CapVisor Associates, LLC
Quarterly Newsletter

CapVisor Associates, LLC

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Insurance Asset Management

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Inside this issue:

How are you positioning your portfolio for the coming market conditions?

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We can all agree that interest rates will eventually rise and when this happens, the large bond portfolios of insurers will be adversely affected. The real question is, when will this happen? Geo-political, as well as global economic issues continues to cloud the speed at which the US economy proceeds on its slow and meandering path to recovery. When the economy does heat up, in a sustained manner, we know that the Fed will tighten withdrawing liquidity from the market and affect both stock and bond markets. With the long Bull Run perching most stocks precariously at or near all-time highs, the equity market may be especially susceptible to any shock wave that causes investor flight to quality. Such unpredictability, along with the potential for high volatility, makes it an important time for insurers to re-examine their investment strategy and asset allocations.

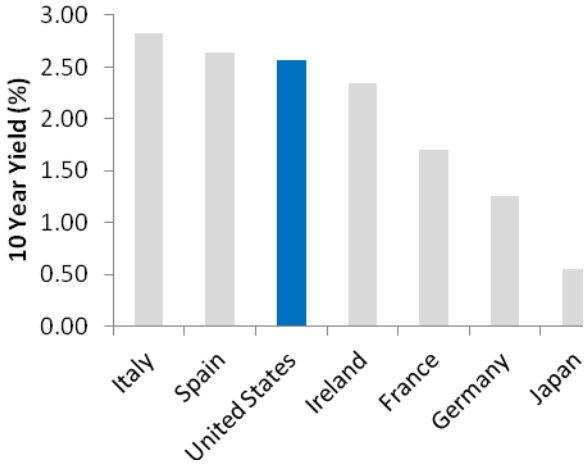
What NOT to do

Shortening duration too early: So many bond man-

Economic Review

The downward trajectory of interest rates again surprised investors, who by and large, were expecting higher interest rates – including ourselves. The 10 year Treasury hit a low of 2.44% and finished the quarter at 2.53%. Hard to fathom it was 3.00% just six months ago! The good news for bond investors is that, as a result, negative returns from 2013 have been more than overwhelmed this year. At quarter-end, the 18 month annualized return was 1.21% for the Barclays U.S. Bond Aggregate.

Exhibit 1: As of July 1st, 2014, the 10 year Treasury rate looked compelling when compared to other nations.



Source: Bloomberg

A number of theories have circulated as to why interest rates have declined in 2014, all with some validity. Severe weather conditions can certainly be blamed, especially in light of the recently revised first quarter GDP growth rate of -2.9%. Geopolitical events such as the crisis in Ukraine or the uprising in Iraq could be considered scapegoats as well. Another theory is based on investors posi-

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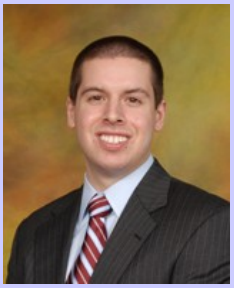

Mr. Piel joined Opus Investment Management in 2007 as a portfolio manager. In his current capacity, he leads the Investment Grade Core, Short Broad Market, and TIPS strategies at Opus. Mr. Piel partners with a variety of account types, including pension funds and insurance companies. Previously, Mr. Piel was employed with Genworth Financial as an asset liability analyst within their Institutional Markets Group

"A number of theories have circulated as to why interest rates have declined…..severe weather conditions …recently revised first quarter GDP growth rate of -2.9%. … Geopolitical events ... . investors positioning their portfolios for higher rates, which did not materialize forcing them to cover shorts driving rates lower still. The most compelling argument might be the simplest to explain – Treasury yields look relatively cheap"

Economic Review

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tioning their portfolios for higher rates, which did not materialize forcing them to cover shorts driving rates lower still. The most compelling argument might be the simplest to explain – Treasury yields look relatively cheap! Spain and Italy 10 year yields are essentially in-line with the United States, and Ireland actually yields less! When considering market liquidity and credit ratings, the pendulum swings further in favor of the United States.

Growth proving to be elusive

Domestic growth was expected to be weak in the first quarter because of challenging weather conditions, but few expected to see a decline of 2.9%. Although a bounce back is projected for the second quarter of around 3%, this implies roughly zero growth in the first half and assuredly guarantees another year of 2% expansion. The good news is that the labor market is mending (if not strengthening), consumer confidence is rising, capital spending is poised to rebound, and industrial utilization is approaching pre-crisis levels. While monitoring these and other measures, the Fed has reduced the level of monthly bond purchases down to $35 billion.

Other central banks are not sharing in the same fortunes. Battling low growth and deflation risks, the European Central Bank introduced a package of measures to stimulate growth including negative rates on excess bank reserves, additional liquidity actions, and a study on private asset purchases. The Bank of Japan, already engaged in accommodative policies, could ease further if growth fails to meet expectations. Additionally, the People's Bank of China is attempting to rebalance their economy away from exports while containing their housing market and financial system.

Easy monetary policy across the globe has brought tremendous liquidity to the capital markets pushing valuations to historic highs. The Dow Jones Industrial Average just broke through 17,000, now up over 150% since the low in 2009. Within fixed income, spreads (compensation for risk) are trading at multi-year lows and approaching decade lows. For example, corporate bond spreads are only 20 basis points from the lows of the last 10 years. Amazingly, investors

	Policy Stance	Trending
Federal Reserve	**Easing**	**Less**
Bank of England	**Easing**	**Less**
European Central Bank	**Easing**	**More**
Bank of Japan	**Easing**	**More**
People's Bank of China	**Neutral**	**Neutral**

Source: Opus Investment Management,

Economic Review

barely shrugged at the uprisings, upheavals and revolts this year and volatility has essentially evaporated: a high degree of confidence in monetary policy the cause.

However, with comfort comes complacency. Fixed income investors may be amidst the most difficult investing environment in years: low yields, low spreads, low growth, and dissipating Federal Reserve support. Unlike the "Great Recession" where minimal risk garnered high yields, today maximum risk nets only marginal yield. Certainly default risk is low, and timing of a turn is unknown, but slowly transitioning the portfolio to a more defensive stance is warranted.

Concluding thoughts

The second half of this year should bring the end of Quantitative Easing by the Fed and focus will eventually turn to the timing of the first rate hike. As evidenced by market reactions last year, this could result in the reappearance of volatility domestically and abroad. Understanding that default risk is low and yield is so difficult to pass up, valuations today justify preparing for the unexpected. This could simply be selling one corporate bond, or investing slightly higher in quality or possibly buying 2 year risk instead of 10 year; all while sticking with the Opus philosophy of "yield wins over time".

One thing is certain to us, rates and spreads will rise in the future and opportunities will present themselves and Opus will be up for the task!

How are you positioning your portfolio for the coming market conditions?

agers shorten bond portfolio duration to reduce interest rate sensitivity with the expected rise in rates. Unfortunately, bond yields remain low and rates have yet to rise. This action has been very costly in terms of lost return on client portfolios and underperformance vs managers' benchmarks. There is reason to believe that when rates rise, it will happen slowly and be methodically controlled to the extent possible by the Fed. Given the Fed's new "transparency" and self-appointed "soft mandate" of managing markets, we expect that short term rates will rise in a manner that ensures continued economic progress. We can also be somewhat confident that some rise will be priced in early enough to lessen the actual impact when it comes.

Move to a large cash position: Cash is not an investment strategy and holding it will violate many insurers Investment Policy Statements' objectives of "protection of principal" and earning a positive real rate of return. Raising your cash position with the intension of reinvesting at a more opportune time may make sense, but as an ongoing strategy, it is just a market timer's folly. Missing the perfect timing should be expected and the high opportunity cost for missing is almost always a certainty.

What to consider

If you are hoping to maximize your success on a long term basis, stay invested but tweak your allocations and evaluate your performance in more meaningful terms. Here are some specific suggestions:

Optimize your investment strategy to better fit your company's unique financial situation and risk tolerance. This can be accomplished with Strategic Asset Allocation modeling, preferably using dynamic financial analysis. It is the single most important thing you can do to improve your long term investment result.

Incrementally add allocations that eliminate a risk barbell. Most insurers have the bulk of their portfolios sitting in very conservative, low-risk bonds (reserve portfolio) that earn a very low real return in today's market. The remainder, hopefully not an amount to exceed their surplus, is sitting in stocks, arguably the most risky asset class one can own. These firms have a risk barbell. Exploring low to inversely correlated asset classes, that bring diversification benefits, will improve risk-adjusted returns and smooth out performance over choppy markets.

Focus on "Real, Real returns". Most insurers are focused on nominal rates of return. A "real" return is simply defined as a return that exceeds the inflation rate, protecting buying power

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Risk, Stress and the FED

Michael J. Vogelzang, CFA, is President and Chief Investment Officer of Boston Advisors LLC, a boutique investment company headquartered in Boston.

"Could it be that the Fed's objective of transparency and clarity of intent has changed investor behavior and market outcomes – for the worse? As a working theory, perhaps the Fed's well intentioned efforts have created lower levels of anxiety among long term investors"

"In fiction: we find the predictable boring. In real life: we find the unpredictable terrifying."

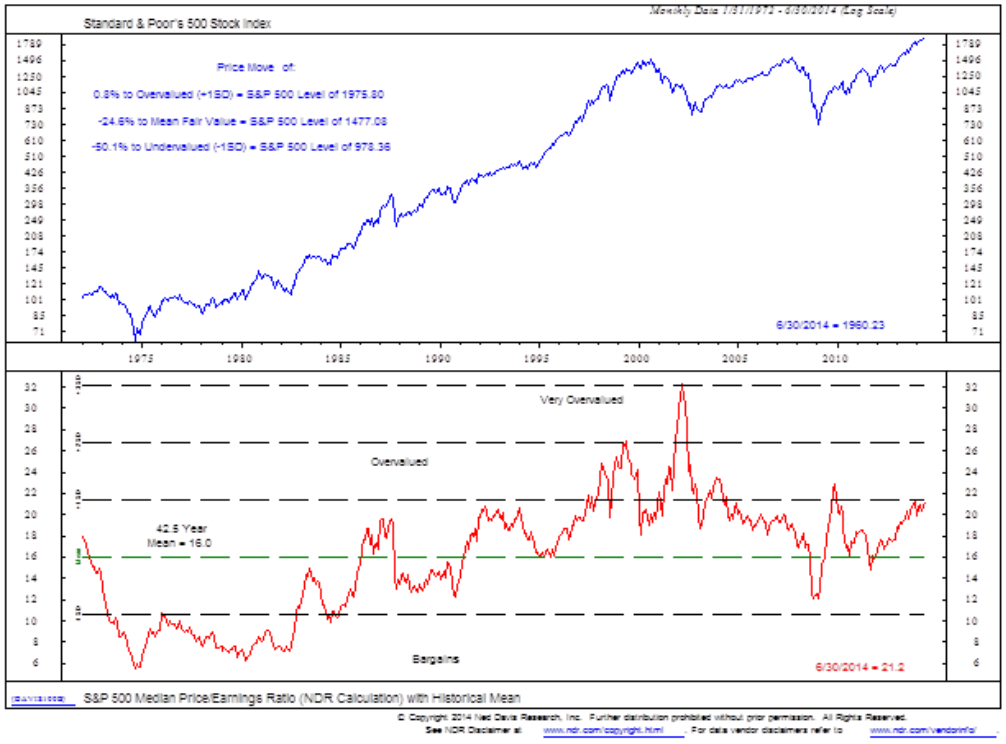
Mokokoma Mokhonoana

While fiction readers may like the unpredictable, investors find the converse: predictability is intoxicating, it enhances the opportunity to take risk. But like "real" life, unpredictability terrifies investors.

We have often recently commented on how stock market "valuations" are becoming quite stretched when compared to historical averages. The chart at the right shows the S&P 500 at just over 21 times earnings compared to a long term average of 16.

What I have never understood, however, is that the last forty years appear to have at least two distinct periods – the first, when P/Es were lower and then today, after the mid-'90s, when P/Es have risen. Recent research and reading have led us to a theory about why the markets have shifted and what implications we may take away and apply to portfolios.

John Coates, in his book "The Hour Between Dog and Wolf," describes stress holistically and articulates the connection between the mental response to stress and the physiological response – how the body and mind join forces to muster our preparedness to face a risky environment. His recent New York Times article about the "Biology of Risk" (http://www.nytimes.com/2014/06/08/opinion/sunday/the-biology-of-risk.html?) connects our own personal risk appetite (and level of metabolic risk) with our investment behavior. Dr. Coates is in a unique place to comment on stress levels, investment risk and the human body: he spent years on a Goldman Sachs



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Risk, Stress and the FED

trading desk before leaving to become a neuroscientist. It's widely known that unpredictability creates higher levels of stress in humans. For example, for office workers who need to walk to a downtown train after work, summer creates stress with its penchant for random late afternoon thunderstorms. Do I need an umbrella? Should I wear my rain shoes? If, however, the predictability of rain was eliminated – it will rain every third day at 1:45 for 15 minutes, for example – showers would cause zero stress. Unpredictability is why many people like sports viewing. If the outcome of a contest is known before watching (DVR alert: the Red Sox lost - again), the interest in watching the game disappears for most viewers. In entertainment, we like a bit of unpredictability; it increases our stress levels, creating a pleasurable response.

Stress, however, creates a very different feeling among investors. Coates conducted a test with 17 traders on a London trading floor. Researchers saw cortisol (the main hormone produced in response to heightened risk) increase 68% in the traders during periods of higher price volatility. When cortisol levels were similarly artificially increased in laboratory volunteers, risk appetite among those volunteers fell by 44%. Here's an interesting quote from Coates' piece:

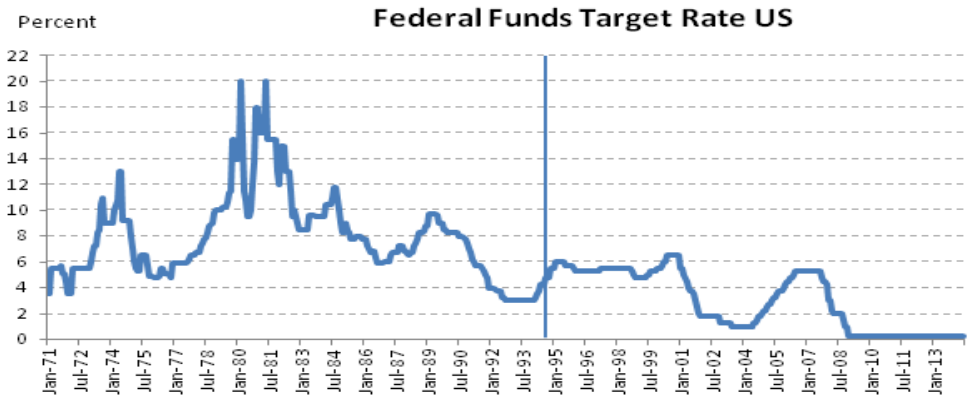
Most models in economics and finance assume that risk preferences are a stable trait, much like your height. But this assumption, as our studies suggest, is misleading. Humans are designed with shifting risk preferences. They are an integral part of our response to stress, or challenge.

When opportunities abound, a potent cocktail of dopamine — a neurotransmitter operating along the pleasure pathways of the brain — and testosterone encourages us to expand our risk taking, a physical transformation I refer to as "the hour between dog and wolf." One such opportunity is a brief spike in market volatility, for this presents a chance to make money. But if volatility rises for a long period, the prolonged uncertainty leads us to subconsciously conclude that we no longer understand what is happening and then cortisol scales back our risk taking. In this way our risk taking calibrates to the amount of uncertainty and threat in the environment.

Given that unpredictability creates stress in humans (and traders), it is a logical step to see that unpredictability decreases risk appetites. Therefore, during times of greater certainty, risk taking increases – across all spectrums of human behavior including investing. During the bear market of 2008, the stress levels were almost unprecedented. Markets were falling, housing prices were plummeting and the economy was threatening a repeat of the 1930s. Investors, from stock and bond traders to real estate speculators, were de-risking their portfolios by selling – selling anything and everything they could. The heightened risk levels drove the crowd behavior into a panic and prices plunged.

The Federal Reserve and Transparency

Prior to 1994, the US Federal Reserve and its Federal Open Markets Committee (FOMC) decisions about interest rates, monetary policy and economic expectations were a complete mystery to investors. A "popular" book at the time had the title of "*The Secrets of the Temple*" - Greider, 1987. Investors didn't even know the Fed Funds target rate. Since 1994, however, the US Federal Reserve



Sources: Federal Reserve, Bloomberg and Boston Advisors, LLC research

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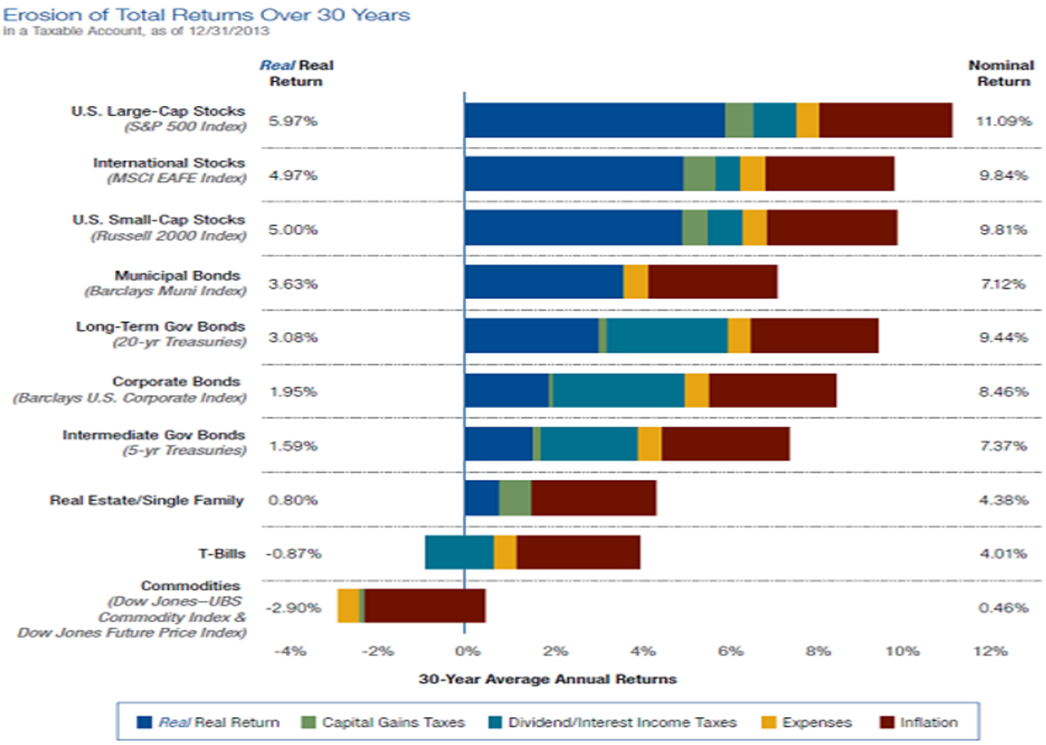
"...to maximize your success on a long term basis, stay invested but tweak your allocations and evaluate your performance in more meaningful terms."

How are you positioning your portfolio for the coming market conditions?

and growing the principal. A real, real return focuses on what you keep. That is, evaluating returns on an after-tax basis. Intuitively, we know this matters. The chart seen here, helps to quantify this concept and proves its importance as it may alter the way you view your current asset allocation. Measuring real, real returns improves your understanding of true asset class contribution towards attaining your long term investment goals.

Assess performance on a risk-adjusted basis. Clients are so often surprised when their investment manager, who was a star performer when selected, suddenly is an underperformer now that market conditions have changed. Unfortunately many instructional buyers often fall victim to the same errors prevalent in the retail market: that of chasing past performance. Evaluating investment managers on a risk-adjusted basis helps to eliminate many future surprises by indicating how a manager's style performs in both up and down markets. It also evaluates whether the manager produced a fair return for the risk level used in producing that return. Beating the benchmark may not be enough and certainly provides little indication of manager "skill".

Avoid the temptation to add too much risk. The Fed's low interest rate policy has served as the main catalyst for enticing many investors into adding inappropriate amounts of risky assets to their portfolios in search of better returns. Fortunately, most insurers have either resisted such temptation or been restricted by DOI regulations. Adding risk incrementally makes sense particularly in situations where the longer term benefits may even exceed the current benefit of such allocations. The bottom line is that enterprise-wide risk must be reevaluated when investment risk is added.



Source: CULLEN ROCHE, THORNBURG FUNDS

Risk, Stress and the FED

has pursued a policy of greater and greater transparency regarding its policies – the level and direction of interest rates, how long quantitative easing will last, etc. – to investors and the broad economy. Alan Greenspan began this shift in '94 with the Fed communicating to the public the outcome of the FOMC deliberations decisions – for the first time. And shortly thereafter, the Fed began publishing the Fed Funds target rate.

Changes have continued over the last twenty years. Here's a partial list of the Fed's transparency campaign:

1994 – Fed begins to publically communicate decisions of the Federal Open Market Committee (FOMC) meetings. Later, they begin to announce the Fed Funds target rate.
1999 – Fed announces a "bias" to future Fed Funds changes.
2002 – Fed reports the results of the actual vote at the FOMC.
2003 – Future path of the Fed Funds rate announced. With a potential timeline.
2004 – Minutes of the FOMC released after only a three week delay.

Since Greenspan's leadership ended, Ben Bernanke and more recently Janet Yellen continued the transparency progress. Investors know more about the direction, timing and magnitude of future monetary policy than at any time in the past. One outcome of this change has been that since 1994, the volatility of the Federal Funds target rate has fallen by 31%, when compared to the period from 1971 through 1994. Much of the uncertainty and fear created by capricious (or at least mysterious) Federal Reserve policy pre-1994 has been eliminated.

With this confidence in Federal Reserve activity on the part of the investment community, investors have added risk with great gusto. Beginning in the mid-90s, technology stocks were the recipient of this risk taking, driving prices into bubble territory normally reserved for Dutch tulip bulbs. After the 2000 market crash, another period of low volatility and high returns developed, with the S&P 500 climbing 13% per year for the five years from 2003 through 2007. Oh yes, another crash in 2008. Since the bottom of the market on March 9, 2009, we have seen US stocks move up over 21% per year, in an almost vertical rise not seen since the late '90s.

Could it be that the Fed's objective of transparency and clarity of intent has changed investor behavior and market outcomes – for the worse? As a working theory, perhaps the Fed's well intentioned efforts have created lower levels of anxiety among long term investors. We already know through Dr. Coates' work that in periods of more predictability, investors take on more risk. Are investors more accepting of stock market risk because the Fed provides more guidance?

One simple and clear measure of investors' risk appetite is the price they are collectively willing to pay for equities. Higher valuation levels equate to taking more risk, and vice versa. This is intuitive. It's much riskier to buy shares of Tesla Motors with an estimated p/e of 196 (!) than shares of ExxonMobil at 13 times earnings.

Investors since 1971 have been willing to pay, on average, $16 for every dollar of corporate earnings (or, a P/E of 16). However, looking at the average P/E both before and after the Fed's "transparency regime change" is revealing. Investors paid 12 times earnings for companies in the index between 1971 and the end of 1994. However, beginning in 1995, investors have paid, on average, $20 for every dollar in earnings. Said simply, since the Fed has increased transparency and reduced investor uncertainly around Federal Reserve policy, investors have been willing to pay 66% more for stocks.

Other measures of valuation show a similar pattern. Price to Sales ratios have on average mostly doubled, from 0.8 times sales to 1.5 times. Dividend yield has moved down (higher dividend yield means cheaper stocks) from above 4% to more recently less than 2%. Price to Book Value ratios have moved up from 1.75x to 3x. All these measures mean the same thing – investors are willing to pay a lot more for stocks, almost two times as much – since the Federal Reserve began a campaign of transparency, clarity and open communication.

Many other things impact valuations and stock prices, of course. Federal Reserve policy is only one. Others are earnings growth rates, returns on equity, interest rates, the economic environment and regulation and tax policy. But the consistency of impact on price with the

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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

We are on the web at
www.capvisorassociates.com

Risk, Stress and the FED

coincidence of the Fed's well documented policy change, make this an interesting speculation.

What implications might there be for investors in this new "regime" of a more communicative Federal Reserve? Many come to mind, but here are a few obvious ones:

- At 21 times earnings, maybe the stock market is not as expensive as widely believed. We are simply hovering around the "average" P/E for the post-1994 stock market.

- It's highly unlikely the Fed will go back to mysterious and capricious interest rate changes. Arguing for more cloak and dagger policy in 2014 is unthinkable. The political pressure on Chairwoman Yellen for unexplained and potentially destabilizing actions would be unbearable. "Even the NSA can't spy in private. Why should the Federal Reserve escape scrutiny??" could be the lead editorial in The Wall Street Journal.

- We should expect more extreme cycles in stock prices; higher highs, fewer minor corrections and deeper crashes as market valuations extend during good times. When the news is good, things will be great – like today. But when the environment turns ugly, the market will be very painful – like 2008. And it may happen more often.

In his NY Times article,

Dr. Coates makes a cogent argument that the Federal Reserve has two interest rate utensils. One is the level of interest rates. The second is the uncertainty of rates. The Fed has inoculated the investment community against interest rate shocks, it has calmed the market and lost the power to scare. It has disavowed use of uncertainty as a tool. For the benefit of investors, it's a shame that the Fed has ceded control of one of the most useful tools against speculation, complacency and inappropriate risk taking. We will all likely pay the long term price.

Upcoming Events

Carl will be exhibiting at The **NAMIC Annual Convention** September 21-24, 2014 Gaylord National Resort & Conference Center | National Harbor, Md. Please stop by booth #510 and say hello!

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