CHANDLER ASSET MANAGEMENT

February 2010

Bond Market Review

A monthly review of fixed income markets

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Since 1988, Chandler Asset Management has specialized in the management of portfolios of high quality, fixed income securities. Chandler's mission is to provide fully customizable, client-centered portfolio management that preserves principal, manages risk and generates income in our client's portfolios.

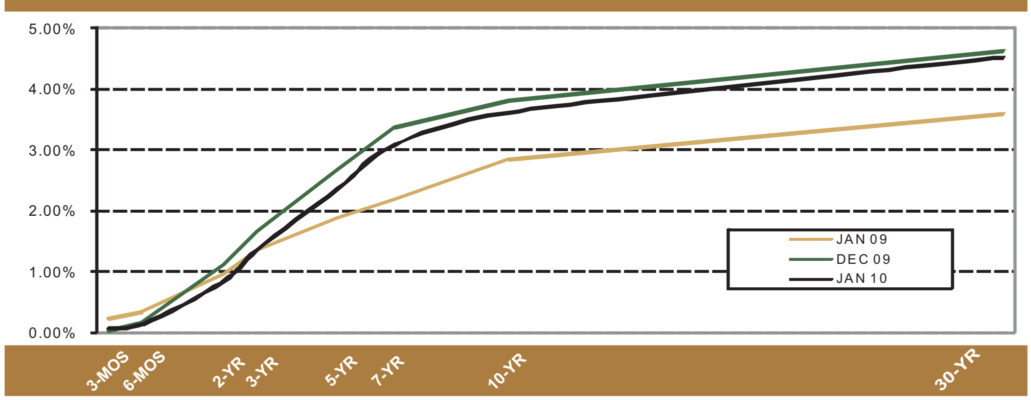
Market Summary

Treasury prices reversed December's decline last month, as market participants purchased Treasuries in response to financial fears in Europe. Two year Treasuries declined 30 basis points (0.30%) and ten year Treasuries declined 22 basis points (0.22%.) In addition to concerns over the state of public finances in Greece, Portugal, and other "peripheral" European Union nations, buyers of Treasuries were also motivated by concerns about the US economy's ability to grow following the removal of government stimulus. Going forward, market participants will continue to debate the strength of the economic recovery, the withdrawal of central bank liquidity measures, and continued heavy issuance of Treasury bonds.

The January employment report showed that the economy lost 20,000 jobs last month; however, the unemployment rate declined to 9.7%. The overall trend in employment remains positive (although at very weak levels) - and the future course of the labor market is probably the single most important indicator of the true strength of the US economy. Although CPI readings have been creeping higher, this is largely a function of oil prices that have risen from last winter's severely depressed levels. Most economists, as well as the Federal Reserve, forecast that inflation will remain muted during the year ahead, and may even decline.

The FOMC remains on hold and most prognosticators forecast no increase in the fed funds rate during 2010. However, the Fed is already removing some of the temporary liquidity measures put in place during the height of the credit crisis. As financial market conditions and the economy improves, look for the Fed to continue removing excess liquidity in the market place. At the same time though, the Fed stands ready to react to any further weakening in the economy and the Federal Government may implement a second stimulus package if they perceive that the economy is not recovering as strongly as they would like.

TREASURY YIELDS LOWER IN JANUARY



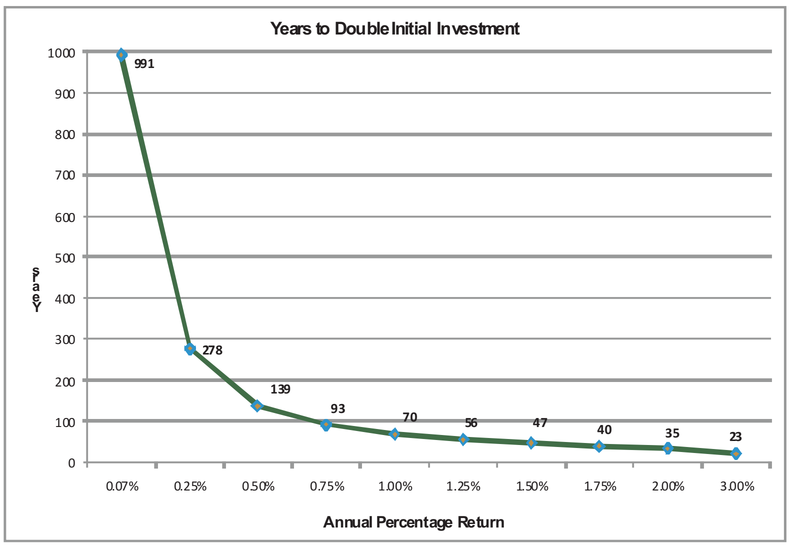
Treasury yields declined in January as market participants reacted to financial turmoil in Greece and concerns about the strength of the US economic recovery.

YIELDS	1/31/10	12/31/09	Change
3 Month	0.07	0.05	0.02
2 Year	0.83	1.14	(0.31)
3 Year	1.36	1.67	(0.31)
5 Year	2.35	2.68	(0.33)
7 Year	3.08	3.38	(0.30)
10 Year	3.61	3.83	(0.22)
30 Year	4.51	4.63	(0.12)

Sticking With A Long-Term Investment Plan

Selecting a long-term investment plan and maintaining it over time is the key to investment success. However, market conditions that are constantly changing can make this difficult to do. The current bond market environment, where rates are exceptionally low and seem likely to rise eventually, can tempt investors to deviate from their established investment plan by purchasing securities shorter than those that they would typically consider. These investors are engaging in market timing, although they may not even realize they are doing so.

<u>Trying to Time the Market</u>
At first glance, market timing can appear to be a viable investment strategy. In fact, accurate market timers could generate returns in excess of those available to adherents of a more consistent investment strategy. Furthermore, the benefits of successful market timing go beyond financial rewards. There is a tremendous amount of emotional and psychological satisfaction that comes from correctly predicting market movements. The feeling that "I'm smarter than the market" is quite tempting and very appealing. Often times, these non-monetary rewards are so great that they cause a market timer to remember fondly those occasions when they have correctly predicted market moves. These instances are then used to justify further attempts at market timing. Unfortunately, this often leads the investor to avoid a realistic and rational measurement of the portfolio's long-term performance.



If the investor did measure their portfolio performance against a market benchmark, they would probably find that over time their portfolio had performed relatively poorly. That is because, while market timing is a concept that sounds good in theory, it is nearly impossible to execute in the real world. "Trying to predict (the market's) direction over the near term is an exercise in futility." These words were spoken by the legendary mutual fund manager Peter Lynch, one of the most successful investors of all time.

<u>The Difficulty of Interest Rate Forecasting</u>
When it comes to investing in the bond market, successfully forecasting future interest rate movements should result in superior long-term investment returns. However, in order to be successful, the prognosticator must not only correctly determine the direction of interest rate movements, but also their magnitude and timing. The majority of academic studies, as well as many market participants, agree that doing this on a consistent basis is virtually impossible.

To make matters even worse, successful market timing requires the prognosticator to correctly forecast the market, not once, but twice. A market timer must successfully predict a market movement, which prompts them to deviate from their established investment strategy in an attempt to capture additional returns. Then, the market timer must make another correct prediction in order to decide when to return to their chosen long-term investment strategy.

If the odds of correctly timing a market movement are 50/50, then the chances of correctly entering and reversing a market timing trade are 25%. The chances of correctly executing two market timing trades are 6 in 100, and the odds are only 1 in 1000 that a market prognosticator will be able to correctly time their entry and exit from the market on five separate occasions (this is a failure rate of 99.9%). While some market timers might argue that their odds on any given trade are greater then 50/50, many studies indicate that this is unlikely to be the case. In fact, academic surveys that measure the predictions of many of Wall Street's leading economists and market strategists indicate that their actual success rate at predicting interest rate movements is less than 50%. In other words, some of the world's most successful economists are less accurate than a coin flip.

<u>Finding Long-Term Success</u>
In order to enjoy long-term success, an investor must have a process that works and that is repeatable. While correctly predicting one, or even two, or perhaps even ten market movements may be possible, an honest investor must ask themselves whether or not these predictions are truly and consistently repeatable. For most, the answer will be a resounding no.

One of the ways in which an investment manager can add value to a client's portfolio is by providing the discipline necessary to stick with a long-term investment strategy. A good investment manager will have a track record based upon an easily explained, repeatable, consistent process. At those times when the client feels most tempted to search out the hottest new investment trend the manager can remind the client of why a particular investment strategy was implemented in the first place. In today's low interest rate environment, long-term investment discipline is more important than ever.

Brian Perry, Vice President, Investment Strategist

Consumer Prices

In December, the CPI showed that consumer prices increased 2.7% on a year-over-year basis, due in part to higher energy prices. The year-over-year Core CPI (CPI less food and energy) increased at a 1.8% y-o-y rate. Despite a strengthening economy and an increased money supply, many economists believe that inflation will remain moderate over the next 12 months.

Retail Sales

In December, Retail Sales rose 5.4% on a year-over-year basis, a significant improvement over the previous several months' readings. Consumer spending appears to have rebounded somewhat from the depths of the recession, but consumers remain cautious due to job losses, the housing market contraction, and a general tightening of credit standards.

Labor Markets

The January non-farm payroll employment report showed a mixed picture, with a slightly worse than expected loss of 20,000 jobs and larger than expected downward revisions to prior months' reports offset by a decline in the unemployment rate to 9.7%. Although the economy continues to lose jobs, the pace of decline has moderated, and it does appear that the labor market is gradually stabilizing. The trend in the unemployment rate is likely to be the key to the strength and durability of the economic recovery.

Housing starts

Single-family housing starts declined 6.9% in December to 456,000. Recent data indicates a housing market that has stabilized, but remains weak.

Credit Spreads Wider

CREDIT SPREADS	Spread to Treasuries (%)	One Month Ago (%)	Change
3-month top-rated commercial paper	0.10	0.24	(0.14)
2-year AA corporate note	0.35	0.49	(0.14)
5-year AA corporate note	0.60	0.79	(0.19)
5-year Agency note	0.28	0.29	(0.01)

Source: Bloomberg

Data as of 1/31/2010

Mixed Economic Data

ECONOMIC INDICATOR	Current Release	Prior Release	One Year Ago
Trade Balance	(36.40) $Bln NOV 09	(33.19) $Bln OCT 09	(43.25) $Bln NOV 08
GDP	5.70% DEC 09	2.20% SEP 09	(5.40%) DEC 08
Unemployment Rate	9.70% JAN 10	10.00% DEC 09	7.70% JAN 09
Prime Rate	3.25% JAN 10	3.25% DEC 09	3.25% JAN 09
CRB Index	265.59 JAN 10	283.38 DEC 09	220.37 JAN 09
Oil (West Texas Int.)	$72.89 JAN 10	$79.36 DEC 09	$41.68 JAN 09
Consumer Price Index (y/o/y)	2.70% DEC 09	1.80% NOV 09	0.10% DEC 08
Producer Price Index (y/o/y)	4.40 DEC 09	2.40% NOV 09	(0.90%) DEC 08
Dollar / EURO	1.39 JAN 10	1.43 DEC 09	1.28 JAN 09

Source: Bloomberg

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