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## The Strategic Case for Private Debt in Small to Mid-Size Insurance Company Investment Portfolios

In today's dynamic investment landscape, institutional investors continuously seek alternative asset classes to meet long-term liabilities, especially in low-interest environments. Small to mid-size insurance companies face unique challenges, balancing yield enhancement with capital preservation. Private debt has emerged as a compelling solution, offering enhanced yields, diversification benefits, and tailored liquidity options that align with insurance

portfolios.

Defining private debt, or private credit, involves non-bank entities providing debt financing directly to companies through bilateral negotiations. This flexibility allows tailored terms, and its illiquid nature is compensated by higher spreads and yields compared to publicly traded debt with similar credit profiles. Typically targeting middle-market firms, private debt fills

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## Q1 Economic and Market Review

### Fixed Income Review

The "Trump Bump" of the fourth quarter became the "Trump Slump" in the first quarter, but high-quality bondholders benefitted amidst falling interest rates. The Aggregate Index generated a 2.78% return, and the Intermediate Government/Credit Index earned a 2.42% total return for the quarter. Ten-year Treasury yields fell from 4.57% to 4.21%, and two-year Treasury note yields fell from 4.24% to 3.89%.

Volatility increased in the quarter, resulting in wider bond spreads relative to Treasuries. The average spread over Treasuries for the investment grade

corporate bond index widened thirteen basis points, to 0.93%.

Before the turmoil of the tariff news, some economists believed that immigration restrictions would lift inflation more than tariffs. Tariffs will increase the cost of doing business in America, but in a loosening and still tight labor market, a reduction in the supply of workers may drive wage costs higher.

The administration has fired the first shots of a trade war, and the April 2nd tariff announcements will be more burdensome than first expected. When compared to

tax hikes, the initial tariff proposals represent 1.6% of GDP, larger than any tax increase in recent history. Maybe the administration will soon declare victory and weaken proposed high tariff rates in the future. In either case, uncertainty is causing executives to delay corporate plans and foreign trading partners to re-think their relationship with the United States.

The relationship between tariffs and inflation is difficult to predict. A review of periods of higher tariffs in the past is

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inconclusive. Higher tariff rates may slow business investment, creating deflationary recession conditions. On the other hand, if tariffs aid the administration's goal of re-industrializing the country in a tight labor market, inflationary conditions may persist. Most are convinced higher tariffs mean higher prices. Nevertheless, the initial market reaction of lower equity and higher bond prices suggests a deflationary, weaker economic growth environment in the near term.

The prospect of stagflation, a low growth economy with higher prices, puts the Federal Reserve in a difficult spot. Raising short rates risks dampening growth, while lowering short rates risks higher inflation.

Aggregate employment statistics remain strong, and the labor market remains a key support for economic growth. So far, there don't appear to be any signs of contagion from federal government job cuts infecting headline employment growth. Over the past two years U.S. Government and government-related sectors like education and healthcare contributed 73% of job creation. The Quits Rate has fallen and may be an early indication of a softening employment outlook. The presumption is that workers do not quit unless for a better opportunity, and fewer good opportunities are available.

Investors worry about the strength of the U.S. consumer, as

both consumer confidence and sentiment register declines. Uncertainty regarding policy has grown, and real consumer spending has stagnated.

**“The initial market reaction of lower equity and higher bond prices suggests a deflationary, weaker economic growth environment in the near term.”**

Initial estimates put the overall weighted-average new tariff rates at 29%, the highest in over 100 years. For perspective, the highest U.S. weighted-average tariff rate of the past 100 years was the 20% level of the Smoot-Hawley Act in 1930. Prior to the announcement, many expected a weighted-average tariff rate of about 12%, far below the 29% current estimate. The higher figure shocked the markets.

Lower interest rates and oil prices are exactly what the administration has said it wants. Equity prices are a secondary concern. Treasury Secretary Bessent, a brilliant investor before entering government service, has



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has 30 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 also worked at Conning, Bank of America, Legg Mason, and First National Bank of Maryland.

warned of a detox period and said, “Over the medium term, which is what we’re focused on, it’s a focus on Main Street. Wall Street’s done great, Wall Street can continue to do fine, but we have a focus on small business and consumers.”

We had hoped that market volatility preceding the April 2nd tariff announcement would represent a “buy the rumor, sell the news event,” signaling a peak in policy uncertainty and a near term high for credit spreads and low for equity prices. Hope is not an investment strategy, and because of the higher-than-expected tariff announcements we remain cautious, expecting policy uncertainty to produce higher volatility. We favor higher quality bonds, less cyclical issuers, domestic over

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foreign credits. In volatile times like these, the income and safety of high quality bonds offers greater certainty in an uncertain environment.

### Market Conditions

In the first quarter of 2025 the total return of the S&P 500 Index fell 4.28% after six consecutive quarters of positive returns.

One factor contributing to investor caution was uncertainty about the current administration's approach to trade issues, namely implementing tariffs on the United States' global trading partners. While candidate Trump and then President Trump strongly signaled his intention to use tariff increases as a major policy tool, equity investors seemed to shrug off the potential implications of such policies until they became more imminent and concrete.

Complicating matters further is the rapidity with which the administration has signaled changes to its tariff policies. This has led to a significant increase in equity market volatility.

This same policy uncertainty also greatly complicates matters for the Federal Reserve, with its dual mandate to support employment and keep inflation under control. It is unclear what tariffs will mean for each of these mandates. Tariffs clearly and immediately increase costs, which is inflationary as long as the same amount of goods and services are

purchased, but they also may lead to decreased economic activity which would harm the job market and could eventually lead to lower inflation. Thus, the Fed has to decide whether to keep rates high to fight the potential inflationary impact of tariffs, or to lower rates in anticipation of potential economic weakness from tariffs.

This lack of certainty around the impact of higher tariffs (as well as a lack of clarity around what tariff policy actually will be) is not just a problem for the Federal Reserve. It is also a problem for companies trying to navigate this uncertainty.

**“Complicating matters further is the rapidity with which the administration has signaled changes to its tariff policies. This has led to a significant increase in equity market volatility.”**

Businesses are reticent to make investments and to hire workers when they feel unsure about their future operating environment. Some public companies have already decided to stop issuing forward guidance on revenues and earnings, with many specifically

sighting uncertainty about tariff policy and the potential impact of tariffs on their companies specifically and the economy more generally. This is unlikely to bode well for economic growth going forward.

Given the amount of attention we have devoted in prior letters to the extreme market concentration in the S&P 500 and impact of the Magnificent Seven (“Mag 7”) specifically, we would be remiss in not mentioning the reversal of fortunes for these and other technology stocks in the first quarter.

As mentioned above, the S&P 500 retreated 4.28% in the first quarter of the year, but the S&P 500 Technology Sector fared significantly worse, falling 12.79% in the quarter. Things were even more dire for the Mag 7 (measured here by the Bloomberg Magnificent 7 Index) with those stocks dropping 15.98% in the quarter.

One factor affecting the sector is that investors are still waiting to see economic returns on the significant investments that have been made in the infrastructure necessary to run data- and energy-intensive artificial intelligence applications. The longer investors have to wait to see tangible financial results from these capital expenditures the tougher things may become for stocks that have benefited

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## Q1 Economic and Market Review

from the extreme optimism that has propelled the shares of AI-related companies over the past several years.

### Equity Strategy

Tariff uncertainty also complicates the work of equity analysis. Very few, if any, companies would not be impacted to some extent by the implementation of broadly higher tariffs. Thus, an ongoing assessment of what those impacts might be for current and potential investments is important.

However, uncertainty in equity investing is always present. Anticipating the future is a difficult pursuit even in benign market environments. We believe our investment approach is as relevant now as it has ever been.

The three key factors we seek in potential investments are:

companies with high and consistent profitability, companies with strong balance sheets, and companies trading at valuations commensurate to our assessment of their prospects.

Of these three factors, profitability is the one most likely to be directly affected by tariff levels. Companies that can maintain above average margins in the face of increased tariffs will be of great interest to us.

As we have moved from a regime of extremely low interest rates to higher rates, balance sheet resilience has become even more important.

Companies that don't need to borrow to fund their operations will be advantaged over those that must acquire new debt or roll over existing debt at higher rates to fund their businesses.

Finally, valuation, while seeming ignored in some parts of the market over the past several years, has suddenly become a more relevant factor to investors recently. While we think the price you pay for an investment is important in any market environment, it becomes particularly important when the overall market is expensive relative to history, as it continues to be. □

SPX Index		Settings		
Range 12/31/2024 - 03/31/2025		Period Daily	No. of Period 90 Day	
Security	Currency	Price Change	Total Return	
1) SPX Index	USD	-4.59%	-4.28%	
2) BM7T Index	USD	-15.98%	-15.98%	
3) S5INFT Index	USD	-12.79%	-12.65%	

## The Strategic Case for Private Debt in Small to Mid-Size Insurance Company Investment Portfolios

the financing gap for companies with limited access to public capital.

Key private debt strategies include:

- **Direct Lending:** Non-bank lenders issue loans directly to small-to mid-sized entities (SMEs), covering senior secured loans and subordinated debt, supporting growth, acquisitions, or refinancing.

- **Other private debt strategies include:**
  - **Mezzanine Debt:** Subordinated debt that combines debt and equity features, offering higher returns with increased risk.
  - **Distressed Debt:** Acquiring debt of financially troubled companies, aiming for recovery or

- restructuring.
- **Venture Debt:** Providing capital to early-stage companies, complementing equity financing.
  - **Special Situations:** Financing unique corporate events such as restructuring.

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- Other Forms: Unitranche debt, infrastructure debt, real estate debt, and asset-backed loans.

### Focusing on Direct Lending

#### Yield Advantages and Equity Participation

Direct Lending's primary appeal lies in its higher yield. New-issue senior secured private loans are currently yielding above 10% unlevered. Additionally, some strategies include equity participation through "equity kickers," providing insurers with upside potential as borrowing companies grow.

#### Enhancing Diversification and Risk Management

Direct Lending offers notable diversification benefits due to its low correlation with public markets, helping reduce overall investment program volatility. Its performance is often driven by borrower-specific factors rather than broader market sentiment, insulating portfolios from public market fluctuations.

Furthermore, Direct Lending opens access to SMEs not present in public markets, broadening investment horizons and reducing concentration risk. Structural features like senior collateral-backed loans and robust covenants offer downside protection, allowing lenders proactive intervention in the unlikely event of borrower distress. Historical data shows that default rates in Direct

Lending markets are comparable to, or even lower than, public markets, aided by closer lender-borrower relationships and tighter documentation.

**“Some strategies include equity participation through "equity kickers," providing insurers with upside potential as borrowing companies grow.”**

#### Risk-Adjusted Returns and Historical Performance

Direct Lending has consistently delivered attractive risk-adjusted returns, outperforming high-yield and investment-grade public bonds over the past decade, often with lower volatility. Direct lending, the most prevalent private credit form, has historically shown higher returns and lower volatility than leveraged loans and high-yield public bonds.

Moreover, the buy-and-hold nature of Direct Lending contributes to lower mark-to-market volatility, ensuring stable valuations that align with insurers' intermediate to longer-term liabilities and regulatory capital management. This price stability, combined with higher yields and low

public market correlation, enhances portfolio efficiency.

#### Addressing Illiquidity Concerns

Historically, Direct Lending's illiquid nature deterred insurance companies. However, contemporary strategies have adapted with shorter lock-up periods (1-7 years) and improved liquidity management options, accommodating insurers' reserve portfolios. Allocating a portion of surplus portfolios to Direct Lending further balances liquidity requirements with enhanced returns.

Liquidity risks can be mitigated by diversifying across vintages and Direct Lending funds, staggering maturity dates, and maintaining liquid assets to cover short-term needs. Partnering with experienced managers further ensures effective liquidity management.

#### Regulatory Considerations

Insurance companies operate under stringent regulatory frameworks, dictating investment activities to ensure solvency. Notably, in the U.S., some Direct Lending managers have obtained NAIC investment-grade ratings for their strategies, facilitating lower risk-based capital (RBC) charges. Capital-efficient vehicles also offer simplified accounting and reporting treatments, minimizing

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### Schedule BA allocations.

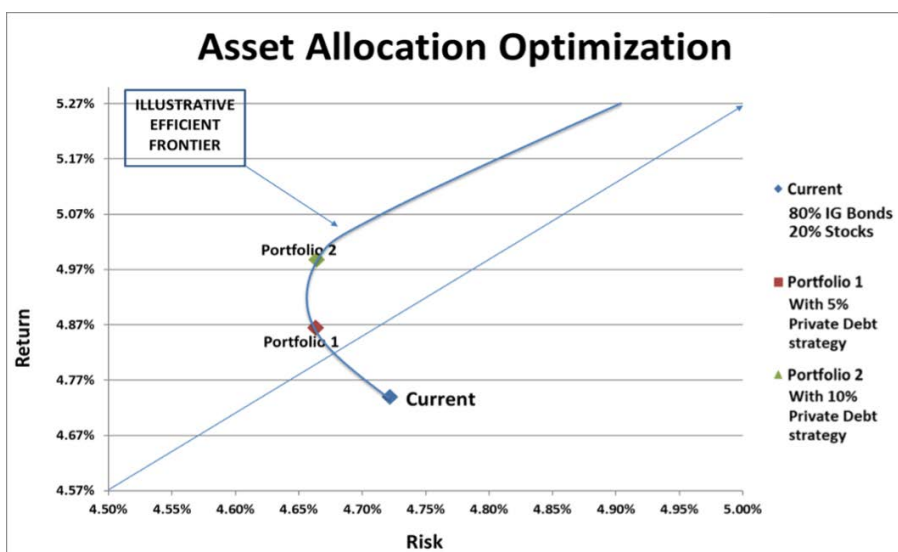
Globally, regulatory recognition of Direct Lending's stability has improved. European insurers benefit from Solvency II's favorable treatment of private credit, and non-admitted carriers like captive insurers must navigate domicile-specific regulations. Understanding these frameworks is essential when incorporating Direct Lending into portfolios.

### Due Diligence and Risk Management

Direct Lending requires thorough due diligence to assess manager expertise, borrower creditworthiness, and deal structuring. Insurers are best served when working with consultants who can provide oversight of fund managers' risk management frameworks to monitor credit, liquidity, and operational risks while ensuring regulatory compliance. Consulting with experienced insurance professionals to evaluate fund managers and conduct comprehensive assessments is crucial.

### Matching Liabilities with Direct Lending Characteristics

Direct Lending's predictable income streams align well with insurers' intermediate-term liabilities when considering newer strategies that cater to the shorter lock-up periods (1-5 years) of most P&C writers. Infrastructure and real estate debt, in particular, offer long



Data Source: Forward looking data based upon JP Morgan LTCMA 2025  
Analytics: CapVisor Strategic Asset Allocation Analysis

durations that match extended liability timeframes of life companies. Additionally, the high degree of customization enables insurers to tailor debt structures to align with liability profiles and risk tolerance.

### Strategic Asset Allocation (SAA) and Portfolio Optimization

A strategic allocation to Direct Lending should start modestly, prioritizing diversification across debt strategies to mitigate risk. Often superior managers will offer low minimum allocations in the range of \$500K - \$5 MM. Direct lending offers familiar risk profiles while enhancing yields. Collaborating with reputable consultants to find "Best Fit" fund managers ensures proper due diligence,

risk assessment, and alignment with regulatory requirements.

### **CapVisor Summary and Recommendations**

Direct Lending presents numerous advantages for small to mid-size insurers, including:

- Enhanced yields compared to public markets
- Portfolio diversification and reduced volatility
- Customizable structures tailored to liability profiles
- Stable income streams and improved downside protection
- Access to less competitive investment opportunities

Though historically dominated by larger institutions, Direct

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Lending is increasingly accessible to smaller insurers through capital-efficient vehicles that optimize returns while addressing regulatory requirements. Strategic allocation, diversification, and partnering with experienced consultants pave the way for successful integration into insurance portfolios.

In conclusion, Direct Lending is a valuable addition to small to mid-size insurance company portfolios, enhancing risk-adjusted returns and diversifying sources of income. While its illiquidity and regulatory complexities require careful navigation, these

challenges are often outweighed by the benefits when approached with robust planning and due diligence.

### Next Steps

- Start with consideration of Direct Lending with a modest strategic allocation based on risk tolerance and liquidity needs.
- Work with an insurance investment consultant to match lock-up periods and minimum investment to fit the insurance company's liability structure and risk tolerance, respectively.
- Partner with experienced

consultants that will provide expertise in due diligence, assess fund managers, and navigate regulatory landscapes working in coordination with the investment committee.

Direct Lending offers small to mid-size insurers a powerful tool to improve portfolio performance and resilience in today's complex investment environment.

Interested in learning more? A [full research report](#) is available on the CapVisor website. ☐

## Investing in an Era of Disruption: Discipline Over Prediction



Ari Sass, CFA  
– President &  
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Prior to joining  
M.D. Sass in  
2004, Mr.  
Sass was

CEO and Co-Founder of Insound, LLC, a media firm founded in 1999 and subsequently sold to Time Warner and private equity. Previously, he was Manager of Finance at Elektra Entertainment Group and held positions at Bear Stearns and Deloitte and Touche. B.A., Economics from the University of Michigan and M.B.A. from New York University. Mr. Sass has over 20 years of investment experience.

Successful investing hinges on one of two insights: identifying change before others do, or recognizing stability when others expect disruption. If we're right in either case, we position ourselves for outperformance. Today, we are clearly in a period of profound change. The real challenge, however, isn't simply acknowledging that change exists—it's in accurately assessing its scope and implications across our portfolio. That task has rarely been more complex than it is today.

Consider the current U.S. tariff policy. On the surface, the

Trump administration's "reciprocal" tariffs are framed as an effort to protect American industries by addressing unfair trade practices. The policy aims to reduce trade imbalances, cut the deficit, promote domestic reindustrialization, and pressure other countries to eliminate trade barriers against U.S. goods. These are all admirable objectives—seeking fairness in global trade, bringing manufacturing back to U.S. shores, and addressing long-standing trade deficits. However, achieving these goals requires threading a delicate needle. The administration

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needs to be extremely careful, as a reckless approach could not only fail to achieve these objectives but also cause lasting damage to international relations, global trade, and the long-term health of our economy. While the logic of reciprocity—retaliating against foreign trade barriers to incentivize their removal—makes sense in theory, the scale of the proposed tariffs does not comport with the definition of reciprocal. This approach is consistent with the administration's well-known negotiating style: unpredictable, direct, and aggressive, with maximalist demands designed to unsettle counterparts and force concessions. While these tactics can be effective in certain situations, they also come with risks—particularly when they disrupt established trade relationships and supply chains. The longer these policies remain in place, the greater the potential for enduring economic damage, including retaliatory tariffs and a reshuffling of alliances.

We don't have the luxury of sitting back, taking it in, and seeing how it goes.

Even if the magnitude of the proposed tariffs is being used as a negotiating tool, the current structure is hard to ignore. A 10% universal tariff applied even to countries where the U.S. has a trade surplus raises questions about whether the policy is truly about fairness or something

else. Furthermore, the administration appears focused on reducing the trade deficit through tariff revenue, which suggests that some form of these tariffs could become permanent. Stephen Miran, chair of the Council of Economic Advisers, has argued that tariffs are a way to reduce the deficit and promote reindustrialization, as outlined in his recent paper, *A User's Guide to Restructuring the Global Trading System*. Even if negotiations progress, there remains uncertainty about whether major trade partners will be willing to accept a higher tariff floor on U.S. goods while simultaneously eliminating their own trade barriers.

**“The bottom line: negotiations need to start immediately to mitigate what could soon become stagflation in the near term and lasting economic damage in the long term.”**

The bottom line: negotiations need to start immediately to mitigate what could soon become stagflation in the near term and lasting economic damage in the long term.

Some of that damage may

already be done. The Federal Reserve Bank of Atlanta's GDPNow model, adjusted for gold import/export dynamics, forecasts a 0.8% decline in Q1 GDP. Given escalating tariffs heading into Q2, prospects for a near-term economic rebound appear increasingly bleak. While equity markets have pulled back sharply, they have yet to price in a full-blown recession. The S&P 500 remains above bear market territory, and forward P/E multiples—still elevated by historical standards—are based on earnings estimates that now appear outdated and overly optimistic. In short, despite recent volatility, there may be more downside ahead unless we see meaningful progress on trade negotiations.

This backdrop creates significant uncertainty. How do we forecast earnings amid a global trade conflict and what amounts to the largest effective tax hike since 1968, especially with uncertainty about when, or even if, these policies will be rolled back, and to what extent? How will consumer spending—the primary revenue driver for numerous companies—adapt to sudden price hikes across large swaths of discretionary and nondiscretionary products? What will happen to companies whose revenue is dependent on other businesses as uncertainty causes

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## Investing in an Era of Disruption: Discipline Over Prediction

managers to halt investment in new projects? What will the long-term margin profiles be for companies navigating the rapid unwinding of four decades of globalization, along with the growing risk of obsolescence in their legacy supply chains?

To navigate this environment, we are applying the same disciplined framework that served us well during the COVID crisis. We've re-underwritten downside scenarios for every portfolio holding under the assumption of a recession. We've also identified "trigger" prices—valuation levels at which we would step in and add to positions—based on discounted multiples of trough earnings and a minimum 3:1 risk/

reward ratio. In markets like this, success isn't about getting the upside right. It's about controlling risk by understanding the downside, quantifying it, and acting decisively when risk/reward becomes compelling. Periods of market dislocation caused by excessive fear and pessimism can present significant opportunities. As panic drives investors to shorten their time horizons and focus primarily on immediate concerns, we believe this is precisely the moment to take a longer-term view and identify opportunities beyond the short-term upheaval. This

market disruption has created the chance to invest in high-quality businesses benefiting from secular growth trends and sustainable moats at attractive valuations. We remain strong believers in several long-term, investable themes and have used recent market weakness to build positions in areas such as power demand, artificial intelligence, and demographic aging. We believe these structural trends are not only resilient, they're likely to accelerate in the coming years. □

## Upcoming Events

Carl Terzer is speaking at the NCCIA Annual Conference in Charlotte, NC from May 14-17. We hope you join his session, "Taking Advantage of Captive Investments as a Profit Center: Why the Investment Program of the Captive can be an Afterthought."

Travis Terzer is exhibiting at the NYIA 2025 Annual Conference in Monticello, New York from May 28-30. We hope to see you there!

CapVisor is headed to the Bermuda Captive Conference on June 9-11. Don't miss Carl Terzer's session, "Captive 101: Understanding the Fundamentals."

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