CapVisor Associates, LLC
Quarterly Newsletter

CapVisor Associates, LLC

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Inside This Issue

What's Ahead: Market Turmoil or Continued Stumbling Forward?

Are you prepared for the next liquidity crunch? Is it possible to expect that your portfolio manager will have the foresight to be the first to head to the exit doors sparing you the market value decline that all others will experience? Or, is it more realistic to think that there might be steps that you can take now to ensure that the damage is limited? Perhaps neither. First, a bit of backdrop to the situation we face in our markets going forward.

We are presently in the midst of a "market manipulation" unprecedented in recent memory, perhaps in history. We have experienced over six years of Fed liquidity injected through various QE programs resulting in historically low interest rates, with repression across the yield curve, and arguably, also causing inflated valuations in US equity markets. We have government bonds with negative "real"

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Economic Review

Welcome Back Ben

A voice we had not heard from for an extended period of time returned to market prominence recently. Former Fed Chairman Ben Bernanke recently began posting a blog for the Brookings Institution. His first two posts, "Why are interest rates so low?" and "Why are interest rates so low, part 2. Secular stagnation," received a lot of notice. Bernanke raises doubts about the "secular stagnation" hypothesis, arguing that low interest rates should eventually incentivize positive return projects somewhere in the world. However, Bernanke acknowledges that economic fundamentals portend a low "equilibrium" real interest rate requiring the Fed to continue its accommodative policy stance. Janet Yellen, the current Fed Chair, also delivered some dovish words recently in a speech entitled "Normalizing Monetary Policy: Prospects and Perspectives." Bernanke and Yellen's analyses combined with our own thoughts lead us to a conclusion about how the Fed is viewing the economy and when they will likely "make the move".

Assessing the Economic Situation

With its sixth birthday just a few months away, the current economic recovery is maturing but not running out of steam, in our opinion. Only in the past 12-18 months has the recovery begun to positively impact the middle and lower classes as a result of stronger job growth and improving home prices. Since World War II, the average recovery has increased to 58 months with the last three recoveries being the longest of the eleven recoveries by far. Recoveries end as a result of three kinds of excesses: major asset bubbles (house or equity prices), overexpansion of cyclical sectors (consumer leverage), and high inflation (the rapid rise of oil prices has caused several recessions). These risks are simply not present today. We believe the primary risks today are not to the upside through financial excesses or commodity shortages, but rather, to the downside through a stronger dollar and a premature move higher in interest rates by the Fed.

We believe the Fed has "threaded the needle"

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Economic Review

John Saf, CFA (28 years fixed income investment experience) is a Managing Director, Insurance Portfolio Manager for Oppenheimer Investment Management LLC. He is primarily responsible for Insurance portfolio management in addition to his research responsibilities for the Bank and Finance, Insurance and Municipal bond sectors. Prior to joining OIM, John was a Vice President and Portfolio Manager at 40|86 Advisors, Inc. He served as a co-portfolio manager for the Conseco insurance portfolios and primary manager for the non-affiliated insurance clients as well as performing and overseeing Asset Liability Management (ALM). He holds a B.S.B.A. from Drake University with majors in Actuarial Science and Accounting. He is a Fellow in the Life Management Institute, holds a Certified Public Accountant certificate and is a CFA charterholder.

"They (the Fed) should strictly adhere to their dual mandates of full employment and low inflation and continue to allow the economy to heal itself over time by staying out of the way of slow, but steady, progress."

exceedingly well since 2010. Employment conditions have steadily improved over time (see chart on page 3) and are nearing the 5.0% "full employment" target of the Fed. In addition, Core Personal Consumption Expenditures (Core PCE), the Fed's preferred inflation metric, remains well below the targeted 2%. This leads us to question the appropriateness of rate increases before the unemployment rate drops below 5% and Core PCE approaches 2%. We have previously written about forces constraining economic growth (demographics, deleveraging, low productivity growth, etc.). Now the significant fall in oil prices and strengthening dollar have added to the disinflationary forces at work. A stronger dollar makes domestically produced goods more expensive for global customers while making imports relatively cheaper for domestic customers. Annualized GDP has very gradually increased over the past 5 years, but by no means has the U.S. economy gotten overheated. First quarter 2015 GDP is tracking near 1% and payroll growth stumbled in March (payrolls grew 126K versus the survey of 245k). Although we believe some temporary factors (such as weather) negatively impacted momentum in Q1, we are not concerned that the economy is near the point of overheating or requires large rate increases by the Fed.

Source: Bureau of Labor Statistics

So when will the Fed raise the targeted Fed Funds rate of zero to 0.25%? Perhaps later this fall, but we would not be surprised if the start was pushed back to early 2016. We believe interest rates are low for a reason, and it is not because the Fed wants them to be low. There is a lack of compelling growth stories that need significant investment, not only in the U.S., but globally. Interest rates rise when companies demand capital to implement great ideas, not when they buy back shares. So what should the Fed do at this point? We believe they should remain patient. They should strictly adhere to their dual mandates of full employment and low inflation and continue to allow the economy to heal itself over time by staying out of the way of slow, but steady, progress.

Consumer Conundrum

We entered 2015 with reasonable optimism regarding consumer spending. Challenges that had held back spending in recent years, including deleveraging, tight credit conditions, and limited job growth appeared to be abating while consumer confidence accelerated throughout 2014 on wealth gains and lower gas prices. However, recent consumer spending data has been disappointing. Retail sales, excluding autos, gas and building materials, were essentially flat in the first quarter using quarter over quarter annualized data. Furthermore, personal consumption and job growth data demonstrated a similar slowdown this quarter after improving for much of 2014.

We believe the first quarter was at least partially impacted by weather and we will see improved consumer spending in the second quarter. Weakness in weather-sensitive components of the retail sales data, including restaurants and apparel, and the jobs data, including construction and hospitality, confirm this hypothesis. While demographics, a lack of global investment, underemployment and modest wage gains will continue to constrain growth below historical levels, we expect improved consumer spending trends as we move through 2015.

Fixed Income Market Liquidity

Over the past six months there has been much written and discussed regarding liquidity in the fixed income market. Large

Economic Review

Wall Street firms have likely reduced their inventory of bonds and trading for their own account. While this may impact mutual funds, ETFs and hedge funds, its impact on our client portfolios has been limited. In our opinion, our long-only, separate account and traditional fixed income management style provides greater flexibility and focus on names we select for our portfolios. In the secondary market, not only do we understand the underlying fundamentals of each credit we select, but we also evaluate the book runners who placed the offering, current holders of the bond, and market trading depth. Prior to purchasing any bond for our total return accounts, we check two-way trading flows and TRACE data. Additionally, our investment style is not conducive to mercurial investors, but rather longer term investors looking for a stable and consistent approach to wealth protection and creation.

Capital Markets and Performance

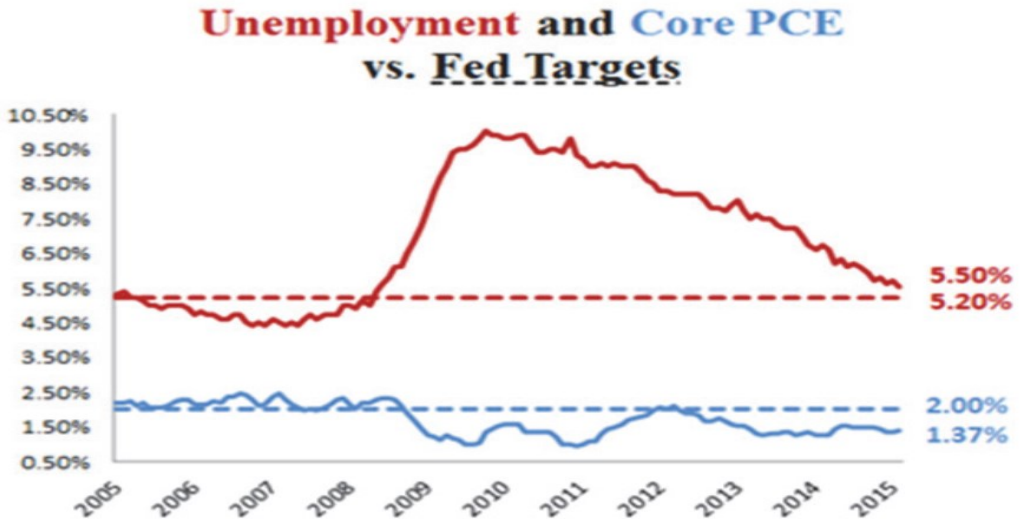
Once again the fixed income market witnessed declining interest rates during the first quarter. Volatility increased as U.S. economic data came in weaker and commentary from the Fed implied a rate increase on the horizon. This uncertainty caused U.S. Treasury securities to rally as the bellwether 10-year Treasury yield declined 24 basis points during the quarter to close with a yield of 1.92%. On the back of lower yields, the Barclays Capital U.S. Aggregate Index returned 1.61% for the quarter. Corporate securities performed best at 2.32% followed by Treasury securities with 1.64%. The Agency and mortgage-backed sectors continued to lag in performance with returns of 1.21% and 1.06%, respectively. High Yield performance, as measured by the BofA/Merrill Lynch High Yield Master II Index, returned 2.52% in the quarter as lower rated securities outperformed.

We are pleased to report that all of our investment grade composites outperformed their respective benchmarks during the first quarter of 2015 while our high yield composite reported the highest overall return of all the OIM portfolios for 1q15. We remain steadfast in keeping an eye toward the future and maintaining our long term investment mentality. Although the timing of interest rate movements remains uncertain, we will keep portfolio durations biased shorter than our respective benchmarks in anticipation of a drift higher in rates as the year progresses.

How we are positioning portfolios?

We remain focused on portfolio duration and credit. We plan to maintain our modest bias toward rising interest rates and favor corporate credit. While the credit sector will hit bumps in the road, as it did in the final quarter of 2014, we expect that long-term, patient investors will be rewarded. The U.S. economy has been improving. Clipping higher coupons provided by U.S. corporate bonds should result in superior portfolio performance over the long term. While market fluctuations can cause short-term underperformance, our long-only style of investing in fundamentally sound companies has delivered positive results with reduced volatility over the long term.

Source: Bureau of Labor Statistics



Adjusting Your Sails– Considering Covered Call Strategies

Stefan ten Brink, Managing Director joined the Firm in January 2011 from Petercam Asset Management in Amsterdam. He has 18 years of investment advisory experience, having co-managed the Ahold Pension Fund prior to joining Petercam. He has 15 years' experience with the HOLT framework. Stefan holds a degree in Logistics & Economics from Arnhem Business School and an MBA from Nijmegen University. Stefan is a Certified European Financial Analyst (CEFA).

"Over the last decade, as investors have sought opportunities to earn both consistent returns and income, covered calls have gained in popularity."

An Unprecedented Low Yield Environment Today's low yield environment has made it incredibly hard to find reliable sources of income without sacrificing quality. Treasury rates have been on a downward trend for 33 years, which has fueled an impressive bull market for bonds. Although the Fed seems committed to its low rate policy in the near term, most economists believe current levels are unsustainable over the long run. This certainly seems true based on the chart to the right. Of course, an increase in interest rates will almost certainly increase the volatility of bond portfolios and cut into investment returns. Diversifying risks will be more important than ever.

Balancing Risks & Return Low yielding investment grade bonds have pushed income-seeking investors out the risk curve in search of attractive yields. They inevitably end up in either high yield (junk) bonds with significant credit risk or in alternative income categories like REITs and MLPs, which carry full equity market exposure as well as interest rate exposure.

More and more investors are considering a high quality covered call portfolio in order to diversify their risks. Covered call strategies can offer investors income of 6-8% without taking significant credit risk (for example, the average credit rating of our covered call portfolio holding is AA, compared to single B for most high yield bond funds). And of course, a covered call portfolio can carry less market risk than long-only stocks. This balanced combination of income and price appreciation is shown below, compared to the other major asset classes.

Over the last decade, as investors have sought opportunities to earn both consistent returns and income, covered calls have gained in popularity. Institutional investors and investment advisors alike are embracing the strategy as part of a diversified equity allocation. However, as the market becomes more familiar with covered call strategies, investors continue to gain an understanding of the nuances between approaches.

History of Covered Calls Over 10 years ago the Chicago Board of Options Exchange (CBOE) and Standard & Poor's (S&P) created the standard for covered call benchmarks known as the CBOE S&P 500 Buy-Write Index (BXM). The BXM Index is designed to track the performance of a hypothetical buy-write strategy on the S&P 500 Index (for more info, see www.cboe.com/micro/bxm/introduction.aspx). Several high-profile studies have helped to bring covered calls to the forefront of equity allocation discussions as well.

The CBOE website references three studies in particular from the past 10 years that look at the risk-return dynamics of covered calls. All three firms conducting these studies (Callan Associates, Ibbotson, and Asset Consulting Group) concluded that a passive buy-write strategy has a superior risk-return profile over long-only equities, achieving similar long term returns at significantly lower risk. And while a passive buy-write strategy (index replication)

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indeed has solid relative characteristics, an active buy-write strategy has the potential to further improve the outcome. Yet the active application of buy-write strategies can differ significantly in both process and outcome. In short, not all covered call strategies are created equal.

The Nuance of Covered Call Investing

Most simply defined, a covered call position is the ownership of equity shares of a corporation whereby the owner then offers to sell his shares to another investor at a higher price in the future. For this offer, the owner receives income from the call option buyer. At Van Hulzen, we believe that a covered call strategy is inherently an equity strategy (but with an advantaged risk profile) which by default should require a diligent investment manager to be proficient in fundamental analysis. It is for this reason that we designed our investment process around disciplined cash flow fundamentals. Our first priority is to construct a high quality equity portfolio. We turn to the option market as our *second* step, in order to add incremental yield and downside protection.

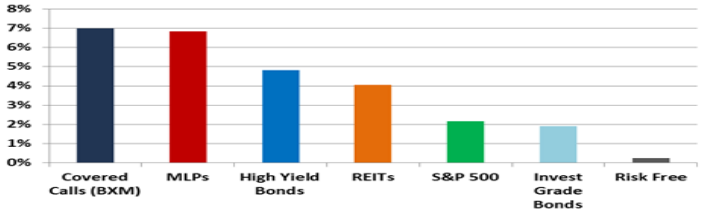
However, most covered call strategies are designed to primarily focus on the collection of call option premiums and to derive their alpha solely from the implied volatility embedded in the option price. These types of strategies generally include theta capture, over-writing, beta-seeking, and leveraged players. As a result, the manager's core competency in these strategies tends to be in the modeling of implied volatility versus actual volatility, not in whole or in part in fundamental equity analysis. The inherent challenge we see in these strategies is that they seek to profit from a portfolio constructed on option-based inputs and generally fall apart in periods of distress and market declines.

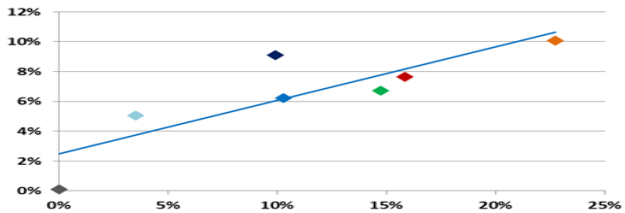
Index replication studies show the value of including covered calls in an equity allocation. Active managers who focus on a strong fundamental process can extend that value further and even improve it. But beware the option-based volatility strategies calling themselves covered calls: They might be better suited to limited partnerships and option derivatives.

Covered call investors typically fall into two groups:

Equity investors: Because equities are the highest returning asset class, most investors see them as an important allocation. However, with the market at new highs, the outlook is more uncertain and volatile than ever. Covered calls are a nice way to stay invested in equities but to take a more cautious approach by focusing on income and downside risk management. The call premiums received in a covered call strategy supplement the dividend income, and increase total portfolio yield dramatically. These strategies are a good way to meet long term goals and sleep a little better at night during market pullbacks.

Fixed income investors: Today's low yield environment has made it incredibly hard to find reliable sources of income without sacrificing quality. And on top of that, interest rates stand poised to rise over the near to intermediate term, which will almost certainly increase the volatility and cut into the returns of this asset class (as we saw in 2013). With treasury yields at all-time lows and investment grade corporate bonds yielding 2-4% compared to their historic range of 4-7%, income-seeking investors are having to move out the risk curve to find attractive yields. They inevitably end up in either high yield (junk) bonds with significant credit risk or in alternative income categories like REITs and MLPs, which carry fully equity market exposure as well as interest rate exposure. A high quality covered call port-





High Yield Bonds represented by the IBOXX HY Index, Investment grade bond represented by Barclays U.S. Aggregate Bond Index, Long only stock represented by the S&P 500 index, Hedge Fund index represented by the Credit Suisse Hedge Fund Index. Source: Bloomberg, Inception date: 12/31/2001. Each of these asset classes has its own set of investment characteristics and risks and investors should consider these risks carefully prior to making any investments. Past performance is no guarantee of future performance. The referenced indices are shown for general market comparisons and are not meant to represent the strategy.

"How can insurance companies and their investment managers prepare for a rising rate environment?"

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yields, junk bonds with ultra-low yields and US stock prices that are at or near record levels, without the fundamentals and economic strength to support such valuations.

The Fed has warned the market that interest rate increases are imminent. However, their predictions of robust US economic growth resulting from QE have not been realized and their forward projections of growth have proven to be consistently too optimistic. With the conflicting economic data over the past few quarters, the Fed's timetable for rate increases has been backsliding. Current thinking is that September or perhaps even later this year rates might rise and most expect the rise to be incremental rather than drastic.

How can insurance companies and their investment managers prepare for a rising rate environment? This question can best be answered by looking into our crystal ball to determine if/when rates rise, at what speed and at what magnitude will these anticipated interest adjustments occur. Bond issuance by companies is at or near record levels as evidenced by the anticipation of rising interest rates. In essence, companies are selling bonds like madmen to take advantage of "cheap money" which will soon no longer be available. This behavior is indicative of a group that feels fairly certain that rates will rise fairly soon and perhaps rather sharply. On the other side of the coin, many bond managers interpret the very same signals as a forecast that while rates will rise, it is entirely possible that rates will stay low, from a historical perspective, for an extended period going forward. Of course, these groups' perspectives are different. Investment managers are concerned with beating the market. The definition of this is simply that when rates go up and the entire market takes a beating, these managers just merely need to have lower market value losses than the

Daily Treasury Real Yield Curve Rates

http://www.treasury.gov/resource-center/data-chart-center/interest-rates/Pages/TextView.aspx?data=realyield

DATE	5 YR	7 YR	10 YR	20 YR	30 YR
04/01/15	-0.26	-0.04	0.07	0.39	0.60

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index or other general measurements of the bond market. Our view is that the Fed would be most prudent in rising rates slowly, and with pauses, allowing the markets time to adjust and enabling the Fed to assess the impact on economic growth before proceeding with future increases. We might expect a period of several years with below historical average rates to continue. Of course, macro conditions including global economic and political factors will also impact such decisions.

As we prepare to address how insurers might react to anticipated changes, let us first review simple bond market dynamics. As many readers know, interest rate risk for bond portfolios is typically measured by duration. Without getting into all the technical details of the various formulas and types of duration that are measured, suffice it to say that duration measures interest rate risk sensitivity of a security, or in aggregate, of a portfolio. For example, a bond portfolio with the duration of four years, would be expected to have a market value movement of approximately 4% for every 1% change in interest rates. With interest rates expected to go up, bond market values will correspondingly go down. Most long-time institutional investors have an appreciation for this fundamental principle that bond yields and bond prices are inversely related. However, since we have had a 30 year bull market in bonds, over which time they have generally been decreasing, a long memory is required to fully appreciate the potential pain awaiting the unaware.

Some institutional investment professionals might be tempted to suggest that insurers continue to tilt their allocations towards riskier assets such as convertible or high-yield bonds, equities or alternatives to enhance total return as well as a method for increasing current income, in some cases. While these strategies may have been a necessity over this extended period of low rates, caution must be exercised to determine whether this strategy will remain advantageous during the period of interest rate increases.

Insurance Asset Management professionals know that their clients have business operational considerations, shorter investment time horizons and possible tax sensitivity to consider unlike other institutional investors. We err on the side of caution.

For example, equity markets are currently trading at or near historical record levels. Many economists or investment professionals believe that the low interest-rate environment has forced capital into the equity markets raising prices without sufficient support of fundamentals to justify those lofty prices. Nor do we see robust economic growth generally required to support a booming stock market. There is much hand-wringing on Wall Street as to whether this US bull market in equities can continue, albeit at a slower rate, or whether a crash or retrenchment is in order and perhaps imminent.

While diversification is the best defense against market volatility, other "risk" asset classes have experienced similar robust inflows over the past several years calling valuations into question. We caution insurers that unless enterprise –wide risk analysis has analytically determined the appropriate level of such investment allocations, de-risking might be a prudent consideration as we approach an inflection point in rates and/or a turning point in the bull market for stocks.

Summary

With near certainty that bond markets will face difficulties ahead and a probability that equity values, currently perilously high, have an increasing chance of a correction or crash, where can insurers protect their portfolios and ensure their financial stability? Prudence and conservatism in the insurance industry has served it well over the years not only because it is regulatory constrained, but also because insurance executives appreciate that this chosen approach to the markets assures financial stability, claims paying ability and ultimately, solvency. With risks seemingly high in areas that historically have not been highly correlated it is confusing to know how and where to prudently and conservatively invest new funds or reallocate existing funds. Our advice is simple, insurance companies must take a long-term view and position their portfolios strategically over this extended time horizon. Of course, there needs to be tactical changes made to accommodate expected market conditions along a long-term path. In this context we believe that overall strategic asset allocations should not be altered, notwithstanding the current situation that we face in the markets today. However, from a tactical standpoint de-risking a bit may make sense for cautious firms that might be more financially susceptible to market volatility or oth

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folio can offer investors income of 8-10% while also significantly reducing market exposure. Combining one of these strategies with a high quality, short duration bond ladder (3-4 year duration, for example) can further reduce volatility and provide a weighted average portfolio yield of approximately 5-7%.

Covered Calls in Summary Wherever you stand as an investor, the consideration for a covered call strategy is both widely researched and supported. The current market environment has brought such strategies ever more into the spotlight as a potential solution for income seeking, risk conscious investors. As the saying goes, "The pessimist complains about the wind; the optimist expects it to change; the realist adjusts the sails." How are you adjusting your sails?

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erwise have lower risk tolerance. It is more imperative for insurers that may have been tempted to "chase yield" over the past few years. For example, lightening up on bond credit risk and certainly lowering duration risk are good starting points for bond portfolios. Perhaps reducing potential equity volatility can be accomplished through reallocating from small and mid-cap equities into large cap names offering more price stability and dividend income to offset market value decreases. Retreating slightly from global equity exposures might make sense given the fact of Euroland's and many South East Asian countries difficulties. US markets still appear to be the cleanest of the dirty shirts. Companies that have the wherewithal to weather stormy markets ahead, minor reallocations rather than drastic measures are advised. In all cases, diversification is your best defense.

For better or worse regarding interest rate predictions, bonds are still the place to be for insurers seeking to provide a solid foundation for claims paying ability. Managing duration through an interest rate increase will be critical while balancing income requirements.

Upcoming Events

CapVisor will be exhibiting at the VCIA Annual Conference August 11-13 in Burlington at the Sheraton. Please stop by booth #49 on level 1 to say hello!

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