

BOND MARKET REVIEW

A MONTHLY REVIEW OF
FIXED INCOME MARKETS



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Since 1988, Chandler Asset Management has specialized in the management fixed income portfolios. 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.

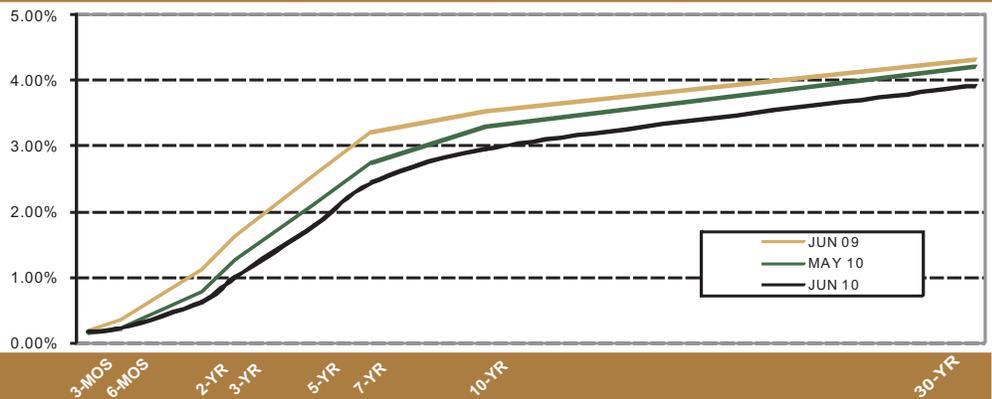
MARKET SUMMARY

Concern over the possibility of a double-dip recession helped push Treasury bond prices higher and interest rates lower for the second consecutive month. Market participants are worried that sovereign debt problems in Europe and high U.S. unemployment rate might prompt another downturn in the economy.

US economic data is still mixed; however several readings in June were relatively weak. Non-farm payrolls declined, the ISM Manufacturing Index fell and housing starts dropped. Inflation remains tame, and the Fed has noted that some raw materials prices have actually declined. The FOMC is being extremely careful that they do not harm the incipient economic upturn; to that end, they have reiterated that conditions "are likely to warrant exceptionally low levels of the federal funds rate for an extended period."

Going forward, market participants will continue to debate the impact of sovereign debt concerns and the strength of the economic recovery. Many traders also remain nervous about the impact that financial reform and other government regulation will have on the markets and the economy.

TREASURY YIELDS LOWER IN JUNE



Treasury yields ended the month lower as market participants grew concerned that the economy may weaken again, and perhaps, even experience a "double-dip" recession.

YIELDS	6/30/10	5/31/10	CHANGE
3 Month	0.17	0.15	0.02
2 Year	0.62	0.77	(0.15)
3 Year	0.99	1.25	(0.26)
5 Year	1.79	2.10	(0.31)
7 Year	2.43	2.76	(0.33)
10 Year	2.95	3.30	(0.35)
30 Year	3.91	4.22	(0.31)

INVESTMENT MANAGEMENT IN A LOW YIELD ENVIRONMENT

The current interest rate environment has made it difficult for investors to generate attractive returns and has also exposed them to the possibility of future interest rate increases. Some investors have been tempted to sell longer securities and invest in money market instruments, but interest rate anticipation is a difficult and costly game to play. The question, then, is how investors can maximize returns while managing potential risk.

While there are no magic solutions for investing in a difficult environment, there are several techniques investors can use to enhance their current returns and provide some protection against possible interest rate increases. Investors can follow these strategies to feel more confident in meeting the challenges today's market environment presents.

Can You Afford to Wait 1000 Years to Double Your Money?

At first glance, selling longer securities and holding a portfolio of very short, fixed-income instruments seems to make sense in the current environment. This would protect against future interest rate increases and provide the investor with maximum flexibility when yields are higher. Unfortunately, academic research and market experience demonstrate that the ability to consistently predict the direction, magnitude and, most importantly, the timing of future interest rate increases is extremely rare. This means that most investors are not likely to shorten the average maturity of their portfolio at just the right time, wait for the interest rate increase and then reinvest at higher yields.

The opportunity cost of incorrectly timing this strategy can be enormous. At recent money market yields (0.07%, or 7 basis points), it would take investors nearly 1000 years to double their money. On the other hand, a fixed-income portfolio earning 2% would take 35 years to double in value.

Given the difficulty of correctly timing interest rate movements and the opportunity cost of mistakes, most investors find that a strategy that anticipates interest rate changes is not appropriate. A more sensible approach would be to select a long-term strategy, represented by an appropriate benchmark, that fits the investor's risk profile and return objectives. The investor should then stick to this strategy over time, making only slight adjustments to incorporate current market conditions and their opinion on the direction of future market movements.

Maximizing Performance in a Low-Yield Environment

If interest rate anticipation is not the answer, what tools can investors employ in the current market environment? One possible strategy is to increase holdings of spread products (bonds that provide additional returns above Treasuries), such as U.S. government agencies and high-grade corporate bonds. The additional compensation these products provide can really make a difference when Treasury market yields are at historic lows. As an added bonus, spreads tend to compress

during periods of rising interest rates. This means that if interest rates were to move higher, government agency and corporate bonds would likely outperform Treasury bonds, thus alleviating some of the pain caused by rising interest rates.

Another strategy investors might consider is selectively adding to their holdings of callable securities, which have an embedded call provision that allows the issuer to repurchase or redeem the security by a specified date. When interest rates are low, the additional yield offered by callable securities can help increase the overall income of the portfolio. Of course, if interest rates do increase, it is unlikely that callable securities will indeed be called. This makes it important to consider the impact of holding a callable security until its final maturity. Additional factors to consider are that callable securities are often less liquid and more expensive to trade than non-callable securities, and that analyzing callable securities can be a complex endeavor. Despite these challenges, holding a portion of a portfolio in callable securities might make sense in the current interest rate environment – for those investors with the necessary resources and experience to properly analyze them.

Investors should also be aware that different portfolio structures are appropriate in different interest rate and yield curve environments. For instance, a portfolio in which securities are concentrated in the middle of the maturity range (a structure known as a bullet) performs best across a wide range of scenarios. However, if interest rates begin to increase, or the difference between short-term and long-term yields declines (known as a yield curve flattening), investors may find that concentrating holdings at the short and long ends of the yield curve provides the best returns (a structure known as a barbell). Yield curve management provides an additional and often underused tool to enhance portfolio performance and risk management.

Conclusion

The current interest rate environment presents investors with a variety of challenges that are exacerbated by the fact that, at some point, interest rates are likely to move higher. However, interest rate anticipation might seem to be an attractive strategy, but attempts at timing future interest rate increases are likely to result in failure. Furthermore, the opportunity cost of incorrectly timing future interest rate movements is extremely high. It makes sense, then, to use tools for enhancing current portfolio returns and protecting against future interest rate movements.

There is no sure way to produce high returns in a low interest rate environment or to protect against market price declines if interest rates rise in the future. However, properly implementing an appropriate investment strategy, while taking a disciplined approach to portfolio management, can produce optimal returns across market cycles. In the long run, investors who implement this disciplined approach are likely to enjoy the most consistent returns, along with less likelihood of an investment mistake caused by an incorrect forecast or an emotional response to market movements.

Brian Perry, Vice President, Investment Strategist

ECONOMIC ROUNDUP

CONSUMER PRICES

In May, the CPI showed that consumer prices increased by 2.0% on a year-over-year basis. The year-over-year Core CPI (CPI less food and energy) increased at a 0.9% rate. Tame inflation readings reduce the pressure on the Fed to aggressively reverse their historically easy monetary policy. Despite a strengthening economy and an increased money supply, many economists believe that inflation will remain moderate over the next twelve months.

RETAIL SALES

In May, Retail Sales rose 6.9% on a year-over-year basis. Consumer spending appears to have rebounded from the depths of the recession but has not yet reached the heights of the previous economic expansion. Consumers remain somewhat cautious due to job losses, home price declines and a general tightening of credit standards.

LABOR MARKETS

The June employment report showed that the economy lost 125,000 jobs due in part to census worker layoffs. The decline was in line with expectations. Private hiring was positive but came in below expectations, fueling concern that the employment picture remains weak. The unemployment rate declined to 9.5% with the drop being attributed to discouraged job seekers giving up their search. Despite the relatively weak report, many market participants expect that the employment situation has turned and that the economy can continue to add jobs in the months ahead.

HOUSING STARTS

Single-family housing starts decreased 17.2% in May to 468,000. Although this was a worse than expected reading, it is believed that flooding in the Southeast part of the country may have contributed to the weakness.

CREDIT SPREADS WIDER

CREDIT SPREADS	Spread to Treasuries (%)	One Month Ago (%)	Change
3-month top-rated commercial paper	0.43	0.31	0.12
2-year AA corporate note	0.53	0.49	0.04
5-year AA corporate note	0.80	0.77	0.03
5-year Agency note	0.23	0.23	0.00

Source: Bloomberg

Data as of 6/30/2010

MIXED ECONOMIC DATA

ECONOMIC INDICATOR	Current Release	Prior Release	One Year Ago
Trade Balance	(40.3) \$Bln APR 10	(40.1) \$Bln MAR 10	(28.4) \$Bln APR 09
GDP	2.70% MAR 10	5.60% DEC 09	(6.40%) MAR 09
Unemployment Rate	9.50% JUN 10	9.70% MAY 10	9.50% JUN 09
Prime Rate	3.25% JUN 10	3.25% MAY 10	3.25% JUN 09
CRB Index	258.52 JUN 10	254.8 MAY 10	249.96 JUN 09
Oil (West Texas Int.)	\$75.63 JUN 10	\$73.97 MAY 10	\$69.89 JUN 09
Consumer Price Index (y/o/y)	2.00% MAY 10	2.20% APR 10	(1.30%) MAY 09
Producer Price Index (y/o/y)	5.30% MAY 10	5.50% APR 10	(4.80%) MAY 09
Dollar / EURO	1.22 JUN 10	1.23 MAY 10	1.40 JUN 09

Source: Bloomberg

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