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## Insurance Asset Management

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by  
Carl Terzer

**Prudent** Insurance executives keep a vigilant watch for risks on both sides of their balance sheet. They closely and continuously monitor local and global events and conditions evaluating their potential effects on insurance underwriting and investment activities.

Naturally, these threats include obvious weather, geological and political risk factors affecting insurers' liabilities. Economic issues presenting potential risks include the sovereign debt crisis, US monetary policy, taxes, foreign exchange rates, etc. One of these threats to their investments, inflation, has

not received much attention.

At an Insurance Insider conference in London in September, Martin Sullivan, Deputy Chairman of Willis Group Holdings PLC said, "Inflation could well be the monster under the bed." Not everyone is paying attention to the im-

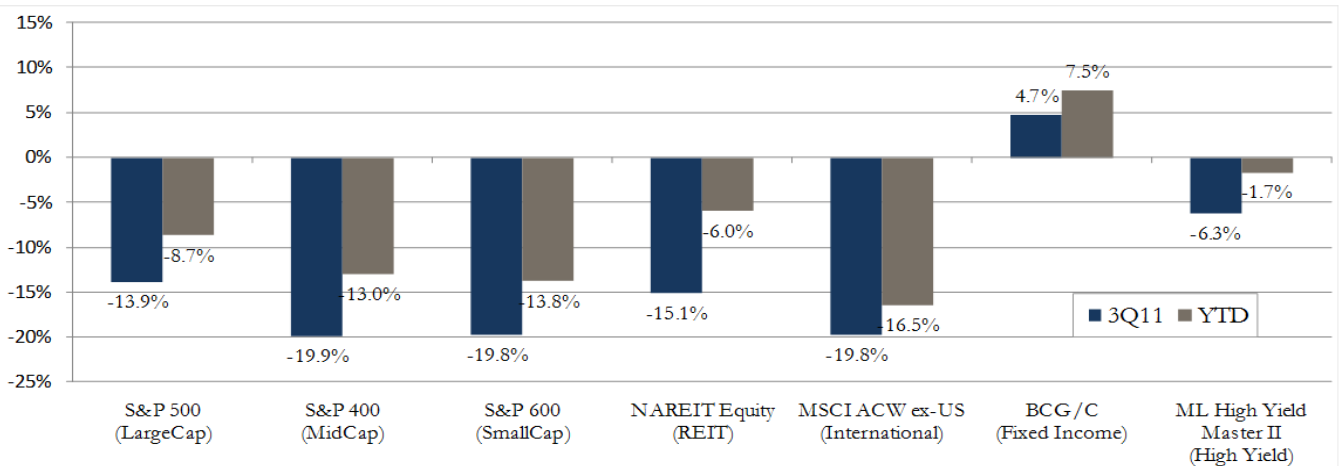
**Economic Review** 1  
by  
Randy Root and  
Art Burtscher

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**Investor** tolerance for risk took a sharp nosedive during the third quarter as a number of global events conspired to reduce optimism about future economic growth, both here and abroad. Foremost among these events was the failure of policy makers in the U.S. to put aside partisan bickering and compromise on extending the debt ceiling

until the eleventh hour. The debt rating agency, Standard and Poor's, took that as a sign of further stalemates ahead as Congress attempts to address our untenable debt situation and acted by removing the triple-A rating from U.S. Treasuries. The downgrade was accompanied by heightened concerns about a possible Greek debt default and the potential for a financial

crisis in Europe. Finally, weakening economic data, including a lack of job creation during August, prompted more selling by volatility-weary investors. Although stock losses were widespread during the quarter, the market continued to trade in a range following the steep early August sell-off, with rallies occurring following any indication of progress





Tom Krasner, CFA is Co-Founder and Principal of Concise Capital Management, LP, which manages short-duration, smaller issue high yield bond separate accounts and a hedge fund. Mr. Krasner has spent over 20 years in fixed income, distressed debt and high yield bonds, including extensive experience in corporate restructurings and workouts. Mr. Krasner holds a B.A. in Economics/Mathematical Sciences and a M.A. in Economics from Rice University.

**“The correlation of high yield is higher to equities at 0.57% that to bonds at 0.29, which suggest that high yield can serve as a good substitute to equities...”**

## High Yield: An Alternative for Insurance Company Portfolios

*The current* investment environment for insurance companies offers many challenges for the earning of investment income. A typical insurance company portfolio contains high-quality fixed income securities, blue-chip equities, and real estate. The low yields on income-producing securities have negated the investment income from a conservative investment strategy and placed a heavy reliance on underwriting gains to drive income. At the same time the recent volatility in the equity and real estate markets has generated capital losses in many portfolios, diminished share-

holders' equity, and caused some companies to reevaluate their portfolio exposure. The investment performance demonstrates the hybrid characteristics of high yield. In the short-term an investor offer an attractive alterna-

tive to these asset classes. It is a hybrid asset with many of the characteristics of traditional insurance company investments. Like stocks, the fundamentals of a company's financial performance, specifically, its ability to generate cash, cover its interest expense, and payoff its debts, determine the price behavior of a high yield bond. Like investment grade bonds, interest income generates the vast majority of the return.

high yield market delivered a mean return of 9.26% with a standard deviation of 8.82%. This long term mean return lies between the long-term mean returns of equities and corporate bonds. The standard deviation of high yield is about 60% that of equities but twice that of corporate bonds. The correlation of high yield is higher to equities at 0.57% than to bonds at 0.29, which suggest that high yield can serve as a good substitute to equities, especially for more conservative portfolios. The correlation with bonds and equities, however, is low

Figure 1 shows the historical performance of high yield bonds relative to the

Figure 1  
Investment Performance—1984 to 2011

	High Yield	S&P 500	Barclays Aggregate Bond Index
Mean Return (%)	9.26	10.70	8.05
Standard Deviation (%)	8.82	15.60	4.40
Sharpe Ratio	0.21	0.19	0.28
Correlation to HY		0.57	0.29

Source: Bloomberg, Barclays Capital

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enough to diversify and reduce the overall volatility of the entire investment portfolio. Between 1984 and 2011 the should expect some diver-

# Risk Management and Inflation

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pact inflation can have in ravaging the balance sheet of an insurer. For example, inflation can cause claims cost to rise at a faster rate than the value of their investments. Worse, inflation can drive up interest rates reducing the market value of insurer's fixed income portfolios. Potentially, a perfect storm!

Sullivan said he sees that inflation may be a bigger risk for insurers than tsunamis or Europe's sovereign debt crisis because claims costs could climb faster than the value of their firm's investments. Investment portfolios with concentrations in US Treasury issues are already well acquainted with this problem: that of experiencing negative real returns due to an inflation rate which exceeds the yield on the instruments. With 2-year notes yielding around .274% and 10-year notes at about 2.127% and an inflation rate running currently above 3.8% the math is not pretty for these investors. It is expected that the Federal Reserve will continue to keep benchmark interest rates in a target range of zero to 0.25 percent for an extended period. "Of all the issues out there, inflation could be the one that comes to surprise a lot of companies," said Sullivan. "In a zero interest-rate environment, reinsurers face two options: they either accept a continuously weaken-

ing balance sheet or they raise their rates."

How real is the inflation threat for insurers? Already this year, we see consumer prices rising in developed economies such as the U.S., the U.K. and Germany. The same is true for developing economies such as Russia, India and China where rates are rising at the fastest level since 2008, during which time the world was concerned with the rapid and sustained rise in commodity prices (Figure 1).

While the US inflation rate has been increasing, most attribute the rise to food and energy price increases as well as the government's efforts to stimulate the economy. For example, the U.S. Agricultural Department expects food prices to increase between 3.5 and 4.5% this year after climbing just 0.8% in 2010. With current market expectations for a slow and unsteady economic recovery, many economists have not yet focused on the looming, longer-term inflation threat. In fact, most predictive indicators, such as Financial

Forecast Center, LLC below, illustrate a declining inflation threat over the next 6 months.

high energy and commodity prices should wane over the coming months, inflation re-

## U.S. Inflation Rate Forecast

Year Over Year Change in Consumer Price Index Percent

Month	Date	Forecast Value	50% Correct +/-	80% Correct +/-
0	Aug 2011	3.76	0.0	0.0
1	Sep 2011	3.6	0.2	0.4
2	Oct 2011	3.3	0.2	0.5
3	Nov 2011	3.0	0.3	0.6
4	Dec 2011	2.5	0.3	0.7
5	Jan 2012	1.7	0.3	0.7
6	Feb 2012	0.9	0.3	0.8
7	Mar 2012	-0.1	0.4	0.8
8	Apr 2012	-0.7	0.4	0.9

Updated Monday, September 19, 2011

It was not long ago that the greatest risk was that of deflation. Experts still argue that inflationary trends are not an immediate problem. At the Federal Reserve meeting on October 17, differences of opinion were apparent. The Richmond Fed's Jeffrey Lacker acknowledged that while inflationary pressures from

mains a threat. Some at the Fed seem inclined to acknowledge, but tolerate, increased inflation levels in order to pursue policies aimed at arriving down unemployment rates, a top priority that the Fed has not been successful in combating. In any case, "Operation Twist" and the Fed's prior efforts to stimulate

Figure 1: September 2011 Inflation Rates

<u>Developed</u>		<u>Developing</u>	
US	3.87	Russia	8.14
UK	5.19	China	6.1
Germany	2.59	India	8.99*
Euro Zone	2.98		

\* August 2011



Mr. Burtcher, former Chairman of McCarthy Group Advisors, LLC was named SVP with oversight of the Omaha branch of Westwood Trust upon the acquisition of McCarthy Group Advisors by Westwood Holdings Group, Inc. He is a member of the Westwood Trust Board of Directors. He is also a board member of Nova Star Financial, The Silver Stone Group, Jetlinx Aviation and lead director for NICS, Inc. He has been published and has been a speaker on subjects dealing with financial management. Art has earned the following securities licenses: Series 6, Series 63 and series 65



Mr. Root graduated from Washington & Lee University in 1983 with a degree in Geology and received his MBA from Southern Methodist University in 1992. Mr. Root began his career at Geophysical Exploration, then he worked for Amerada Hess, before joining Fidelity Investments in 1986. Mr. Root joined Westwood in 1993, he currently serves as Senior Vice President and is responsible for asset allocation and separate account management of client portfolios, as well as new business development and ongoing client service. He chairs the Westwood Trust Investment and the Asset Allocation Committees.

## Economic Review

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towards a solution to the European debt crisis.

During the quarter, defensive stocks, companies with predominately domestic revenue sources, and shares of high quality companies were the best performers. In addition, the flight to quality, coming on the heels of increased investor fears of global slowing, drove capital into other U.S. Dollar-denominated assets and created a tremendous increase in bank deposit balances. The best performing sectors in the third quarter included Consumer Staples and Utilities. The Technology sector also performed relatively well due to the high quality nature of many of the larger stocks in the S&P 500. Energy, Producer Durables, and Materials & Processing, the most economically sensitive sectors, were the worst performers. Despite the continued strong operating results of many companies in these sectors, their shares were driven lower by the extreme macro-economic fears.

The Federal Reserve made two major announcements during the quarter. The first was a commitment to keep the Fed Funds rate near zero until at least mid-2013, while the second, a tactic referred to as "Operation Twist," is a

plan to sell short-term Treasury notes and purchase longer-term Treasury notes. The combination of these two actions is designed to keep interest rates across the yield curve at a very low level for an extended period of time. The goal is to boost economic activity through lower mortgage rates, increased bank lending, and greater risk taking by investors looking to meet certain portfolio return targets. Neither action produced an immediate positive reaction by equity investors, but they have produced multi-generational lows in interest rates. The real impact on the economy is yet to be seen.

As if the events that roiled the equity markets were not enough to prompt a sharp fall in Treasury rates, U.S. Treasury yields posted one of their sharpest declines in history, with the yield on the 30-year bond finishing the third quarter at 2.91%, a stunning 150 basis points lower than at the end of the second quarter. Fixed income investors were rewarded with positive returns in the third quarter, but the range of performance was exceptionally wide. Without question, the star performer was the 30-year Treasury bond, which gained an astonishing 31% in the third quarter. The 10-year

Treasury also posted a return of just over 12%. After proving largely immune to market volatility, credit spreads widened sharply in the third quarter, but most investment grade corporate bonds still managed to generate positive returns. However, issues in the Financial sector proved to be an exception, sharply lagging the broader market.

The third quarter was the worst quarter for the broad High Yield market since the third quarter of 2008, although the trends in underlying corporate fundamentals of most high yield issuers remained generally positive. More highly-rated securities, as well as securities trading to a short maturity date, outperformed the broad market as investors shunned lower-rated securities that are more susceptible to slower economic growth or generally rising risk premiums. All sectors posted negative returns for the quarter although the Energy, Automotive and Consumer Cyclical sectors outperformed in a sharply negative period. The Financial, Technology and Telecommunications sectors were the worst performers due to their concentration of large, liquid low rated securities that are most sensitive to a market sell-off.

Performance for the Short

## Economic Review

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Duration portion of the High Yield market maintained its historical relationship to the broader market, participating in about one-third of the decline. This decline had the effect of pushing yields on the shorter end up in the third quarter. Typical yields for lower volatility, short duration credits moved from 5% to 7.5%.

Commodity prices fell in tandem with stocks during the quarter. Crude oil fell from the mid \$90s/bbl to the low \$80s/bbl, off sharply from a recent high of \$113/bbl. Industrial commodities, such as copper, which fell 25%

during the quarter, were also under pressure as traders discounted the slowing pace of global economic activity. Even gold finally lost a bit of its luster, as the bullion price retreated from an all time high of almost \$1900/oz. to end the quarter at roughly \$1600/oz.. International equity markets fell sharply in the third quarter, driven by ongoing macro-economic concerns. Mounting evidence of slowing growth in both the United States and China was exacerbated by Europe's failure to address its sovereign debt crisis, raising concern over a potentially more dramatic economic shock. In this environment, cyclical stocks

performed poorly, particularly those in the Financial sector, while the defensive sectors generally performed well. Japan outperformed, as their economy is recovering from its earthquake-induced slump, and its consumers and corporations are far less leveraged than those in other parts of the world. Emerging Markets performed well initially, but came under pressure toward quarter-end, with some sharp moves in emerging market currencies and in commodities, as funds returned to the U.S. dollar.

While macro issues may be dominating the markets and driving the surge in

volatility, it is worth noting that there are more than a few positives to point to today. Many asset classes, including equities, offer attractive opportunities for investing. In addition, there is a tremendous amount of liquidity in the system, including on corporate balance sheets, while interest rates are at a level that is very conducive to fostering economic growth. Falling commodity prices and low mortgage rates are favorable for consumers, and the telltale signs of a recession are just not present today. However, what is lacking is confidence.

## High Yield: An Alternative for Insurance Company Portfolios

gence from these long-term mean returns. Currently, with yields on most investment grade bonds between 3% and 4%, a near-term return of 8.05% seems unlikely. But, with average yields above 9%, high yield seems to have a better chance to achieve its long-term mean return.

The timing of investing in high yield is an important concern. Investment returns ranged from a low of -26.16% in 2008 to a high of 58.21% in 2009. Although we are unlikely to again see the extreme volatility of the financial crisis, an investor can expect to

experience some volatility over the credit cycle. As yields rise with equity, rising volatility erodes investor confidence and tends to coincide with lower returns. In the high yield market fears of rising defaults and an impending credit crisis foreshadow a market sell-off while alleviation of these fears is a prerequisite to confidence and price appreciation.

The most important determinant of high yield returns is perceived default risk, which, in turn depends on the willingness

of lenders to assume risk and often dries up on anticipation of a recession. Historical annual default rates have ranged between 1% and 15% with an average default rate of 4%. Credit spreads, the part of the bond yield that exceeds the yield on a Treasury bond of comparable maturity, usually start to widen over a year ahead of the default rate in anticipation of a decline. The credit spread compensates the investor for the default risk he assumes in owning the high yield bond. A similar effect occurs with the re-

covery rate on defaulted bonds, the percentage of the principal value that an investor will recover in the event of a default. During economic distress, an investor recovers less on a defaulted bond than on good times and vice versa. Prior to investing in high yield, an investor should ask himself whether the current credit spreads sufficiently compensate him for the expected default risk and the expected recovery should the bond default.



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**CapVisor Associates, LLC**

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## Upcoming Events

- **The Cayman Captive Forum** will be November 29-December 1 at the Ritz Carlton in Grand Cayman and Mr. Terzer will be a featured speaker and moderator of the investment session.

**Stay tuned for the CapVisor 2012 event calendar**



We are please to announce that Dave Moore has joined CapVisor Associates, LLC as Managing Director. Dave is formerly the Chief Investment Officer of AEGIS, a Bermuda Captive, where he oversaw a multi-billion dollar portfolio. Prior to AEGIS, Mr. Moore was the CIO of AAA of Michigan. He will contribute greatly to CapVisor's asset allocation modeling and client consulting capabilities.

Carl Terzer was recently named the Investment Instructor for the International Center for Captive Insurance Education (ICCIE -- pronounced "I see"). Born in the summer of 2004, ICCIE is the first and only comprehensive captive insurance education program in North America.

Mr. Terzer was recently selected to join the Finance Committee of the Vermont Captive Insurance Association (VCIA).

Carl was also recently

## In the News

selected as a member of the Alternative Risk Transfer (ART ) Committee of the Self Insurance Institute of America, Inc., (SIIA) , a dynamic, member based association dedicated to protecting and promoting the business interests of companies involved in the self insurance and alternative risk transfer industry, both domestically and internationally.



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

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## Risk Management and Inflation

the debate is more about whether this reckoning is within the next year or two or whether it can be pushed further out or dissipated over time. In addition to the timing question, it is magnitude of this attack on insurers' balance sheets that is in question since our artificially low interest rate environment could cause a more sudden, accelerated rise later on in response to inflationary pressures. While my

crystal ball does not provide a clear answer, I remind clients to begin positioning ahead of the "conventional wisdom" pack. In my opinion, it would not be too early to begin planning for ways to protect their balance sheets, and more specifically, their investment portfolios against the possible inflationary threats that lurk in the shadows.

CET