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Trends in Insurance Asset Management

Insurance Asset Manager LLC has long been considered an industry-leading publication and an acknowledged authority with regard to outsourcing within the insurance asset management business. Publisher Justine Ceylan and editor Alex McCallum produce a well-respected annual survey of insurance asset managers. The recently released 2010 edi-

tion reports that as of year-end 2009, a total of \$1.38 trillion in third party insurance company assets was reportedly managed by the 46 U.S. based investment firms that participated in the survey. This represents an increase of 29% from year-end 2008. No doubt the atypical increase is attributable to the effects of the credit crunch and economic recession on insurance portfolios. While the

study does not detail the source of these funds, specifically whether they were internally managed at the insurance company or externally managed by an investment manager not participating in the study, one can assume that a disproportionate amount were previously internally managed with disappointing investment results.

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Economic Review: Relative Value & Sector Outlook

Following the substantial rally in the bond market during the third quarter, we believe a great deal of additional quantitative easing is being "priced in" by the market due in part to a general sense of angst regarding the prospects for growth. In other words, the market believes the US economy is dead in the water and the Fed will respond by buying bonds in the open market.

Against all odds, bonds rallied by 20 to 50 basis points this quarter depending on the maturity (30 year and 5 year Treasuries, respectively). Since the majority now believes the Fed will remain on hold through most or all of 2011, the five year segment of the market fell most in yield as flows remained heavy into bond mutual funds by risk-averse

consumers moving out of money market funds, CDs and other cash products which yield close to zero.

Economic data point to slow growth

While most economists had predicted growth would slow during the second half of the year, the slow-down seemed to come sooner and more abruptly than the market expected. The following observations are pertinent:

High unemployment is problematic: low-skilled workers have few options even as pockets of skilled labor shortages are emerging. Meanwhile, many hiring managers remain reluctant to add workers due to higher regulatory costs and/or uncertainty

(particularly related to health insurance).

Housing remains mired in a state of over-supply of unsold homes, both new and existing (foreclosures). Tougher mortgage underwriting is limiting mobility, while real estate's recent performance and poor outlook have changed perceptions among many Americans who appear to be emphasizing the utility aspect of homeownership again as opposed to the investment potential.

"The Great Deleveraging" is a long process whereby consumers shun additional debt, the financial sector must shrink and the corporate sector is committed to a more sensible use of debt.

The European debt crisis continues to exert a variety of pressures on the bond market and likely will

A Harbor in the Financial Storm: What Reinsurance Can Do For Your Company



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“A quota share will cede a proportional amount of premium to a reinsurer in return for taking on a proportional share of the losses. “



Editor's note: Part 1 of this two part article can be found in the July 2010 quarterly newsletter at <http://www.capvisorassociates.com/Archives.html>

Part 1 Recap

Reinsurance is a useful financial tool for insurance companies. It can effectively manage capital in the following ways:

1. Protects from catastrophic loss
2. Enables a company to

3. write higher limits
3. Provides income stabilization
4. Reduces premium to surplus leverage

In addition to providing an overview of the state of the reinsurance market, Mr. Fox reviewed how the recent volatility of the investment markets has caused issues with the capital structure of many smaller insurance companies.

More specifically, some in-

surers are having difficulty achieving the require leverage ratio of 3:1. He went on to offer four solutions to mitigate this problem:

1. Reduce premium writings
2. Raise capital
3. Seek higher returns on investments
4. Utilizing reinsurance

Part 2 of 2 begins on the next page

Reinsurance Example

Reinsurance Agreement:

25% Quota Share
30% Ceding Commission
Gross Written Premium: \$20,000,000
Company Surplus: \$5,000,000

Without Reinsurance

Gross Written Premium \$20,000,000
Ceded/Reinsured Prem \$ -
Net Written Premium \$20,000,000
Surplus \$ 5,000,000
Leverage Ratio 4.00

NR: Insurance Regulator may shut company down.

With Reinsurance

Gross Written Premium \$20,000,000
Ceded/Reinsured Prem \$ 5,000,000
Net Written Premium \$15,000,000
Surplus \$ 5,000,000
Leverage Ratio 3.00

Direct Insurer - Before Reinsurance

Original Premium \$20,000,000
Expected Loss \$12,000,000 60% Loss Ratio
Operating Costs \$ 6,000,000 30% Expense Ratio
Underwriting Profit \$ 2,000,000

Reinsurer

Assumed Premium \$5,000,000
Assumed Loss \$3,000,000
Ceding Commission Paid \$1,500,000
Profit \$ 500,000

Profit:

With Reinsurance \$ 1,500,000
Without Reinsurance \$ 2,000,000
Lost Profit \$ 500,000

A Harbor in the Financial Storm:

(continued from page 2)

Utilizing Reinsurance

The most common reinsurance structure for reducing leverage is via a quota share reinsurance agreement. A quota share will cede a proportional amount of premium to a reinsurer in return for taking on a proportional share of the losses. In addition, as the insurance company incurs considerable costs for acquiring the original business, the reinsurer provides a ceding commission to reimburse the reinsurance company for that expense. The reinsurance cession provides replacement capital in two ways:

- By ceding away premium, the leverage ratio is directly reduced.
- The ceding commission helps reduce the statutory expense burden by reimbursing costs as the business is written. This is particularly helpful for companies that are growing quickly.

The example below demonstrates how a company can use reinsurance to go from an unacceptable leverage ratio of 4:1 to an allowable ratio of 3:1.

In addition to proportional reinsurance, excess of loss treaties can similarly be a source of capital for an insurance company. An excess of loss reinsurance contract, with a carefully selected attachment point, can also reduce leverage

concerns. In addition, it can stabilize profits and allow a company to write higher limits.

Reinsurance Costs

Reinsurance certainly comes with its costs, though it tends to be much more efficient than raising capital. For example, the above scenario shows a "Lost Profit" of \$500,000. Meanwhile, the insurance company would need to raise \$3,000,000 in funds, should it want to get to the same 3:1 ratio. This comparison would suggest that reinsurance comes at a capital cost of 16.67%. While that rate of return may seem dear, an insurer must also consider the following in its cost/benefit analysis:

1. While the "Lost Profit" of \$500,000 is significant, it is an economic cost (i.e. opportunity cost). That lost profit would not exist without reinsurance, as the company would likely be shut down, without any alternative improvements to the capital structure.
2. The reinsurance transaction is scalable. A capital raise, perhaps via preferred stock or even a surplus note, must pay a return to investors at a set rate regardless of whether the capital was employed (i.e. premium was written). The above reinsurance transaction's profit is determined by the volume

written by the insurance company.

3. A reinsurance agreement can be implemented in a relatively short period of time, when compared to raising capital. A reinsurance transaction can often be implemented within a matter of a few months.
4. Reinsurance can give a company access to key business partners, who can help advise and grow the insurance company's business.
5. An alternative form of capital may not exist in the current financial world. Is there even an appetite for small insurance company investments, at a rate less than 20% expected return on capital? Will that investor be willing to take a minority stake?

Currently, the cost of reinsurance is stabilizing to trending downward, while the ability to raise capital is becoming increasingly difficult. For this reason, many insurance companies facing capital constraints should consider buying (or buying more) reinsurance. The right reinsurance structure, with the right reinsurance partner can create tremendous value for a smaller insurance company. These transactions, with the assistance of a thoughtful and talented reinsurance broker can help a company effectively manage through these volatile economic times.



"An excess of loss reinsurance contract, with a carefully selected attachment point, can also reduce leverage concerns. In addition, it can stabilize profits and allow a company to write higher limits."



Economic Review

(continued from page 1)



Rich Litchfield, VP Rich is Head of Trading and Portfolio Management with a prominent Insurance Asset Manager and a CapVisor Network member. With more than 15 years experience managing tax and liability sensitive portfolios, his group advises over \$6.5 billion in insurance assets.

"...total returns are quite attractive due to the powerful rally and attendant price gains, bear in mind interest rates will rise one day which will produce price declines on existing portfolio holdings..."

be a frequent topic of discussion for the next several years.

Relative Value and Sector Outlook

Corporate sector

- We are struck at how compressed yields are among sectors of the corporate market. Even so, there remains a powerful incentive to buy BBB bonds since absolute yields are so low and the outlook for corporate profits remains sound.
- We continue to favor "low beta" companies with a demonstrated track record of fiscal discipline. Boring is good as far as we're concerned!
- We seek companies with favorable growth prospects in overseas markets, particularly in developing economies with vibrant demographics, a stable political milieu and a growing propensity toward consumption, such as Brazil. Year to date, curve-adjusted excess return is 72 basis points for the sector.

Securitized sector

- We remain underweight in the residential MBS sector due to poor valuations and high dollar prices. In short, this sector is highly distorted due to the Fed's massive intervention, while the continued threat of a stream-lined government-sanctioned refi program is reason alone to be leery.
- We are very selective in the CMBS and ABS segments, but look to add well-underwritten and well-

structured bonds.

- Year to date, curve-adjusted excess return is -52 basis points for the MBS sector, which means an underweight position has been the right call.

Municipal sector

- Although fundamentals remain challenged, this sector does offer decent yield pick-ups over Treasuries along with high ratings and good liquidity.
- Selectivity is also key here: we favor jurisdictions with higher wealth measures, greater diversity of taxpayers/employers, demonstrated fiscal prudence and balanced political environments.
- As of 9/30/10, the yield to worst is 3.01% for the municipal index (tax-exempt).

Keep today's low rates in perspective

- While year-to-date and trailing 12 month *total returns* are quite attractive due to the powerful rally and attendant price gains, bear in mind interest rates will rise one day which will produce price declines on existing portfolio holdings. When and how quickly are the key questions.
- Investment income will suffer as long as rates stay in the current range, and even more so if the bond rally continues, so build this reality in to your business plans.
- Exacerbating prospective lower income is the growing level of call activity by both corporate and municipal borrowers. With lower rates come opportuni-

ties for both types of borrowers to call bonds either through exercising call options or initiating tender offers, which removes high book yields from portfolios and forces reinvestment at lower yields.

- The rally has resulted in unrealized gain positions on nearly every holding in your portfolio...a highly unusual circumstance!

Extraordinary situations proliferate

- The Great Financial Crisis may be over, but we are still dealing with the aftermath: low interest rates, high unemployment, anemic growth, new financial regulations, risk-averse consumers, MBS valuation distortion, etc.
- Our major concern at the moment is not corporate credit quality or even municipal credit quality (the media's current favorite whipping boy), but rather **the direction of fiscal and monetary policy**. The Fed has become increasingly politicized and is a virtual tool of government efforts to stimulate an economy that is not responsive to lower rates because the major players (i.e. consumers and businesses) seek lower leverage. Meanwhile, the government sector has taken on the leverage mantra and is scaring currency markets in the process. This reality is causing gold to rally to new highs, as the era of fiat currencies is being tested like never before, and has even spawned a new political movement known as the Tea Party.

Trends in Insurance Asset Management (Continued from page 1)

Supporting this viewpoint, PricewaterhouseCoopers LLP (PwC) recently reported in a study that impairment write downs on securities positions has led companies to mandate a very careful review their company's risk appetite, investment strategies, and internal compliance policies. Added PwC, "Investment management functions will continue to explore other business models, such as outsourcing some or all of the investment function, as they search for a cost-effective operating model."

The near-collapse of the financial markets in 2008 and the corresponding punishment sustained by many insurers' portfolios suddenly focused attention on investment portfolios. Clearwater Analytics LLC, a leading investment portfolio reporting and analytics firm, recently published an article in which one of their clients, Bret Myers, assistant treasurer at Group Health Cooperative stated, "In the past few years, there has been an awakening among senior management and boards at insurance companies in the way that they view investment portfolios," He went on to add, "At many insurance companies, investment management has historically been treated as an afterthought,...it has not had as much focus in the past as a way of augmenting the bottom line, but rather was kind of a complement to core operating results". Things have changed.

Consultants Preferred

In addition to increasing investment manager searches, the proportion of insurers engaging investment consultants has grown significantly. David F. Holmes, a partner in Eager, Davis & Holmes reported in a survey that the financial crisis triggered a surge in demand for investment consultants specializing in insurance asset outsourcing. The report indicated that in 2008, when the crisis hit, consulting activity in third-party insurance asset management was continuing at its traditional low level, with new insurer general account mandates placed through consultants accounting for a meager 15% of the total. By mid-year 2010, however, Holmes found that consultant-aided manager hires had doubled to 30%.

The Soft Market

Best Practice in insurance asset management has always focused on correlating the investment strategy with underwriting activity, that is, approaching risk and reward from an enterprise-wide perspective. Sadly, insurers' financial performance cannot be expected to be bolstered by the liability side of the balance sheet. Risk and Insurance Management Society (RIMS) revealed in a recent survey that the soft market is "far from over". Fortunately the pace of decline is abating as premiums declined less during the third quarter.

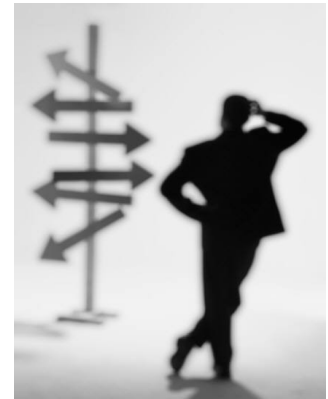
Clearly the market is still in a

situation of too much capacity chasing too little premium. RIMS stated that in this past quarter, the biggest drop in average premium was 4 percent for directors and officers policies. Property insurance premiums declined 3 percent, and general liability and workers' compensation fell less than 1 percent.

"Rates in some lines are back to where they were at the depths of the last soft market," said Robert Cartwright, RIMS board member and loss prevention manager for Bridgestone Americas Holding Inc. "That might suggest that the market is poised for a turn, but competition is still intense."

The Bottom Line

With the expectation of continued market volatility, economic uncertainty, a low interest rate environment, and a prolonged soft market for underwriting, many small to midsize insurers have discovered, or are yet to discover, that internal portfolio management is best left for those insurers large enough to embrace this responsibility as a core competency. That is, those with the critical mass to deeply resource a professional investment capability with strong risk management capabilities as required for competitive results in today's marketplace. CET



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Up Coming Events



- The **Cayman Captive Forum** will take place November 30 through December 2, 2010 at the Ritz Carlton, Grand Cayman, Cayman Islands.
 - **CICA 2011 International Conference** will be on March 13-15, 2011 Westin La Paloma Resort & Spa in Tucson, AZ. This year's theme: Changing Times - Distinctive Solutions
 - The **Vermont Captive Insurance Association Legislative Day** event, while not yet announced, will no doubt be the first event of the new year.
- Carl Terzer will be a conference delegate at all of these upcoming events.
- Hope to see you soon!**



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