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Cycle and Inflection Points

Everything seems to move in cycles: the economy, the stock market, the bond market…most things in nature and nearly all things in investing. Therefore, understanding those cycles and trying to identify signs of possible inflection points is a worthy pursuit.

No doubt you have read that we are in the midst of a historically long bull market cycle in US stocks. You will also recall that the bond market recently completed a 30-year cycle, one of generally decreasing interest rates, in December of 2015. That was the time of the Fed's first rate increase in which rates moved from a prolonged period at zero. This event signaled an inflection point from a decreasing interest rate cycle to an increasing rate cycle. As mentioned, even the overall US economy moves in cycles. Since the 2008-09 recession, we have experienced a long slow growth cycle. Spotting the inflection points of past cycles is easy; how to spot inflection points that lie ahead is not so easy.

Most security values, and corresponding cycles, are dependent upon general economic circumstances and so the economy will serve as a good starting point. As you may know, Gross Domestic

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Economic Review

1Q19 Insurance Portfolio Review and Outlook, April 2019

- The Federal Reserve Board (Fed) bowed to pressure from frozen credit markets, weak economic data, and Executive tweets to put rate hikes on hold which soothed the markets and continued the recovery rally.
- Intermediate credit spreads recovered 39 of the 48 bps widening in 4Q18 that drove credit securities to their worst quarterly performance since 2008.
- First quarter earnings are lower as expected, but not a disaster.

Fed performs about-face and hits the pause button

Despite the longest economic expansion in U.S. history and the lowest unemployment rate in 49 years, the equity and credit market disruption in December threatened to end the cycle. When the FOMC raised their Fed Funds target 25 bps and guided toward two more raises in 2019 on December 19th, it confirmed market suspicions that the Fed was ignoring signs of softening worldwide economies and they would keep tightening monetary conditions until something broke as they had it the past. The equity market responded by dropping almost 7% over three trading sessions before recovering modestly to end December, but not enough to avoid a loss for the year.

After the biggest ISM manufacturing drop since 2008, led by a 10 point drop in new orders on January 3rd, the Fed took notice. The following day chairman Jay Powell said that muted inflation readings now allowed the Fed to be "patient." At the next meeting on January 30th they hit the pause button with both hands. Not only did they remove the language that "some further gradual increases" would still be necessary going forward, but they also indicated that they only intend to shrink their balance sheet to a level where "active management of the supply of reserves is not required." Ending quantitative tightening (QT) later this year leaves the Fed's balance sheet only modestly smaller than when QT began. The March 20th meeting provided additional detail that the Fed intends to end quantitative tightening in September, at which point they will maintain the size of the balance sheet, though they will allow the mortgage-backed securities to continue to pay down until they own 100% Treasuries as they did pre-crisis.

Our old favorite graph of the Fed Funds Rate, Fed Balance Sheet and VIX show the December market volatility spike was not abnormally large in the context of prior disruptions, but given the delayed impact of rate increases working their way through the economy it made sense for the Fed to let the economy and the markets catch their breath and digest the stream of nine rate increases since we flat-lined at zero percent for seven years.

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Economic Review

John SAF, CFA
Vice President, Co-Portfolio Manager
John Saf contributes 25 years of investment industry experience. Prior to joining Calamos in 2017, he served as a managing director and portfolio manager at Oppenheimer Investment Management (2006-2017). In this role, he was responsible for nearly $1 billion in assets, including insurance portfolios. From 1995-2006, John served at 40|86 Advisors (formerly Conseco Capital Management), where he held a variety of positions, including fixed income portfolio manager, where he co-managed more than $25 billion in insurance portfolios and had responsible for asset allocation decisions. He also served as a credit research analyst and as Director of Asset Liability Management. Earlier in his career, he worked at American Life and Casualty and at Ernst and Young. He holds a BSBA from Drake University, with a joint major in actuarial science and accounting. In addition to being a CFA charterholder and Certified Public Accountant (inactive), John is a Fellow in the Life Management Institute.

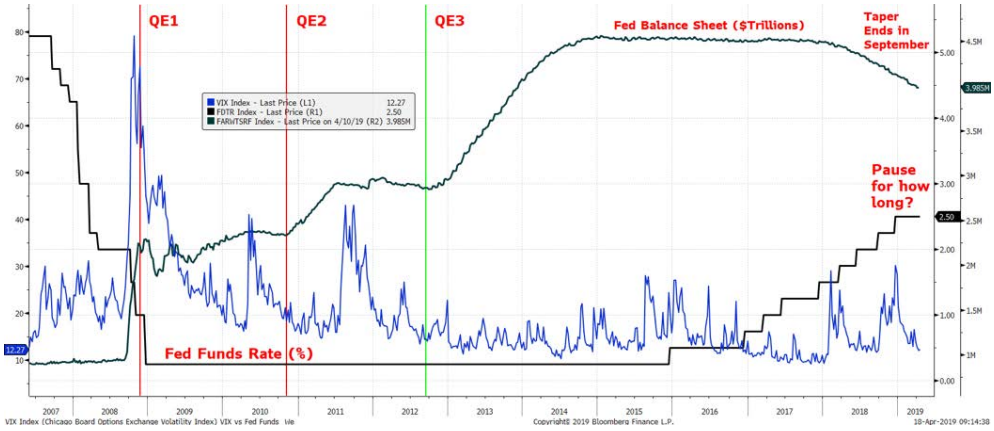
As we concluded in January, the fourth quarter panic was "an overreaction, not a prelude to a recession." High yield and investment grade credit spreads have almost completely retraced the fourth quarter blow-out, as did the VIX equity volatility index.

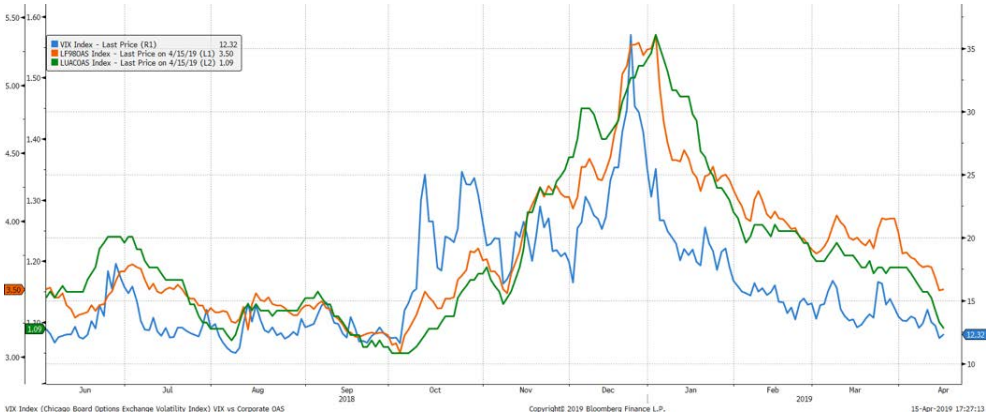
Where do we go from here?

The Fed's stance has changed substantially since October when Federal Reserve Chairman Jerome Powell stated interest rates are a "long way from neutral." The question now is whether they will continue raising interest rates later or whether the next move is a rate cut and we are done with this tightening cycle.

FED POLICY MONITOR: FED FUNDS RATE, BALANCE SHEET & VIX

Past performance is no guarantee of future results. Source: Bloomberg





The current consensus for 1Q19 GDP quarter over quarter growth is 1.8%. While this is less than every quarter in 2018, it is still positive growth despite: the federal government shutdown from December 22, 2018 to January 25, 2019; continuing trade war tensions with China; and terrible winter weather with record low temperatures.

The first quarter of every year has produced the lowest growth for the past three years in a row, 7 out of the past 10 years, and 9 out of the last 15 years – see table below. It is reasonable to expect growth and possibly inflation to pick-up the rest of 2019 given the established seasonal pattern and the impact of Chinese stimulus taking effect.

In an over-reaction to the Fed's pause treasury yields dropped 20 to 25 basis points beyond twelve month maturities leading to a curve inversion between 1 and 10 year maturities. The 10 year Treasury yield has collapsed from 3.25% in November to under 2.40% in late March. Some of the drop was due to the gravitational pull of stubbornly-low European sovereign rates, but it also reflected the Fed's perceived new stance. At one point during the quarter Fed Funds futures predicted up to two interest rate cuts in the next 12 months.

The inverted yield curve is showing pressure on the economy, but not the commencement of a recession. The Fed's course should be very data dependent. Given the announced cessation of balance sheet run-off in September, the next interest rate move is also likely to come in the fourth quarter or later. Since we expect U.S. and global growth to rebound from the first quarter, we do not

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VIX, HIGH YIELD & INVESTMENT GRADE OAS

Past performance is no guarantee of future results. Source: Bloomberg

Economic Review

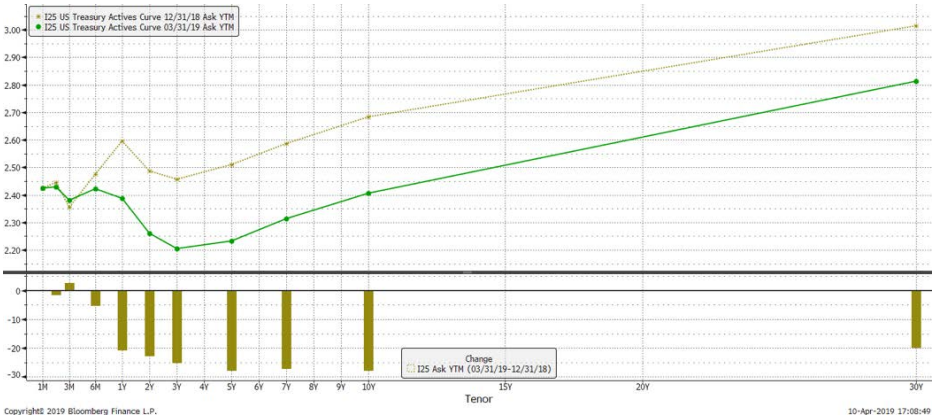
SEASONALITY OF U.S. GDP OVER THE PAST 15 YEARS

Past performance is no guarantee of future results. Source: Bloomberg Finance L.P.

	2004	2005	2006	2007	2008	2009	2010	2011	2012	2013	2014	2015	2016	2017	2018
1Q	2.2	4.5	5.4	0.9	(2.3)	(4.4)	1.5	(1.0)	3.2	3.6	(1.0)	3.3	1.5	1.8	2.2
2Q	3.1	1.9	0.9	2.3	2.1	(0.6)	3.7	2.9	1.7	0.5	5.1	3.3	2.3	3.0	4.2
3Q	3.8	3.6	0.6	2.2	(2.1)	1.5	3.0	(0.1)	0.5	3.2	4.9	1.0	1.9	2.8	3.4
4Q	4.1	2.6	3.5	2.5	(8.4)	4.5	2.0	4.7	0.5	3.2	1.9	0.4	1.8	2.3	2.6

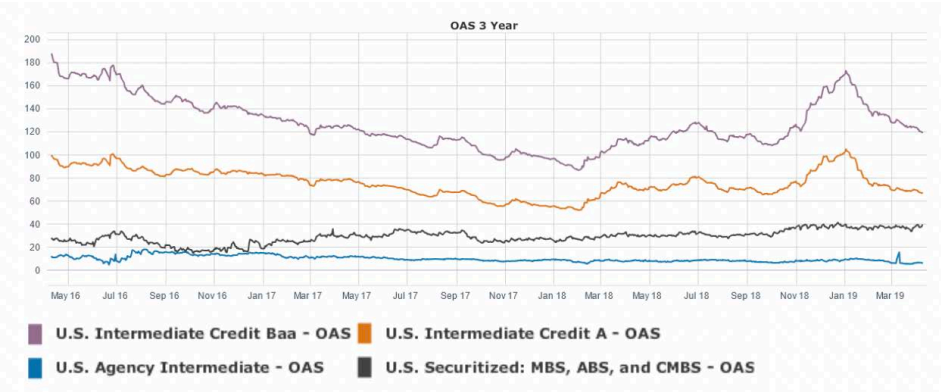
TREASURY YIELD CURVE MOVEMENT DURING THE QUARTER

Past performance is no guarantee of future results. Source: Bloomberg



3 YEAR HISTORY OF OPTION-ADJUSTED SPREADS (OAS)

Past performance is no guarantee of future results. Source: Barclays Live - Chart.



expect a rate cut in 2019, but another hike will only come after a clear resumption of growth trends.

1Q19 Performance

Corporate securities were the best performing sector in the Bloomberg Barclays Intermediate U.S. Aggregate Index for the first quarter after recovering from their worst quarterly performance since 2008 during the 4Q18 risk-off panic. Intermediate Corporate produced 210 bps of excess returns, followed by Government Agencies, Securitized (MBS, ABS and CMBS), and Treasuries with quarterly excess returns of 60 bps, 34 bps and zero bps over duration-matched Treasuries, respectively. The yield-to-worst of the Bloomberg Barclays Intermediate U.S. Aggregate Index decreased from 3.13% to 2.78%.

The Bloomberg Barclays Municipal 1-10 Year Blend Index's 1Q19 total return of 221 bps (approximately 230 bps after tax gross-up) performed in line with the Bloomberg Barclays Intermediate U.S. Aggregate Index's total return of 228 bps, which has about the same duration.

Investment Strategy

Given the uncertainty around the future of interest rates and yield curve shape, we are targeting portfolio duration between one-quarter year short and neutral with the performance benchmark's duration. We are also using the Bloomberg Portfolio & Risk analytics solution, PORT, to monitor and reduce key-rate duration differences with the benchmark to minimize performance disruption from changing curve shape. Our strategy has always sought to minimize interest rate bets and focus on asset allocation and security selection to attempt to outperform our benchmarks. We are even more committed to this strategy to avoid future performance volatility relative to the benchmark. We continue to sell our longer maturity floating rate coupon securities and buy fixed coupon bonds where it makes sense.

We continue to enjoy extra yield from our credit exposure overweight, but we will modestly underweight BBB exposure and take advantage of the relatively flat yield

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Economic Review

curve to keep our BBBs in shorter maturities until we get better clarity on corporate earnings. Although we do not expect a recession in the next 12 to 18 months since the Fed took their foot off the brake, we think it is prudent to build a defensive stance by restricting more illiquid or cyclical holdings to maturities under five years and gradually increasing overall portfolio credit quality.

Securitized (MBS, ABS and CMBS) fixed income was the worst performing intermediate sector in 1Q19 and during the 15 months since the tax law change. While we modestly increased our securitized exposure to maintain portfolio credit quality when selling tax-exempt municipals we will continue to underweight MBS going forward, especially since the Fed intends to let their mortgage holdings run-off and privatization efforts for Fannie Mae and Freddie Mac may increase volatility.

Finally, intermediate tax-exempt municipal bonds have significantly outperformed all other intermediate investment grade categories since the tax law change in 2018, except for taxable municipal bonds, even when applying the new tax rate adjustment factor. We used the rally to swap (sell, then buy) into taxable municipals and other taxable asset classes to improve after-tax portfolio returns. Portfolio tax-exempt weightings are now 6 to 15%, compared to 35 to 40% when we entered 2018. We will continue using our relative value framework to swap tax-exempts where appropriate. ☐

Cycle and Inflection Points

Product (GDP), is the most common measure of economic health. Currently, the hard data imbedded in "economic indicators" say that the economy is healthy. GDP growth rate projections are expected to remain between the 2% to 3% this year and perhaps into next: an ideal range. Unemployment is forecast to continue at historical lows. Notwithstanding the low unemployment, we expect neither inflation nor deflation risks in the near horizon. In summary, our current conditions are often described by what is known as the goldilocks economy: conditions are not too hot and not too cold.

However, things are never all good or all bad. Are there risks present for a cycle change now? Yes. These factors include potential changes in supply, demand, capital availability, and the market's perception of the economic future. We closely watch these factors for indications that we are moving from a GDP, or economic, growth cycle towards a recession or economic contraction. We also look for indications as to market responses, such as a bull market cycle switching to a bear cycle. In addition to hard economic and market data, sentiment plays a key role in the economy's and market's behavior. Market sentiment is a bit of a wild card that can be, and often is, influenced by non-economic and non-market events.

Non-economic and non-market related factors can also be almost solely responsible for a change in the economic/business cycle. For example, President Trump has a politically-motivated target of a 4% economic growth rate. That may be faster than is healthy and can lead to overconfidence and excesses that accompany such an environment. The "boom" conditions can lead to a damaging "bust". We also see an expensive US stock market. Valuations (P/E) are once again historically high in part due to the Q1 2019 rebound. This was all primarily due to Fed monetary policy changes, i.e. politics. Global socio-political conditions, such as relationships with Iran, Russia and North Korea as well as economic stability of "Euroland", et.al., are all wild card factors with implications for US economy. The much-discussed trade war between the US and China is center stage amongst these threatening factors. Any adverse developments, in any of these issues, may serve as the catalyst for a change in both the economic and market cycles. The outcome, especially an unexpected outcome, of these types of influential events can quickly change sentiment, as well as significantly affect key economic indicators.

> **"Currently, the Fed doesn't expect to increase interest rates for the foreseeable future. A rising rate cycle abruptly abandoned!"**

With a presumed continuance of steadiness in these extraneous factors, the hard data continues to look good. The most recent forecast from the Federal Open Market Committee

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Cycle and Inflection Points

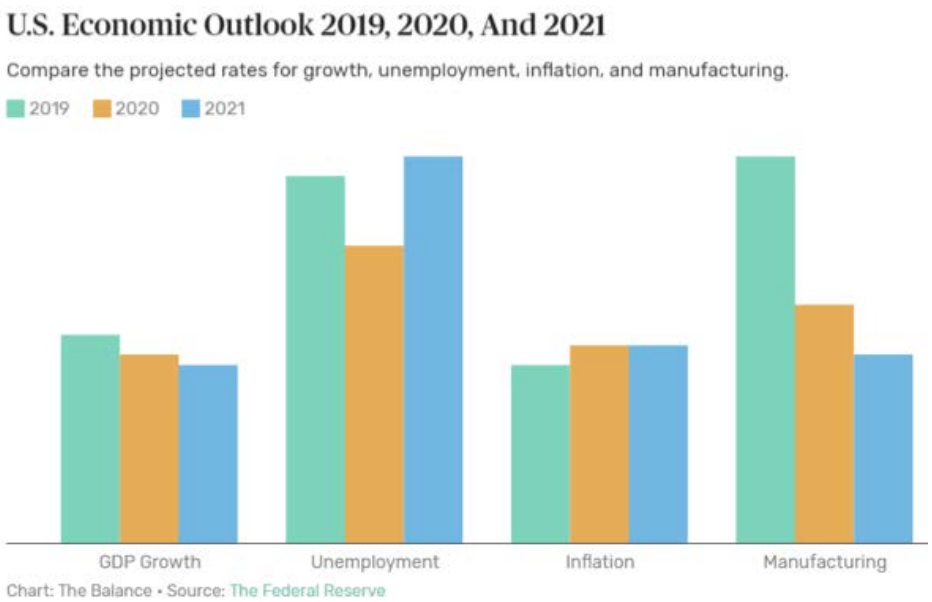
meeting (March 21, 2019) projects that U.S. GDP growth is expected to slow from 3% in 2018 to 2.1% in 2019, 1.9% in 2020 and 1.8% in 2021. That's good news as it means continued economic progress, albeit slower, with no recession foreseen.

Another key indicator supporting these projections are unemployment rate expectations. The current projected unemployment rate is 3.7% for 2019, with only a slight increase in 2020 and 2021 of 3.8% and 3.9% respectively. Some argue that the real unemployment rate, factoring in the part-time employed who seek full time employment, is about double the widely-reported rate. However, US workers continue to reenter the labor force amid cyclically low unemployment rates. Tight labor markets have spurred accelerating wage growth, which is typical during late cycle and provides support to US consumer spending.

In spite of accelerating wage growth, inflation is expected to remain well under control. Projections are 1.8% in 2019 and 2% for 2020 and 2021. Since the Fed closely watches inflation to cue Fed fund rate changes, there may only be a small impetus for any future rate increases. If the economy faulters, the market expects that rates could actually come down again, perhaps as early as later this year.

However, more good news can be found in the U.S. manufacturing forecast. Expectations are for increased capital growth to be faster than the general economy with higher exports which will boost manufacturing. Predicted production growth rates are 3.9% in 2019 with a slowing to 2.4% and 1.9% in 2020 and 2021, respectively.

In summary, the US economy is strong for now for the near future. However, it is firmly in a late cycle stage while at low near-term risk of recession. Global growth remains positive but has become more uneven, and many major economies have progressed toward more advanced stages of the business cycle.



Market Cycles - Bonds

As most investors know, the bond market is most heavily influenced by credit-worthiness and interest rates. Therefore, the strength of the economy and the Fed's interest rate policies are closely watched indicators for the bond market outlook. Investment professionals will often refer to the credit or interest rate cycles as these are derivations of larger cycles.

The last time the Fed steadily raised rates was for a short period starting in 2005. It proved to be an important factor in helping to cause the subprime mortgage crisis which in turn, cast the economy into the great recession. Does history repeat itself? The Federal Open Market Committee raised the current fed funds rate to 2.5% on December 19, 2018 following a short but steady period of raising rates. In December, they also signaled that interest rates had a way to go before reaching neutrality, a point at which rates neither speed nor slow the economy. In fact, their expectation was for 2 more increases in 2019 and one more in early 2020. Spooked by the market's 4th quarter 2018 reaction, and the history lesson learned, it was not too surprising to witness the January 2019 about-face in Fed policy. Currently, the Fed doesn't expect to increase interest rates for the foreseeable future. A rising rate cycle abruptly abandoned!

Portfolio Impacts

For insurance bond portfolios, this is generally good news. It means that the market value damage done to portfolios in rising rate environments has ended for the time being. However, it also means that bond returns, after ten years of low returns, will be lower than historical levels

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Cycle and Inflection Points

for a while longer. The discontinuance of rate increases also served to provide some relief to the yield curve inversion which happened in December. The normally upward sloping yield curve developed an inversion in which shorter maturity bonds paid higher rates than some longer maturity bonds.

This is a nonsensical situation since investors typically demand higher rates as compensation for the additional risks embedded in longer maturity bonds. Inflation is one of these key risk factors, and with low inflation expectations, the yield curve is unusually flat. This flatness does not allow for a large margin of error for the Fed in setting rate policy. They risk inverting the curve by raising short term rates too high, too fast, while the long maturity end of the curve does not move much, if at all. The inverted curve has been a fairly accurate predictor of recessions which typically follow the inversion by several months. The bottom line is that the Fed's new stance should provide some stability for the outlook for bond portfolios.

Key Takeaways

- US is firmly in the late-cycle economic phase, though near-term recession risk remains low.
- Global as well as US economic growth is slowing
- Dovish Fed rate policy shift will help propel economic growth onward.
- Recession appears at bay for the next several quarters
- Bonds portfolios should experience stable positive returns

In our next newsletter, we will focus on the US stock market, and its cycle, within an updated economic outlook. ☐

2018 Review on Active Management

Berlinda Liu, CFA, is Director, Global Research & Design, at S&P Dow Jones Indices. She is responsible for quantitative research & design covering volatility, commodity, and other derivative-based indices and strategies. Berlinda joined S&P in December 2007. Prior to S&P, she was an equity derivatives strategist at both Bear Stearns, London, and Credit Suisse, New York, where she joined as a business analyst. Berlinda is a CFA charter holder. She holds a bachelor's degree in international business management from Wuhan University of China, a master's degree in information system management from Carnegie Mellon University, in addition to her master's in computational finance from Carnegie Mellon.

2018 was a rollercoaster ride for financial markets. The S&P 500® (-4.38%) finished 2018 with its first calendar-year loss in a decade, while the S&P MidCap 400® (-11.08%) and the S&P SmallCap 600® (-8.48%) also fell. The volatile domestic stock market turned out to be even more challenging to active managers, as our reports demonstrated.

Contrary to the myth that active managers tend to fare better than their benchmarks during volatile markets, evidence from the SPIVA U.S. Year-End 2018 Scorecard puts a question mark over the ability of active managers to generate alpha during market turmoil: 68.83% of domestic equity funds lagged the S&P Composite 1500® during the one-year period ending Dec. 31, 2018, making **2018 the fourth-*worst* year for active U.S. equity managers since 2001** (see Exhibit 1).

For the ninth consecutive year, the majority (64.49%) of large-cap funds underperformed the S&P 500. Similarly, small-cap equity managers found it more

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2018 Review on Active Management

challenging to navigate 2018's market environment compared with 2017's range-bound market movements; 68.45% of all small-cap funds lagged the S&P SmallCap 600 over the one-year horizon. Mid-cap mutual funds fared better; for the second consecutive year, the majority (54.36%) beat the S&P MidCap 400. Over the fifteen-year investment horizon, however, 80% or more of active managers across all categories underperformed their respective benchmarks.

In 2018, active managers contitued facing enormous challenge of beating the benchmarks consistently. As shown in Exhibit 3, only 27.38% (or 298) of the 1,089 large-cap funds that existed in the universe as of September 30, 2015 outperformed the S&P 500® in the previous three years. During the following year, 9.38% of those winners beat the benchmark. And by the end of September 2018, only 2.73% of the 298 winners were able to maintain that status for three consecutive years. Aside from the real estate category, where additional factors such as benchmark mismatch may have contributed to higher persistance, we observe little to no evidence of performance persistence among active managers.

It is equally challenging for active managers to consistently stay at the top among his fellow active managers. Out of 550 domestic equity funds that were in the top quartile as of September 2016, only 7.09% managed to stay in the top quartile at the end of September 2018 (2.33% as of March 2018). Furthermore, 6.60% (0.93%) of large-cap funds, 3.95% (0%) of mid-cap funds, and 7.69% (3.85%) of small-cap funds remained in the top quartile (Exhibit 4).

Performance of active managers in 2018 dismissed the long-held myth of active

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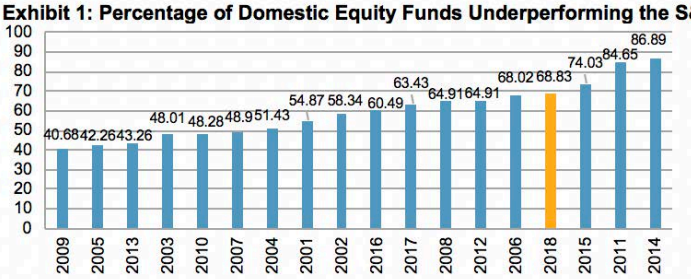
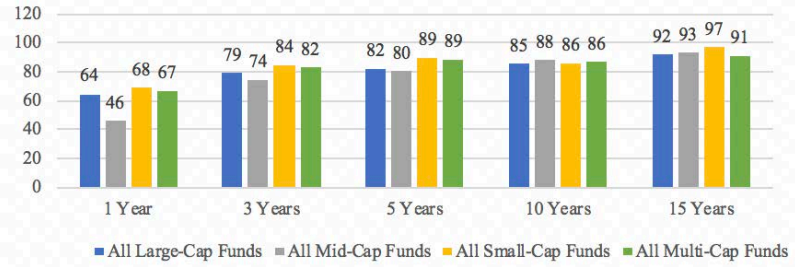
Exhibit 1: Percentage of Domestic Equity Funds Underperforming the S&P Composite 1500



Source: S&P Dow Jones Indices LLC. Data as of Dec. 31, 2018. Past performance is no guarantee of future results. Chart is provided for illustrative purposes.

Exhibit 2: Percentage of Domestic Equity Funds Underperforming by Benchmarks



Source: S&P Dow Jones Indices LLC. Data as of Dec. 31, 2018. Past performance is no guarantee of future results. Chart is provided for illustrative purposes.

Exhibit 3: Outperformance Persistence Over Three Consecutive Years

FUND CATEGORY	BENCHMARK	TOTAL NUMBER OF FUNDS	NUMBER OF FUNDS OUTPERFORMING THE BENCHMARK	PERCENTAGE OF FUNDS OUTPERFORMING THE BENCHMARK	PERCENTAGE OUTPERFORMING THE BENCHMARK (PERIOD END)		
			SEPT. 30, 2015		SEPT. 30, 2016	SEPT. 30, 2017	SEPT. 30, 2018
All Domestic	S&P Composite 1500®	2702	759	28.10	12.81	6.40	3.06
All Large-Cap	S&P 500	1089	298	27.38	9.38	6.64	2.73
All Mid-Cap	S&P MidCap 400®	416	123	29.55	11.54	4.81	0.96
All Small-Cap	S&P SmallCap 600®	610	101	16.64	7.78	3.33	2.22
All Multi-Cap	S&P Composite 1500	740	217	29.34	9.94	3.87	2.21

Source: S&P Dow Jones Indices LLC and CRSP. Data as of Sept. 30, 2018. Past performance is no guarantee of future results. Table is provided for illustrative purposes.

Exhibit 4: Performance Persistence of Domestic Equity Funds Over Three Consecutive 12-Month Periods

MUTUAL FUND CATEGORY	FUND COUNT AT START (SEPTEMBER 2016)	PERCENTAGE REMAINING IN TOP QUARTILE	
		SEPTEMBER 2017	SEPTEMBER 2018
TOP QUARTILE			
All Domestic Funds	550	21.09	7.09
All Large-Cap Funds	212	14.15	6.60
All Mid-Cap Funds	76	23.68	3.95
All Small-Cap Funds	130	32.31	7.69
All Multi-Cap Funds	132	21.21	9.85
MUTUAL FUND CATEGORY	**FUND COUNT AT START (SEPTEMBER 2016)**	**PERCENTAGE REMAINING IN TOP HALF**	
		SEPTEMBER 2017	**SEPTEMBER 2018**
TOP HALF			
All Domestic Funds	1099	46.31	25.20
All Large-Cap Funds	423	40.19	23.64
All Mid-Cap Funds	152	39.47	21.71
All Small-Cap Funds	260	47.31	20.00
All Multi-Cap Funds	264	42.80	25.38

Source: S&P Dow Jones Indices LLC, CRSP. Data as of Sept. 30, 2018. Table is provided for illustrative purposes. Past performance is no guarantee of future results.

2018 Review on Active Management

managers' superior performance over passive strategies in market turmoil. It did not help active managers to beat their benchmarks or stay on top of their peers, according to our research. Our study continues to show a lack of long-term perfromance persistence among actively managed mutual funds.

S&P Active vs. Passive Reports

The SPIVA U.S. Scorecard measures the percentage of active managers that beat their benchmarks across various equity and fixed income categories. It has served as the de facto scorekeeper of the active versus passive debate since its first publication in 2002.

The Persistence Scorecard shows the likelihood that a top quartile manager remains its status in subsequent periods. The Fleeting Alpha report studies the degree to which outperforming funds from one period continue to beat their benchmarks thereafter. These two reports provide statistics to evaluate long-term performance persistence among actively managed mutual funds. ☐

Upcoming Events

1. CapVisor is a sponsor for the 2019 Strategic Risk Solutions Symposium at the Loews Hotel in Chicago May 28-30. Carl is speaking at a Captive 101 Session on Tuesday May 28 so please say hi to Carl!

2. CapVisor will be exhibiting at the IASA Annual Educational Conference & Business Show at the Phoenix Convention Center in Phoenix, AZ, June 2-5. Carl Terzer and Rachel Libowitz will be representing CapVisor at booth 928. Carl will also be a speaker for a session entitled Presenting to the Board on Tuesday June 4 at 1:15 and we hope that you can attend or stop by the booth to see Rachel and Carl!

3. The Bermuda Captive Conference is at the Fairmont Southampton June 10-12. Carl will be speaking at a session on Monday at 3:30. If you can attend the session please try to catch up with Carl at its conclusion or maybe see him around during the event.

4. Carl Terzer and Grant Davis will be attending the TCIA Annual Conference in Nashville, TN June 17-19. Carl will be speaking at a session on Tuesday Jun 18 at 4PM with Anne Marie Towle of JLT so hopefully you can attend!

5.CapVisor will be exhibiting at the VCIA Annual Conference Aug 6-8 at the DoubleTree by Hilton in Burlington, VT. Rachel Libowitz and Paul Deeley will be representing CapVisor at Booth #8. Hopefully your schedule allows for time to stop by and say hello! Rachel will be speaking on Tuesday Aug 6 from 1:45-2:45.

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