CHANDLER ASSET MANAGEMENT

September 2010

Bond Market Review

A monthly review of fixed income markets

What's Inside

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.

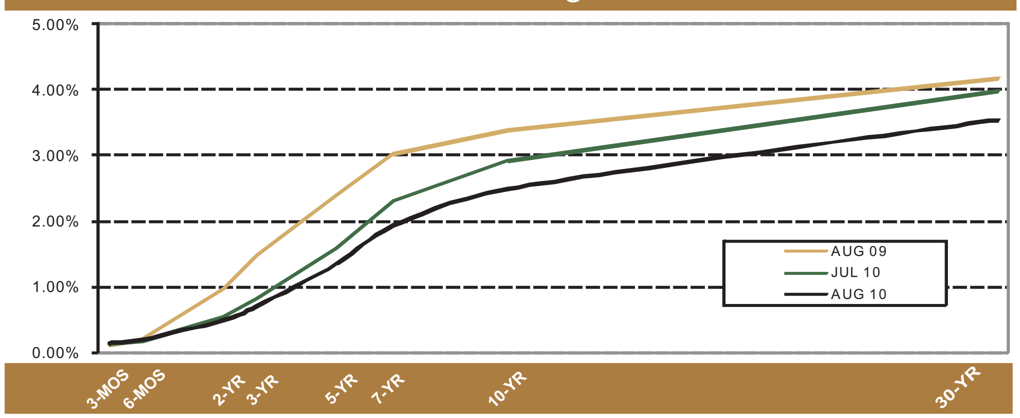
Market Summary

Market participants debated the impact of an extended period of weak economic growth and possible deflation in August, sending Treasury yields lower. Current market opinion falls primarily into two camps: those that think the economy will continue to muddle along with sluggish growth and low inflation, and those that think the economy will slide back into a "double-dip" recession. Under this last scenario, some market participants fear the U.S. will experience an extended period of declining prices (deflation) that would have negative implications for the economy and the financial markets.

U.S. economic data has been relatively disappointing, although activity has picked up significantly from the depths of the recession. Unemployment remains high (9.6%), and the economic recovery is unlikely to gain momentum until a meaningful recovery in the jobs market begins. Inflation is tame, and market participants have turned their focus from higher inflation to the possibility of deflation. Consumer and business spending remains constrained, and it is not clear what the primary driver of economic activity will be in the months ahead.

Going forward, market participants will focus closely on additional measures that the Federal Reserve can take to stimulate the economy (such as additional quantitative easing), as well as the possibility of further fiscal stimulus from the government. Other important developments will include: the upcoming mid-term elections, whether or not the Bush tax cuts are allowed to expire, China's slowing economy, and continued sovereign debt concerns in Europe.

TREASURY YIELDS LOWER IN August



Treasury yields ended the month lower as market participants anticipated sluggish economic growth and the possibility of deflation. Longer term Treasury yields declined more than shorter term yields, resulting in a flatter yield curve than last month (although the curve does remain relatively steep overall).

YIELDS	8/31/10	7/30/10	CHANGE
3 Month	0.13	0.14	(0.01)
2 Year	0.48	0.55	(0.07)
3 Year	0.70	0.82	(0.12)
5 Year	1.34	1.59	(0.25)
7 Year	1.92	2.30	(0.38)
10 Year	2.48	2.91	(0.43)
30 Year	3.53	3.98	(0.45)

Consumer Prices

In July, the CPI showed that consumer prices increased 1.2% 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 reduced the pressure on the Fed to aggressively reverse their historically easy monetary policy. Most economists believe that inflation will remain moderate over the next twelve months, and that deflation currently appears to be more of a concern than inflation.

Retail Sales

In July, Retail Sales rose 5.5% 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 August employment report showed that the economy lost 54,000 jobs, which was better than expected. In addition, the previous two months experienced positive revisions totaling 123,000 jobs. The unemployment rate increased to 9.6% from 9.5%. Most economists currently believe that it will be some time before the unemployment rate declines in a meaningful way.

Housing Starts

Single-family housing starts decreased 4.2% in July to 432,000. The housing recovery seems to have lost some momentum, as the expiration of government tax credits for new home buyers and continued high levels of foreclosures weigh on the market.

Credit Spreads Mixed

CREDIT SPREADS	Spread to Treasuries (%)	One Month Ago (%)	Change
3-month top-rated commercial paper	0.17	0.17	0.00
2-year AA corporate note	0.40	0.42	(0.02)
5-year AA corporate note	0.67	0.69	(0.02)
5-year Agency note	0.24	0.21	0.03

Source: Bloomberg

Data as of 8/31/2010

Mixed Economic Data

ECONOMIC INDICATOR	Current Release	Prior Release	One Year Ago
Trade Balance	(49.90) $Bln JUN 10	(41.98) $Bln MAY 10	(27.14) $Bln JUN 09
GDP	1.60% JUN 10	3.70% MAR 10	(0.70%) JUN 09
Unemployment Rate	9.60% AUG 10	9.50% JUL 10	9.70% AUG 09
Prime Rate	3.25% AUG 10	3.25% JUL 10	3.25% AUG 09
CRB Index	264.19 AUG 10	274.35 JUL 10	253.68 AUG09
Oil (West Texas Int.)	$71.92 AUG 10	$78.95 JUL 10	$69.96 AUG 09
Consumer Price Index (y/o/y)	1.20% JUL 10	1.10% JUN 10	(2.10%) JUL 09
Producer Price Index (y/o/y)	4.20% JUL 10	2.80% JUN 10	(6.90%) JUL 09
Dollar / EURO	1.27 AUG 10	1.31 JUL 10	1.43 AUG 09

Source: Bloomberg

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How SEC Money Market Reform Lowers the Odds of "breaking The Buck"

Recently, there has been much discussion and some controversy regarding the safety of money market funds (MMF). Many investors of public funds have historically used these funds for safety, liquidity, diversification, and professional management. The Government Finance Officers Association has endorsed the use of MMFs by public cash managers through its model investment legislation for state and local governments. Because of the important place of MMFs in government portfolios, it is crucial that investors of public funds understand the effects of changes to Rule 2a-7, the rule governing MMFs. This article addresses how some of the changes included in the current money market reform may make such funds safer and less likely to "break the buck."

RECENT EVENTS

The general financial market turbulence during 2007-2008, as well as specific events (i.e. the default of Lehman Brothers Holdings Inc. and the problems of debt securities issued by structured investment vehicles (SIVs)) exposed unforeseen risks in MMF. Historically, investors used MMFs with the primary goal of preserving their principal. The stated objective of seeking to maintain a constant or stable one dollar ($1) Net Asset Value (NAV) provided investors with a level of confidence. There are over $3.3 trillion assets managed by these funds, comprising over 30 percent of all mutual fund assets.

When the Reserve Primary Fund "broke the buck" or repriced its securities under $1.00 a share, and subsequently stopped redemptions, shock waves reverberated through the market of MMF investors. During the week of September 15, 2008, when the Reserve Fund broke the buck, investors withdrew almost 14% of the assets held in taxable MMFs. This exacerbated dislocations in the credit markets.

The federal government, through the U.S. Treasury and the Federal Reserve, went to previously unseen lengths to provide liquidity and to contain the loss of confidence in MMFs. Specifically, in September 2008, the U.S. Treasury created its Temporary Guarantee Program for MMFs. This program guaranteed certain investments in MMFs that chose to participate in it. As well, during the same month, the Federal Reserve created its Asset-Backed Commercial Paper Money Market Mutual Fund Liquidity Facility. This program was intended to help MMFs that held such paper in meeting redemptions and fostering liquidity in the asset backed commercial paper market and the broader money market. These programs were effective in containing the run on MMFs.

WHY THE SURPRISE?

It is important for investors to be aware that while these funds seek to maintain a constant or stable NAV, this is not guaranteed. MMFs have used the amortized cost method for valuing securities. In other words, securities are valued at cost plus any premium amortized or discount accreted. The thinking has always been that the high quality combined with the short maturities of securities in MMF portfolios would inhibit any discrepancies in value using this method compared to market value. However, MMFs have always and currently continue to "shadow price" their portfolios, whereby the amortized cost is compared to mark-to-market values. If the difference between the methods is more than one-half of one percent, ($0.005), MMFs must act, including possibly repricing under $1.00. Fluctuations in NAV have always been possible. Historically, sponsors of such MMFs have stepped in to support these funds. However, there is no obligation to do so. In the case of the Reserve Fund, the sponsor could not provide such support.

HOW THE CHANGES ENHANCE THE SAFETY AND LIQUIDITY

The SEC began considering ideas to strengthen MMFs. After a period of comments from interested parties, the SEC adopted certain changes to Rule 2a-7, the rule governing MMFs. These changes are now being phased in stages. The changes should make fluctuations in NAV of money market funds less likely.

Portfolio quality. The changes enhance the quality of MMF portfolios. They reduce MMFs investments in "second-tier securities." These are securities deemed to be of lesser quality. In other words, second-tier securities are securities with ratings other than the highest short-term debt ratings if they do have ratings, and, if the securities are not rated, they are securities determined by the MMF board to be of comparable quality to second tier securities.

Limit lesser quality investments. Investments in second tier securities are reduced from 5% to 3% (a 40% reduction).

Limit concentrations in single issuers. Concentration limits in second tier securities of a single issuer are reduced. The permitted concentration of total assets in second tier securities of a single issuer is reduced to $1 million or one-half of one percent (whichever is greater).

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How SEC Money Market Reform Lowers the Odds of "Breaking The Buck" (cont.)

NRSROs. A change to Rule 2a-7 requires MMF boards to designate four or more nationally recognized statistical rating organizations (NRSROs) to whose short-term credit ratings the MMF would turn to in determining eligible securities (and second tier securities). Further, the modifications to the Rule require that MMF boards determine, at least annually, whether the identified NRSROs are providing reliable ratings.

Maturity restrictions. The changes to the rules reduce the maturity of MMF's portfolios. Shortening maturities is one way to reduce fluctuations in value.

WAM reduction. Weighted average maturity (WAM) is reduced from 90 days to 60 days (a 33.3% reduction).

Weighted average life limit. The changes also limit the weighted average life of a MMF's portfolio to 120 days.

Liquidity requirements. The new rules enhance liquidity, or a MMF's ability to meet reasonable redemptions. The SEC expects MMFs to adopt policies and procedures to identify investor risk characteristics, including liquidity needs.

The new rules enhance liquidity requirements as follows:
Daily. At a minimum, 10 percent of assets must be in cash, U.S. Treasury securities or securities that can be converted to cash within one day, for taxable funds.
Weekly. At a minimum, 30 percent of all assets must be in cash, U.S. Treasury securities, or other government securities, or securities that convert into cash within one week, for taxable and tax-exempt funds. The remaining securities must mature within 60 days.

Limits on illiquid securities. Changes restrict concentration of illiquid securities to 5% from 10% (a 50% reduction). An "illiquid security" is any security that cannot be sold or disposed of within seven days at carrying value.

Stress testing. Under the changes, MMFs must have procedures for periodic testing of the MMF's ability to maintain a stable NAV based on hypothetical events (determined by the MMF board to be appropriate under current market conditions).

Repurchase agreement limits. Repurchase agreements are a big part of MMF portfolios. The changes to the Rule limit collateralization of repurchase agreements to cash items or government securities. In addition, an MMF's board will be required to evaluate the credit-worthiness of counter parties to repurchase agreements.

Suspension of redemptions. The changes allow MMFs to suspend redemptions under certain circumstances. MMFs need not actually "break the buck" before such a suspension. This change reduces the negative effects on a portfolio of a run on a MMF.

Selling securities to meet redemptions in a panic environment can have a detrimental effect on the pricing of such securities. Suspensions and arrangements for orderly redemptions can be expected to go a long way in maintaining principal value.

ENHANCED DISCLOSURE

Web postings. The modifications include monthly electronic reporting requirements. For each security held, there are required disclosures and Web site postings, timeliness requirements and length of time of postings.

SEC reporting. The SEC has created a new form, N-MFP, to be completed and submitted to the SEC with information on each portfolio security. This information includes market value pricing. This information will be available to the public 60 days after the end of the month to which the information pertains.
The changes to disclosure and reporting ultimately enhance timeliness and relevance, leading to greater transparency and increased accountability. Changes that lead to a greater understanding of performance and measurement of risk are positive. Together, these may result in better-informed decisions on the part of investors of MMFs and more risk-averse portfolios by MMFs.

CONCLUSION

Among the other changes, heightening credit quality, shortening maturities, and arranging for orderly redemptions can help stabilize the NAVs of money market funds and work against "breaking the buck" - anathema to investors for a variety of reasons. Along with heightened transparency and accountability, these changes should help MMFs meet the goals of investors: safety and liquidity.

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