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Short Duration High Yield: Consider the Advantages

For property and casualty (P&C) insurers with admitted assets between \$10 million and \$1 billion, optimizing asset allocation within your investment program to balance return, risk, and liquidity is critical. In today's environment of compressed yields and heightened economic uncertainty, short duration high yield (SDHY) bonds offer a compelling allocation. In a summary of our research of small-mid-sized P&C insurers, our actuary-built asset allocation optimizer general recommended allocating 2-10% of invested assets to SDHY bonds. The risk/reward and low correlation characteristics of

this mandate can enhance portfolio yield while mitigating certain risks associated with broader high yield strategies. This article explores the rationale for SDHY bonds, contrasts them with general high yield mandates, and highlights the advantages of active management over passive approaches in this space.

Why SDHY Bonds for P&C Insurers?

P&C insurers face unique investment challenges. Their liabilities are often short- to medium-term, driven by claims payments that can be unpredictable in timing and

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Q2 Economic and Market Review

The Unfolding Challenge: Global Debt, Federal Reserve Policy, and the Fixed Income Landscape

The global economy is currently navigating a complex and often contradictory environment. On one hand, central banks worldwide, led by the Federal Reserve, have embarked on aggressive monetary tightening cycles to combat persistent inflation. On the other hand, global debt levels continue to reach unprecedented heights, raising concerns about sustainability and potential financial instability. These two powerful forces are on a collision course, with profound implications for fixed income

markets.

The Elephant in the Room: Soaring Global Debt

Global debt, encompassing government, corporate, and household debt, has been on an upward trajectory for decades, punctuated by sharp increases during crises. The COVID-19 pandemic, with its massive fiscal stimulus packages and economic disruptions, accelerated this trend dramatically.

According to recent reports, global debt rose to over \$324

trillion in Q1 2025, a new record high, after adding nearly \$7 trillion in 2024. While developed economies hold the lion's share, emerging markets have seen their debt-to-GDP ratios reach record levels, often borrowing at significantly higher rates than their developed counterparts.

The implications of this burgeoning debt are multifaceted:

- **Increased Debt Servicing Costs:** As interest rates rise, the cost for governments and corporations to service

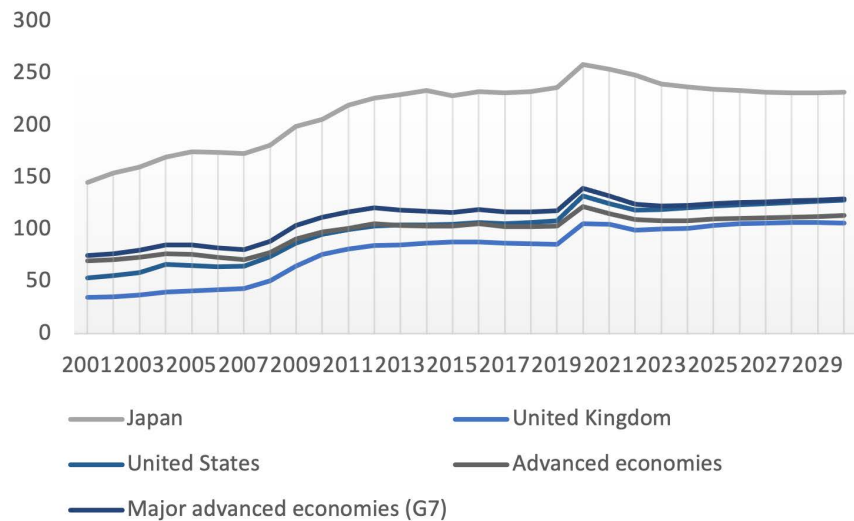
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Q2 Economic and Market Review

their existing debt and issue new debt increases. This diverts funds from other productive investments like infrastructure or social programs.

- **Fiscal Constraints:** High debt levels limit governments' flexibility to respond to future economic downturns or unforeseen emergencies with fiscal stimulus.
- **Refinancing Risk:** A significant portion of existing debt across both sovereign and corporate sectors is set to mature in the coming years. Refinancing this debt at higher yields presents a substantial risk, potentially leading to a "debt trap" where more borrowing is needed simply to pay interest.
- **Sovereign Risk:** For highly indebted nations, especially emerging markets, rising debt service costs can elevate the risk of default, triggering financial contagion.

Government Gross Debt / % of GDP



The Federal Reserve's Tightrope Walk: Policy Normalization

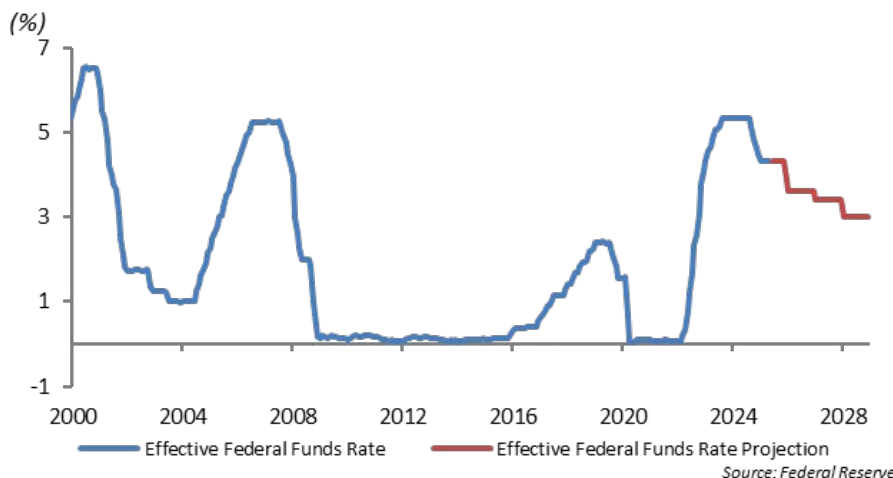
In response to elevated inflation, the Federal Reserve, along with other major central banks, embarked on a period of aggressive monetary tightening from 2022 onwards. This involved:

1. Raising the Federal Funds Rate: Making borrowing more expensive across

the economy. As of June 2025, the Federal Funds Rate has been held at a range of 4.25% to 4.50%. While market consensus and some Fed projections anticipate rate cuts later in 2025 and into 2026/2027, the path remains data-dependent and subject to change, especially with the wild card of tariff policies potentially impacting inflation.

2. Quantitative Tightening (QT): Reducing the size of its balance sheet by allowing maturing bonds to roll off without reinvestment. The Fed's balance sheet has shrunk significantly from its peak, though the pace of reduction has slowed in 2025. This unwinding effectively withdraws liquidity from the financial system and puts upward pressure on long-term yields.

Effective Federal Funds Rate



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Q2 Economic and Market Review

Impact on Fixed Income Markets

The confluence of rising global debt and Federal Reserve policy has profound implications for fixed income investors:

1. **Yield Volatility:** The uncertainty surrounding both the future path of interest rates and the sustainability of global debt levels is leading to increased volatility in bond yields. Investors demand higher compensation (yield) for holding debt in an uncertain environment, particularly for longer maturities.
2. **Higher Borrowing Costs for All:**
 - a. **Government Bonds:** Even for developed economies like the U.S., higher debt levels combined with central bank tightening mean increased government bond yields. This directly translates to higher interest payments for national treasuries.
 - b. **Corporate Bonds:** Corporations face similar pressures. While credit spreads (the extra yield demanded for corporate bonds over government bonds) have remained somewhat subdued for investment-grade companies, higher underlying Treasury yields still push up their overall borrowing costs. This can constrain corporate investment and profitability, especially for highly leveraged firms.
 - c. **Emerging Market Debt:** Developing countries are particularly

vulnerable. High global interest rates exacerbate their already elevated debt burdens, making refinancing challenging and increasing the risk of debt distress.

3. **Shifting Risk Premiums:** Investors are increasingly scrutinizing the fiscal health of nations and the creditworthiness of corporations. As global debt mounts, the "risk-free" nature of even highly rated government bonds may face questions, leading to higher term premiums (the extra yield demanded for longer-term bonds).
4. **Yield Curve Dynamics:** The Federal Reserve's actions, particularly quantitative tightening, tend to exert more upward pressure on long-term yields. This can lead to a "steepening" of the yield curve (where the difference between long-term and short-term yields widens), although other factors like inflation expectations and economic growth outlook also play a significant role. A steepening curve can reflect market expectations of future economic growth and inflation.
5. **Liquidity Concerns:** While major bond markets like U.S. Treasuries remain highly liquid, the sheer volume of outstanding debt and central bank balance sheet reduction could, in



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extreme scenarios, test
market liquidity, especially
during periods of stress.

Navigating the Fixed Income Future

For fixed income investors, the current environment demands careful consideration. Strategies may need to adapt to a world of potentially higher interest rates, increased volatility, and differentiated sovereign and corporate credit risk. Diversification across geographies and credit qualities, along with an eye on central bank policy and evolving global debt dynamics, will be paramount in navigating this challenging yet opportunistic fixed income landscape. The interplay between global debt and central bank policy will remain a defining theme for investment strategy for the foreseeable future. □

Short Duration High Yield: Consider the Advantages

magnitude. Regulatory requirements further emphasize capital preservation and liquidity. SDHY bonds—typically high yield securities with maturities of one to five years—address these needs effectively. They offer higher yields than investment-grade bonds, providing income to support underwriting profitability, while their shorter durations reduce interest rate sensitivity and align with the liability profiles of smaller to mid-sized P&C insurers.

For small to mid-sized P&C insurers a small but meaningful allocation to SDHY bonds strikes a balance. Conducting a Strategic Asst Allocation (SAA) optimization can find the right allocation size(s) to be substantial enough to boost portfolio yield but modest enough to avoid excessive risk concentration. Based on historical data, SDHY bonds have delivered yields in the 4-6% range in recent years, compared to 2-3% for investment-grade corporates of similar duration. This yield premium can meaningfully enhance returns for insurers operating in a low-margin environment, where every basis point counts.

SDHY vs. General High Yield: Risks and Rewards

While general high yield (HY) mandates also seek to capture higher yields, they differ significantly from SDHY in risk and reward profiles. General HY mandates typically include bonds with longer maturities (7-10 years or more) and a broader range of credit qualities, often dipping into lower-rated (e.g., CCC or below) securities. These characteristics introduce distinct risks that may

not align with the needs of P&C insurers.

- **Interest Rate Risk:** General HY bonds' longer durations make them more sensitive to interest rate changes. For example, a 1% rise in rates could cause a 7-10% price decline in a 10-year HY bond, compared to a 3-5% decline for a 3-year SDHY bond. Given the Federal Reserve's recent signals of potential rate volatility, SDHY's lower duration offers a buffer against price erosion.
- **Credit Risk:** General HY mandates often include lower-rated issuers, increasing default risk. SDHY strategies, by contrast, typically focus on higher-quality high yield issuers (e.g., BB or B ratings) and benefit from shorter maturities, which reduce the time horizon for potential defaults. Historical default rates for SDHY bonds average 1-2% annually, compared to 3-5% for general HY, based on Moody's data from

- 2010-2024.
- **Liquidity:** SDHY bonds tend to be more liquid than longer-dated HY bonds, as their shorter maturities attract a broader investor base. This is critical for P&C insurers, who may need to liquidate assets to meet unexpected claims, such as those from natural catastrophes. General HY bonds, particularly those with lower credit ratings, can face wider bid-ask spreads during market stress, complicating sales.
 - **Yield and Return Potential:** While general HY mandates may offer slightly higher yields (e.g., 5-7% vs. 4-6% for SDHY), the incremental yield often comes with disproportionate risk. SDHY bonds provide a sweet spot, capturing much of the yield premium of high yield while limiting exposure to the volatility and default risks of longer-dated or lower-quality securities.
 - **Summary Table below.**

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Advantage	Short-Duration High Yield	General High Yield Market
Interest Rate Risk	Lower	Higher
Return Volatility	Lower	Higher
Capital Efficiency	Higher	Lower
Liquidity/Flexibility	Higher	Lower
Liability Matching	Better for short liabilities	Less optimal for short liabilities
Default Risk Exposure	Lower (closer to maturity)	Higher (longer time to maturity)

Short Duration High Yield: Consider the Advantages

For P&C insurers, whose investment portfolios must prioritize stability and liquidity, SDHY bonds offer a more tailored risk-reward profile than general HY mandates. A 5-10% allocation to SDHY can enhance yield without compromising the portfolio's ability to meet regulatory or claims-driven liquidity needs.

Active vs. Passive Management in SDHY

The decision between active and passive management is pivotal in executing an SDHY strategy. While passive approaches, such as investing in SDHY exchange-traded funds (ETFs), offer low costs and broad market exposure, active management is superior for P&C insurers in this asset class for several reasons.

- **Credit Selection:** Active managers can conduct rigorous credit analysis to avoid issuers with deteriorating fundamentals, a critical advantage in high yield markets where defaults can erode returns. Passive ETFs, which track indices like the Bloomberg Barclays High Yield Very Liquid Index, include a broad basket of securities, often without regard for issuer-specific risks. Active managers, for instance, can overweight BB-rated issuers or sectors with strong cash flows (e.g., energy or consumer staples) while avoiding overleveraged firms.
- **Risk Management:** Active management allows for dynamic adjustments to portfolio duration, sector exposure, and credit quality in

response to market conditions. For example, in 2023, active SDHY managers reduced exposure to cyclical sectors like retail ahead of economic slowdowns, outperforming passive strategies by 100-150 basis points, according to Morningstar data. Passive strategies lack this flexibility, as they are bound to index compositions.

“...from 2018-2024, active SDHY funds outperformed their passive counterparts by an average of 0.8-1.2% annually, net of fees, per Lipper Analytics.”

- **Yield Optimization:** Active managers can exploit mispricings in the SDHY market, such as identifying undervalued bonds or capturing call premiums from early redemptions. These opportunities are particularly valuable in the less efficient high yield market, where pricing discrepancies are common. Passive strategies, by contrast, offer no such alpha potential.
- **Tailored Portfolio Construction:** Active managers can customize SDHY allocations to match an insurer's specific risk tolerance, liquidity needs, and regulatory constraints.

For a P&C insurer with \$500 million in admitted assets, an active manager might construct a portfolio with a 3-year average duration and a focus on BB-rated industrials, ensuring alignment with the insurer's liability profile. Passive ETFs offer no such customization.

While active management entails higher fees (typically 50-75 basis points vs. 10-20 for ETFs), the potential for outperformance and risk mitigation justifies the cost for P&C insurers. Historical data supports this: from 2018-2024, active SDHY funds outperformed their passive counterparts by an average of 0.8-1.2% annually, net of fees, per Lipper Analytics.

Implementation Considerations

For P&C insurers considering an SDHY allocation, several practical steps are key:

- **Portfolio Fit:** Assess the 5-10% allocation in the context of the broader portfolio using an SAA analytic process, preferably one that incorporates your company's liability structure. An SAA will ensure that the SDHY allocation complements existing holdings, such as investment-grade corporates or Treasuries, to maintain or improve diversification.
- **Manager Selection:** Choose active managers with proven expertise in high yield credit analysis and a track record of outperformance in SDHY. Look for firms with top

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Short Duration High Yield: Consider the Advantages

- quartile performance over 3- and 5-year rolling periods. In addition, be sure that they demonstrate robust risk management frameworks and have demonstrated expertise and experience in this asset class.

 - **Regulatory Compliance:** Verify that the SDHY allocation aligns with state/domicile insurance regulations, particularly regarding credit quality and capital charges. Explore RBC implications, if applicable.
 - **Monitoring:** Regularly review
- the portfolio’s credit quality, duration, and liquidity to ensure alignment with underwriting cycles and market conditions.

Conclusion

For small to mid-sized P&C insurers an allocation to short duration high yield bonds offers a compelling way to enhance portfolio yield while managing risk. Compared to general high yield mandates, SDHY bonds provide lower interest rate and credit risk, better liquidity, and a
- more suitable alignment with P&C liability profiles. Active management further enhances the strategy’s value through superior credit selection, risk management, and yield optimization. In a challenging yield environment, SDHY bonds, when actively managed, can be a powerful tool for P&C insurers seeking to balance income, stability, and regulatory compliance. ☐

Are you Missing an Opportunity in Private Credit?



JEFF HAAS – President SR Alternative Credit
Jeff has rich history of financial expertise in portfolio management, transaction

structuring, and operational leadership. Jeff manages SRAC's operations and has played key roles in business development, transaction sourcing and deal structuring. Additionally, he is a member of SRAC’s Investment Committee. His career has seen significant roles in portfolio management, business development and trading. Jeff holds an MBA from NYU's Leonard N. Stern School of Business.

What is Private Credit?

Private credit involves private lenders lending directly to borrowers rather than through banks or investment banks. These borrowers are typically small and medium-sized enterprises (SMEs) with limited access to conventional financing options.

What is Driving the Investment Opportunity for Private Credit?

Over the last decade, SMEs have had difficulty obtaining credit from conventional lenders as consolidation and other factors have caused a decline in the number of U.S. banks (in the late 70’s there were over 14,000

banks which is now less than 4,000). At the same time, regulatory capital requirements have increased, making it less economical for conventional lenders to engage in SME lending.

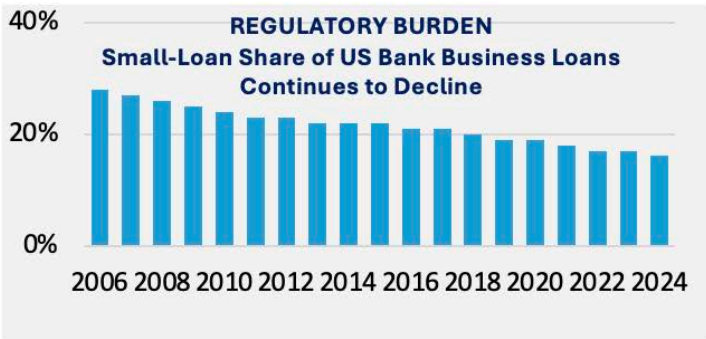
In the United States, there are more than 25 million private companies compared to less than 4,000 public companies. Private businesses are the backbone of the American workforce, accounting for over 80% of all jobs. As a result, expanding access to capital for these companies is vital for economic growth. These dynamics have fueled a significant and growing opportunity for private credit lenders.

As of late 2023 private credit assets under management exceeded \$1.5 trillion and

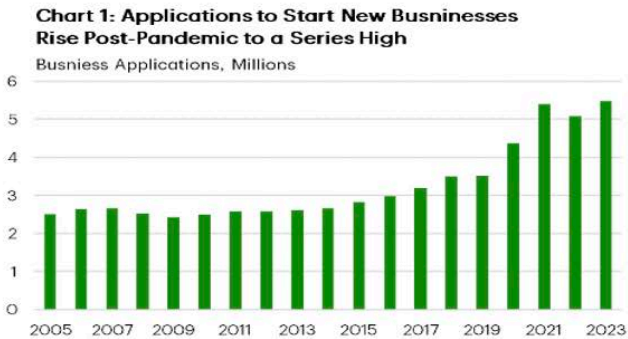
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	PUBLIC CREDIT	PRIVATE CREDIT
Type of Borrower	Large or medium-sized company	Small and medium enterprises (SMEs)
Number of Lenders	Usually many, or syndicate	Few; often just one
Loan Size	\$100 million+	\$1-\$100 million
Yield	Subject to market conditions	Varies; from 7% to 15%+
Loan Terms	Standardized	Tailored
Liquidity	Liquid – rated and publicly tradeable	Illiquid – not rated or publicly traded

Are you Missing an Opportunity in Private Credit?



Source: Federal Deposit Insurance Corporation (December 2024)



Source: TD Economics & Census Bureau (May 2024)

continues to grow as borrower demand remains unmet. Preqin forecasts that private credit global assets under management will hit \$3 trillion by 2028 further reinforcing the long-term opportunity in private credit.

Why Invest in Private Credit?

Potential For Attractive Returns – Because private credit is illiquid it will generally carry an illiquidity premium resulting in a higher yield than public debt.

Lower Correlation – Private credit investments have historically shown low correlation to public market investments.

Less Volatility – Private credit offers insulation from public market volatility through structural protections, collateral backing, and a long-term investment approach. Many private credit investments are held-to-maturity and are not subject to market fluctuations, resulting in a smoother return profile.

Greater Diversification – Private

10-year annual returns: Private credit vs income-generating assets

As of December 31, 2024

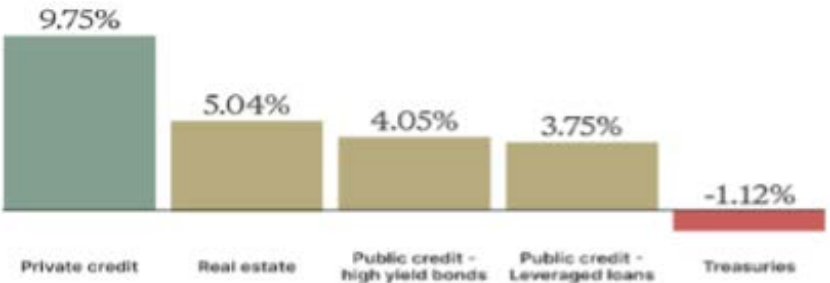


Chart Disclosure: Based on last 10-year annualized total returns as of December 31, 2024. Funds used to represent asset classes include: VanEck BOC Income ETF (BOCI), Vanguard Real Estate Index Fund ETF (VNQ), iShares iBoxx \$ High Yield Corporate Bond ETF (HYG), Invesco Senior Loan ETF (BSLN), and iShares 20+ Year Treasury Bond ETF (TLT). Past performance does not guarantee future results.

Source: Heronfinance, as of December 31, 2024.

CORRELATIONS	U.S. Equities	Non-U.S. Equities	Emerging Markets	Global High Yield	Aggregate Fixed Income	Private Equity	Private Infrastructure	Private Debt	Private U.S. Real Estate
U.S. Equities	1.00								
Non-U.S. Equities	0.89	1.00							
Emerging Market Equities	0.80	0.85	1.00						
Global High Yield	0.41	0.44	0.39	1.00					
Aggregate Fixed Income	0.26	0.27	0.25	0.65	1.00				
Private Equity	0.41	0.42	0.40	0.04	0.00	1.00			
Private Infrastructure	0.46	0.52	0.50	0.14	0.11	0.66	1.00		
Private Credit	0.33	0.36	0.31	0.78	0.20	0.06	0.14	1.00	
Private US Real Estate	0.37	0.33	0.28	0.07	0.08	0.53	0.60	0.03	1.00

Source: Russell Investments, 2023

Continued on page 8

Are you Missing an Opportunity in Private Credit?

credit investments offer diversification and are a good complement for investors looking to replace or supplement traditional public fixed income exposure in a portfolio.

Income Generation & Distribution – Many private credit strategies focus on generating income by incorporating cash payments of interest coupons and lending fees, this allows for a distribution of income to investors despite the illiquid nature of most private credit strategies.

Private Credit Strategies

The following represent some of the most common forms of private credit investing:

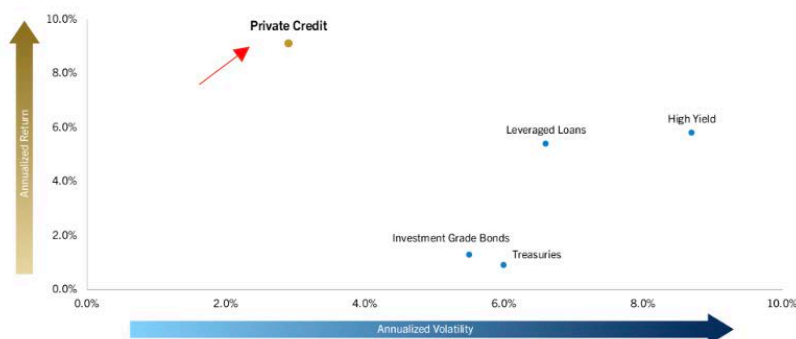
- **Asset-Based Lending - Asset-based lending (ABL)** involves loans made against assets pledged as collateral security that can be sold if the borrower defaults.
- **Cash Flow or Direct Lending -** Cash flow lending involves a loan made to a business that is secured by a company's expected cash flows/EBITDA and relies on the creditworthiness of the company.
- **Distressed Debt:** loans made to companies that are in financial difficulty—either bankrupt or insolvent, or close to it.
- **Venture Debt:** A type of debt financing obtained by early-stage companies and startups.

Asset Based Lending vs. Cash Flow/Direct Lending

Asset-Based Lending and CashFlow/Direct Lending are the two

Annualized Returns and Volatility*: Private Credit and Traditional Fixed Income⁶

Q4 2015 – Q4 2024



Source: *Golbud Capital, 2025*

Asset-Based Loans (ABL)

- **Collateral-based:** Lending on the value, liquidity, and stability of pledged assets
- **Loan-to-Value (LTV) is key:** LTV ratios determine lending thresholds
- **Lower risk:** Backed by tangible assets and not projected revenue
- **Stable assets:** Often less impacted by business cycles
- **Non-Sponsored Based:** borrower is not controlled by private equity sponsor
- **Cash Interest Payments:** Many ABL loans feature interest payments in cash
- **Higher Recovery Rates -** ABL deals are secured by an asset which results in a higher recovery rate in the event of a default
- **Requires monitoring:** Frequent reviews of asset values and loan coverage

most common forms of private credit lending. However, they differ in their underwriting approach, risks and benefits. See graphic above.

How to Invest in Private Credit

As the private credit market continues to grow and mature, there are many opportunities for investors to add this asset class to their portfolios for

Cash-Flow Based Loans

- **Cash flow-driven:** Based on free cash flow and operational metrics
- **EBITDA-focused:** borrowing capacity is driven by a multiple of free cash flow
- **Higher risk:** Sensitive to economic conditions and operational fluctuations
- **Ongoing analysis:** Intensive modeling of business performance
- **Sponsor Based :** private equity sponsor typically controls the borrower
- **Interest Paid-in-Kind (PIK):** Many cash flow loans feature all or part PIK
- **Lower Recovery Rates -** cash flow deals are based on free cash flow typically resulting in a lower recovery rate in the event of a default
- **Extra protection:** Often includes financial covenants tied to EBITDA

diversification and yield. Below are a few options that can allow investors access to private credit:

- **Interval Funds:** A closed-end fund structure that continuously offers new shares for sale. Investor

Continued on page 9

Are you Missing an Opportunity in Private Credit?

redemptions are accommodated by repurchases of existing shares during specific intervals/periods. These funds are registered under the Investment Company Act of 1940.

- **Private Credit Funds:** Private pooled investment vehicles typically open to accredited investors, often focused on a specific private credit strategy focus (e.g., ABL, direct lending, specialty finance). For example, SR Alternative Credit offers

a private credit strategy focused on asset-based lending.

- **Custom Portfolio of Private Credit Funds:** Investors can access an investment platform to create a custom portfolio of investments in a variety of private credit managers. The platform provider sources the investment opportunities, performs the private credit manager due diligence, etc.
- **Co-investments:** Many private credit managers, including SR Alternative Credit, offer to sell a loan

participation that allow their existing fund investors to participate directly in individual loan transactions.

Investor Value Proposition

Investor's should seek to maximize income while preserving principal. This should be accomplished by requiring significant borrower capital investment for interest alignment and strong asset collateral coverage in the underlying lending transactions. Reasonable targets for a net investor return of 10-13% could be expected. □

Upcoming Events

Carl Terzer and Travis Terzer are attending the SCCIA Annual Conference in Charleston, SC from September 23-25. We hope to see you there!

Stop by our exhibit booth to connect with Carl Terzer and Travis Terzer at the NAMIC Annual Convention in San Diego from September 28 - October 1.

CapVisor is sponsoring the NRRRA National Conference in Chicago from October 6-8. Don't miss Carl Terzer's session, "Economy &

Investments" on Wednesday.

Catch up with Carl Terzer at TCIA's Annual Conference in Nashville from October 13-15.

Travis Terzer is speaking at the CIC-DC Annual Conference in Washington, DC. Join us for his session on navigating market opportunities on October 30.

Carl Terzer and Travis Terzer look forward to seeing you at the Cayman Captive Forum in

early December!

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We share interesting investment information, research, and announcements.



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

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