



Summer 2011

Insurance Asset Management

Volume 3, Issue 3



Inside this issue:

Some Timely Thoughts on Tactical Portfolio Repositioning and Risk 1

By
Carl E. Terzer

Economic Review And Outlook

By
Michael Richman
Leo J. Dierckman
John C. Saf

How Scary is the Municipal Market? 2

By
S. Kip Astheimer

Some Timely Thoughts on Tactical Portfolio Repositioning and Risk

Many surveys have shown that insurers are tending toward more aggressive investment strategies in 2011 due to the continuance of our unprecedentedly low interest rate environment. “Risk on”, meaning movement toward riskier assets in search of increased returns, has been the buzzword as many insurers contemplate significantly larger allocations to riskier assets. Perhaps the events of the last few weeks will cause

some insurers to take pause and reflect on those decisions or at least, to proceed with extreme caution.

The markets face yet another year of economic turbulence, marked by a frustratingly slow and uneven economic recovery in the US, coupled with the threat of a domino effect of potential Euro downgrades or defaults. Given all this uncertainty, insurers can be certain of one thing: that their investment

programs will continue to face stiff headwinds and challenges. With high US market volatility and the recent loss of the U.S. government’s AAA debt rating, many insurers are becoming increasingly concerned about protection of principal. In addition, the looming Federal trade deficit has focused everyone’s attention on the inevitable inflationary pressures that lie ahead leading some to the unhappy prospect of signifi-

(continued on page 5)

Economic Review and Outlook (continued on page 3)

1 The Debt Conundrum... what else can we say?

Our job as fixed income investors is to evaluate the credit worthiness of the various debtors that we have loaned money to on behalf of our clients. We take into consideration their ability to generate cash flow, make timely interest payments and ultimately pay their debt in full when due. We study their business plans, speak with management and critique the health of the marketplace in which they function. We like investments backed by reputable and respected management teams that work together and take personal responsibility for the success of their companies. Unfortunately, we are becoming increasingly more skeptical about the creditworthiness of the average US citizen,

and our government by those same standards.

This quarter we will review the mountain of debt on the national and consumer levels, and discuss how it will affect ours and our children’s lifestyles in the years to come. We will also comment on the status of the US economy, the end of QE2, and world events that are affecting the financial markets and global economy.

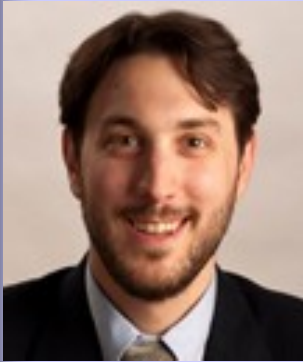
National and Consumer Debt: How did we get here?

The US federal debt is out of control. The Fed’s ability to manage the annual budget is highly questionable and they lack a quality management team. To make matters worse, many US citizens have a similar problem. As a result, they don’t take the government’s problems seriously. What should we ex-

pect? Our government operates in the same way a majority of U.S. households do - too much debt and not enough income. More simply, we as a people and our government are living beyond our means. A recent poll revealed that a majority of US citizens believe that the government should simply default on its debt and start over again. If only it were that easy. For the federal government, the debt accumulated over the past thirty years is the result of expenditures that far exceed the increase in income, resulting in a ballooning debt/income growth ratio. The next graph depicts the US National Debt versus Tax Receipts from 1970 to 2010 .

The federal government, after years of budget deficits, now finds itself in the uncomfortable position of needing to

How Scary is the Municipal Market?



S. Kip Astheimer is involved in research and analysis as a member of the Equity, Fixed Income and Asset Allocation Committees, and is also involved in corporate development. Prior to joining Howe & Rusling, he worked in algorithmic corporate strategy, and in scientific research within the fields of Materials Science, Photonics, & High Energy Physics. He holds a degree in Applied Mathematics from Yale University.

“While bankruptcies of municipal obligations remain very low, with only two so far this year, ...certain types of revenue bonds, such as water revenues, can be a good hedge against balance sheet weakness.”

Ever since 2008, there have been concerns about municipal defaults. These concerns have waxed and waned over time, flaring up as different concerns have hit the markets. Now, in the wake of the Treasury downgrade and the precipitous drop in the stock markets, we find ourselves asking what is next for municipal bonds. Before we can even attempt to discuss the future, let us begin by addressing several of the concerns surrounding municipal markets.

Balance Sheets, Budgets, & Pension Obligations

The first and the most publicized concern is of course the ballooning budget and balance sheet crisis that many states and municipalities have faced over the last few years. Prior to the '08 crash, municipal governments had expanded employment, as well as social welfare and development projects committing funds to these projects well into the future. However, with the crash came, income and property tax revenues declines and sales tax and other economic revenues slowed significantly. Suddenly, municipalities were facing dramatic deficits as their revenue bases declined. Compounding the issue, many of the traditionally generous public pension and insurance funds had been poorly invested in high risk assets. As the market declined, these funds were hit hard, leaving the local governments “on the hook” for the liabilities and further straining their balance sheets.

Case by Case

These problems, coupled with an ineffective political system that requires a supermajority to raise taxes, played a large role in California’s widely publicized problems. In 2008, Vallejo became the largest city in the history of California to declare bankruptcy. This city of 115,000, is located within one of the regions hit hardest by the housing bubble. At the time of its bankruptcy filing, Vallejo was forced to spend roughly 75% of its budget on pension obligations, and unable to negotiate sufficient cuts with the unions to avoid bankruptcy.

More recently, Central Falls, Rhode Island announced that it intended to file Chapter 9 bankruptcy after failing to get cutbacks from pensioners. The credit crisis, high unemployment, and aid reduction have all exacerbated the problems over the last few years, and the city has been unable to meet its pension obligations.

Traditionally, the type of circumstances that led Vallejo and Central Falls to bankruptcy has not had a terrible impact on “general obligation” bonds of the municipalities in question. In the case of Vallejo, during part of the bankruptcy proceedings, interest payments on the city’s general obligation funds were either suspended or paid at lower contractual rates. However, as the city is exiting bankruptcy, it appears that the bondholders will recoup the par value of their invested princi-

pal plus future coupons. While a municipality cannot be forced to sell its assets in a Chapter 9 proceeding, and while creditors are not responsible for proposing the restructuring, bond interest is typically a small portion of a municipality’s expenses and the bond markets traditionally punish borrowers who force their lenders to take a haircut in default with substantially higher rates in the future. Furthermore, the bondholders may take legal action to compel the issuer to raise taxes for the purpose of making payments.

Furthermore, with these types of bankruptcies. The municipalities tend to gain much publicity in advance and the ratings agencies tend to downgrade the municipalities several times. For example, current “at-risk” municipalities, such as Harrisburg, Pennsylvania, are widely known to be in fiscal jeopardy.

Interest Rate Swaps and Auction Rate Securities

For many years municipalities have used interest rate swaps and variable rate bonds to lower their long term borrowing costs. Using floating rate bonds to get lower rates, they would enter into interest rate swaps to protect them from paying more if the rates went up. This combination was designed to let the municipalities borrow at lower overall rates through the use of synthetics. However, the interest rate swaps used, would work by paying the municipality when interest rates rose above a certain level, but require the municipi-

How Scary is the Municipal Market?

pality to pay should rates fall below the threshold. The plan backfired when interest rates were dramatically cut to almost unprecedented levels in response to the financial crisis, at the same time that the market for auction rate municipal bonds (one of the major types of floating rate municipals) collapsed, forcing the municipalities to pay both bond interest and the interest rate swap.

While there is nothing inherently bad about the strategy the municipalities employed, it has become apparent that many municipalities did not understand the implications and intricacies of these inter-

est rate swaps. Some firms, such as CDR, which advised Jefferson County, bribed officials to buy products that were not well suited and have severely hurt the city as a result.

The high profile nature of this case and the sophistication of the products involved have cast a shadow over all municipalities' interest rate swaps and Jefferson County may enter bankruptcy as a result. While bankruptcies of municipal general obligations remain very low with only two so far this year, one could imagine a reevaluation of municipal defaults where the stigma of declaring bankruptcy is lessened and municipalities are able to

enter and exit bankruptcy with their reputations largely intact by scapegoating bankers. However, this is purely speculation.

What to do

While there are new fears to worry about in the municipal markets, the means by which to move forward remains unchanged. As an important asset class for insurance investment portfolios, it is imperative that your investment advisor has the credit skills to research the balance sheets, demographics and legal facets of the municipal securities as well as the marketplace. However a well diversified portfo-

lio of prudently chosen municipalities should not face many, if any defaults. Bonds backed by specific revenues are treated as secured in bankruptcy proceedings, so certain types of these revenue bonds, such as water revenues, can be a good hedge against balance sheet weakness. Similarly, risky project finance bonds, limited tax pledges, and bonds that are otherwise exposed to political risk present greater risk now than before and should be evaluated accordingly.

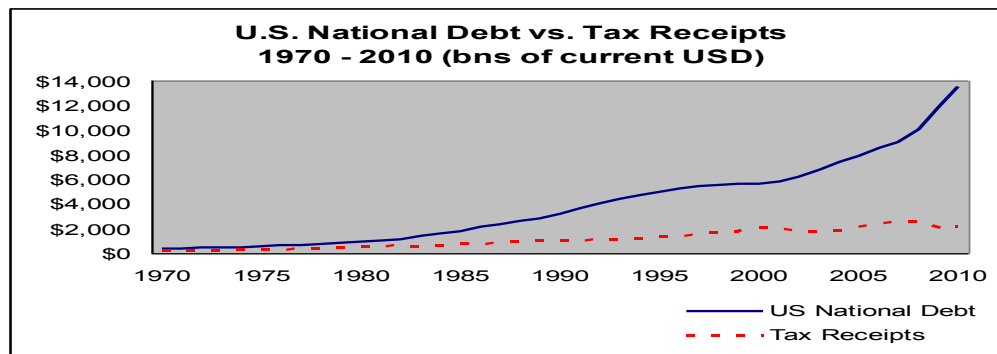


Economic Review and Outlook

(continued from page 1)

reduce spending and likely raise tax revenue, neither of which is conducive to economic growth. While cheap money from our friends abroad has allowed the government to spend beyond its means, we can no longer borrow economic growth from future generations. Simply put, our management team is delivering – or has promised to deliver – too many goods and services relative to the revenue the “company” generates. Additionally, we need to promptly reduce operating inefficiencies.

The graph on page 4 depicts Total Household Debt versus Annual Personal Income from 1970 to 2010.



Source: Office of Management and Budget

We Americans have been efficient at spending nearly everything we've made the past ten years. Up until the early 2000s, we actually showed a bit of restraint. Then suddenly banks were offering us great deals on loans, enticing us with creative ways to finance and refinance our homes which only appeared to go up in value. Many of us

got caught up in the frenzy and had to walk away from our single biggest investment – our homes - when we lost our jobs. The ATM that our homes had become was out of cash and credit cards were maxed out. It will take longer to get out of this mess than it took to get in. Some folks are going

back to school to learn new skills and improve their chances of landing a better job - or landing a job in general - while others are simply walking away from mortgages or filing bankruptcy in near record numbers. Consumer deleveraging only compounds the challenges our economy

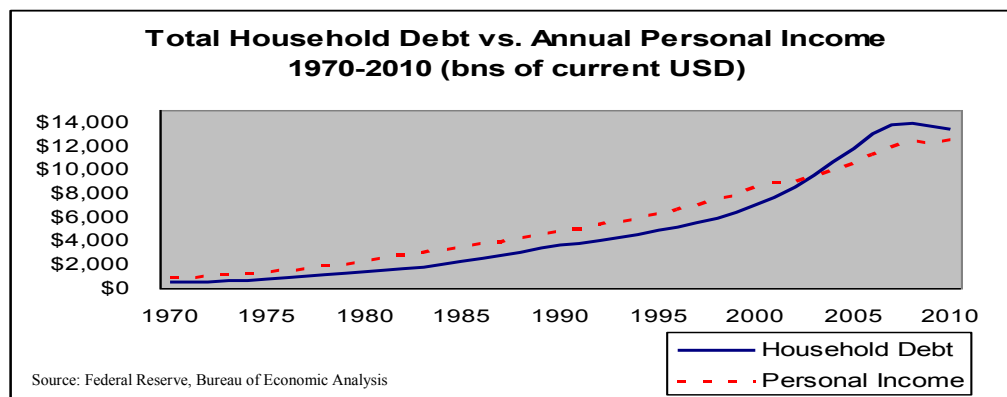
Michael Richman, CFA is a Senior Director, Portfolio Manager for Oppenheimer Investment Management LLC. He has primary portfolio management duties for the Core, Core Plus and Intermediate Composites. He holds a B.S. in Finance from Indiana University and is a CFA shareholder.

Leo Dierckman is a Senior Director, Portfolio Manager for Oppenheimer Investment Management LLC. Leo is primarily responsible for management duties for the High Yield, Bank Loan and Core Plus composites. He holds a B.S. in Finance from Indiana University.

John C. Saf, CFA, CPA is a Senior Director, Insurance Portfolio Manager for Oppenheimer Investment Management LLC. He is primarily responsible for insurance portfolio management. He holds a B.S. B.A. from Drake University with majors in Actuarial Science and Accounting. He is a Fellow in the Life Management Institute, holds a Certified Public Accountant Certificate and is a CFA share-

“...The Second quarter was rocky for credit markets. Fixed income markets once again witnessed a flight to quality ...”

Economic Review and Outlook (continued from page 3)



already faces from government fiscal correction.

On the consumer front, we anticipate that the previously mentioned maneuvers, the slow-healing economy and declining unemployment rate will lead the consumer back into a more traditional debt/income ratio over the next 2-3 years. As a result, the standard of living will rise at a much slower pace but our balance sheets will be more in line with historical measures. It will be painful, but when compared to citizens of other developed nations, we will retain the highest standard of living.

The federal debt conundrum however will be more complicated and in many ways more painful for all of us. The Republican lawmakers' plot to hold the debt ceiling hostage for guaranteed budget cuts is getting some press as Democrats want to raise taxes on the "rich". In the end, both sides of the aisle agree that the debt ceiling should be raised because the alternative is for the U.S. to default on its loan obligations. The global economy is counting on U.S. stability and

the consequences of defaulting could be catastrophic.

We are encouraged that the AARP has finally agreed to become part of the Social Security reform solution instead of maintaining their "hands-off" position. Hopefully Medicare is next in the discussion. We are also encouraged that Vice President Biden may propose \$4 trillion in unspecified budget cuts over the next 10 years to reduce future deficits. This is a good start. It remains to be seen how fast the cutbacks will take place and what impact it will have on the economy. These suggested cuts will likely not happen without an increase in taxes for higher income households (\$250k annually seems to be the minimum target). As discussed in our second quarter 2010 commentary ([available at www.oppenheimerim.com](http://www.oppenheimerim.com)), forced austerity programs that cut too hard and too fast while raising taxes can make matters worse and lead to a decline in GDP, outpacing any benefits. It is the debt-to-GDP ratio we want to stabilize or modestly reduce from the current approximate 60%.

The debt reduction and tax increase debate will be with us for many years to come and will most likely result in reduced entitlement programs and higher taxes to maintain our triple-A rating.

The US Economy

The U.S. economy continued to limp along in the first quarter with a 1.9% QoQ annualized GDP improvement. Second and third quarter growth are expected to be hampered due to the supply chain disruptions from the Japan earthquake. It is our assertion that we need closer to 3% GDP growth to make any progress on the unemployment rate which continues to hover around 9%. The food and energy parts of the CPI have surged higher due to temporary causes (droughts, floods, and political uprisings) but the core CPI (which excludes food & energy) has remained subdued. As explained in our last quarterly commentary ([available at www.oppenheimerim.com](http://www.oppenheimerim.com)) we focus on Core CPI when considering inflation and long term interest rates.

Economic Review and Outlook

(continued from page 4)

The Second Quantitative Easing program (QE2) ended on June 30th, but the Treasury purchases that were made will not be sold. The Fed's balance sheet will remain the same size and the interest and maturity payments received will be rolled over into similar Treasury securities they were buying before the program ended. The impact of the QE2 program ending is causing hesitation in the market, with an initial sell off in the ten-year Treasury from an approximate 2.90% to 3.15%. We anticipate that during the second half of 2011, the ten-year will reenter the 3.5-

4% range that we predicted at the end of 2010.

Worldwide Politics & Economy

The uprisings in the Middle East and North Africa (Tunisia, Egypt, Syria, Libya, Yemen and Bahrain) were certainly disruptive, but their affect is starting to fade. West Texas Intermediate (WTI) crude prices have returned to the low \$90s area (where they started the year) after spiking to the \$115 area at the end of April. This story is not over, but for now has been moved to the back burner by Greece.

The crises du jour is the timing

of Greece's fifth payment (approximately \$15 billion) of its original \$157.5 billion rescue package this month. The problem is that Greece needs further austerity measures imposed as a condition of a second bailout. Wages have been cut and pensions have been slashed while the economy has not improved. There has been no progress on debt and interest rates are higher than ever. The citizens are protesting against further austerity measures and privatization that would make the country more competitive. Some speculate that the next round of austerity may have to include a debt restructur-

ing to reduce the overall debt load or no amount of austerity will dig them out of the hole they are in. The concern is that a debt restructuring, or other form of default, would cause similar behavior by other ECU countries in similar circumstances (Ireland, Portugal and Spain), which would cause significant losses at European banks, undermining the ECU banking system in a Lehman Brothers-type meltdown. The contagion could possibly spread worldwide.

The ECU has the benefit of understanding what could happen. Having Lehman Brothers fresh in their minds should keep them from sinking the world's

(continued on page 6)

Some Timely Thoughts on Tactical Portfolio Repositioning and Risk

(continued from page 1)

cant losses in bond portfolio market values. Does that mean to suggest a move to a "Risk off" position, and therefore lower return strategy?

Perhaps, maybe the best strategy may not to be whether the pursuit of a Risk On or Risk Off approach is better, but rather one of finding an optimal course to meet the insurer's objectives and risk constraints. An insurers' first duty is to maintain an investment program that ensures the prompt payment of claims obligations and accordingly, preservation of principal and sufficient liquidity should be the #1 concern for insurance company "reserve" portfolios. A reserve portfolio that is constructed using asset/liability

matching techniques and immunization should position the insurer to meet these obligations under varying scenarios.

Insurers can look to potentially increasing the risk profile of the reserve portfolio should the firm's financial stability and underwriting conditions permit. That said, the search for higher returns typically begins with non-reserve assets or surplus. While hedge funds (which get most of the press), market neutral strategies and commodities are among the first alternatives reviewed in an effort to increase returns, for the most part these asset classes have not met their investors' expectations since 2008 although they continue to maintain their very high fee structures. In addition to these options, most insurers would be well served to consider a wide spectrum of asset classes to

complement their high quality bond portfolio. These investments could simply include expanding exposures within the fixed income spectrum, such as sovereign debt, high yield, preferreds, convertibles and adding more risk, perhaps even emerging market debt. Within these categories, very interesting and highly specialized disciplines (e.g. short term HY, institutional/retail preferreds arbitrage) are often left unexplored. In addition to large cap US equities, which can often be an expensive "market beta" purchase, insurers should look to enhance returns with small-mid cap portfolios and choosing a style (core, growth or value) that suits their risk tolerance and investment philosophy. Of course, with the US now accounting for less than 50% of the world market's capitaliza-

tion is not only important but is prudent for proper diversification.

As a final thought, these tactical decisions should be considered within the context of a well designed investment plan. Rather than focusing on selecting the best hedge fund manager, MLP or REIT, insurers would be better served by first ensuring that their strategic asset allocation is optimized across a diversified selection of asset classes within their risk tolerance, regulatory environment and liability structure and is accommodative of their financial position. This architecture will allow the insurer to incorporate more asset classes for better diversification to improve results in navigating our challenging investment conditions.

CET

CapVisor Associates, LLC

P.O. Box 693

Chatham, NJ 07928

Phone: 973-219-7106

E-mail:

carl.terzer@capvisorassociates.com

CapVisor Associates, LLC

CapVisor Associates, LLC is an SEC - Registered Investment Advisor specializing in providing highly customized investment asset management services to Insurers world-wide. We bring more than 27 years of insurance asset management experience to correlate the insurer's investment strategy with their business objectives. Following a rigorous evaluation of the client's situation, we work collaboratively to design and implement customized investment programs or specific strategies in accordance with the insurer's liabilities, liquidity requirements, risk budget, regulatory, accounting and tax situation. We use an unbiased, multi-manager approach for manager selection, manager review & performance analysis. Our tailored solutions often include investment strategy and guideline design, benchmark customization and strategic and tactical portfolio optimizations. CapVisor Associates is a trusted advisor to clients, acting as an extension of their executive management team, to provide investment program enhancements and value-added services with expertise, diligence and integrity.

We're on the web!

www.capvisorassociates.com

financial system over a \$15 billion payment. They can't kick the can down the road for ever though. Greece's debt load is too big to fix and they will eventually be forced to restructure.

Capital Markets, Performance and Strategy

The second quarter was rocky for the credit markets. Fixed income markets once again witnessed a flight to quality as investors nervously watched developments in Greece, news on the US debt ceiling, and a steady stream of subpar economic numbers unfold throughout the quarter. Given this environment, US Treasury securities were the best performing sector. The investment grade bond market, as measured by the Barclays Capital Aggregate Index, returned an impressive 2.29% for the quarter. The high yield market, as measured by the BofA/Merrill Lynch High Yield Master II Index (MLHYI II), returned 99 basis points as defaults continued to be virtually non-existent.



Up Coming Events

- **The NAMIC Annual Conference** will be September 18-21 at the JW Marriott Indianapolis, IN. CapVisor will be exhibiting.
- **Captive Live 2011** will be September 26-27 in Chicago at the Hilton. Mr Terzer will be a featured speaker and CapVisor will be exhibiting.
- **The SIA National Educational Conference & Expo** will be October 9-12 in Phoenix at the J.W. Marriott Desert Ridge Resort & Spa. Mr. Terzer will be attending.
- **The Cayman Captive Forum** will be Nov 30-Dec 2 at the Ritz Carlton in Grand Cayman. Mr. Terzer will be a speaker at this event.
- **The CIC-DC Annual Conference** will be at the Madison Hotel in Washington, DC Oct 24-25.



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