Inside This Issue

It's All About the Fed... Almost

This 2-part article will look at the Federal Reserve's rate policy and its effect on insurance company bond and stock portfolios. With the Fed's extreme measures to stabilize the US economy and to prevent a full economic depression in 2008, significant market distortions were created and knowingly tolerated. These distortions were caused by the massive liquidity injected into the US economy through interest rate policies as well as the purchasing of bonds by the central bank. These strategies sought improved market liquidity and to reflate the economy after the shock in 2007-08. While still suffering a recession, the economy did recover but on a much slower track than it had in previous recessions. In fact, it took the S&P 500 until the third quarter 2012 to return to, and remain higher, than its fourth quarter 2007 peak. The NASDQ was even slower in its recovery from its 2007 peak finally surpassing it in early 2013.

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Federal Reserve has a Soft Landing in View

For the past 10 years, the Federal Reserve has maneuvered through the monetary policy gauntlet with what must now be characterized as excellent results. The measures employed by the Fed since the financial crisis include moving the Fed funds rate to the zero bound; implementing multiple rounds of qualitative easing (QE) to lower interest rates across the yield curve; improving policy communications and transparency; strengthening the financial system by regulating capital requirements; slowly increasing short-term interest rates in a methodical and well signaled fashion; and finally, slowly unwinding the QE program by shrinking its balance sheet. As we inch closer to what economists estimate as the "neutral rate" where monetary policy is neither accommodative or restrictive, the Fed appears to be threading the needle as unemployment is at the lowest levels in decades (3.7% as of September) while inflation remains right on target (Core Personal Consumption Expenditures (PCE) 2.0% year-over-year in August). The question now is whether the Fed can manage a soft landing where they do not tip the economy into recession or allow growth and inflation to overheat. We believe so far, so good.

In our third quarter commentary, we will review recent performance in fixed income markets, provide a more detailed assessment of the Fed's dual mandate, and evaluate the current expansion in its historical context.

Third Quarter Fixed Income Recap

Once again, low quality bonds remained resilient to rising rates given a larger yield cushion. The riskiest bonds continue to be one of the top performing high yield segments, despite spreads hovering near historically tight levels. High quality, longer duration instruments posted negative returns. The following is a summary of fixed income returns for the third quarter 2018:

- CCC and below rated corporate credit was the top performing segment as the ICE BofAML US High Yield (CCC & Lower) Index returned 2.8% for the quarter. Broad high yield, via the ICE BofAML US High Yield Index, returned 2.4%. High Yield spreads tightened modestly, ending the quarter at 360 basis points above Treasuries. This is significantly below the long-term average of 580 basis points.
- Floating rate leveraged loans also performed well during the quarter, as the S&P/LSTA US Leveraged Loan 100 Index returned 2.1%.
- Investment grade corporate credit posted a positive return, as the Bloomberg Barclays Aggregate Investment Grade Credit Index was up 1.0%.
- The yield curve flattened modestly over the quarter, with the two-to-ten year Treasury spread narrowing 9 basis points to 20 basis points. The 2-year Treasury rose from 2.52% at

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the beginning of the quarter to 2.81% at the end of the quarter, mainly due to heightened expectations of an additional Fed rate hike in the fourth quarter. The 10-year Treasury rose from 2.85% to 3.05% due to a risk-on trade causing bonds to sell off in favor of equities. Higher rates caused longer bonds to underperform in the quarter, with the Bloomberg Barclays US Treasury 20+ Year Index down 3.0%.

- High yield municipal bonds posted good returns of 0.8% for the quarter while investment grade municipal bonds were slightly down per Bloomberg Barclays Municipal Bond indices.

- Global bond performance for the quarter was predominantly influenced by currency exposure amid the continued rally in the US Dollar. Despite a challenging month of August for emerging markets, the JPMorgan EMBI Global Diversified Index returned 2.3% for the quarter as the US and Mexico solidified trade negotiations. However, currency effects overwhelmed locally-denominated emerging and developed market debt, as they returned -1.8% and -1.7%, respectively. The chart below summarizes Q3 performance for US fixed income market sectors.

Update on the Fed's Dual Mandate

Core PCE Inflation: Low inflation expectations are proving difficult to shake because reality keeps getting in the way. Core PCE, the Fed's preferred metric which excludes food & energy, remained near 2% year-over-year in August, equaling the Fed's target.

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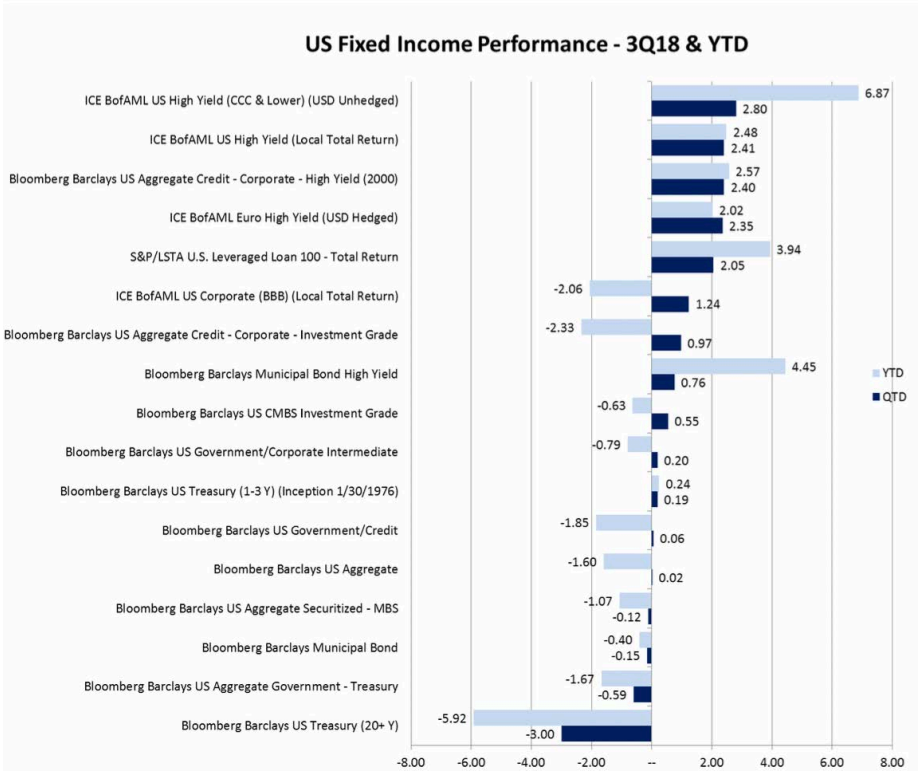

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We do not anticipate Core PCE to be sustained significantly above 2% in the near term, for a few reasons. First, we believe the recent run-up in oil prices (+27.2% and +33.4% YTD in WTI and Brent prices, respectively) is primarily due to short-term supply shocks resulting from destabilization in Venezuela and US sanctions on Iran. There is plenty of spare production capacity worldwide, particularly in Saudi Arabia and the Permian Basin, than can be brought online in a reasonable amount of time to meet global demand growth, keeping a lid on prices. Second, the 3.7% rise in the value of the dollar YTD is disinflationary as prices for imported goods become cheaper in USD terms. Additionally, as US goods become more expensive abroad, demand for USD exports declines. Though trade disputes could offset some of this disinflationary pressure, we do not expect trade to be a meaningful factor in moving inflation significantly above the current 2% range. Finally, we anticipate one more 25 basis point increase in the Federal funds rate this year, reaching 2.25-2.50%, and continued rate increases into 2019 that will be sufficient in offsetting inflationary pressures from a growing economy.

Unemployment: Weekly jobless claims reports continue to signal a very low pace of layoffs. The four-week moving average of initial weekly unemployment claims was 209,500 as of October 6. Even though recent claims remain somewhat elevated in hurricane-affected states, the last time average weekly claims were below 230,000 was in the 1970's. Continuing claims, the number of persons receiving benefits through unemployment insurance programs, paints a similar picture of the job market. Though claims have increased recently due to hurricanes, they reached a cycle low 1,645,000 in early September. The last time claims were below 2,000,000 was in 1973.

Average hourly earnings rose 0.3% month-over-month and 2.8% year-over-year in September. Hurricane Florence likely inflated wage increases due to gains in the construction and utility sectors. Average weekly hours remained stable at 34.5 while total hours worked increased 1.6%. As third quarter GDP estimates are over 3% (Bloomberg consensus 3.2%), the economy appears to making continuing productivity gains.

> **"Policy makers at the Federal Reserve often give public speeches, providing insights into their individual views on the economy and necessary policy actions. These speeches are often used by the Fed to telegraph future policy moves and influence market sentiment."**

September nonfarm payrolls rose 134,000, less than estimates (185,000 Bloomberg consensus) but the miss was offset by prior month revisions (18,000 and 69,000 in July and August, respectively), resulting in a greater than expected net job gain for the three month period. The unemployment rate fell month-over-month from 3.9% to 3.7%, the lowest rate since 1969 when it was 3.53%! While a tight labor market has resulted in some increase in wage growth, we expect inflation to remain contained due to productivity gains (as mentioned above) and labor force participation which has remained steady despite expected declines from an aging population, implying workers are returning to the labor market.

Recent Fed speak: Telegraphing Plans once the Neutral rate is reached

Policy makers at the Federal Reserve often give public speeches, providing insights into their individual views on the economy and necessary policy actions. These speeches are often used by the Fed to telegraph future policy moves and influence market sentiment. New York Fed President John Williams recently gave a speech at a central banking forum in Indonesia that we think provides helpful insight into the Fed's thinking as monetary policy moves from accommodative to neutral, or perhaps restrictive. FTN recently provided a helpful summary:

- The economy is strong. So strong, in fact, inflation will overshoot 2%. But there is no reason to think it will overshoot by much, which means it should be easily managed by the Fed.
- We are nearing the end of the normalization process, by which Williams means policy will no longer be clearly accommodative. Three more increases and then a pause….
- As policy approaches neutral, the natural rate concept loses its usefulness. Williams explains, "as we have gotten closer to the range of estimates of neutral, what appeared to be a bright point of light is really a fuzzy blur, reflecting the inherent uncertainty in measuring the neutral rate."
- From here, policy decisions will be based on operating in the vicinity of the neutral rate, while watching "economic and labor market indicators, wage and price inflation, global developments, financial conditions, the risks to the outlook… the list goes on and on."
- The Fed has one more important choice to make about the balance sheet. It might choose to shrink the balance sheet considerably, returning to the system used before the financial crisis, when the supply of reserves was kept small and the Fed maintained the Fed funds target with frequent open market operations. Or, the balance sheet could remain fairly large, and the Fed funds rate would be maintained

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as it has been since the crisis, through adjustment of administrative rates. Williams indicates a decision will be made after careful consideration "in the coming months."

The complete speech, a clear and relatively concise read, can be found at https://www.newyorkfed.org/newsevents/speeches/2018/wil181009.

Interesting Facts and Figures:

- The share of mortgages outstanding which are subprime is at the lowest level in decades. Approximately 4%of all mortgages are currently subprime versus 17% in 2006 according to Duetche Bank research.
- The new NAFTA deal nibbles around the edges of the prior deal and in our opinion is not a game changer when it comes to trade with Mexico and Canada. One point that has been passed over by many, however, is the manner in which trade with China is restricted and penalized for Mexico and Canada. The long term effect is to further minimize China's influence and further segregate them from taking advantage of open economies. Look for more of the same language in the South Korea and Japanese revised trade agreements. China's continued theft of technology from open market economies and unwillingness allow foreign competitors on its shores merit these steps.
- Big companies are getting bigger. Since 2008, the percentage of workers employed by companies with more than 10,000 workers has increased from 3% to 4% of total employment. Companies employing less than 20 works have declined by a similar amount. Our economy has become less dynamic and workers have less bargaining power.
- Bank of America, a firm we have consulted with over many years regarding the status of the housing market, has called the peak for existing home sales. This is the result of reduced affordability and deteriorating housing sentiment. Look for longer listing times, reduced prices (albeit modest for now) and a return to a buyers' market. New home sales will remain positive because supply has been very well restrained and they have lagged existing home sales since the beginning of the recovery.
- BCA Research, an independent research firm that we have read for at least the past 15 years, reports their Corporate Health Monitor has moved from "deteriorating health" territory to the "Improving Health zone. Why? The sharp increase in after-tax cash flows. Also, firm's net debt-to-EBITDA has improved in recent quarters. These trends were anticipated in previous editions of our commentary.

Our Strategy

We believe corporate bonds and the coupon advantage they offer remain the best opportunity in fixed income given the strength of the underlying economy. We also maintain our view favoring defensive sectors and up-in-quality as the flat yield curve is not offering enough value to extend in maturities or add additional risk to the portfolios. ☐

Stefan ten Brink, Managing Director

Mr. ten Brink joined the Firm in January 2011 from Petercam Asset Management in Amsterdam. He has 22 years of investment advisory experience, having co-managed the Ahold Pension Fund prior to joining Petercam. He has 18+ years experience with the HOLT framework.

Mr. ten Brink holds a degree in Logistics & Economics from Arnhem Business School and an MBA from Nijmegen University. Stefan is a Certified European Financial Analyst (CEFA).

Welcome Back Volatility

Insurance companies often invest the surplus component of their investment portfolio in stocks/equities. To be more precise, most invest in US Large Cap stocks, such as those typically in the S&P 500 index. Insurers usually hold these securities in "long-only" positions, meaning they own the stocks outright and hold them at their custodian bank whether they are internally or externally managed by an investment manager. These portfolios can be subjected to great volatility and suffer significant market value losses during market downturns. As market volatility increases and the likelihood of a cyclical change, or turning point, in the long bull run for the US equity market may be approaching, it is understandable that insurance companies are becoming increasingly concerned about their stock portfolios.

Insurance companies are also typically wary of the use of derivatives in their portfolios. These securities are often viewed as risky, are not well understood and have had reputational issues in the past. Derivatives are simply defined as "a financial security with a value that is reliant upon, or derived from, an underlying asset or

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group of assets. The derivative itself is a contract between two or more parties based upon the asset or assets. Its price is determined by fluctuations in the underlying asset"1. Derivatives include security types such as such as futures, put and call options, credit default swaps, interest rate swaps, warrants, etc.

As one might expect, a closer look reveals that not all derivatives are the same, and in particular, they carry different risk and reward levels. Among the most conservative are Covered Calls. These are call options that are "covered" due to the fact that the seller of the call option already owns/holds the security in their portfolio, a long-only position. A naked or uncovered call, in which the security would need to be bought in order to satisfy the call option when exercised, would be the risky version of a call option strategy.

As might be expected, Insurers have found Covered Call writing strategies to be useful in generating additional current income, from the call "premium" earned when the options are sold, and perhaps more importantly, they can convert long-only portfolios into defensive equity strategies. This is an especially important feature in times of market volatility. Given the two recent bouts of equity market volatility, in February and October of this year, many insurers are inquiring about techniques or strategies to protect their stock portfolio values in down markets. Therefore, Covered Call writing is a significant defensive equity strategy consideration.

Covered calls strategies are defensive in that they shift the long-only total return formula for stocks (price appreciation and dividend yield ~80%/20) to a more balanced 45/55 (dividend + option premium). In this way, the portfolio is less dependent on unknown price appreciation expectations and shifts the return composition to a better-defined component of total return i.e. income

Covered call strategies have historically out-paced the market during volatile periods. After six years of record low volatility, we believe covered call strategies are once again poised for out-performance. Here are the reasons why.

- **Higher yields:** During periods of heightened volatility, option premiums have a tendency to increase in price, as more investors are willing to pay for a hedge in their portfolios. Because covered call strategies are designed to sell options for income purposes, these higher premiums typically result in a higher yield to the investor. For example, some covered call strategies have averaged 6-8% annual yields over 15+ year periods, but currently annualized yields have increased to a range of 10-12% due to higher overall market volatility.
- **Downside protection:** Because covered call portfolios are designed to provide a higher income stream than most long-only equity strategies, they tend to do a particularly good job of protecting portfolios when the market declines. Call premiums can provide an income buffer that helps mitigate downside exposure, and this buffer potentially expands as volatility rises.
- **Rotation Towards Quality:** We have seen unprecedented market dispersion over the past 4-5 years, with growth stocks (largely driven by Big Tech) far out-performing the rest of the market. A well-managed covered call strategy is focused on quality and tends to lean more towards value than growth. Less speculative stocks (and particularly

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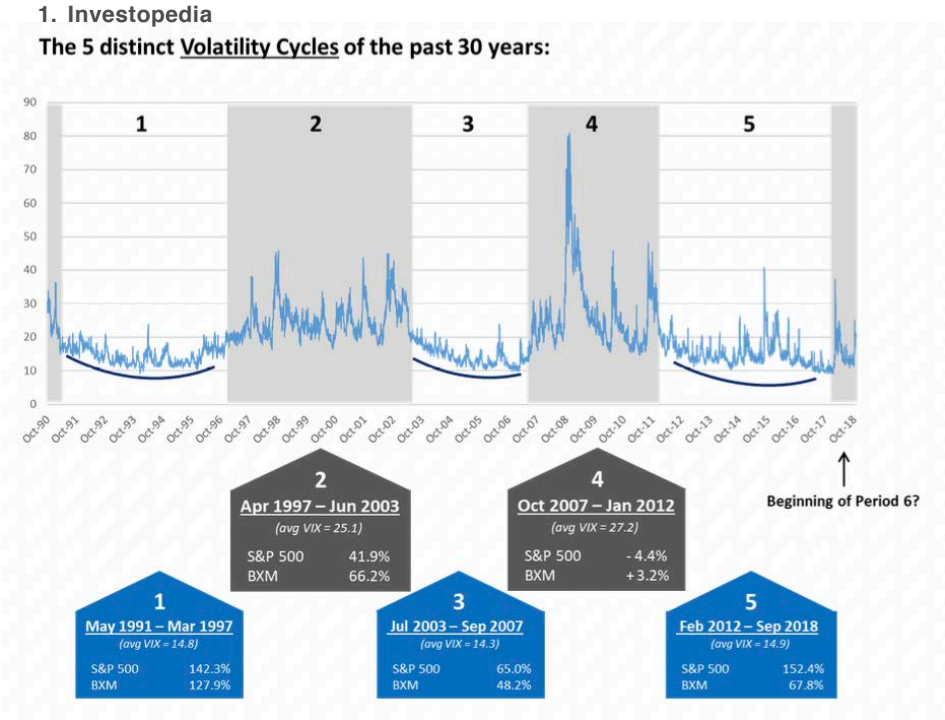
1. **Investopedia**



Footnote: the BXM is the ticker symbol for the CBOE S&P 500 BuyWrite Index, the index or performance benchmark typically used to evaluate the performance of covered call writing programs.

Welcome Back Volatility

the defensive sectors) typically do better during periods of heightened volatility. To reference our favorite baseball analogy, players who don't strike out get on base more and score more runs. The most successful strategies are those that are singles and doubles hitters. It's less exciting than hitting home runs but much more consistent and much more appropriate strategies for insurance company portfolios.

The CBOE volatility index, perhaps better known as the VIX, has averaged ~20 over the long term, meaning the market typically expects future volatility to be around 20%.

The VIX is often referred to as the market's "fear gauge" since it spikes during periods of uncertainty. We have studied the full history of the VIX, back to 1990. In the chart above, grey periods represent stretches when VIX traded above its long-term average of 20, while the white periods represent below average stretches.

Our research indicates that there have been five distinct volatility cycles over the past 30 years, and there is a clear distinction between investment returns during these periods. Referring to the graphic above, please note:

- Periods 1, 3 & 5: Low volatility (avg VIX of 14.7) – Long-only stocks significantly out-performed hedged strategies (including covered calls)
- Periods 2 & 4: High volatility (avg VIX of 26.1) – Covered calls significantly out-performed long-only stocks

Conclusion: It's clear that investors who utilized covered calls have significantly outperformed during periods of heightened volatility.

Key Takeaways

There are a few other noteworthy points about these findings:

- The dispersion of returns between the S&P 500 and the BXM in period 5 has been truly unprecedented, with long-only stocks gaining 152% versus 67% for covered calls. The past six years have been a really, really tough environment for hedged strategies. We expect to see some mean reversion
- Period 2 shows what a period of consistently high volatility looks like. The market went up an average of 6-7% per year during that period, but covered calls did significantly better relative to long-only stocks
- A prolonged period of consistently high volatility could be really, really good for covered call investors

We believe that the market has entered a new (potentially lengthy) period of above average volatility. Covered call strategies have historically been well suited for this environment and should be a consideration for insurers looking to protect stock portfolio values.

If you believe the market will shake off this recent uncertainty and the longest bull market in history will continue higher, then covered calls may not be for your company at this time. But if you think we may be beginning "Period 6" then now may be an ideal time to reallocate some capital from long-only equities into covered calls as your "hedge" against market uncertainty. ☐

It's All About the Feds... Almost

Today, we still see and feel the distortions from the extreme Fed policies. This first article will examine the impact on the bond market as the great "unwinding" of strategies is undertaken. The reversal of Fed Policies involves the steady increase in Fed Funds interest rates and the reduction in the Fed's balance sheets by selling bonds to remove market liquidity. Part 2, to be published in the next edition of the Quarterly CapVisor Insurance Asset Management Newsletter, will cover the effects of Fed Policy on the US stock market. To begin, we start with a quick reminder of how we got to where we are today.

Part 1: Understanding Fed policy and its effects on insurer's bond portfolios.

Fed rate policy: a historical recap

Remember what happened in the bond market on December 15, 2015? Probably not, but the bond market was informed of the first Fed rate increase since 2008. This announcement signified a transition from an "easy money" to a tighter monetary policy. As you will recall, in 2008 the Fed attempted to buffer the effects of the great recession by reducing interest rates, rather rapidly, down to 0-25 basis points, representing a historical

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low point. For some historical context, and to fully appreciate this long and anomalous low interest rate environment, consider that interest rates in the United States averaged 5.72 percent from 1971 until 2018, reaching an all-time high of 20 percent in March of 1980. That point in 1980 essentially marked the beginning of the great bull market for bonds - see figure below.

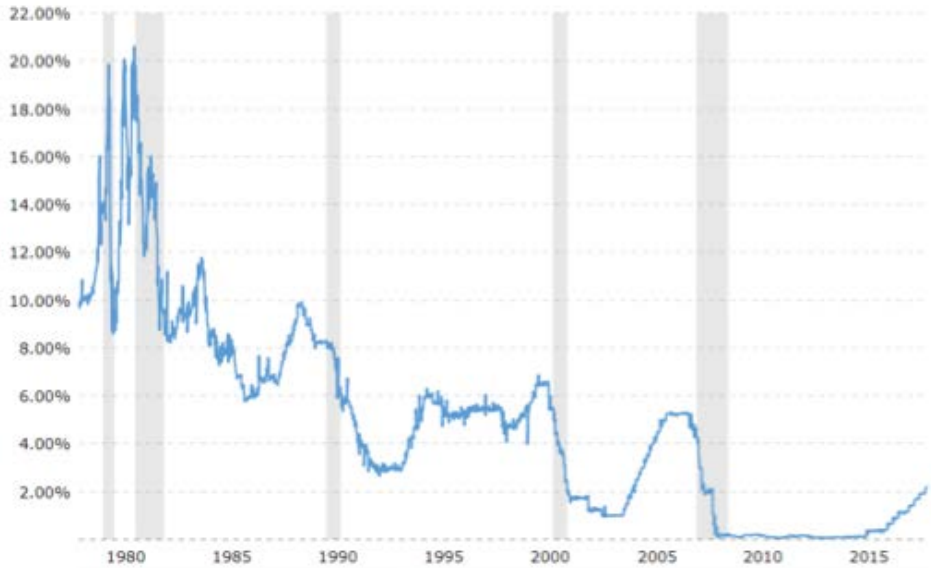
Except for a few, rather brief periods while rates were rising since the 2008 crisis, this long bull market for bonds represented a fairly steady rate decline in Fed rates from the 20% in 1980 through our recent period of near zero rates, which provided steady returns for insurers until the past few years. (A quick reminder: Bond portfolio market values increase as interest rates decrease and vis-a-versa.)

December 2015 marked the long anticipated "inflection point" in the Bond market demarcating the "beginning of the end" to the 35 -year bull market cycle in bonds. This cyclical change was due to the ending of the Fed's accommodative rate policy. Their plan to tighten the money supply began with their announcement to gradually increase interest rates. In October 2017, after 3 more incremental rate changes of 25 Basis points each, the Fed also announced their plan to gradually remove liquidity from the market by beginning to roll off its $4.5 trillion balance sheet accumulated during their bond-buying phase. From December 15 until September 2018, we have endured 8 rate changes. Hopefully none of our readers are surprised by the escalating carnage in Bond land! Insurers, in fact all bond investors, have seen negative year-to-date returns in 2018. The Bloomberg Barclays Bond Aggregate, the index representing the US investment grade bond market, has a rate of return of –2.28% year-to date (10/31/18). Policymakers are projecting one more rate hike in December, possibly three rate increases in 2019 and one more in 2020.

Fed rate policy effects on the bond market

The stability of these low interest rates, from 2008-2015, changed investor behavior. For several of those years, negative "real" (nominal return less inflation) returns were earned by investors in government securities that were less than 5 years in maturity, forcing investors, or their investment managers, to take more credit exposure, using more corporate bonds of lower quality than government securities to enhance returns. In addition, many extended the maturity structure of their portfolios to preserve principal to earn real returns.

Figure 1: Federal Funds Historical Rates
Source: Macrotrends (grey periods represent recession)



We also saw duration1 of major bond indexes, such as the aggregate and intermediate government/credit indexes, lengthen as companies issuing bonds prolifically provided the market with new offerings as they were anxious to take advantage of low cost access to capital. For example, The Bloomberg Barclays' US Bond Aggregate Index duration was 4.57 years back on December 31, 2009. It increased to 5.51 years by August 2016 and more recently this year was 5.89 years. Bond issuers increased debt, much of it to longer term bonds to lock in low interest rates. Simply put, it was a period of cheap financing. Many insurers, and other large institutional investors, also incorporated the use of high yield bonds, convertibles and other bond asset classes in their search to supplement their low yield investment-grade "core" bond portfolios. Extending maturities increased exposure to interest rate risk. Decreasing credit quality increases credit risk. It was "risk-on" as investors went yield chasing.

And, so here we are today…

The Treasury Yield Curve

The treasury yield curve can help to explain this year's bond performance. Yield curve tend to change shape as well as shift up or down in response to policy changes and bond market expectations. You will note the significant upward shift in the curve over

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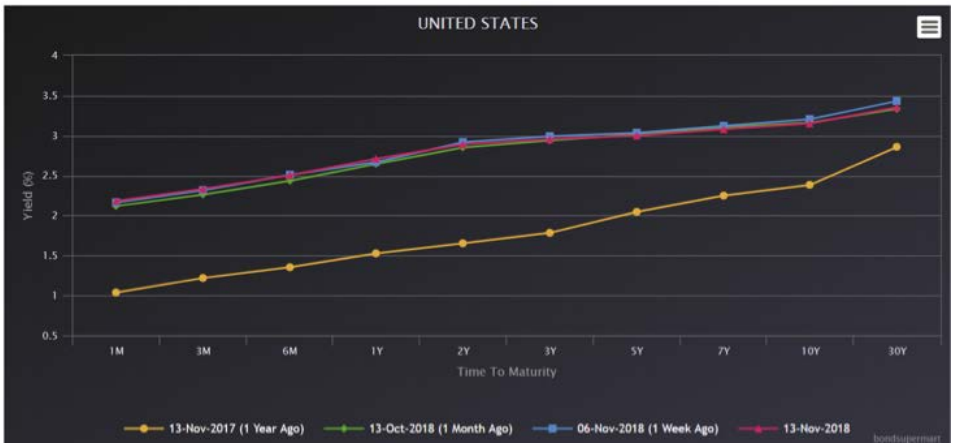

the last year. The fed rate increase has served to lift the short maturity section of the curve upward. Low inflation expectations have held the long maturity end of the curve for rising very much. These forces combined to cause flattening of the curve. The spread, or delta, between this and last year's yield curves was 1.14% at the short end of the curve (1-month rates) and only .49 % at the long end of the curve, the 30-year maturities. These spreads demonstrate the flattening effect since the short, or front end, of the curve rose much higher than the long end. With current rates higher at all maturities than they were last year, there was no place to hide with bond market values decreasing due to the yield increases.

With these changes, bond manager strategies also needed to alter their strategies. As the yield curve flattened, there was no advantage to assuming duration risk by buying longer maturity bonds. Investors were simply not being compensated for the additional interest rate, or credit risk, inherent in holding long-dated bonds.

The yield curve also offers a glimpse of the possible future of the bond market, at least based upon its current understanding of the factors. One could assume that should the FED raise rates 3-4 more times over the next 4-5 quarters, that the yield curve will shift up again. Absent any signs of future expectations of inflation, the curve could go flat or worse, inverted. This issue has been a well-publicized concern of many critics of Fed Policy. Should the FED raise rates to fast, or too high, they could invert the curve. Looking back to Figure 1, you will note that Fed's record in this regard warrants such concern. Note that the Fed over-tightened, by raising rates too much or too fast, several times in recent history with the result being a recession (the gray time periods) after a several month time lag.

Since 2008, the Bloomberg Barclay's Aggregate index, a proxy for the US investment grade bond market only had two negative years; 2013 (-2.02 and this year's return of -2.38 through 10/31/18) bond market. Bond managers will be hard pressed to protect client's market values in this difficult unwinding period. Insurer's would be best served to evaluate their manager's success based upon the degree of principal protection provided rather than based upon the actual portfolio return. While it is not that rewarding to be simply less negative than the benchmark, it should still be considered a good result. When you have lemons, make lemonade

Upcoming Events

1.Carl Terzer will be speaking and CapVisor will be exhibiting at the re-scheduled 19th Annual SCCIA Executive Educational Conference at Hyatt Place, Charleston SC from Dec 11-13. Please stop by and say hello to Carl and Rachel and our newest Associate Grant Davis.

2. CapVisor will be exhibiting at CICA at The JW Marriott Tucson Starr Pass Resort & Spa in Tuscon, Arizona, March 10-12, 2019. Carl Terzer will also be a speaker at this event. Please stop by booth #23 and visit with Carl and Paul Deeley. Hope to see you there!

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