomes thereof are difficult to anticipate.

A Market on the "juice"

With interest rates still at extremely low levels and the stock market backing off from its highs of 2013, Insurers are now faced with the possibility of low real returns in both major asset classes in the near term. Federal Reserve QE programs seem to have had their greatest impact in driving the stellar 2013 stock market run rather than the intended goal of revving the US economic engine. These programs have also served to punish risk-adverse bond investors, such as insurers. By increasing liquidity and holding down short term rates at historically low levels, Fed Policy resulted in fixed income instruments' returns that were negative on a nominal basis

Figure 1

Source: Yahoo Finance

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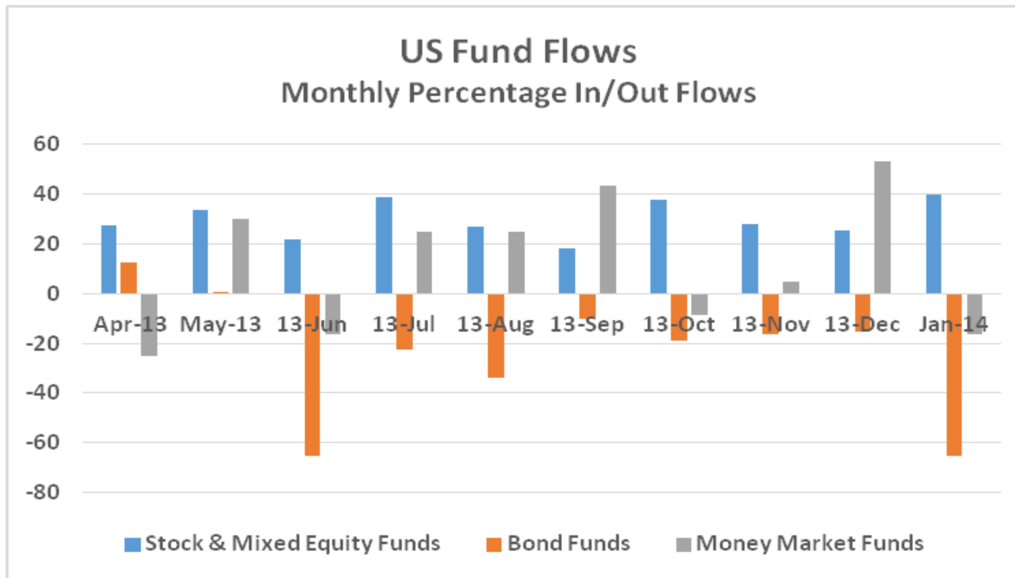
2014….A Rough Start

Figure 2



Source: Lipper

and even worse on a "real" return (after inflation) basis. This forced many investors to add risk to portfolios as the only way to generate returns that could beat inflation to avoid principal erosion. For example, many insurers substituted riskier assets, namely dividend-paying stocks or lower credit bonds, for investment grade bonds to the extent possible. While capturing higher current returns, these investors now have more market value volatility in their portfolios.

What's Ahead?

As the economy continues to muddle through a "recovery", we can expect that interest rates will remain low absent any unexpected inflationary pressures. Manifestation of these "pressures" would generally require consumers, businesses and/or the government to significantly increase spending; a trend that appears unlikely near term. Consumer demand has been slack, businesses continue to either hoard cash or use it for stock buy-backs rather than invest in future productivity and the government is still under pressure to reduce or control spending. Tapering will have some effect on long term bond yields but the real risks of sharp rate increases is probably down the road a bit. This means a continuance of the low yielding environment for insurers and other bond investors.

As for the stock market, we may have seen the last of the raging bull. Ignoring outside factors and focusing on the US economy, one would expect that the stock market's returns over the next several years to be below historical averages. The expected Fed "Tapering" will get the stock market "off the juice" and functioning in better alignment with normal market-driven factors. With most market watchers agreeing that the US stock market is currently either fully-priced or overpriced, it would be hard to expect outperformance relative to historical annual rates of return. Therefore, even with interest rates poised to slowly rise over time, the normal benefit to the stock market of rising rates may already be priced in.

Strategies for Insurers

Over the past several years we have been extolling the virtues of looking beyond the classic "risk barbell" that many insurers have in place. That is, most insurers have 70-90% of their asset allocation in low risk, high quality bonds and at the other extreme, the remaining portfolio allocated to high risk equities. While this will remain the industry norm, the normal diversification benefit of this type of allocation has not produced optimal results in these times of market distortion. There are several strategic asset classes, those that have low to inverse correlations with investment grade bond and stocks that could significantly improve an insurer's risk-adjusted returns. At the margin, these asset classes can have a larger than expected impact on dampening overall volatility of returns and contributing stable positive income. Many insurers have not optimized their asset allocation and have not been encouraged to since their current investment management firms may not manage these additional asset classes. Therefore, it is incumbent upon the insurer's senior management, finance committee and/or board to seek out unbiased and independent advice, preferably from sources that are free from conflicts of interest, i.e. managing and advising, when determining the appropriate asset allocation.

Tactical allocation considerations should also be explored. For example, should non-US equity exposures be increased and/or should there be a rebalancing of portfolio's market capitalization within US equity exposures? With regard to bonds, insurers should determine their ap-

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CapVisor Associates, LLC

CapVisor Associates,

219 Main St. #693
Chatham, NJ 07928

Phone: 973-665-6370

E-mail:

carl.terzer@

capvisorassociates.com

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propriate duration target as a function of the expected market value losses that could be incurred in a rise interest rate environment. Of course, an insurer's liability duration should be used as the yardstick around which portfolio duration targets are chosen. In addition to managing interest rate risk (as measured by duration), credit risks should be reevaluated to determine if quality should be liberalized or held within a stricter tolerance going forward. An insurer's claims history and capitalization are among the factors that must be considered in making these decisions.

Another important idea would be to reexamine tax efficiency of the portfolio. Balancing the allocations of tax-exempt vs taxable securities in an insurance portfolio to maximize the after-tax return (AKA Crossover Management) is often overlooked or under-utilized. Crossover Management requires rebalancing of the taxable/tax-exempt mix in accordance with the insurer's changing tax rate which in turn is dependent on many factors such as underwriting results, investment income, etc.

This year, along with the next few will present some unique challenges to meeting the insurance industry's typical investment objectives of preserving principal, generating sufficient income and maximizing surplus growth. Properly assessing risk and fine tuning your investment program accordingly to meet these challenges should be a priority.

Upcoming Events

The **PIAA 2014 Medical Liability Conference** is May 14-16 at the Fairmont Royal York in Toronto Canada. CapVisor will be exhibiting at this event. Please stop by **booth 9** and say hello!

The 2014 **USA Risk Annual-Conference** will be at the Ballantyne Resort in Charlotte, NC May 20-22. Carl Terzer will be a speaker at this event.

The **Bermuda Captive Conference** will be June 1-4th at the Fairmont Southampton Resort in Bermuda. Carl will be in attendance and hopes to see you there.

Carl E. Terzer
Principal

Editor in Chief

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