CapVisor Associates, LLC
Quarterly Newsletter

CapVisor Associates, LLC

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Inside This Issue

Passive vs Active Investment Management?

In our last article, we examined some common truths driving the wave of investment dollar flows into passive management strategies, namely ETFs (Electronically Traded Funds). We also pointed out that misconceptions are abound since many perceived advantages are not universally applicable when compared to other options available to insurance company investors. As you will recall, ETFs are like mutual funds except that ETFs trade intra-day, on major securities exchanges just like stocks. Mutual funds only trade after the close of the trading day, when each fund's Net Asset Value (NAV) can be calculated to determine the purchase/sale price and number of shares effected by the transaction.

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Some truths that highlight key advantages of ETFs, when compared to actively-managed mutual funds include:

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Economic Review

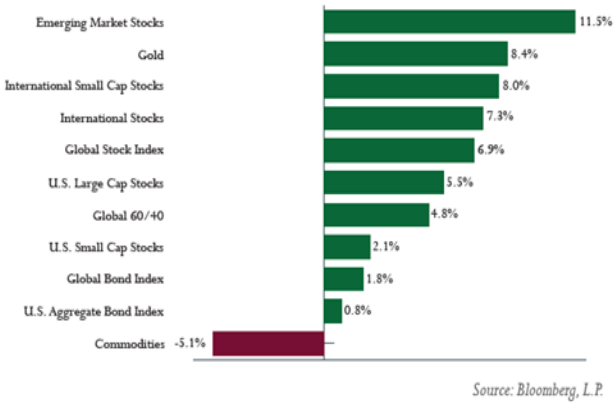
Proving once again the value of prognostication, the U.S. stock market defied most experts and started 2017 like gangbusters. After a strong rally through January and February, the prices eased off somewhat and finished slightly lower for the month of March. After the dust settled, the S&P 500 gained an impressive 5.5% for the quarter. International equity indices rallied even more as emerging markets powered up 11.5% followed closely by developed international bourses rising 7.3% for the quarter.

During the quarter, several broad themes impacted markets, including: U.S. politics, rising U.S. interest rates, politics in Europe, the strength/weakness of the U.S. dollar, an expanding global economy and strong international equity markets. We expect investors' short attention spans to continue to hyper-focus on these themes as 2017 progresses.

U.S. Political Situation

With the vote to repeal and replace the Affordable Care Act seemingly permanently postponed, many are left wondering about the degree to which Trump can work with his own party. While not meant as a political statement, the current administration has clearly gotten off to a rocky start in terms of leadership. The Freedom Caucus, made up of the most conservative Republicans, has dug in its heels on issues like healthcare and continues to cause a split in the party. Polarization between Republicans and Democrats at almost every level compounds the political tension, creating dysfunction and lack of progress on many key issues faced by the country and—as it relates to the markets—the economy.

The graph (on page 2) shows recent polling data taken by NBC on Trump's job approval ratings. The weakening approval rating could further impact his credibility and ability to get things done. However, he



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Peter Anderson is the Executive Vice President, Chief Marketing Officer and Director of Business Development for Boston Advisors. He is responsible for the management of sales, client service, consultant relations, marketing and PR of the firm's strategies globally.

Mr. Vogelzang is President and Chief Investment Officer of Boston Advisors. Mr. Vogelzang has managed Boston Advisors since 1997 and led the firm's management buyout in 2006. As President and CIO, he is responsible for overseeing the firm's equity, fixed-income and alternative investment activities, risk management strategy and general business practices. In his role as the firm's Managing Member, he also chairs the independent Board of Directors.

Economic Review

has a reputation as a deal maker and many believe that with a bit more political experience under his belt, deals will start to happen in D.C.

As mentioned, we saw some softness in the U.S. equity market in March. Investor consensus remains that Trump can still make significant progress towards his goals of infrastructure spending, tax reform, and increased jobs for Americans – but it may take a bit longer due to the political turmoil. Depending on the timing, a modest pullback in the market makes sense as economic stimuli would arrive later. Regardless, the U.S. economy remains strong with solid and improving earnings growth, high and growing employment, and a positive outlook for the remainder of the year.

U.S. Interest Rates: A Rising Rate Environment

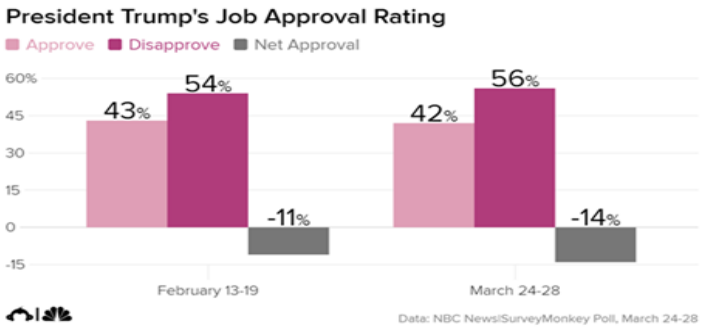
At the beginning of the year, the Federal Reserve (Fed) expected to increase its benchmark interest rate three times during 2017. The first increase is now behind us (in mid-March), leaving two more potential rate increases on the table for the next nine months. The Federal Funds Futures currently price in a very low probability of a rate hike in May but expects a 60% chance of an increase in June. That probability jumps to 80% by September. This graph on page 3of the Fed's famous "dot plot" gives an idea of what the Federal Reserve members expect today. Each dot represents the opinion of one voting committee member. It shows that in 2017, six members believe the Fed's benchmark rate will end up between 1.25% and 1.50%, and three members believe it will end up between 1.0% and 1.25% – today it remains between 0.75% and 1.0%. Also, the Fed just released the notes from its March meeting, indicating that it will likely start shrinking its balance sheet later this year – another way to reduce liquidity in the economy. The big takeaway is the expectation that rates will rise over the next few years. An expectation held not only by the market, but by the officials setting those rates.

International and Emerging Equities: Returning Growth Continues

Non-U.S. stock markets rallied this past quarter, continuing to show signs of reversing multi-year price weakness. The big draw for investors? Cheap(er) companies and increasing growth prospects. Valuations of companies in international developed markets (particularly Europe) and emerging markets remain significantly lower than companies in the U.S. – a relative bargain. However, these other markets do come with risks that bear watching closely.

While emerging market equities took the crown for the best performing asset class in the first quarter, the U.S. economy/dollar persists as a risk facing these regions. If the U.S. economy heats up, it motivates investors to move money from emerging market investments to the U.S. Ironically, a strong U.S. economy with good prospects for investment (both fixed income and equity) siphons money away from international investing, driving down the emerging currencies. The irony is that stronger U.S. economic vibrancy also provides the "engine" for stronger emerging economies, setting up excellent investment opportunities.

The biggest risk in Europe continues to be political, as populism could gain ground, creating pressure on the common currency Euro region. While real—we have certainly seen examples of surprising election outcomes over the last year—we think this risk has gotten a bit overblown, particularly as the European economies begin to strengthen. Populism is directly catalyzed by weak economic conditions. With the current uptick in continental growth, there is less disenfranchisement and hence lessened appeal to populism. For example, we saw the populist candidate fail in the Netherlands several weeks ago. And



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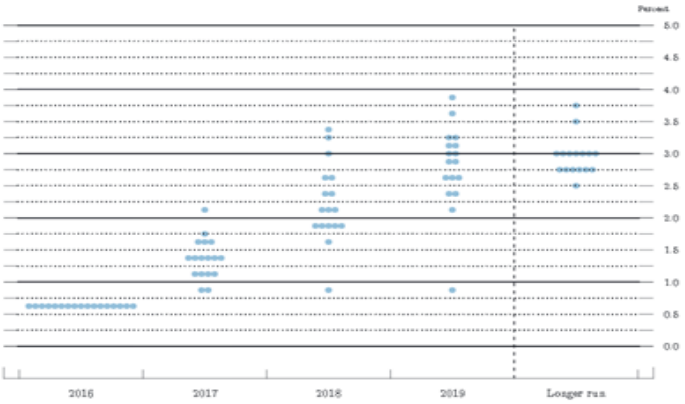
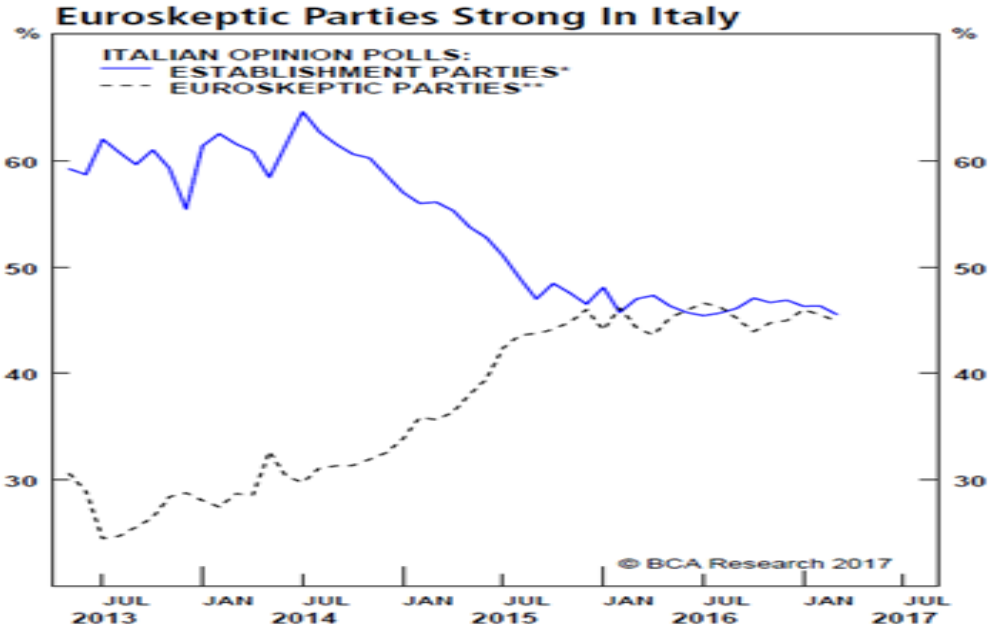
Economic Review



even though Marine Le Pen, the leader of France's Populist Party, made it through round one of the presidential election just days ago, opinion polls expect her to lose soundly to Emmanuel Macron in round two.

Political or populism risk has the largest toehold in Italy with one of the continent's largest economies. The chart shows so-called "Euroskeptic" parties polling strongly in "the Boot." Furthermore, the number of Italians that stand opposed to the Euro currency has grown while many Italians remain confident in the prosperity of an Italian state outside of the EU. While real, this risk remains muted for now, as the earliest Italian elections would happen is this fall, but more likely in May of 2018.



Passive vs Active Investment Management?

1.Simplicity: Primarily passive strategies that mimic major indexes (S&P 500, Bloomberg Barclays Bond Aggregate) in their risk/reward characteristics
2.Inexpensive: Low cost, relative to active management
3.Liquidity: Intra-day trading
4.Performance: Investment returns beat many/most actively-managed, higher cost funds/ strategies, with fee drag as a primary factor.

Some of the misconceptions include:
1.Simplicity: Popularity of passive ETF strategies has created an enormously complicated array of ETF choices including a multitude of sector funds (such as technology, healthcare and energy), ETFs using leverage, hedged and contrarian strategies, ETFs mirroring minor, if not obscure indices, just to name a few. There are now nearly 5,000 ETFs as compared to the approximate 5,000 US-listed stock issues!
2.Inexpensive: While ETFs generally carry low fees, such as the commonly referenced SPDR S&P 500 (SPY) with a 10 Basis Point (BP) charge, the average fee for a comparable US large cap core/blend ETF is far higher with a category average of 32 BPs. Actively managed separate accounts, typically used by insurers, may charge in the 60-80 BPs range but those fees are rapidly experiencing fee compressions causing this fee

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Michele is responsible for the design and execution of portfolio strategies, supervising portfolio positions, credit analysis, and portfolio risk exposure. She has been actively involved in the municipal bond market since 1974 with positions in portfolio management, institutional sales, trading and operations.

Michele is a member of the Southern Municipal Finance Society and its associate organization, the National Federation of Municipal Analysts. Prior to founding The Moorings Group in 2003, Michele managed over $2 billion in municipal bond assets for Banc of America Capital Management and its predecessors in Charlotte, N.C. During her 12 year tenure and as a Director of Fixed Income she managed mutual funds and separate accounts. Michele also had supervisory responsibilities for a team of portfolio managers.

Previously she held positions with Bankers Trust Company, Financial Service Corporation (FSC), The Robinson-Humphrey Co. and Shearson Loeb Rhoades.

Implications for the Tax-Exempt Municipal Bond Market

It is impossible at this point in time to know what changes to tax policy will be enacted by Congress and signed by the White House this year, if any.

U.S. tax reform that is currently being debated will face impassioned scrutiny as the new administration and Congress grapple with the policy implications for the broad economy and the myriad of embedded interests.

State and local government issuers have long enjoyed the right to use tax-exempt bonds to finance long-term basic infrastructure needs at relatively low rates (Revenue Act of 1913).[1]

This original public/private partnership provides a benefit to state and local governments (and ultimately their citizens) by providing capital at lower interest rates and provides a benefit to investors with higher taxable equivalent yields than Federal or corporate bonds. This long standing relationship may be threatened if tax reform is enacted with significantly lower marginal tax rates for individuals and if corporate rates are flattened and lowered. Past tax reform efforts have also targeted the entire allowance for the issuance of tax-exempt bonds.

The municipal bond market has so far yawned at the prospects for significant change in the tax code. This is likely due to the fact that this isn't the first time that the tax-exempt bond market has been targeted. While there are several reasons for the market's lack of concern, the current environment for political compromise is probably the greatest factor providing skepticism towards tax reform. Also another factor would be the reality that for multiple decades, municipal bond yields have reflected the risk of varying tax rates particularly for longer dated maturities (10 years and longer).

For a comparatively simple analysis of the relative value, investors should look at the ratio of AAA tax-exempt bonds to the US Treasury curve. As of May 1st 2017, **ratios** were as follows in the chart below:

Maturity	AAA muni/US Treasury	Taxable Equivalent Yield Compari
sons (35%/**20%**)		
1 year	.84%/1.08%=**78%**	1.29%/**1.05%**
3 year	1.17%/1.48%=**79%**	1.80%/**1.46%**
5 year	1.45%/1.84%=**79%**	2.23%/**1.81%**
7 year	1.78%/2.10%=**84%**	2.73%/**2.22%**
10 year	2.16%/2.32%=**93%**	3.32%/**2.70%**
15 year	2.59%/2.48%=**104%**	3.98%/**3.24%**
20 year	2.86%/2.71%=**105%**	4.40%/**3.57%**
30 year	3.02%/2.94%=**103%**	4.64%/**3.77%**

Source: Bloomberg L.P.

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Implications for the Tax-Exempt Municipal Bond Market

A corporate investor with a 35% marginal tax rate currently receives a tax benefit of 39 basis points on a 5 year AAA muni with a yield-to-maturity of 1.45% that has a taxable equivalent yield of 2.23%. (1.45% divided by the reciprocal of the marginal tax rate .65%).

While a corporate tax rate of 15% has been proposed in the White House proposal of April 25th "2017 Tax Reform for Economic Growth and American Jobs", it is prospectively an opening rate to be negotiated upward. It is our belief that by the time the U.S. House of Representatives and the U.S. Senate have their political needs met in the process, the corporate rate will more likely be in the 20% to 25% range. For corporate tax payers: a worst case rate of 20% would not provide any economic benefit (see above chart) at current 5 year tax-exempt yield levels with a taxable equivalent yield of 1.81% (1.45% divided by the reciprocal of the marginal tax rate .80%).

Given the perception of having a lower degree of creditworthiness and more limited liquidity than US Treasuries, municipals should be a greater spread than is currently reflected in yields for corporate entities with a projected tax rate of 20%. The current 5 year AAA municipal bond is probably overvalued by 30 to 35 basis points if the corporate rate is reduced to 20%. Long dated maturities (10+ years) are more appropriately valued but still overvalued. This observation is not assuming any other market valuing influences, such as central bank policy, credit issues or supply side dynamics.

Please keep in mind that corporate entities (primarily insurance companies and commercial banks) represent only about 30% of the demand side for tax-exempt municipal bonds. It is expected that the individual investors with marginal tax brackets of 25% and 35% would still find tax-exempt municipal bonds attractive particularly in the higher state income tax locations. However, there would be some reduction in the demand side of the municipal bond market that would likely result in increases in yield along the yield curve.

The other general threat would be the loss of tax-exemption feature altogether by deficit fighting House and Senate members who are committed to funding tax cuts with the elimination of tax expenditures.[2] The exclusion of interest on public purpose state and local bonds is approximately $423 billion through 2026 and ranks 15th among the largest of the tax expenditures.[3]

Not surprisingly the interested parties in maintaining the tax-exempt status for municipal bonds include: The National Governors Association (NGA), the Council of State Governments, the National Association of Counties, the National Conference of State Legislatures, the National League of Cities, the U.S. Conference of Mayors and the International City/County Management Association. Additionally a coalition to preserve the exemption for municipal bond interest has been formed named the "Municipal Bonds for America" which represents 385 other organizations across the country.

In the past these organizations have been successful in educating members of Congress and new executive branch personnel as to benefits of the exemption and thereby thwarting any change. While this may continue in this year's effort for tax-reform, there is no assurance that this tax-expenditure isn't sacrificed to pay for tax cuts. It is too early in the process to gauge the ability to enact tax legislation that could be perceived to grow deficits.

The abolition of the tax-exempt status for state and local government financing would be counter-intuitive for both political parties, who have vowed to support much needed infrastructure projects. Other types of public/private partnerships are less conducive to most local projects that are not revenue producing entities.

Issuance of tax-exempt bonds by state and local governments for schools, streets, bridges, and utilities provide local control and notably tax-payer oversight.

We would expect that ultimately the exemption remains, and therefore volatility producing headlines coming out of the current political environment may afford a good opportunity to add to tax-exempt municipal bond portfolios or construct new portfolios at very reasonable levels.

1 The Tax Foundation: "Re-examining the Tax Exemption of Municipal Bond Interest" July 2016

2 Tax expenditures are defined by law as "revenue losses attributable to provisions of the Federal tax laws which allow a special exclusion, exemption, or deduction from gross income or which provide a special credit, a preferential rate of tax, or a referral of tax liability." –US Department of Treasury.

3 Bloomberg Intelligence

Passive vs Active Investment Management?

gap to continually narrow. Most insurers do not have the internal expertise to analyze and select from the nearly 5,000 ETFs. Like stocks, each ETF has its own unique risk reward characteristics and performance and fee differences.

Given the wide array of broad, narrow/sector and niche focused ETFs, most investors, both institutional and retail, have found the need to engage an "ETF Strategist," or a Robo-advisor, to help in the ETF analysis and selection process. Of course, this adds an additional fee layer which serves to further close the fee gap between active and passive management, making the cost savings slight, if not somewhat disappointing.

3.Liquidity**:** The ability to trade ETFs intraday is generally positive for liquidity but it also creates an "active" trading environment for passive strategies that are now traded like a typical stock portfolio. Transaction costs can erode the passive management cost savings. There are also concerns about a freeze-up, denying liquidity to ETFs in sudden, large market declines when underlying security pricing may not be able to be determined.

4.Performance: Passive investments are designed to capture market beta[1], or the risk characteristics of the index they mirror. In this manner, they also capture the expected return of that index. An ETF with a beta=1, means it exactly mirrors its index in risk and return. Unfortunately, over time, ETFs will generally underperform their index. Indexes do not experience the performance drag of fees or trading costs (of rebalancing the underlying securities in the ETF to the index). Since no active management decisions are made, there is no opportunity to outperform the index over the long term. Perhaps worse, ETFs have no risk controls to provide market downside protection, a significant feature often overlooked by insurers when fees are the primary consideration. It is also important to compare performance on an "after-fee" basis as active managers typically report and are compared on a gross of fees basis while ETFs report net of fees. Making sure the performance is reported in the same manner is imperative for doing an accurate analysis.

Our last piece on the topic of ETFs (Winter 2017 edition CapVisor Insurance Asset Management Newsletter) we also addressed the fact that most articles written about the virtues of ETFs are:

Written to address the investment sophistication level and needs of "retail", as opposed to more sophisticated "institutional" investors. Passive ETFs often protect retail investors from themselves and save them money as they seldom, if ever, have the analytic capabilities needed to select active managers that may consistently outperform.

Touting studies show passive ETFs outperform actively managed mutual funds. While this is true of many strategies, it is <u>not</u> true of all. More importantly, they do not compare performance results of ETFs to actively-managed separate accounts, by far the most popular vehicles used by institutional investors, and insurers in particular. For example, when analyzing bond performance, which represents the largest asset class(es) in an insurance company's portfolio allocation, our analysis[2] indicated that 68% of the active managers handily beat their performance benchmark (Bloomberg Barclays Aggregate index) and therefore a corresponding ETF. More compelling is that **96% these managers beat the benchmark on a risk-adjusted basis** (as measured by Alpha)[3]! Insurers typically invest in separately managed accounts, rather than mutual funds, and so this observation is particularly important.

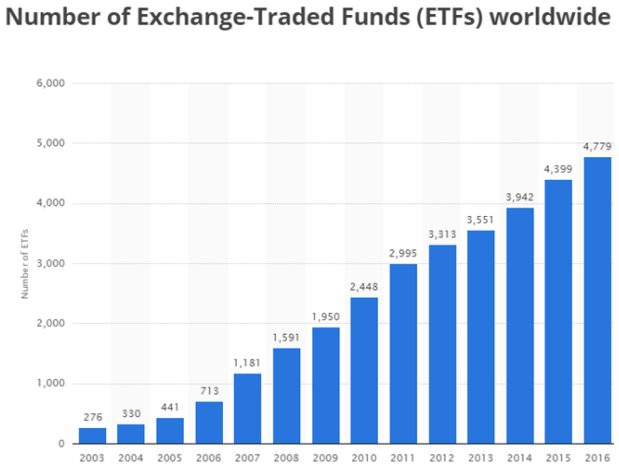
And so, to revisit our question of passive vs. active portfolio management, we say simply "that is the wrong question!"

How can active and passive management strategies complement each other in insurance portfolios?

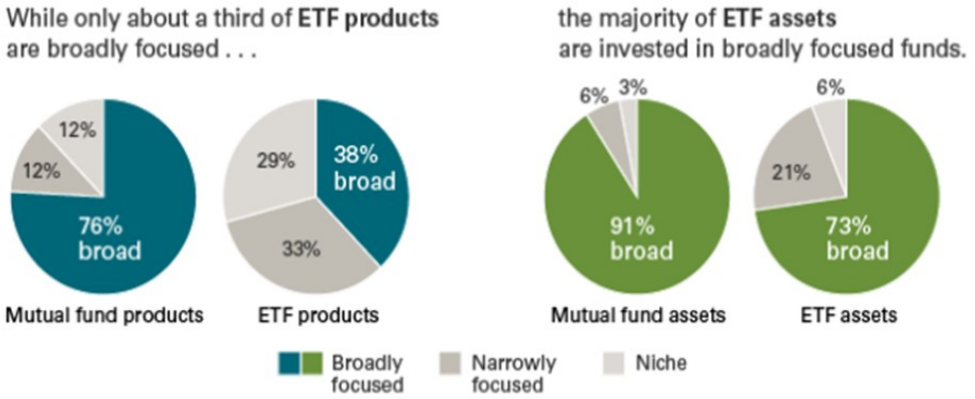
Active management is extremely important to the typical insurance company investors for several reasons.

Risk Control

First and foremost, professional active separate account management allows the investment manager to customize the risk level of the portfolio. Asset Liability Management (ALM) techniques allow the portfolio to be designed around the unique liability structure of the insurer. Regulatory constraints, as well as the management and board's risk tolerances, can be reflected in the design of the investment guidelines for the portfolio. In this manner, the portfolio can demonstrate asymmetrical behaviors. For example, a highly skilled manager can out-perform the index's return while taking less risk than the benchmark. This asymmetric behavior is perhaps better understood when looking at a slightly less skilled manager. In this example, a manager may lag their benchmark in an up-market, say obtaining 90% of the up-market's return,



Passive vs Active Investment Management?



Sources: Vanguard calculations, using Morningstar data, as of May 31, 2016.
Excludes bond and balanced funds.

but due to superior risk controls they limit the downside and protect client portfolios by only experiencing 60 or 70% of the downside in a market decline. Both aforementioned manager skill levels could be preferred by insurers to a passive ETF strategy. Why? For comparison, a passive ETF strategy would get benchmark index-like returns (less expenses) and receive a bit less than 100% of the market index's upside and a bit more than 100% percent of the market index's downside (due to the fee and transaction drag).

Return Potential

Actively managed separate accounts provide the opportunity for a skilled manager to outperform benchmark indexes or passive (ETF) investments. Insurance investors, perhaps those with long, reliable claims histories and extensive surplus, typically can afford to have more aggressive asset allocations. Enterprise risk management allowing for more complex asset allocations can often benefit from the proverbial "free lunch" – when higher returns can be attained while simultaneously reducing overall portfolio risks. An example regarding an insurer's bond portfolio might be when incremental allocations to high yield and/or convertible bonds, preferreds, bank loans, etc., are added to a high-quality bond (core) portfolio to allow the overall portfolio to outperform the typical high quality bond portfolio with little to no extra risk or even reduced risk levels. Some of the extra risk inherent in the additional asset classes can be diversified away, through low or negative correlations to the core bonds, providing more stable returns through volatile market conditions. These active management benefits, when properly executed, can serve to provide faster capital growth and may serve to gain competitive advantages through improved financial positioning.

Why insurers should consider both active and passive strategies

Passive management strategies, particularly those using ETFs rather than passive mutual funds, are an extremely important development for insurers as it makes diversification easier and at lower cost.

Diversification lowers risk

Insurers can invest in ETFs with small amounts of capital to gain instantaneous diversification benefits. For example, let's say than an insurer conducts a Strategic Asset Allocation (SAA) optimization that determines that a small $1 or $2 MM allocation to High Yield bonds would improve the risk/reward characteristics of their overall portfolio. The insurer would find this allocation very difficult to execute with an active manager for a few simple reasons.

First, separate account management would typically be the preferred implementation strategy since for a specialty asset class like high yield it is usually not best managed by a "generalist" bond manager. However, the aforesaid amount would be below the threshold for the minimum account size for most, if not all, actively managed separate account managers. The second issue is that with such a small amount of capital, or allocation, the manager would find it difficult, if not impossible, to purchase enough bonds to properly diversify the portfolio. Even if these hurdles could be cleared, the small allocation would undoubtedly be at the highest fee break point on the manager's fee schedule.

In looking for an alternative to all these issues, one might try a High Yield Mutual Fund, even with the understanding that in buying a "product", the insurer would lose control over the preferred risk levels taken by the manager. When looking at the somewhat high fees expected with this investment vehicle, the insurer might quickly decide that this is a perfect situation for a passive ETF solution. There is still no control over risk levels but the fee would be much more affordable, with better liquidity, and more flexible minimum investment amounts. The ETF provides all the risk/return characteristics of the asset class and any dollar amount can be easily invested for instant diversification. The ETF is clearly the best low cost solution for fulfilment of the asset allocation directive.

Some of the best applications for ETFs, in our opinion, lie with equities. Our rationale is based upon several factors:

Fewer active managers, particularly US large, mid and small cap managers,

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can beat their benchmarks than managers of other asset classes
The fee difference between active and passive strategies is often the greatest about
the aforementioned equity strategies
The portfolio can be allocated to many more strategies, and therefore be better diversified, more cheaply than any other method of accessing these US equity capitalization strategies

We are not suggesting that passive ETFs are the automatic replacement for consideration of an active manager search for equities. Rather, a carefully researched "after fee" comparison of return should be weighed against the possible risk level customization that is forfeit in making the ETF decision. To complete the review process most efficiently, we would recommend an analysis of Modern Portfolio Theory (MPT) risk -adjusted return statistics for the ETFs and/or active managers composite portfolios in question.

After all, the real goal should always be to get the biggest bang (return) for the buck (dollar at risk).

[1] Beta is a measure of the volatility, or systematic risk, of a security or a portfolio in comparison to the market as a whole. Beta is used in the capital asset pricing model (CAPM), which calculates the expected return of an asset based on its beta and expected market returns.
[2,3] CapVisor analysis of PSN Enterprise active manager universe dated 3/31/17

Upcoming Events

After a very busy Spring agenda including speaking and sponsoring of the USA Risk Conference in San Juan Puerto Rico and Sponsorship at the SRS Symposium in Sarasota FL and exhibiting at the IASA in Orlando FL. in May and early June please look for CapVisor in attendance at the TCIA Summer Spotlight June 20-21 at the Franklin Marriott Cool Springs, Franklin TN

In a preview to our summer schedule:

Carl Terzer and Associates of CapVisor will be exhibiting at the VCIA Annual Conference August 8-10 at the Sheraton Hotel & Conference Center in Burlington VT. Please stop by to say hello!

CapVisor will be at the Bermuda Captive Conference Sept 11-13; The SCCIA Conference in Charleston SC Sept 12-14 and we will be exhibiting at the NAMIC Annual Conference in Denver, CO Sept 25-27.

We also hope to see you at the NRRA Conference in Chicago Sept. 26-28.

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