CHANDLER ASSET MANAGEMENT

November 2011

BOND MARKET REVIEW

A MONTHLY REVIEW OF FIXED INCOME MARKETS

WHAT'S INSIDE

Since 1988, Chandler Asset Management has specialized in the management of 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 clients' portfolios.

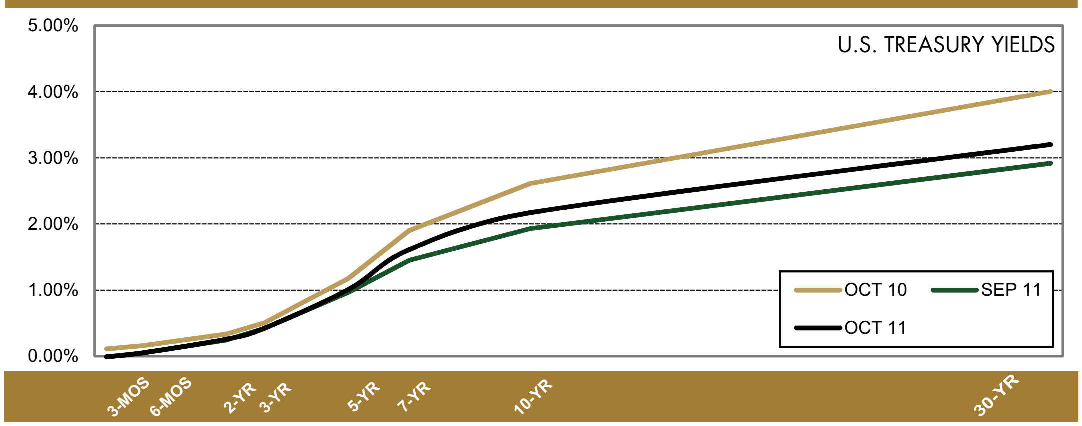
Market Summary

Treasury yields remain at compressed levels but nonetheless bounced higher on a month over month basis as equity markets rallied to start the 4th quarter of 2011. Operation Twist continues to have a large influence on prices for longer-term Treasury securities. Concerns about debt issues in the euro zone remain a key issue and have been the primary driver of market movements over the past few months.

Recent domestic economic data has improved slightly, helping to calm some fears that another U.S. recession might be near. The three-month moving average of non-farm payrolls is 114k, not enough to bring down the unemployment rate of 9.0%, but yet not weak enough to cause a material downdraft in economic growth. In our view, domestic economic data remains indicative of a slow growth environment. However, political turmoil related to the sovereign debt crisis in Europe has heavily influenced the day-to-day movement in global equity and bond markets and largely overshadowed any positive or negative economic news out of Asia or the United States. The sovereign crisis in Europe has spread with concerns shifting from Greece to Italy, where borrowing costs have jumped sharply. Some market participants are concerned that a severe contraction in the European economy could derail the already fragile U.S. economic recovery. We continue to believe the U.S. economy will muddle along at a slow pace, but an escalation of the crisis in Europe could alter our view.

In early November, the Fed announced it would keep its Fed funds target rate unchanged at 0%-0.25% and expects to keep the rate exceptionally low through mid-2013. The Fed will also continue to engage in "Operation Twist" by extending the average maturity of its Treasuries purchases. This program is intended to put downward pressure on longer-term interest rates. The Fed expects a modest pace of economic growth in coming quarters, but noted, "there are significant downside risks" to the current economic environment. The Fed slightly lowered its outlook for economic growth in 2012 and 2013, and now expects the economy to expand by about 2.7% in 2012, 3.3% in 2013. The next regularly scheduled FOMC meeting is December 13.

A TWIST IN THE YIELD CURVE



TREASURY YIELDS	10/31/11	9/30/11	CHANGE
3 Month	(0.01)	(0.01)	0.00
2 Year	0.26	0.25	0.01
3 Year	0.42	0.42	0.00
5 Year	1.01	0.97	0.04
7 Year	1.61	1.45	0.16
10 Year	2.17	1.93	0.24
30 Year	3.20	2.92	0.28

Economic Roundup

Consumer Prices

In September, the CPI showed that consumer prices increased 3.9% on a year-over-year basis. The year-over-year Core CPI (CPI less food and energy) increased at a 2.0% rate. Although some producer prices have begun to increase, prices on consumer goods are not expected to rise sharply in the months ahead. The Federal Reserve has noted that it is monitoring commodity price increases, but believes that over the coming quarters, headline and core inflation is likely to settle at levels consistent with their mandate.

Retail Sales

In September, Retail Sales rose 7.9% on a year-over-year basis. Consumer spending has rebounded from the depths of the recession and recent activity has been moderate; however, activity is still far short of the heights of the previous economic expansion as a weak job market and high energy prices restrain consumer spending.

Labor Markets

The October employment report showed that the economy added 80,000 jobs and the previous two month's totals were revised higher by 102,000. The unemployment rate fell to 9.0 from 9.1%. This report was an improvement; nevertheless, the employment situation in the country remains poor. Even though the economic recovery is more than two years old, the pace of recovery in the labor market has been weak, and is one of the primary reasons why the recovery has been tepid.

Housing Starts

Single-family housing starts rose 1.7% in September to 425,000, compared to 418,000 in August. The housing market remains weak but seems to have stabilized following several years of sharp declines.

Credit Spreads Mixed

CREDIT SPREADS	Spread to Treasuries (%)	One Month Ago (%)	Change
3-month top-rated commercial paper	0.44	0.38	0.06
2-year AA corporate note	0.44	0.55	(0.11)
5-year AA corporate note	0.53	0.69	(0.16)
5-year Agency note	0.42	0.42	0.00

Source: Bloomberg

Data as of 10/31/2011

Mixed Economic Data

ECONOMIC INDICATOR	Current Release	Prior Release	One Year Ago
Trade Balance	(43.1) $Bln SEP 11	(44.9) $Bln AUG 11	(44.0) $Bln SEP 10
GDP	2.5% SEP 11	1.3% JUN 11	2.5% SEP 10
Unemployment Rate	9.0% OCT 11	9.1% SEP 11	9.7% OCT 10
Prime Rate	3.25% OCT 11	3.25% SEP 11	3.25% OCT 10
CRB Index	319.84 OCT 11	298.15 SEP 11	300.67 OCT 10
Oil (West Texas Int.)	$93.19 OCT 11	$79.20 SEP 11	$81.43 OCT 10
Consumer Price Index (y/o/y)	3.9% SEP 11	3.8% AUG 11	1.1% SEP 10
Producer Price Index (y/o/y)	6.9% SEP 11	6.5% AUG 11	3.9% SEP 10
Dollar / EURO	1.39 OCT 11	1.34 SEP 11	1.39 OCT10

Source: Bloomberg

5 Reasons Why Total Return Benchmarks Are Effective Tools for Measuring and Managing Investment Risk

This article examines five reasons why total return benchmarks are effective tools for measuring and managing investment risk. The purpose of this article is not to argue the merits of total return over other measures. Performance measurement is not an “either/or” choice. Both yield and total return evaluations are important for managing portfolios. Yield calculations provide estimates for the earnings from the portfolio; such information is valuable for budgeting and forecasting. At the same time, total return measures provide important information on the effectiveness in managing the risk in a portfolio.

> A benchmark is a composite of securities that meet certain criteria

1. Requires Consideration of the Proper Risk Profile

The first step in selecting an appropriate benchmark is determining the proper risk profile for an entity's portfolio. This is based on investment constraints, investment objectives, and the risk tolerances of the entity. There are fixed income benchmarks available for just about any risk profile an investor might select as appropriate.

A benchmark is a composite of securities that meet certain criteria, such as duration or maturity, credit quality, and asset class for example. Effective benchmarks are:

- Unambiguous and transparent – the names and weights of securities in the benchmark are clearly defined
- Investable – an investor can purchase the securities in the benchmark
- Measurable – the benchmark's return is calculated regularly
- Appropriate – the selected benchmark should be consistent with the style being gauged
- Reflective of current investment opinions – all market participants must be able to have current knowledge of the benchmark
- Specified in advance – the benchmark is constructed prior to the start of evaluation

The lengthy historical performance data for benchmarks provides investors valuable information on how different risk profiles perform in various interest rate scenarios. The mere process of selecting a benchmark based on the proper risk profile for a portfolio provides an investor the critical, but often missed, opportunity to examine carefully the level of risk and degree of diversification that is most appropriate for the investor.

2. Creates Disciplined Investment Process

Benchmarks are not only used for measuring and evaluating the performance of a portfolio, but also for making investment decisions, such as the mix of securities that will create the targeted risk profile in the portfolio. The benchmark an investor selects helps create discipline in the investment process by establishing a framework for choosing securities that have the proper type and level of risk for the portfolio. For that reason, once selected, benchmarks should only be changed when an investor's constraints, objectives, or risk tolerances change. They should not be changed solely because market conditions change or because the portfolio is being managed to different risks characteristics than the benchmark.

Benchmarks create discipline by:

- Providing guidance for investment decisions and security selection
- Keeping an investor focused on maintaining the targeted risk profile
- Controlling exposure to interest rate changes in the portfolio by targeting the benchmark's duration
- Improving return and earnings expectations in various interest rate environments

3. Measures Effectiveness of Strategies

The effectiveness of an investment program, whether it is achieving its objectives, can be measured by comparing the total return of the portfolio to that of the benchmark. Total return measures total outcomes of investment decisions. It measures the percent

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change in the value of a portfolio over a defined past period, taking into consideration not only interest earnings, but also realized and unrealized changes in market value that occurred during the measurement period.

The goal is not to significantly outperform the benchmark but to achieve a total return comparable to that of an appropriate benchmark with comparable levels of risk. Any returns that are much greater or much less than that of the benchmark should be analyzed.

4. Provides Valuable Information on Fulfilling Fiduciary Duty

Certain investors have special duties for the funds they manage. Investors of public funds, for example, have such a special responsibility for the funds they manage. They are fiduciaries subject to a relationship of trust with the beneficiaries of the funds under their care. They are legally responsible for these funds, and must act prudently and always in the best interest of the beneficiaries.

The primary objectives of public sector investment portfolios are safety, liquidity and yield or return. Safety and liquidity always take precedence over the objective of yield or return. The test of a fiduciary is one of conduct. Comparing the risk characteristics and total return of the portfolio to that of the selected benchmark allows finance directors, treasurers and oversight boards to evaluate whether the portfolio's return is commensurate with the agreed upon targeted risk profile. Total return benchmarks assist in the monitoring of fiduciary duty by:

- Providing clear strategy communication to board / others
- Managing expectations of returns (and risk)
- Performance should be close to the benchmark return
- Any variance in return will be due to variance in decisions for duration, sector weighting, credit quality, and maturity structure
- The degree of variance in the portfolio's return will inform an oversight board on the manner in which the portfolio's risk is being managed relative to the selected benchmark's risk

5. Total Return Benchmarks are the Accepted Industry Standard

Total return is the agreed upon industry standard. It is universally accepted by academic literature and best practice. Uniformly applied to all portfolios, it provides full disclosure, transparent and fair representation of investment performance to allow comparison and evaluation. Yield only measures the income that can be expected from a portfolio during a given period. In preparing annual portfolio revenue projections and for budgeting purposes, yield information can be helpful. However, yield does not measure risk in the portfolio and cannot be compared against a benchmark on a risk and return basis. There is no standard definition of yield. Investors can chose between yield to maturity, yield to call, book yield, and market yield. As well, yield results can be distorted by timing decisions. For example, an investor can decide to generate more income and thereby show higher yield in one particular period by selling securities that show gains. Because of the potential for variability in yield, it provides limited information and no assessment of the risk in a portfolio and how the investor's decisions are working out.

Only by using total return measures compared to an appropriate total return benchmark can an investor gauge the success or failure of his portfolio decisions.

-Sofia Anastopoulos, CFA
VP, Client Service

-Ned Connolly
SVP, Client Service