CHANDLER ASSET MANAGEMENT

March 2010

Bond Market Review

A monthly review of fixed income markets

What's Inside

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.

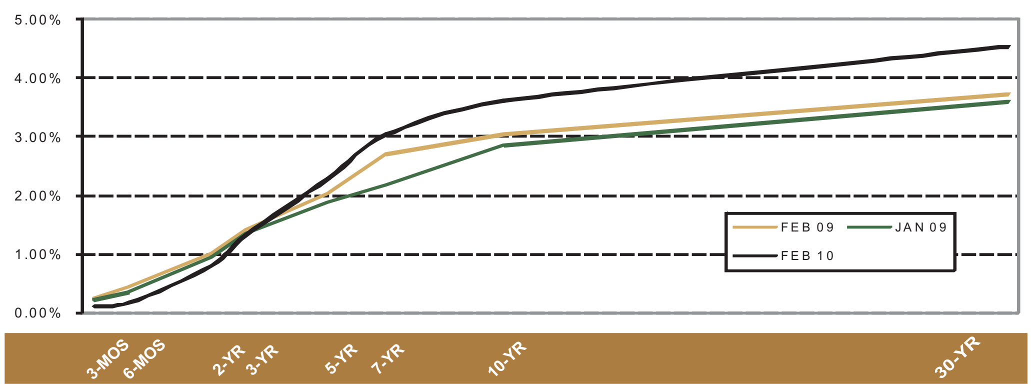
Market Summary

Interest rates remained range bound last month as market participants debated the strength of the economic recovery, the withdrawal of central bank liquidity measures, and continued heavy issuance of Treasury bonds. Treasury market participants fall into two camps: those that believe weak economic growth will keep rates low for the foreseeable future and those that believe heavy issuance of Treasuries and the growing deficit will lead to rapidly rising interest rates. For the foreseeable future, interest rates are likely to fluctuate depending upon which camp's view is in ascendancy at any given moment.

The February employment report was slightly better than expected as the economy lost 36,000 jobs and the unemployment rate remained at 9.7%. Although overall employment remains weak, it does appear that the labor market is gradually stabilizing. The most recent reading for Core CPI (ex food & energy) showed a decline to 1.6% on a year-over-year basis, indicating that inflation remains under control. Other economic indicators have been mixed, although economists believe that readings would have been slightly stronger if not for record East Coast snowfall which curtailed economic activity during the month.

The FOMC has pledged to maintain extraordinarily easy financial conditions at least through the middle of this year. However, the Fed has begun differentiating between monetary policy and emergency liquidity measures put in place during the height of the financial crisis. Many of these extraordinary measures are in the process of being unwound; most recently, the Federal Reserve raised the discount rate. The removal of these extraordinary measures should be seen as a sign that the Fed believes the financial crisis has ended rather than a comment on the strength of the economic recovery or the future path of monetary policy.

TREASURY YIELDS UNCHANGED IN FEBRUARY



Treasury yields ended the month relatively unchanged as market participants continue to debate the strength of the economic recovery and the impact of federal budget deficits and increased Treasury bond issuance.

YIELDS	2/28/10	1/31/10	Change
3 Month	0.11	0.07	0.04
2 Year	0.80	0.83	(0.03)
3 Year	1.32	1.36	(0.04)
5 Year	2.28	2.35	(0.07)
7 Year	3.03	3.08	(0.05)
10 Year	3.59	3.61	(0.02)
30 Year	4.53	4.51	0.02

The Role of Fixed Income in a Diversified Portfolio

The global financial crisis seemed to leave investors with no where to hide. Large cap, small cap, and international stocks all declined. Emerging markets plummeted, and commodities collapsed from their previously dizzying heights. Investors that shun risky assets may have avoided these large losses, but risk aversion generally results in subpar returns over time. Risky portfolios managed by exceptional market timers also might have performed well in 2008, but unfortunately market timing skills are a rare commodity. Investors might therefore conclude that the dilemma of having to choose between settling for subpar returns from risk-free assets and depending upon exceptional market timing skills does not offer a reasonable solution.

Another approach is needed, one which combines exposure to risky assets with the ability to mitigate risk and avoid the catastrophic losses many investors suffered during the crisis. Portfolio diversification, by combining low-volatility fixed income with higher-risk/higher-return asset classes, provides superior risk-adjusted returns across market cycles.

This article will briefly examine the use of fixed income as part of a portfolio diversification strategy before proposing techniques for asset allocation within a fixed income portfolio.

<u>The role of asset allocation in a diversified portfolio</u>

A savvy market timer would choose to hold 100% of their portfolio in equities during bull markets and 100% in fixed income during stock market declines. However, since very few investors possess this skill, they instead need to settle upon an asset allocation strategy that provides them with the highest possible returns over time, given their stated risk preference. Ultimately, this asset allocation decision is responsible for 90% of a portfolio's long-term performance.[1]

2008 provided an excellent example of the power of asset allocation. While a portfolio invested entirely in stocks (as measured by the S&P 500) would have declined by 37%, a diversified stock/bond portfolio would have fallen by a more manageable (though still painful) 20%. This diversified portfolio (60% stocks/40% bonds[2]) would have also performed favorably over a longer time frame. Since 1989, a 60/40 stock/bond mix would have provided more than 95% of the aggregate returns of an all stock portfolio, while demonstrating less than 2/3s of the volatility. For many investors, the cost of sacrificing a small portion of their potential gains is far outweighed by this reduction in risk.

<u>Tactical allocation shifts</u>

Fixed income has performed extremely well since the early 1980s, due in part to a secular bull market which has seen 5 Year Treasury yields fall from the mid-teens to less than 3%. On the other hand, equity markets have recently experienced a very sharp decline, which follows on the heels of the bear market that accompanied the bursting of the tech bubble. The result is that the stock market has been essentially unchanged for the past 12 years, while fixed income has looked very good by comparison. Investors troubled by this long period of stock market stagnation should remember that equities have historically followed these cycles with equally long periods of above average returns.

Financial theory also tells us that over long periods of time riskier asset classes should post higher returns than safer asset classes. If we assume that this relationship will hold true in the future, than the logical conclusion might be to increase a portfolio's equity allocation. This increase should be a marginal one though. Asset allocation changes should generally be tactical, not strategic, and a diversified portfolio should almost always include both equities and fixed income. With that in mind, this article will now examine allocation strategies within the fixed income portion of a diversified portfolio.

<u>Allocation within fixed income</u>

An investor's goals and risk tolerance will determine how their fixed income assets are allocated. However, it is important that investors remember why they hold fixed income in a diversified portfolio. Although higher returns are obviously preferable, the primary goal of a fixed-income allocation is to provide consistent performance to moderate the volatility of the overall portfolio.

This approach argues for maintaining a relatively conservative risk profile within an investor's fixed income holdings. The majority of the portfolio should consist of Treasury, agency, mortgage-backed, and high-grade corporate securities. Several types of fixed-income securities have been excluded from this list, including high yield bonds, emerging market bonds, and complex securitized products. Primarily, this is because fixed income's role in a diversified portfolio is usually to provide safety and stability - two characteristics not always present in these other fixed income sectors. Additionally, many investment professionals classify high yield as a separate asset class—neither equity nor fixed income. Therefore, while high yield might be included as part of a diversified portfolio, it would not be included as part of the fixed income allocation.

<u>Segmenting a fixed income portfolio</u>

Many investors choose to distribute their fixed-income holdings among a longer-term "core" portfolio and a short-term "liquidity" portfolio. This approach, often referred to as "segmentation", assures adequate liquidity for meeting expected or unexpected cash flow needs while retaining the opportunity to generate higher returns over time.

A core portfolio should hold high credit quality securities and have a moderate average maturity. Many core portfolios track one of the popular fixed income benchmark indices, such as the Barclay's Aggregate Index or the Bank of America Merrill Lynch Domestic Master Index. These indices measure the performance of a wide range of investment grade securities and usually have an average maturity of approximately 4 or 5 years.

Investors concerned about interest rate risk might instead structure a similarly high quality portfolio with a slightly shorter average maturity. These portfolios will often contain a range of securities with maturities under five years and an average maturity of 2.0 – 2.5 years. Over time, these shorter portfolios provide approximately 88% of the returns of the longer-term portfolios, with only 50%[3] of the interest rate risk – which makes them an attractive option for the core portion of a fixed income portfolio.

Many investors will also choose to include a short-term "liquidity" portfolio as part of their fixed income holdings. The liquidity portfolio often has an average maturity of less than one year, and therefore has very low interest rate risk. The liquidity portfolio would also hold very high quality securities, thereby minimizing credit risk in addition to interest rate risk.

The liquidity portfolio is an ideal tool for capital preservation, and can be used to meet expected or unexpected cash flow needs. As market opportunities present themselves, the liquidity portfolio can also provide funds for reallocation to other asset classes. Appropriate holdings for a liquidity portfolio might include T-bills, agency discount notes, certificates of deposit, or commercial paper.

Fixed income investors often need to choose between owning pooled products or individual securities. Pooled products, such as money market funds and mutual funds have the benefit of being simple and easy to use, but sometimes suffer from a lack of transparency. Investors also do not directly own the underlying securities. These drawbacks came to the forefront during the market turmoil that followed the collapse of Lehman Brothers. On the other hand, direct ownership of fixed income securities can require more effort and a larger portfolio size in order to be efficient—but this approach is also fully transparent and directly controlled by the investor. Both pooled products and individual securities have benefits and drawbacks, and it is up to each investor to decide which approach best meets their needs.

<u>Conclusion</u>

On the surface, portfolios with a high allocation to fixed income may appear attractive, especially given recent market events and investor sentiment. However, a contrarian approach argues that equities may offer above average long-term value right now. In balancing investors' heightened desire for safety with the necessity of achieving reasonable returns, a moderate approach is advisable. This approach might result in making a tactical decision to shift allocations slightly in favor of equities (for those investors with an appropriate risk tolerance.) However, most diversified investors will continue to maintain a reasonably well-balanced portfolio that includes fixed income securities.

For many investors, the fixed income portion of their portfolio will provide safety, stability, liquidity, and consistent returns. Investors might also benefit from segmenting their fixed income holdings between a "core" portfolio designed to achieve higher returns and a "liquidity" portfolio used to preserve capital and to meet cash flow needs. By incorporating these concepts into their asset allocation strategy, investors can enhance their ability to achieve superior risk-adjusted returns across market cycles.

1) "All About Asset Allocation"; by Richard A. Ferri
2) Statistics calculated for a portfolio comprised of 60% S&P 500/40% Merrill Lynch Domestic Master Bond Index
3) Comparison of 10 year performance for the Merrill Lynch Domestic Master Index and the Merrill Lynch 1-5 Year Government/ Corp A or better Index

Brian Perry, Vice President, Investment Strategist

ECONOMIC ROUNDUP

Consumer Prices

In January, the CPI showed that consumer prices increased 2.6% 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 1.6% 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 January, Retail Sales rose 4.7% on a year-over-year basis. 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 February employment report was slightly better than expected as the economy lost 36,000 jobs and the unemployment rate remained at 9.7%. Economists believe that these numbers would have been somewhat better if not for record snowfall during the month which impeded economic activity in some parts of the country. Although overall employment remains weak, 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 rose 1.5% in January to 484,000. 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	0.12	0.10	0.02
2-year AA corporate note	0.43	0.35	0.08
5-year AA corporate note	0.65	0.60	0.05
5-year Agency note	0.23	0.28	(0.05)

Source: Bloomberg

Data as of 2/28/2010

Mixed Economic Data

ECONOMIC INDICATOR	Current Release	Prior Release	One Year Ago
Trade Balance	(40.18) $Bln DEC09	(36.40) $Bln NOV 09	(41.86) $Bln DEC 08
GDP	5.90% DEC 09	2.20% SEP 09	(5.40%) DEC 08
Unemployment Rate	9.70% FEB 10	9.70% JAN 10	8.20% FEB 09
Prime Rate	3.25% FEB 10	3.25% JAN 10	3.25% FEB 09
CRB Index	274.77 FEB 10	265.59 JAN 10	211.57 FEB 09
Oil (West Texas Int.)	$79.66 FEB 10	$72.89 JAN 10	$44.76 FEB 09
Consumer Price Index (y/o/y)	2.60% JAN 10	2.70% DEC 09	0.00% JAN 09
Producer Price Index (y/o/y)	4.60% JAN 10	4.40 DEC 09	(0.90%) JAN 09
Dollar / EURO	1.36 FEB 10	1.39 JAN 10	1.27 FEB 09

Source: Bloomberg

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