CapVisor Associates, LLC
Quarterly Newsletter

CapVisor Associates, LLC

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Managing the Managers

In the absence of an Investment Consultant, the Board of Directors or the Investment Committee generally has the obligation to manage the investment managers implementing their investment program. It is their responsibility to ensure that the manager operates within the constraint set provided: that is, the investment guidelines governing the management of the portfolio encompassing risk, regulatory, accounting, or tax constraints. The Board or Investment Committee typically meets this obligation by having the manag-

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Investment Strategies

The Bond Market

Bond market performance in the first quarter returned to positive territory after a rare year of negative performance. Most bond sectors gained during the quarter. Our benchmark, the Barclays Intermediate US Government/ Credit index, gained 0.98% for the quarter as of 3/28/2014. The major subsectors of the index also had positive returns with the credit sector continuing to outpace the performance of government bonds. The highest performing subsector was the Investment Grade Industrial – Intermediate index with a return of 1.90% and the lowest performing subsector was the US Agency Intermediate index with a return of 0.51%. The US Treasury Intermediate index fared only modestly better at 0.61%.

However, as we explain below, bonds of longer maturities outperformed those of shorter maturities. Most of the gains have been associated with a decrease in longer-term interest rates, while interest rates at the shorter end of the Treasury yield curve have increased slightly over the quarter. The highest returns on the broader aggregate index were all associated with bonds having maturities in excess of 10 years. The best performing subsector was the US Treasury 20+ year index with a return of 8.04%. The worst performing subsectors were all related to mortgage-backed securities and in particular, those associated with adjustable rate mortgages and asset-backed loans—mainly auto loans. Returns from these subsectors were very close to zero.

Stormy Weather or a Storm of Words?

The biggest effects on interest rates in the first quarter were attributable to various factors. We experienced some very severe weather over the winter months, as well as the most recent geopolitical turmoil associated with Russian intervention in the Crimean peninsula following the overthrow of the existing government and displacement of Ukrainian President Viktor Yanukovych by the political opposition. These events have added to the uncertainty surrounding the US economic recovery and need to be discounted by the markets. The weather is a seasonal factor that usually af-

Vince joined Howe & Rusling in October of 2002. He brings more than 18 years of experience as a financial professional to the firm. Vince is a graduate of the William E. Simon School of Business Administration at the University of Rochester. He started his career as a financial analyst at Xerox Corporation, followed by more than 12 years as an officer in the Treasury group of the former Rochester Community Savings Bank, now part of Charter One Financial. Vince was a member of the Bank's Asset/Liability management team and manager of the Corporate fixed income portfolios. His knowledge of the Capital markets, as well as his analytical experience in modeling portfolio sensitivity to shifts in the Treasury Yield Curve is a valuable addition to Howe & Rusling's management team..

"…QE3, which is expected to end at the end of the third quarter of 2014, then the fed funds rate could move higher from 0 – 0.25% as early as the first quarter of 2015."

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fects the data negatively and adjustments are made to take that into consideration when forecasts are established. This winter, however, has been unusually harsh, and the markets are still evaluating how much of the negativity is due to the weather and how much is real. The geopolitical effects are usually transitory but do require monitoring in the event that tensions escalate to the point of disrupting economic conditions globally. Both of the above factors support the notion that "bad news is good news" for the bond market. Well, it usually works out that way because elevated uncertainty usually leads to a flight to the safety of less volatile securi-ties—US Treasury notes.

That certainly explains some of the positive performance of US Treasuries, and bonds in general, this past quarter. However, the biggest news once again had to do with the Federal Reserve Bank's position on monetary policy and its "forward guidance." The FOMC's (Federal Open Market Committee) March 19 decision to keep short-term fed funds overnight rates between 0 – 0.25% was not a surprise. But, a change in the hard quantita-tive data that the market had relied upon since the implementation of the latest asset purchase plan, QE3 (Quantitative Easing – part 3), did alter the market's outlook on monetary policy going forward. Starting in December of 2012, the FOMC had given the market some parameters to monitor regarding how long the fed funds rate would stay in the "accommodative" range of 0 – 0.25%. So long as the unemployment rate was higher than 6.5% and the outlook for inflation expectations stayed below 2.5%, the market could rest assured that an increase in short-term rates would not be contemplated by the FOMC. There has been some uncertainty in the market surrounding a possible change in stance regarding the well-defined "thresholds." After all, the unemployment rate has decreased from 7.9% in December, 2012, to the latest reading of 6.7%. So, in anticipation of reaching the 6.5% parameter soon, the market was also awaiting some further clarification on whether monetary policy would be adjusted sooner rather than later.

While the statement released by the FOMC did not explicitly change policy, it did give the sense that the Committee was laying the groundwork for more flexibility in setting policy going forward.

In Janet Yellen's first meeting as Chair of the Federal Reserve Board, she did manage to create some volatility in the capital markets. Even though her statements were still consistent with current easy monetary policy, she did leave herself (and the Committee) open to second guessing by the markets. **(continued on page 5)**

Figure 1

US Treasury Note	Change in Yield Post Announcement	Intraday High Yield	Current Yield as of 3/28/2014 Close
2 year	8 basis points	0.44%	0.45%
3 year	15 basis points	0.92%	0.91%
5 year	17 basis points	1.73%	1.75%
7 year	13 basis points	2.32%	2.32%
10 year	8 basis points	2.79%	2.72%
30 year	3 basis points	3.68%	3.54%

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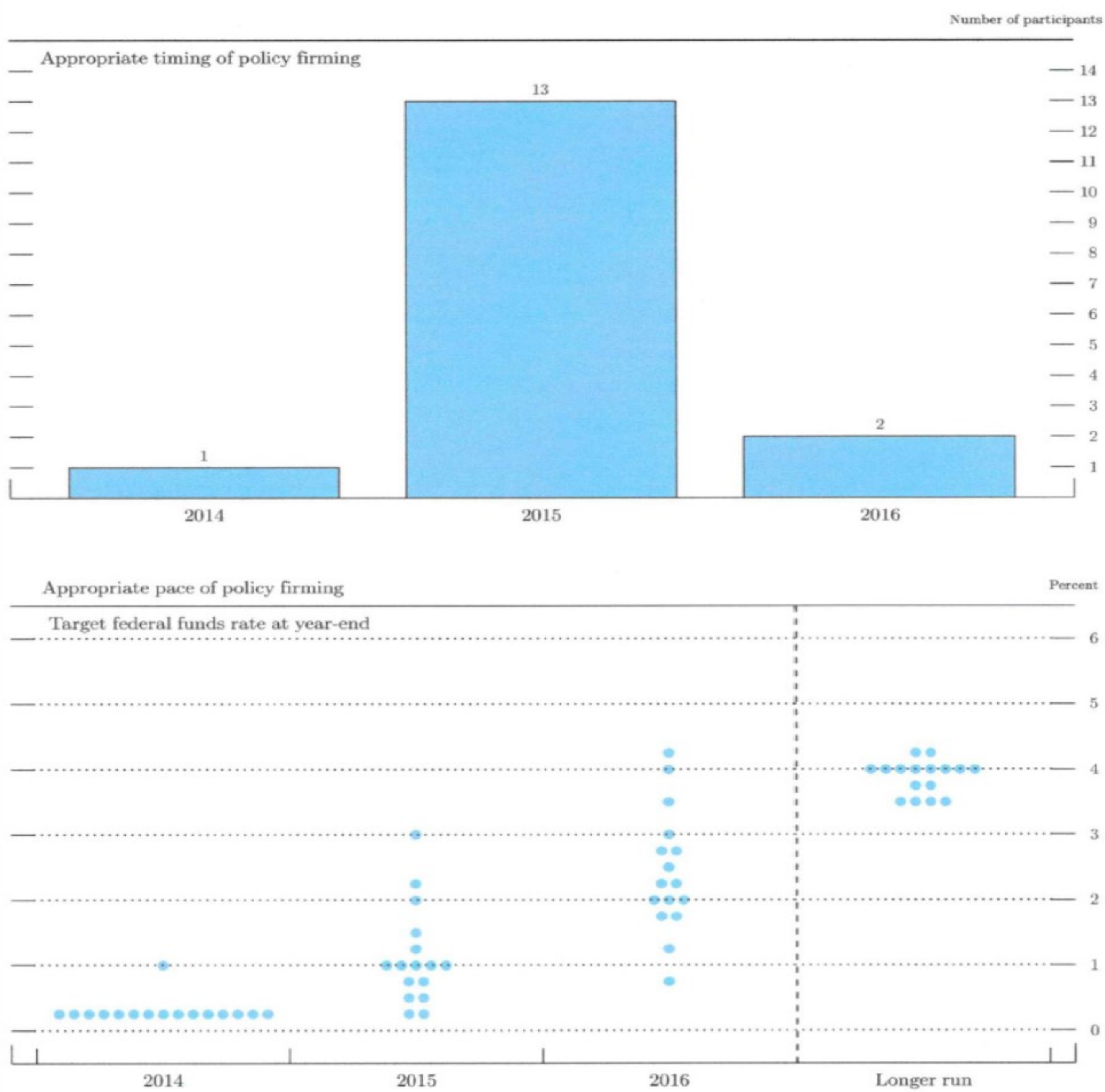
Figure 2. Overview of FOMC participants' assessments of appropriate monetary policy



NOTE: In the upper panel, the height of each bar denotes the number of FOMC participants who judge that, under appropriate monetary policy, the first increase in the target federal funds rate from its current range of 0 to 1/4 percent will occur in the specified calendar year. In December 2013, the numbers of FOMC participants who judged that the first increase in the target federal funds rate would occur in 2014, 2015, and 2016 were, respectively, 2, 12, and 3. In the lower panel, each shaded circle indicates the value (rounded to the nearest 1/4 percentage point) of an individual participant's judgment of the appropriate level of the target federal funds rate at the end of the specified calendar year or over the longer run.

The Shrinking Labor Force Participation Rate: A Few Points to Consider

John Saf, Portfolio Manager for Oppenheimer Investment Management, has over 22 years of experience managing fixed income portfolios. His expertise in managing constrained, liability-sensitive insurance portfolios at prominent insurance asset management firms also includes overseeing Asset Liability Management (ALM) for clients.

"Based on a now stabilized participation rate, the Fed estimates full U3 employment will be reached by 2Q16 and the full U6 rate will be reached by mid-2018"

Between 1947 and 1962, the population of the United States grew at an average annual rate of nearly 2%, an increase from the average annual growth rate of nearly 1% during the 20 years prior to WWII. Sixty five years later, this baby boom is turning into a retirement boom. Beginning in 2012, and continuing for 19 years, 10,000 boomers per day became eligible for retirement. According to the U.S. Bureau of Labor Statistics, approximately 6 million people left the labor force between 2007 and 2010 with 34% returning to school, 18% going on disability and 26% retiring. Another 6.6 million people left the labor force between 2010 and 2013 with 61% retiring, 28% going on disability and 7% returning to school. According to the Pew Research Center population projections, all Baby Boomers will turn 65 by 2030, causing nearly 18% of the nations population to be at least 65 years of age. Today that number is 13%. While much fanfare is made about the declining labor force participation rate, much of that decline is explained by the aging Baby Boomers. Will the labor force continue to shrink for years to come? Not likely. The increase in the retirement rate from 2010-2013 was a result of age eligible people delaying their retirement until after their retirement accounts had recovered from the great recession of 2008.

Our baseline assumption is that the participation rate is now bottoming, as a more normalized retirement rate due to population aging (an approximate 0.25pp/year drag on the participation rate) is offset by a gradual increase in cyclical participation as people re-enter the workforce when they feel they have a rational shot at gaining employment.

The Fed now defines the normalized structural unemployment (full employment) rate to be 5.4% (U3) and the normalized structural U6 rate (including involuntary part-time and marginally attached workers) to be 10%. U3 and U6 are currently 6.7% and 12.7%, respectively. Based on a now stabilized participation rate, the Fed estimates full U3 employment will be reached by 2Q16 and the full U6 rate will be reached by mid-2018. So when will wage pressure become an inflationary factor? If the economy is strong enough to weather the Fed QE3 taper program, we anticipate wage inflation fears will precipitate the first Fed Funds rate increase in the fall of 2015.

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"We know we're not close to full employment, not close to an employment level consistent with our mandate, and unless inflation were a significant concern, we wouldn't dream of raising the federal funds rate target."

However, now it would appear that the Committee will be looking at a "wider range of information," or information that would include a broader measure of labor market conditions: not just the unemployment rate, but the underemployment rate and the labor participation rate. Of course, inflation expectations would also be a critical variable, as well as finan-cial market stability. While measuring all of those variables seems very commonsensical and pragmatic, the task of weighing one or two versus the other(s) is not very clear. That notion, combined with Chair Yellen's definition of what she considers a "considerable time" when talking of keeping the fed funds rate low, caused a bit of an uproar in the markets on March 19. When asked in the press conference following the meeting to clarify how long after the end of the asset purchase program that might be, her response was: "You know, it probably means something on the order of around six months or that type of thing." That was all the markets needed to hear to speculate on the timing of the next monetary tightening cycle. Both bond and equity markets sold off dramatically intraday. The S&P 500 index fell approximately 0.5% right after the announcement. However, the real volatility occurred shortly after the Chair's statement during the press conference. The index fell approximately 0.9% within less than 15 minutes, before bouncing back to close at 1860.77, down 0.6% on the day. Bonds, on the other hand, did not react as negatively across the entire maturity range. The short-intermediate to mid-intermediate range of the Treasury yield curve was more affected than the longer maturities (greater than 10 years). The following table illustrates the volatility of the intraday changes produced by the statement, as well as the current market rates after there has been some time to digest the change in language and guidance. **(see figure 1 on page 2)**

We can see that the market's expectations for tighter monetary policy have changed. Up until that statement, the markets were projecting the first increases in the fed funds rate in late 2015 or early 2016. So, the market quickly reacted to the notion that if an "extended period of time" equates to six months after the end of QE3, which is expected to end at the end of the third quarter of 2014, then the fed funds rate could move higher from 0 – 0.25% as early as the first quarter of 2015. Also supporting this notion is the accompanying "dot chart" which is a distribution of the FOMC participants' expectations of when and by how much they expect the federal funds rate to change.

While most participants still believe that policy would be changing in 2015, the midpoint or median projections of where fed funds would be by the end of each year above changed, and there is a clear bias in the participants' expectations that tightening policy would most likely start sooner than had previously been expected.

Interestingly, the implications for fixed income investment strategies going forward might be different than most would expect. As we've seen, the short- to mid-intermediate term of interest rates reacted quickly to the change in expectations. However, the yields on the longer end of the yield curve have actually diminished. So, while most would think that as mon-etary policy tightens, interest rates across the board have to increase, why would we see the opposite happening here (at least for now)? The answer lies with inflation expectations decreasing. It stands to reason that if the Federal Reserve Board is contemplating a tighter monetary policy sooner, then we would expect that future inflation pressures would be subdued. Indeed, inflation expectations as measured by the difference between yields on Treasury Inflation Protected Securities and Treasury notes does support a modest decrease of 0.10% over a five year time horizon, since the FOMC announcement. Of course, expectations don't always match reality. So, that being said, we continue to be defensive in the short term as we expect continued improvement in economic conditions will still put upward pressure on interest rates – even those of longer maturity. However, we still do be-

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"Understanding how risk-adjusted return compare amongst managers helps to determine how this current manager ranks within their peer group. "

ers present portfolio details along with compliance either in person or via teleconference on a quarterly basis. The manager will usually provide a very comprehensive review of economic conditions followed by a more detailed analysis of current market conditions. Finally, they will address the actual quarterly performance of their client's portfolio typically versus a selected benchmark. In addition to the quarterly performance, the manager may also have other performance analyses such as year to date, one, three, and five year portfolio performance versus the benchmark. Most managers can present this information very effectively and impressively demonstrating a commanding knowledge of the economy's relationship to the markets, the markets performance, and their performance relative to the benchmark.

The Board or Investment Committee would typically evaluate this information on the basis of whether or not they agree with the managers assessment of the economy and its direction, their overview of market performance, and finally an assessment of whether their performance beat the benchmark or was deficient over one or more periods.

So what's missing?

To answer this question let me provide context and an example from the liability side of the balance sheet. A Board or other committee of the insurer would not evaluate their overall underwriting performance based on the amount of premium written/ collected. So, for example, they would not be satisfied knowing that the company has done a great job even if premium has been growing steadily over a five-year period. Why? Because they realize that premiums represent funds coming into the insurance company which must be weighed against funds going our of the insurance company in claims and other operating expenses. In other words, "income" must be weighed against the risk associated with that income. Similarly a Board or Investment Committee must weigh the risks involved in obtaining their investment returns versus benchmark reported by the manager to properly evaluate performance. The real measurement that should be made to evaluate the manager is on the basis of risk-adjusted returns, not exclusively on nominal returns vs benchmark. Unfortunately, most insurers do not have the internal analytic capabilities to measure risk-adjusted returns since specialized systems are required to do these rather complex modern portfolio theory (MPT) calculations. Further complicating a comprehensive manager performance evaluation would be the fact that even if risk-adjusted returns (MPT statistics) are provided to assess the managers "skill", the Board or Investment Committee would still not know how that skill level compares to comparable managers of similar portfolios. Investment professionals refer to this analysis as a "universe comparison".

Risk-adjusted returns require several modern portfolio theory statistical calculations. One cannot rely upon one single measurement to form an opinion of the manager efficacy. Some of these statistical measurements such as alpha, beta, standard deviation, R squared, information ratio, up down capture, batting average, just to name a few, are familiar to the Board and Investment Committee; others may not be familiar. A professional investment advisor or consultant can provide value to the manager assessment process by analyzing and reporting on these various statistical measurements of risk-adjusted performance and

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provide a determination of the skill level of the manager.

An MPT statistical analysis of manager performance by itself may not even provide a clear picture upon which the Board or Investment Committee can base decisions as to whether or not their satisfaction with the current managers performance is truly warranted. Why? Because even if the managers risk-adjusted performance assessment is favorable, we would need to have a comparative basis using similar managers, managing similar portfolios. Understanding how risk-adjusted returns compare amongst managers helps to determine how this current manager ranks within their peer group. "Universe analysis" will enable the Board or Investment Committee to see the quartile ranking of their manager as well as to see the manager's performance on a risk-adjusted basis versus the benchmark as well as the peer group managers.

If it ain't broke don't fix it! Assessing investment managers based solely upon nominal performance versus benchmark can lead to erroneous conclusions. For example, many Boards of Investment Committees will conclude that a manager outperforming their benchmark by 100 basis points in each of the selected rolling time periods, e.g. year-to-date, one, three and five year rolling periods must be doing a satisfactory job. Without being able to effectively analyze the amount of risk taken by the manager to produce that 100 basis points of out performance, the Board or Investment Committee cannot draw any valid conclusions on the efficacy of their manager's performance. In this case, they would be left to wonder that for the given level of risk undertaken, should their manager have been able to out perform the index over each of those periods by 200, or perhaps 300 basis points?

As Boards and Investment Committees become aware that analytic tools are available to help them to better assess the performance of their investment programs as well as the performance of the managers it becomes incumbent upon them to seek out such data to properly execute their fiduciary responsibilities for the insurance company. Upon request many investment managers will gladly provide several modern portfolio theory statistics, offering an indication of their skill level via these risk-adjusted measurements. Even armed with this data, the Board and/or Investment Committee need to assess whether the statistics provided are appropriate and comprehensive enough to provide a basis for their assessment. That is, has there been full disclosure of statistics that might not be favorable to the manager? Illuminating any possible bias in the selection of which statistics would be provided should be carefully policed by the Board and/or Investment Committee; a potentially tricky and difficult job. Additionally, a request for, and subsequent submission of a universe comparison by a manager should be examined for biases in the database of return sets that are utilized. Investment managers may have limited access to data from other managers or cull the universe data in a manner desired by the client. Even under the best of circumstances, having the manager provide the data and assessment opens the door to obvious inherent conflicts of interest.

Even Board and Investment Committees with sufficient expertise to do detailed manager evaluations would be well served to periodically review unbiased risk-adjusted statistics and assess vetted universe comparison analyses. At that time they can take comfort in knowing that "it ain't broke, and doesn't need fixing"- we have a great performance and sound relationship with the right manager for our organization.

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lieve that there are some global headwinds that could have negative impacts on our economic outlook. We still see continued disinflationary pressures in Europe, as well as continued uncertainty in the banking sector of some euro zone members. We are also keenly aware of some of the credit excesses that have been created in China as a result of its rapid economic expansion and the potential for tighter policies as well as restructurings and defaults in the credit market. These, and other emerging market troubles, could have a dampening effect on our own growth potential. **(see figure 2 on page 3)**

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Upcoming Events

Carl will be in attendance at the **IASA Annual Conference - Educational and Business Show** in Indianapolis at the Convention Center from June 8-11.

The **NAMIC Management Conference** is June 22-25 in Williamsburg, VA and Carl will be an attendee at this event.

CapVisor will be exhibiting at the **VCIA Annual Conference** at the Sheraton Hotel and Conference Center , August 12-14 in Burlington, VT Please stop by booth # 49 and say hello!

Carl E. Terzer
Principal

Editor in Chief
CapVisor Associates, LLC