**CapVisor Associates, LLC**
**Quarterly Newsletter**

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## Insurance Asset Management

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# Fine Tuning Your Company's Future

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***Lately***, we are all hearing a lot of buzz about big data and other technology/analytical advances. It is with good reason that insurance executives are paying attention as these advancements have served to make the Insurance business tougher and more competitive than ever. Policyholders expect fast and efficient services using the latest technology—online access to their information, instant ability to file claims on mobile devices, quick settlement of claims—all at the lowest possible cost.

Most insurers have invested heavily in technologies to achieve operational efficiencies as well. These include internal rating and claims filing/management systems or when outside vendors are used, ensuring that they are providing leading –edge tech-

# Economic Review

**Equity Market Review and Outlook**

***The U.S. economy*** at last is beginning to exhibit the kind of growth that is in keeping with a stock market marching to record levels.

Third quarter Gross Domestic Product was revised up to +5.0% following a +4.6% gain in the second quarter—the strongest back-to-back growth in 11 years.

The November jobs report showed an addition of 321,000 jobs, and revisions added another 44,000. Average hourly earnings also rose +0.4% month-to-month (+2.1% year-to-year) and average hours per week rose to the highest level since 2008.

New unemployment insurance claims dropped to less than 300,000 per week, less than half their peak levels.

Consumer sentiment (Reuters/Michigan December report) climbed to 93.8 while real consumer spending rose 3.2% in the third quarter, versus the 2.2% anticipated in prior estimates, and may have reached 4% in the fourth quarter.

Manufacturing output passed its 2007 peak. Capacity utilization of 80.1% is the highest since March 2008, and is now at its average level of the past 40 years.

Even with the upturn in the economy, officially-reported inflation remains subdued at well below 2%, and the Federal Reserve remains accommodative. Additionally, lower energy prices are providing the average consumer with extra pocket money.

The big economic story is the plunge in commodity prices led by crude oil, which relentlessly dropped 50% from its June peak. U.S. oil production continues to surge, recently crossing the nine million barrel-per-day plateau. OPEC is slightly overproducing its official

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***Michael J. Stafford Jr., CFA, Managing Director, Director of Fixed Income Investments -*** Mr. Stafford is Managing Director and Director of Fixed Income Investments for ASB Capital Management and is a member of the ASB Fixed Income Council. He has 25 years of experience in the institutional fixed income business, and previously served as Chief Investment Officer of The St. Paul's (now Travelers) life insurance subsidiary, and Portfolio Manager with Bank of America, Legg Mason, and First National Bank of Maryland. Mr. Stafford is a Chartered Financial Analyst, a past president and director of The Baltimore Security Analysts Society, and has taught investment analysis in the MBA program at Johns Hopkins University. He is a graduate of Georgetown University and earned an MBA from Loyola University of Maryland.

***"Even with the recent rebound, U.S. GDP is expected to grow at a meandering 2.5% rate for all of 2014. With stock prices and profit margins at record levels, the economy will need to sustain its long awaited pick-up in or der to produce the kind o f revenue and profit growth that will suppor t current valuations."***

# Economic Review

quotas, and created market tremors in late November when it declined to cut output.

U.S. monetary authorities ceased their purchases of bonds and hinted that they would like to begin to raise interest rates in 2015. While heightened economic readings would seem to give a data-dependent Fed all the cover it needs to proceed with the rate hikes, low inflation, a still mounting Federal deficit, and a reluctance to spook the markets could cause them to move slowly.
Government bond yields remained near historical lows in the U.S. and sank to all-time lows in Europe. The U.S. dollar rallied 12% versus a basket of global currencies.

After the Dow began 2014 by falling 7.3% in January and early February, it reached record highs in April. Since then, the index has corrected three more times, each time recovering more quickly than the last. The last correction, in early December, abruptly re-gained lost ground when the Fed pledged to "be patient" in raising interest rates.
The S&P 500 Index gained 13.68% for the year, including dividends. The S&P is up for eight straight quarters, and the Dow is up for six straight years. While the Dow crossed the 18,000 mark late in the year and the S&P produced 53 records, stocks sold off sharply on New Year's Eve day and exhibited further weakness in early 2015 trading.

**Equity Investment Strategy**

Stocks are expected to grow revenues at about 2% and earnings at perhaps 7% in the new calendar year. Trailing price/earnings ratios for the S&P 500 Index of just under 20x and price/ sales ratios of 1.7x both stand more than 20% above typical historical levels.

Even with the recent rebound, U.S. GDP is expected to grow at a meandering 2.5% rate for all of 2014. With stock prices and profit margins at record levels, the economy will need to sustain its long awaited pick-up in order to produce the kind of revenue and profit growth that will support current valuations.
A strong dollar helps the U.S. consumer by improving the affordability of imported goods and making it cheaper to travel abroad. However, it also hurts the export business of our trade partners, making it more difficult for them to pull out of their economic doldrums, and dampening the demand for the products of U.S. producers. The continued slowdown in China bears particular watching.

Aside from the obvious short-term stimulus to the consumer, lower oil prices are a mixed bag for the economy. S&P earnings expectations are already starting to come down as a result of the potential energy company impact of dramatically-lower prices than previously assumed. Increased drilling and production activity has also been a major contributor to job growth, and, like real-estate, has a multiplier effect on the economy.
With lower oil prices also comes heightened geo-political uncertainty. It is speculated that, in declining to cut production, the Saudis are not only trying to main-

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# Economic Review

tain market share but also seeking to squeeze oil revenue-dependent adversaries such as Russia and Iran.

Regardless of intent, it is unclear what rogue nations will do when backed into a fiscal corner. Indeed, even ten of twelve OPEC nations feature budgets that require oil prices at much higher than current levels in order to balance. Cutting back social payments and programs could lead to domestic instability.

Finally, the future of interest rates must be considered. The U.S. has not raised rates since 2006. After setting rates at nearly zero, then launching bond buying campaigns QE1, QE2, and QE3, the Fed is now trying to set the stage for hikes in the short-term rate.

Yet, even with the job market and the economy accelerating, and financial markets at all-time highs, it appears to be unable to find the right time to unwind the excess liquidity. Each time the Fed has attempted to stop the printing presses, the markets have corrected and the Fed has relented. Low inflation provides cover for continued "patience."

So, it appears that there is never a good time to reverse course. When the markets are down further, monetary support is presumed to be needed. And when markets are rising, policymakers are reluctant to risk upsetting the status quo.

With interest rates near zero, intrepid investors have moved out onto the risk curve in search of higher returns. The answers to a variety of monetary, economic, and geo-political questions will determine whether they will continue to be rewarded.

**Fixed Income Review and Outlook**

Contrary to broad investor expectations, the U.S. Treasury market delivered its strongest return since 2011, as long-term interest rates fell over the course of the year. The Aggregate Bond Index returned 1.79% in the fourth quarter and 5.97% for the year in 2014.

During the year, thirty-year Treasury yields declined from 3.97% to 2.75%, and ten-year Treasury yields declined from 3.03% to 2.17%. At the shorter end of the curve, yields on two-year Treasury notes increased from 0.38% to 0.67% and yields on three-year notes increased from 0.77% to 1.07%.

The flattening of the two to thirty year yield curve was persistent throughout the year, going from 359 basis points to 201 basis points. Interest rate volatility heightened considerably in the fourth quarter, and the trend to a flatter curve accelerated in December.

The shape and movement of the yield curve for U.S. Treasuries, the world's largest and most liquid interest rate asset class, is often a good predictor of economic activity. A spread of only 2% between two and thirty year yields last occurred during the financial crisis of 2008-09 and, before that, in 2004.

Today's flatter curve reflects investor expectations of low inflation over the long term, an imminent end to the Fed's zero percent Fed Funds rate policy, and slower economic growth going into 2015.

Market-implied inflation expectations held steady around 2.20% until mid-year. However, from the middle of July through the end of 2014, inflation expectations plummeted 60 basis points to 1.60% at year end.

This accelerated drop paralleled the plummeting price of oil. West Texas Intermediate crude futures peaked in late June at $101.33 and recently traded below $50, a 50% price collapse, which largely occurred in the fourth quarter. The bust in energy investments has driven a sell-off in the high yield fixed income sector, where energy issues comprise 15% of the market.

The result is a generous tax break for consumers, who took the latest University of Michigan Consumer Sentiment reading to 93.6, an eight-year high, last seen in January 2007. Restaurants and retailers should be immediate beneficiaries of the savings.

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# Drilling Deeper Into Oil

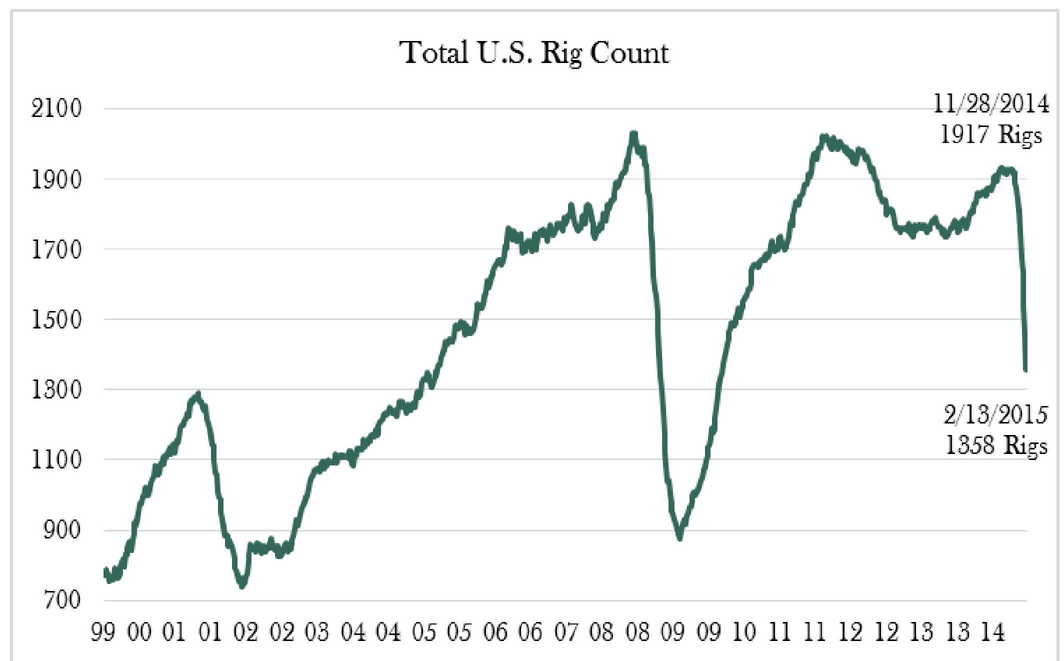
Mr. Schuringa is a globally recognized authority on investing in U.S. energy infrastructure and U.S. energy assets through the MLP structure. He makes regular appearances on CNBC, Bloomberg, Fox, and BNN and is often quoted by major financial publication as an expert on the asset class.

Prior to founding Yorkville Capital Management, Mr. Schuringa was a Partner with the energy-focused investment firm of Estabrook Capital Management. Mr. Schuringa was co-portfolio manager of a Morningstar five-star rated energy-centric mutual fund and he managed over $1.0B in institutional fund structures and managed accounts. His clients included some of world's largest pension funds and institutional investors.

Mr. Schuringa received a BA in Finance from the University of Western Ontario and an MBA in Finance from the Crummer School of Business at Rollins College. He is also a Chartered Financial Analyst (CFA), a member of New York Society of Security Analysts (NYSSA), and a member of National Association of Publicly Traded Partnerships (NAPTP).

***Over the past 3*** years, oil production in the United States has grown rapidly from a rate of approximately 6 million barrels per day in late 2012 to more than 9 million barrels per day (bpd) by the end of 2014. This increase of 3 million barrels per day over the course of three years (or a million barrels each year) has contributed to a globally oversupplied crude oil market. For the fourth quarter of 2014, crude oil production averaged approximately 94.1 million barrels per day worldwide. However, global consumption figures came in 900 thousand barrels lower, at a rate of 93.2 million bpd. This seemingly small (~1%) difference, primarily a result of the rapid growth from the United States' shale production in recent years, has sent the price of oil plummeting from its high in June 2014 over $107 a barrel to a low of under $44 in late January. While the price has since rebounded to over $50/bbl, a slowdown in U.S. production is likely required to correct the oversupply situation and stabilize the price of crude.

As oil has fallen, U.S. producers have made adjustments for a lower oil price environment, which has been most apparent in their 2015 capital expenditures budgets. Integrated majors have slashed spending in the 15% range while smaller players have lowered their capex in excess of 50% (oil companies 2015 budgets are based on full-year crude oil prices in the $50-60 dollar range). Yorkville expects that industry wide capex budgets will ultimately be reduced by approximately 30%. Over time, these capex reductions will begin to show up in declining rig counts and eventually, lowered production. As the chart below illustrates, rig counts have

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# Drilling Deeper Into Oil

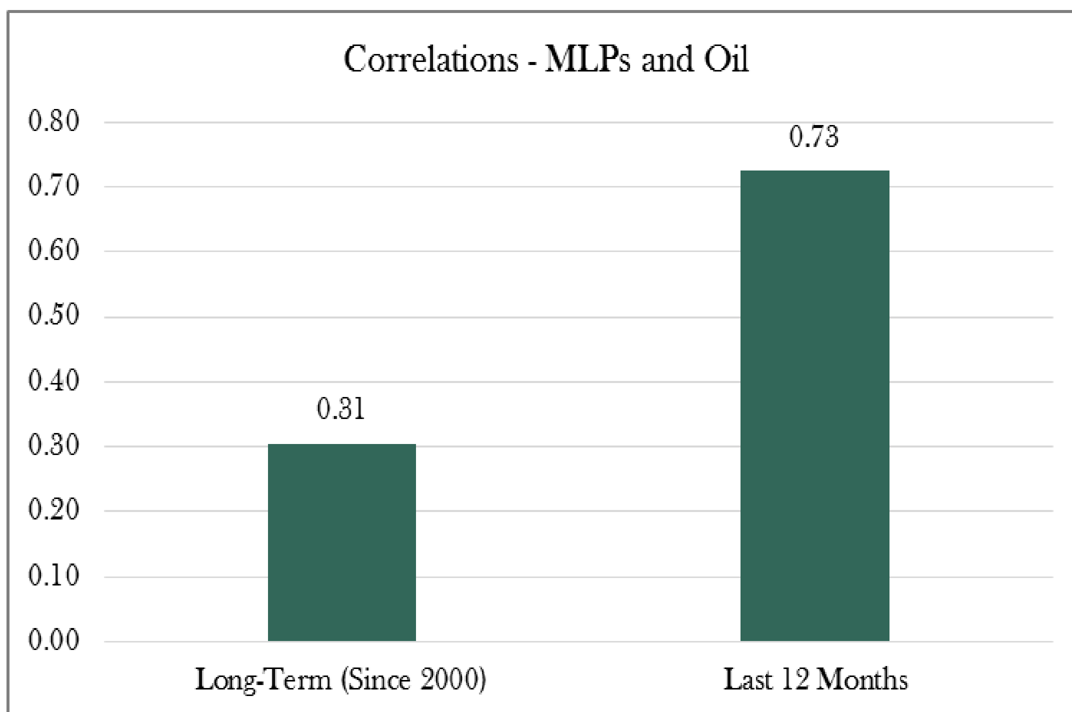
already decreased ~30 percent from their recent highs. Production, however, has continued to steadily grow. We believe that a rig count reduction matching at least that of capex budgets (~30%) is likely.

While U.S. oil production has yet to roll over, the second half of 2015 is likely to see the full impact of the recent (and continued) rig count reductions. This is due to the lag between rig count reductions and production declines. We would expect production to be flat to slightly up from 2014 in the second half of this year.

In the recent oil plunge, we have seen correlations between MLPs and oil spike. Whereas the long-term correlation of crude and MLP total returns has been very low (0.31), correlations over the last 12 months has more than doubled to 0.73. Despite this short term phenomenon, which also occurred in 2008, oil prices don't need to rise for infrastructure/midstream MLPs to achieve positive returns.

It appears that U.S. shale producers who were the primary reason for the oil oversupply in the first place will be the ones primarily responsible for correcting the current supply/demand imbalance. Yorkville forecasts 2015 to be a flat to slightly positive year for U.S. oil production. This will ultimately bring the crude market into balance by 2016, as demand continues to grow a 1-2 percent a year globally. As oil prices continue to fluctuate, MLPs represent a great way for investors to gain exposure to the U.S. energy revolution without having to bet on a rebound in oil prices.

*"the long-term correlation of crude and MLP total returns has been very low (0.31), correlations over the last 12 months has more than doubled to 0.73.*

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# Fine Tuning Your Company's Future

***Kevin Moore, CFA, Managing Director and Director of Equity Investments*** – Mr. Moore is responsible for active equity portfolio management at ASB. He has 25 years of portfolio management experience. Mr. Moore began his career as a securities analyst at the Ohio Company, and then became Senior Portfolio Manager at First of America Corporation. He next moved to the Monetta mutual fund complex as Senior Portfolio Manager, and soon thereafter was promoted to Chief Investment Officer responsible for oversight and direction of six of Monetta's seven mutual funds: The Monetta Fund, and the Monetta Large-Cap, Mid-Cap, Small-Cap, Balanced, and Intermediate-Bond Funds. Two of these funds were Ranked #1 by Lipper Analytical Services during respective 12-month periods. Mr. Moore earned an undergraduate degree from Greenville College, and an MBA from the University of Michigan.
He is a Chartered Financial Analyst and a member of the ASB Equity Council.

***"The opportunity cost for having an inefficient portfolio in a more volatile market can easily offset many of the gains achieved through improved efficiencies on the liability/operational side of the business…"***

nology and efficacy. Safety and other preventative programs have been implemented to reduce risks associated with claims severity and frequency.

Meanwhile, bond portfolio returns, which produce the financial foundation for an insurer's claims paying ability and represent the bulk of most insurance company portfolios, have been at historically low levels for the past few years. The low interest rate environment is primarily responsible and has forced companies to rely less on investment results to offset poor underwriting results. It has caused many insurance executives to focus on the importance of strong underwriting results, lowering expenses, pricing/market share, etc. and has looked to technology solutions to improve efficiency. For many companies, success or even survival will depend upon their ability to develop systems and strategies that focus on portions of the market that require unique products, specialized insights, or customized service. Unfortunately, there is another side to all of this that has not been as well examined – the other side of the balance sheet. Too few of these insurance executives have focused on analytics and efficiencies that can be gained on the investment/asset side of the balance sheet. With the expected continuation of a low interest rate environment, by historical standards, portfolios and asset allocations that were designed a few years ago are most probably badly dated and poorly positioned for optimal results in the coming marketing environments.

For example, a bond portfolio that was designed in a falling interest rate environment, arguably prior to 2013, may likely underperform in the coming rising rate scenarios. Portfolio durations, which measure interest rate sensitivity, should be reconsidered and optimized around the liability duration offered by the insurer's underwriting activities to immunize the bond portfolio. Even investment guidelines that were written fairly recently, perhaps in a strong part of the credit cycle, should be reevaluated to determine if their portfolios are being appropriately compensated for the current and future expected levels of credit risk taken.

Equity allocations may have produced strong returns over our recent multi-year bull market inviting complacency. In a market crash, or even a correction, how will your portfolio fair? History dictates that market cycles always turn at some point. De-risking or additional diversification into low or uncorrelated asset classes may be a prudent move ahead of the unpredictable cycle's turning point. Minimally, insurance executives should use big data and other analytic tools to assess the risk in their portfolio and make sound judgments as to the appropriate levels to accept given their economic and securities market views and their company's financial situation..

Big data and advanced analytics are available to help insurers in these important investment/ asset decisions. For example, reviewing tactical portfolio (i.e. investment manager) performance on a risk-adjusted basis within a "manager

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universe", rather than simply a comparison of nominal returns vs the benchmark, is often an eye-opening experience . Understanding the performance of a manager in past up and down market cycles enables insurers to better anticipate the efficacy of their manager's style in the coming rate, credit and market cycles. The opportunity cost for having an inefficient portfolio in a more volatile market can easily offset many of the gains achieved through improved efficiencies on the liability/operational side of the business that were described earlier.

More importantly, ensuring that the Strategic Asset Allocation (SAA) strategy is optimized can bring significantly improved results. Empirical studies indicate that more than 90% of long term investment results are determined by the Strategic Asset Allocations selected. Too few insurance executives have utilized today's power analytic systems to "optimize" the allocation uniquely to their company's liability structure, risk tolerance and investment objectives. These advanced analytic systems enable both economic scenario and asset mix testing allowing for informed decision-making by financial executives.

# Economic Review

Although lower gasoline prices help the U.S. consumer, they also signal economic weakness abroad. The Eurozone is so weak that German two-year bond yields are negative. Ten-year German government bonds yield 0.50%, 1.60 percentage points lower than U.S. ten-year yields.

Declining commodity prices, including copper at a four-and-a-half-year low, are a sign of economic weakness not just in Europe, but also in the emerging economies of China, South America, and Russia. While the dollar trades at multi-year highs, the Russian ruble is near collapse and raises fears that slower growth elsewhere will spread to our shores.

Economic growth in the United States is being cherished by investors in the midst of weakening outlooks overseas.

**Fixed Income Investment Strategy**

A year ago the broad market view that interest rates would rise in 2014 was as strong a consensus as we could remember since 1994. However, as the year came to a close, this expectation was at best half right. While short rates rose as expected, long rates fell. As we enter 2015, the consensus again is that rates will rise.

Nevertheless, we are less confident that long rates will rise than we are that the yield curve will continue to flatten, due principally to an increase in short-term rates.

Global economies are closely linked, and it is unlikely that the U.S. economy can withstand prolonged long-term interest rates that are considerably higher than those in the rest of the developed world. However, a transparent Fed, admittedly data dependent, wants to raise short rates gradually from the current zero percent, likely in the third quarter.

Recent economic releases indicate steady gains in jobs but inconsistent housing growth. We suspect that secular factors are at work and that any economic recovery will be less dependent on housing growth than previous recoveries.

Investment-grade corporate spreads finished the year about 30 basis points wider than where they began. The underlying bonds now offer reasonable value, trading at wider spreads than they did for long multi-year periods in the 1990's and 2000's.

With regard to mortgages, regulatory overhaul of Fannie Mae and Freddie Mac awaits legislative action. In these government-guaranteed securities we find relative value in the higher coupon structures that are less susceptible to maturity extension from a rise in interest rates.

We also continue to invest in taxable municipals for diversification, credit quality, and yield advantage.

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# Upcoming Events

Performing optimally on the claims and operations side of the business is important for success in today's competitive insurance marketplace. Focused attention and improved efficiency on the asset side is equally important. AM Best reports than in excess of 75% of an insurer's profitability is generated by the investment program. Therefore, keeping it fine-tuned means competitive advantage. Using big data and sophisticated analytic tools bring new and wider options to executive management resulting in better decision-making and ultimately superior results. Redesigning and re-engineering the investment strategy for success in the future is an on-going task because as a general rule, what worked yesterday will not always work tomorrow.

**Carl Terzer will be a speaker at USA Risk Group's 10th Annual Executive Educational Conference at the Ballantyne Hotel, Charlotte, NC May 19-21. Please refer to the conference agenda for Carl's speaking schedule.**

**CapVisor Associates will be exhibiting at The New York Insurance Association 2015 Annual Conference May 27th through the 29th at the Saratoga Hilton, in Saratoga Springs, NY. Please stop by the CapVisor booth and say hello!**

**Carl Terzer will be attending the Bermuda Captive Conference June 8th-10th at the Fairmont Southampton Resort, Southampton, Bermuda and hopes to see you there.**

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

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