CapVisor Associates, LLC

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Inside This Issue

Strategies for a More Volatile Stock Market

Insurers protect their claims paying ability by investing the bulk of their portfolios in investment grade bonds. Investment Managers refer to this portfolio component as the "reserve" portfolio. The surplus component, consisting of assets in excess of those required for anticipated claims and operating expenses, is often predominately invested in equities, at least for P&C insurers. This component is where insurers can add incremental investment risk and generate more attractive returns. Investment success in the surplus component of an insurance portfolio has been critical to overall insurance company growth and competitiveness. This has been particularly true over the last ten years due to the extended period of historically low bond yields and soft market conditions for many of the coverages they write.

Insurers with stock portfolios have enjoyed an extended period of a relatively placid stock market, however, the return of price volatility came swiftly in February as a sharp correction pulled markets lower by 10% in less than two weeks. This decline is primarily attributed to concerns about

Continued on page 4

Economic Review

For insurers, with the largest percentage of their assets in bonds, 2017 was an interesting year. In looking at the US bond market, interest rate movements were relatively muted while corporate bonds outperformed and the yield curve flattened. Is the new year likely to continue these trends? If not, what changes could be on the horizon? Let's begin with a closer look at what happened in the fixed income market last year.

To focus on the general interest rate movements during the year we can look at the U.S. 10-year treasury yield. It began the year at 2.45% and ended the year at 2.41% - a 4 basis point decline. The nearly unchanged rate from the beginning of the year to the end of the year doesn't necessarily mean the range of interest rate movements was limited. The high yield for the year was on March 13th at 2.63% and the low was on September 7th and was 2.04% - a 59 basis point range for the year. So, the 10-year treasury traded in a 59 basis point range last year and nearly ended up unchanged. But that doesn't tell the whole story.

Let's look at the yield curve or term structure of interest rates which is a chart of the yields of similar quality bonds against their maturities. It allows insurers to see how much incremental yield can be received for extending to a longer maturity. The U.S. Treasury yield curve measured as the difference between the 2-year treasury and the 30-year treasury flattened by 103 basis points during 2017 as it shifted from 188 basis points at the beginning of the year to 85 basis points at year end. This large flattening move was a result of the 2-year treasury yield increasing 70 basis points while the 30-year treasury yield actually declined by 33 basis points. This flattening trend has been in place for a while as expectations of the Federal Reserve withdrawing excess stimulus from the system increased, and they began to raise the Federal Funds rate in December of 2015. At the same time, lethargic inflation expectations (and ultimately inflation measures) prevented long term rates from moving up in tandem with short rates and even allowed them to decline.

Another important factor for insurers' fixed income returns during 2017 was the meaningful outperformance of the corporate bond sector, which on an excess return basis (where the durations of the various sectors are equalized so you can compare the various sector returns on a common basis), corporate bonds outperformed treasuries by 3.46%. Within the corporate sector lower rated securities, while still 'investment grade", outperformed higher rated issues by a large margin. Insurers with more flexible investment guidelines, as they relate to credit restrictions, were rewarded.

All of these factors were significant contributors to fixed income returns last year. We know that as interest rates rise, bond portfolio market values decline. However, the overall direction of interest rates uncharacteristically had little influence on return while the change in the yield curve and strong performance from corporate securities had meaningful impacts. So let's take a look at some

Continued on page 2

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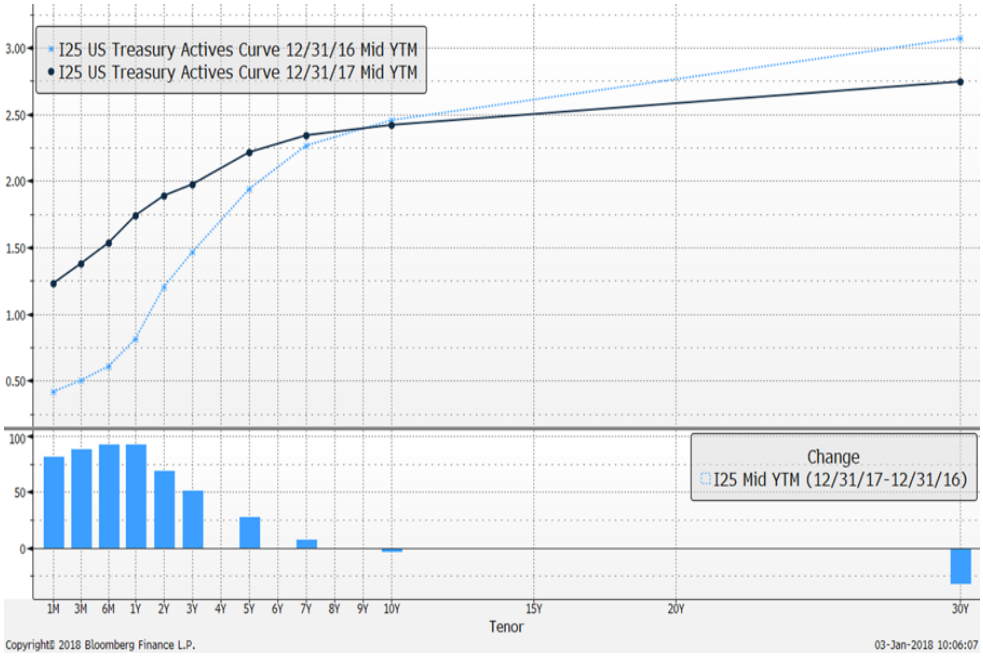
Economic Review

factors that created an environment that produced these results. This is not meant to be an all-inclusive list but is an overview of some factors that we believe were most relevant.

Since the great recession ended in 2009, economic growth as measured by real GDP has been very moderate at about a 2% rate. Also, during this period inflation has been weak, generally remaining below the 2% rate the Federal Reserve has targeted. These moderate economic growth and inflation results were in spite of massive stimulus by the Federal Reserve and they did not elicit expectations of dramatically higher interest rates or a great deal of volatility. As a result of the Federal Reserve's confidence in the sustainability of economic growth they have embarked on a course to remove the excess stimulus they believe is in the system. Let's hope their confidence is justified as consumption contributes about 70% of our economic growth. To maintain their spending consumers have reduced their saving rate to approximately 3% and recently increased their use of credit - which doesn't give the greatest confidence level for continued strength by the consumer.



Wage increases have shown some life lately but have only increased over the last few years enough to create an overall weak trend of wage increases. Also, many economists and academics alike believe that when debt levels increase to above 100% of GDP it begins to reduce economic growth potential in an economy. The national debt during the period increased from $10.6 trillion in 2009 to $20.2 trillion at the end of fiscal year 2017 which equaled 105.6% of GDP. That is quite a bit of fiscal stimulus to achieve only 2% growth in GDP and we are now above the 100% level of debt to GDP which many believe impedes economic growth rate going forward.

We had become mildly concerned about growth in the intermediate term but now are hopeful that the year-end tax cuts will maintain growth trends in the immediate future. This current economic growth cycle is the third longest in US history and is just a few months shy of achieving the notoriety of being the second longest. As we move into the ninth year of economic growth it would seem that more growth is behind us than in front of us. The factors that caused the flattening yield curve were relatively simple in retrospect - the Federal Reserve pushed short term rates up and lethargic inflation allowed longer term rates to decline. Who would have suspected inflation would be so subdued with a 4.1% unemployment rate, a weakening dollar, a major equity market rally and seemingly an upshift in economic growth from 2% to closer to 3%. Looking at next year, new factors will include the impact of recently passed tax cut legislation and possible infrastructure spending. Market expectations are for at least three tightening moves from the Federal Reserve next year which should continue to move short term rates up. The question is what will happen with inflation and inflation expectations during 2018. We have had relatively low expectations for

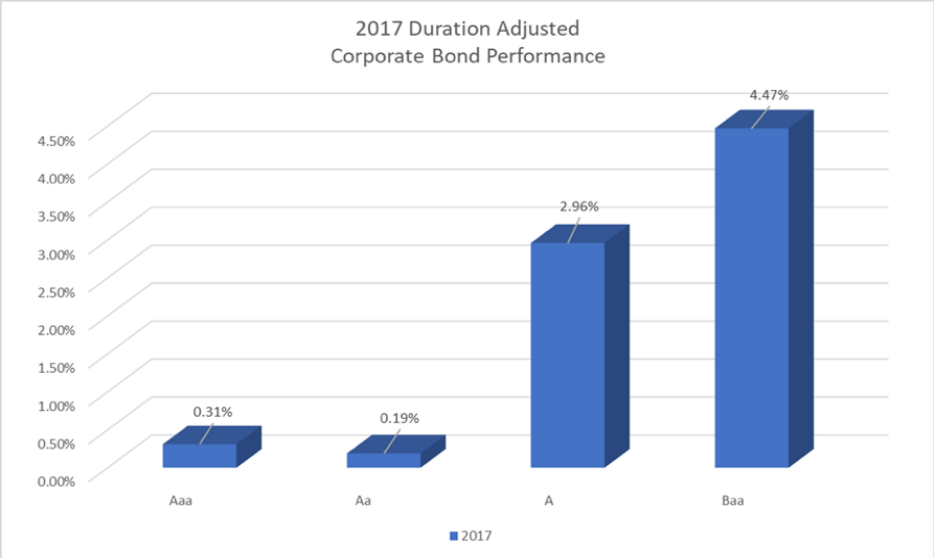
Continued on page 3

Economic Review

inflation for several years but with recent stirrings of wage pressure, the low unemployment rate and a weak dollar we currently believe inflation bears watching closely.

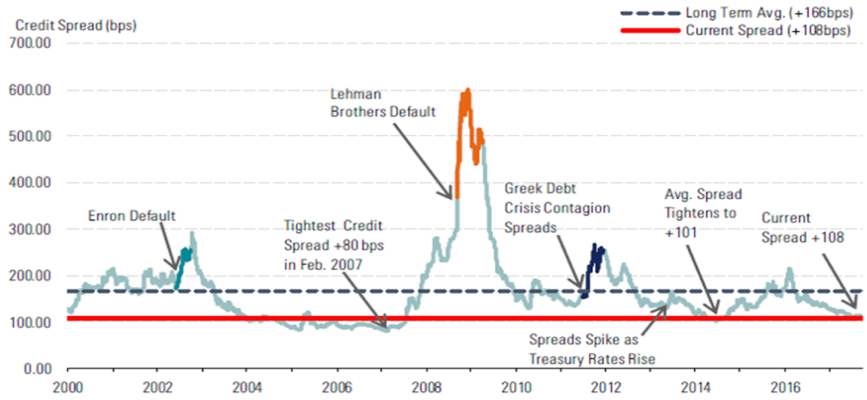
It doesn't seem likely that corporate securities will be able to repeat their outperformance to the same degree in the new year as their dramatic outperformance over the last few years has moved their valuation into the somewhat expensive category.

"We had become mildly concerned about growth in the intermediate term but now are hopeful that the year-end tax cuts will maintain growth trends in the immediate future."



Source: Bloomberg Barclays Aggregate Bond Index

Exhibit 5 Morningstar Corporate Bond Index Average Credit Spread



Source: Morningstar, Inc. Data as of 09/25/2017

However, as can be seen on the graph they can remain relatively expensive for extended periods of time and that might be the most likely outlook at this point. The substantial reduction in corporate tax rates should increase cash flow and after-tax earnings which should allow corporate credit to improve. This should allow corporates to enhance portfolio returns through incremental yield despite being somewhat expensive relative to historic valuation.

Also the new tax law has made tax exempt municipals less attractive for property and casualty insurance investors. Raymond James research indicates that a 3.00% tax exempt yield would be worth 4.37% taxable equivalent yield based on last year's tax law and 3.60% under the new law - a decline of 77 basis points. Life insurance companies also receive a benefit under the new law that gives them a 3.56% taxable equivalent yield on a 3.00% tax free yield. Insurance investors should continue to monitor various fixed income market sectors based on historic valuations and current relative valuations to ascertain the most attractive sector under current market conditions and market outlooks.

There are always changes and surprises that require adjustments to investment outlooks. In 2016 markets were surprised by Donald Trump being elected as president. In 2017 the passage of a major tax reduction bill wasn't generally expected. There will be surprises in 2018 as well. Interest rates forecasts must be adjusted as new information presents itself. This ongoing process reflects itself in changes to investment strategy and implementation. How stimulative the tax cuts are for economic growth will only become apparent down the road. We currently expect interest rates to continue their moderate increase, the yield curve should continue to flatten and corporates to maintain their current valuations and enhance returns through incremental yield. However, there will be surprises just like in every other year. □

Stefan ten Brink, Managing Director

Mr. ten Brink joined the Firm in January 2011 from Petercam Asset Management in Amsterdam. He has 22 years of investment advisory experience, having co-managed the Ahold Pension Fund prior to joining Petercam. He has 18+ years experience with the HOLT framework.

Mr. ten Brink holds a degree in Logistics & Economics from Arnhem Business School and an MBA from Nijmegen University. Stefan is a Certified European Financial Analyst (CEFA).

Strategies for a More Volatile Stock Market

interest rates which have begun to move higher in response to the inflationary pressures produced by an accelerating economy in the US. Despite strong economic data and a corporate-friendly tax change, the markets must now learn to cope with headwinds.

Market watchers and pundits have called the "top" of the slow but steady bull market many times over the past few years. One day they will be correct! Insurance boards and management understand market cycles and tend to display the discipline to focus on the long-term investment horizon. However, they may still need to be accountable to both internal and external constituencies and well as regulators and accounting/ auditing conventions. So how might an insurer protect against the eventual sustained downturn in the stock market?

Several strategies may be considered, including developing a "Dividend Achievers" portfolio designed to hold selected stocks which generate high levels of dividends to serve as a partial offset to market value declines. Another alternative would be to use a covered call writing strategy, which combines stock dividends with "option premium" income from the call writing to offset the market value decline. A third method could be to use both long and short positions, hedging strategies, to buffer the potential losses of steep market declines.

Each strategy has its own merits but Investment Managers find that many insurers appear most comfortable with the middle course, covered call writing, in good part because the underlying stocks, US large cap with recognizable names, are typically in their portfolios already. This strategy is conservative in nature as it essentially trades some upside appreciation for downside protection. Importantly, it has proven to be an effective defensive strategy in market corrections and well as major downturns.

For example, during the recent correction, the covered call writing strategy demonstrated these strong downside protection qualities.

January 31 - February 8, 2018	
S&P 500	-8.55%
BXM (CBOE S&P 500 BuyWrite index)	-7.25%
Investment Manager X	-5.40%

The BXM, the index or performance benchmark for most covered call writing strategies, demonstrates the strategy's value: it shielded 130 basis point of potential S&P 500 market loss compared to investors with long-only portfolios. Active management of covered call writing programs can improve these protections further. The active manager profiled, proficient in executing these strategies, significantly improved the defensive characteristics by reducing

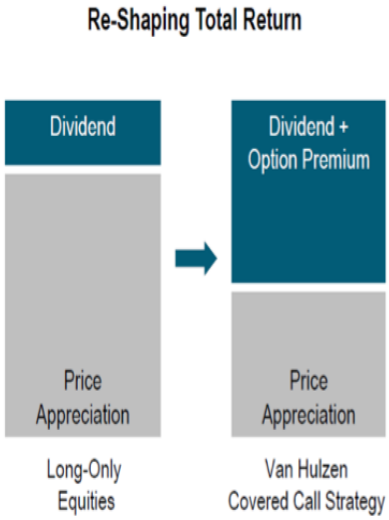
Continued on page 5

1 Market volitility is commonly measured by the VIX, the ticker symbol for the Chicago Board Options Exchange (CBOE) Volatility Index.

The Essentials of Covered Calls

A Brief Overview of Covered Calls

- A Covered Call Strategy invests in a long portfolio of stocks and covers its positions by selling call options. The net long position of a covered call strategy will by definition be smaller than that of the stock portfolio itself.
- By using a Covered Call Strategy, the goal is to exchange the uncertain upside potential of a stock price (beyond a certain pre-determined target price) for a certain amount of current period income.
- The Covered Call Strategy's goal in using covered calls is to outperform the market over the course of a business cycle. These strategies generally perform best in sideways or downward moving markets but may underperform when markets move dramatically higher.



Strategies for a More Volatile Stock Market

the loss by 315 Basis points over the long-only portfolio.

While the market has rebounded somewhat as of this writing, the market will surely suffer future pull-backs or worse, another crash. When those events take place, limiting the recovery time for your portfolio values is important. A more dramatic example of the success of this defensive equity strategy can be illustrated by looking at the 2008-2009 market crash. A long-only S&P 500 portfolio took 37 months to recover to break-even while the actively managed, covered call writing program manager recovered to breakeven in 19 months.

Looking Ahead

Many Investment Managers expect that a higher level of volatility will persist as the market comes to grips with higher interest rates (and corresponding lower price multiples) and the removal of Federal Reserve support. The battle between a strong economy and rising rates will likely result in more volatile price action. Even if the outcome is benign for equity returns, the volatility of price movements is likely to return to normalcy and not repeat 2017's abnormally low volatility.

If the market experienced a "normalization" of equity volatility levels, covered call writing programs would catapult to a strong position relative to the long-only equity strategies more typically used by insurers. After years of extremely low VIX1 readings, in the high single digits and low double digits, a return to normal levels (18-22) would result in higher call option premiums and higher total return potential.

> **"Insurer boards and management understand market cycles and tend to display the discipline to focus on the long-term investment horizon."**

In fact, the difference between selling volatility at 10 versus 20 or 30 is quite significant. A 10% implied volatility level represents much of what happened in 2017, 20% represents normal levels and 30% represents elevated choppy market conditions. A S&P 500 Index Call Option with implied volatility of 10%, yields 5.8% annually while a level of 20% yields 10.4%. And if volatility were to remain elevated around the current level of 30%, the annual yield jumps to 14.8%!

In a market environment where a good economy may win out, but the risk of rising rates could cause a large mean reversion event, it seems prudent to build positions that have good total return potential while also providing downside protection. Call Options as short as three months, and as long as twelve months, offer the best risk/reward outcomes. Shorter term options could produce higher 1 month yields but would offer very little protection. Two-year options would provide more total dollars as protection but sacrifice total return potential.

In this environment, a Covered Call Manager has much more flexibility to build positions and tilt the outcomes toward either:

- more income or
- more total return upside

In a low volatility environment, the manager might produce an annualized yield of 6% on a position but be forced to use a strike price that offers very little price upside. In a more volatile environment, the manager could produce the same 6% income but also have 10% to 15% of price upside, or choose to generate 13-15% yields.

In our sample manager's track record history, when volatility persists around the long-term normal level of 20%, the covered call strategy produces upside results similar to, or even in excess of, the stock index and has the added benefit of reducing downside risks.

If interest rates and inflationary pressures win out, then the higher total dollars collected from options in the 3-12 month window will provide more downside protection than short term options and option income from recent low volatility periods. Whether the market goes higher, lower or chops sideways in this range, the higher level of volatility will favor covered call strategies over long-only strategies on a relative risk basis. □

A New Landscape for Municipal Bonds in Insurance Portfolios

The Tax Cuts and Jobs Act of 2017 was signed into law on December 22, 2017, with an effective date of January 1, 2018. The provisions most important to insurance companies are:

- The marginal federal corporate tax rate was permanently lowered from 35% to 21%.
- The company's share percentage for P&C insurers was lowered from 85% to 75% while it was raised for life insurers to a fixed level of 70%.

Continued on page 6

A New Landscape for Municipal Bonds in Insurance Portfolios

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.

- The Alternative Minimum Tax (AMT) was repealed for corporations but only modified for individual payers.

The impact of decreasing both the marginal federal tax rate and the company's share percentage for P&C companies lowered the multiplier for calculating tax-equivalent yields for former 35% marginal rate payers from 1.46 to 1.20. The company's share adjusted marginal tax rate used by P&C insurers to gross-up tax-exempt coupons decreased from 31.4% to 16.6%, compared to the marginal rates of 32% for married couples filing jointly with taxable income over $315,000 and 37% for taxable income over $600,000. It is easy to see that tax-exempt municipals are now less attractive to P&C insurers. Individual taxpayers will likely set the market price higher, and yield lower, than P&C insurers will be willing to pay.

One important exception may be bonds subject to AMT. Because individuals are still subject to a 28% AMT rate for married couples filing jointly with Alternative Minimum Taxable Income (AMTI) above $191,500, the yields on AMT bonds may remain higher than comparable non-AMT bonds, creating a pocket of opportunity for insurance companies.

Life insurers have been limited participants in the tax-exempt municipal market because their company's share percentage was a rather complicated calculation using estimated end-of-year reserve values that typically produced company's share percentages in the 30% to 50% range. Now that their company's share percentages are fixed at a much higher 70%, life insurers may find 30-year tax-exempt municipals attractive because they line up better with their long-duration life insurance policies and 30-year corporate spreads. Thirty-year municipals are traditionally the cheapest compared to Treasury bonds in the tax-exempt universe (see Figure 1).

We believe municipal bonds still merit a healthy allocation in P&C portfolios due to the lack of attractive alternatives, but they must be in the right spot.

We will focus our analysis on intermediate maturities. In a rising interest rate environment, we believe it is prudent to limit interest rate risk when not compensated to extend duration. The yield-to-worst (YTW) of the Bloomberg Barclays U.S. Intermediate Index (duration of 4.17 years) was 2.56% at December 31, 2017, while the YTW of the U.S. Aggregate Index

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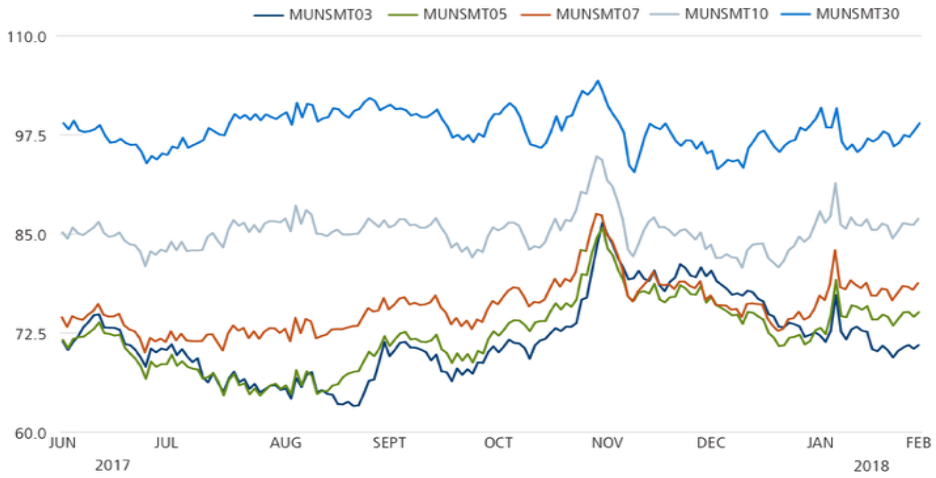

Figure 1. Muni yield as % of treasuries (3,5,7,10 and 30 year maturities) Past performance is no guarantee of future results. Source: Bloomberg.

A New Landscape for Municipal Bonds in Insurance Portfolios

(duration of 5.98 years) was only 2.71% (Figure 2). The 1.81 year duration gap between the two indices is near the all-time high and the 0.15% (15 basis points) yield pick-up at an all-time low. Most P&C companies have aggregate liability durations under 10 years. Why take additional duration risk?

Municipals have better relative value than corporates, agencies, mortgage-backed securities (MBS) and U.S. Treasury bonds. Corporate bonds consistently provide more option-adjusted spread (OAS) than agencies, mortgage-backed securities (MBS) and Treasury bonds (OAS = zero) as compensation for their additional credit risk (Figure 3). Municipal bonds often have better relative value (default experience, adjusted yields and correlation benefits) than corporate bonds (and agencies, MBS and Treasury bonds, by extension.)

- ***Default Experience.*** Default studies published by Moody's and Standard & Poor's show that municipal bonds have better default experience than higher-rated corporate bonds. Municipal bonds with BBB ratings have 10-year cumulative average default rates (annualized) comparable to corporate bonds rated AAA (Figure 4). Default rates on (A3/A-) or higher rated municipals have been almost zero.

- ***Adjusted Yields.*** Bloomberg's generic AA rated municipal bond yields adjusted to a pre-tax basis under the old tax law (represented by **AA Muni B4** in Figure 5) exceed AA rated corporate bond yields (**AA Corps**) past five-year maturities when both are adjusted for expected default losses, but using the new tax law produces the much lower **AA Muni** yield curve. However, we believe there are still pockets of value for insurers in the municipal market. As we noted, these include AMT bonds-which are less attractive to individuals-and state housing revenue bonds. These AMT and state housing revenue specialty issues (**AA SPC**) have adjusted yields that exceed **AA Corps** past six-year maturities.

- ***Low Correlation.*** Finally, intermediate municipal total returns have had only moderate correlation with intermediate corporate bonds (ρ = 57%) and the intermediate fixed income universe (ρ = 66%) over the past 10 years, according to Morningstar (Figure 6). This indicates that municipal bonds

Continued on page 8

	YIELD TO WORST	DURATION (YEARS)	YIELD PER DURATION (YEARS)	COUPON	MATURITY (YEARS)	OAS (BPS)	SPREAD (BPS)
BBg Barclays U.S. Aggregate Index	2.71%	5.98	0.45%	3.06%	8.27	36	49
BBg Barclays Intermediate U.S. Aggregate Index	2.56%	4.17	0.62%	2.82%	5.20	27	43
Difference	0.15%	1.81		0.24%	3.07	9	6

	YIELD TO WORST	DURATION (YEARS)	YIELD PER DURATION (YEARS)	COUPON	MATURITY (YEARS)	OAS (BPS)	SPREAD (BPS)
BBg Barclays U.S. Aggregate Index	2.55%	5.96	0.43%	3.06%	8.25	38	54
BBg Barclays Intermediate U.S. Aggregate Index	2.35%	4.20	0.56%	2.82%	5.26	28	48
Difference	0.20%	1.76		0.24%	2.99	10	6

Figure 2. Yield benefit from maturities past 10 years is near all-time lows
Past performance is no guarantee of future results. Source: Barclays Live.

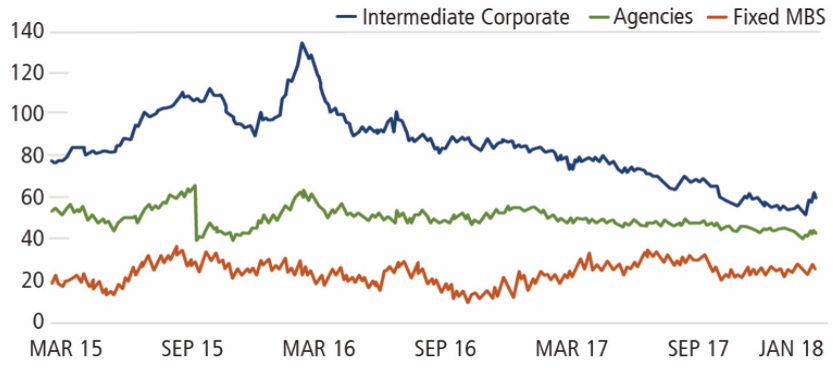

Figure 3. Corporate bonds have best OAS of any sector in intermediate aggregate index
Intermediate - term option adjusted spread, 3 years
Past performance is no guarantee of future results. Source: Barclays Live.

A New Landscape for Municipal Bonds in Insurance Portfolios

Figure 4. Historic default rates (annualized)
1Moody's Investor Services-U.S. Municipal Bond Defaults and Recoveries, 1972-2016 2S&P-U.S. Public Finance Cumulative Average Obligor Rates, 1986-2016 (%) (10-year average cumulative default rates/10)
3S&P-U.S. Corporate Cumulative Average Obligor Rates, 1981-2016 (%) (10-year average cumulative default rates/10)

	MOODY'S[1]		STANDARD AND POOR'S[2,3]	
	MUNICIPAL	CORPORATE	MUNICIPAL	CORPORATE
Aaa/AAA	0.00	0.04	0.00	0.09
Aa/AA	0.00	0.08	0.00	0.11
A/A	0.01	0.23	0.01	0.19
Baa/BBB	0.04	0.40	0.06	0.46
Ba/BB	0.42	1.65	0.50	1.53
B/B	1.79	3.93	1.15	2.74
Caa-C/CCC-C	2.60	4.80	3.88	5.67

Figure 5. Corporate vs. tax and default adjusted muni yields at 2/28/18
Past performance is no guarantee of future results. Source: Bloomberg. Assumes defaults are average of Moody's and S&P historical rates in Figure 4 and 50% recovery rate.

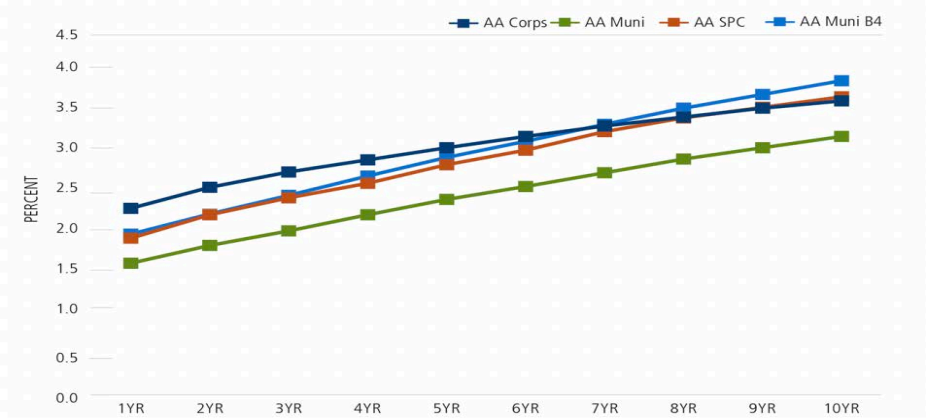

Figure 6. 10-year total return correlations January 2008 - December 2017
Source: Morningstar

BLOOMBERG BARCLAYS INDEX	1	2	3
1 Municipal Intermediate-Short 1-10	1.00		
2 U.S. Aggregate Intermediate	0.66	1.00	
3 U.S. Intermediate Credit	0.57	0.81	1.00

also provide risk reduction benefits through proper portfolio diversification.

Conclusion: How should P&C insurers reposition their municipal exposure? As indicated in Figure 5, we believe insurers should swap their "on-the-run" general obligation and revenue bonds into "off-the-run" bonds subject to AMT or other specialty sectors that have more tax-adjusted yield. They should also consider swapping into AA rated taxable municipal bonds and a credit barbell combination of AAA rated structured securities (ABS, MBS and CMBS) with A rated corporates or taxable municipals. Unfortunately, the intermediate taxable municipal market is only slightly more than 10% of the size of the intermediate tax-exempt municipal market.

Insurers must maintain high weighted-average portfolio credit quality to satisfy regulators, equity holders and policyholders. The weighted-average credit quality of municipals held by most insurers is in the (Aa2/AA) area. Tax and default-adjusted yields for AA rated corporate bond yields, taxable municipal bonds and tax-exempt bonds are very comparable right now, but most insurers don't have a lot of room to add corporate exposure.

The goal should be to maintain the highest possible municipal exposure (tax-exempt or taxable) allowed by tax and default-adjusted relative yields because of the superior default and total return correlation history shown above. Portfolio managers must constantly monitor the dynamic relative value relationship shown in Figure 5 to keep their portfolios in top shape. ☐

"This content is an excerpt from Calamos Advisors"

Upcoming Events

1.CapVisor will be in attendance at the CICA Conference March 11-13 in Phoenix at the Westin Kierland Resort where we will be exhibiting and our booth is #20 so we hope that you have an opportunity to stop by to say hello!

2.Carl Terzer and other CapVisor associates will also be at the IASA in Nashville at the Gaylord Opryland June 3-6. Carl Terzer will be speaking at 2 sessions in addition to exhibiting at booth #919. We hope that you have an opportunity to hear Carl speak or to stop by the CapVisor booth.

3. CapVisor will be in attendance at the Bermuda Captive Conference June 11-13 at the Bermuda Fairmont Southampton – hope to see you there!

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