CHANDLER ASSET MANAGEMENT

January 2012

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.

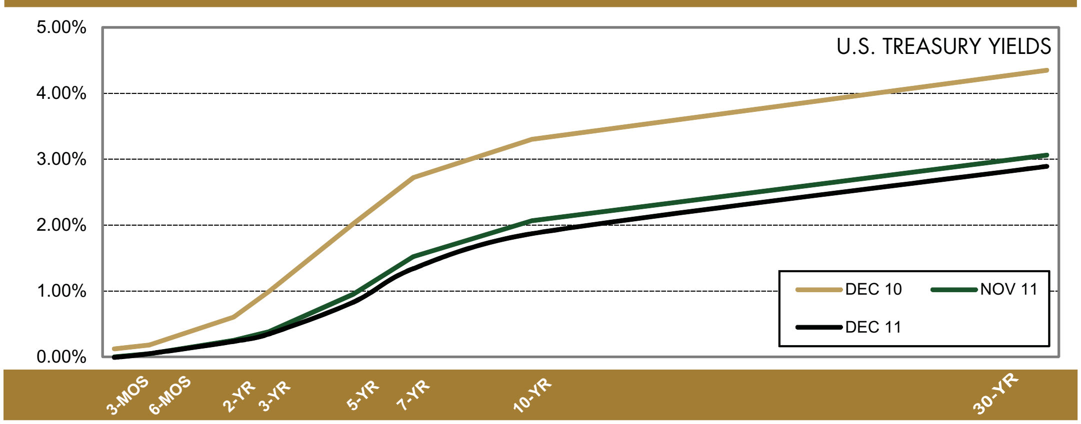
Market Summary

Treasury rates across the yield curve moved lower in December. Domestic economic indicators showed improvement during the month, but not enough to suggest a recovery strong enough to create fears of inflation and significantly higher interest rates. Concern about the European sovereign debt crisis remains a significant factor for the financial markets, and demand for US Treasury securities, still considered the safest in the world, remains high, driving Treasury prices higher and yields lower.

In our view, while domestic economic data is indicative of a continued slow growth environment, political turmoil in Europe continues to have a strong influence on day-to-day movements in global financial markets largely overshadowing improving US economic trends. A severe contraction in the European economy caused by its debt crisis could derail the fragile U.S. economic recovery. We continue to believe the U.S. economy will muddle along at a slow pace of growth, but developing events in Europe could alter this view.

In December, the Fed announced it would keep the Fed Funds target rate unchanged at 0%-0.25% and again affirmed that it expects to keep the rate exceptionally low through mid-2013. The Fed continues to engage in "Operation Twist" by extending the average maturity of its Treasuries purchases in order to lower long term rates. The Fed noted that, "the economy has been expanding moderately, notwithstanding some apparent slowing in global growth." Nevertheless, the Fed justified its continued easy monetary policy by stating the unemployment rate remains elevated, and noted, "strains in global financial markets continue to pose significant downside risks to the economic outlook."

TREASURY YIELDS LOWER IN DECEMBER



Treasury yields across the yield curve moved lower in December, with yields on longer securities declining the most.

TREASURY YIELDS	12/31/11	11/31/11	CHANGE
3 Month	(0.01)	0.00	(0.01)
2 Year	0.24	0.25	(0.01)
3 Year	0.35	0.39	(0.04)
5 Year	0.83	0.95	(0.12)
7 Year	1.34	1.52	(0.18)
10 Year	1.87	2.07	(0.20)
30 Year	2.89	3.06	(0.17)

Economic Roundup

Consumer Prices
In November, the CPI showed that consumer prices increased 3.4% on a year-over-year basis. The year-over-year Core CPI (CPI less food and energy) increased at a 2.2% rate. Overall, price increases remained subdued and the Federal Reserve has recently noted that some cost pressures have eased.

Retail Sales
In November, Retail Sales rose 6.7% on a year-over-year basis. Consumer spending has rebounded from the depths of the recession and recent activity has been moderate; however, high unemployment continues to restrain consumer spending.

Labor Markets
The December employment report showed that the economy added 200,000 jobs and the six-month average is 142,000 jobs. The unemployment rate fell to 8.5% from 8.7%. This report was better than analysts' expectations and many market participants are forecasting continued positive labor market momentum into early 2012. Although the unemployment rate remains elevated, current economic data suggests the labor markets may be entering a period of slow sustained growth.

Housing Starts
Single-family housing starts rose 2.3% in November to 447,000, compared to 437,000 in October. The housing market remains under pressure but seems to have stabilized following several years of sharp declines with some housing data surprising to the upside.

Credit Spreads Wider

CREDIT SPREADS	Spread to Treasuries (%)	One Month Ago (%)	Change
3-month top-rated commercial paper	0.46	0.54	(0.08)
2-year AA corporate note	0.49	0.65	(0.16)
5-year AA corporate note	0.69	0.77	(0.08)
5-year Agency note	0.48	0.46	0.02

Source: Bloomberg

Data as of 12/31/2011

Economic Data Modestly Improving

ECONOMIC INDICATOR	Current Release	Prior Release	One Year Ago
Trade Balance	(43.5) $Bln OCT 11	(44.2) $Bln SEP 11	(39.5) $Bln OCT 10
GDP	1.8% SEP 11	1.3% JUN 11	2.5% SEP 10
Unemployment Rate	8.5% DEC 11	8.7% NOV 11	9.4% DEC 10
Prime Rate	3.25% DEC 11	3.25% NOV 11	3.25% DEC 10
CRB Index	305.30 DEC 11	313.82 NOV 11	332.80 DEC 10
Oil (West Texas Int.)	$98.83 DEC 11	$100.36 NOV 11	$91.38 DEC 10
Consumer Price Index (y/o/y)	3.4% NOV 11	3.5% OCT 11	1.1% NOV 10
Producer Price Index (y/o/y)	5.7% NOV 11	5.9% OCT 11	3.4% NOV 10
Dollar / EURO	1.30 DEC 11	1.35 NOV 11	1.34 DEC 10

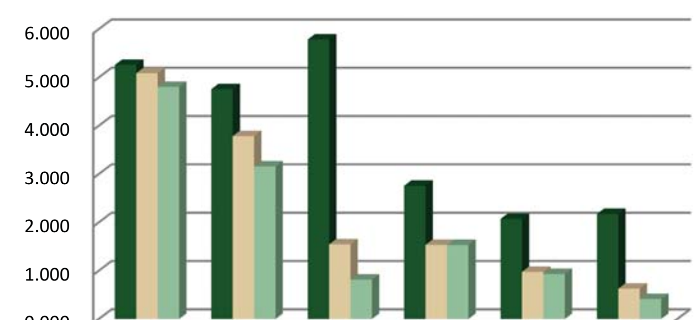
Source: Bloomberg

Investing High Quality Portfolios in a Low Interest Rate Environment

The asymmetric risk profile for fixed income investors is a challenge compounded by the low interest rate environment employed by the Federal Reserve. The Federal Funds rate, the primary tool used by the Federal Reserve to implement monetary policy, has been set at a range of 0.00% - 0.25% since December 2008. In an effort to encourage investors to invest in assets outside of ultra-safe, high quality, short maturity government securities, the Federal Reserve has stated it expects to maintain exceptionally low interest rates until at least mid-2013, 18 months from now. Despite the subtle strengthening in domestic economic data, the global economic backdrop remain uncertain, in particular the sovereign debt issues facing Europe. Current levels of two-, five-, and ten-year U.S. Treasury securities imply monetary policy will remain highly accommodative beyond midyear 2013.

Although the Federal Reserve attempts to be agnostic when it comes to politics and avoid picking "winners and losers," fixed income investors might feel otherwise. Short maturity investments in U.S. Treasury and Agency securities are well below the annualized core inflation rate which was 2.2% as of November 2011. Multiple factors outside of U.S. monetary policy are contributing to the low rate environment. The supply of short maturity fixed income securities away from the market for U.S. Treasury securities is persistently shrinking as consumers and banks continue to deleverage. Both Fannie Mae and Freddie Mac remain under "conservatorship" with a mandate to continue to contract, in turn reducing supply of a highly rated asset class for conservative investors. Additionally, all of the global angst and uncertainty has created international demand for deep and transparent markets like US dollar based assets, further depressing yields.

Historical Yields of Sector Components



	12/31/06	12/31/07	12/31/08	12/31/09	12/31/10	12/31/11
Credit 1-5 yrs A-AAA	5.259	4.757	5.784	2.757	2.071	2.174
Agencies 1-5 yrs	5.087	3.785	1.544	1.533	0.975	0.629
US Treasury 1-5 yrs	4.803	3.158	0.814	1.531	0.929	0.413

Source: Bloomberg / Bank of America Merrill Lynch Global Bond Indices

Fixed income investors that depend on their bond portfolios to generate a certain level of income on a year over year basis continue to face challenges. The annual income currently generated is much lower than historical norms. Investors who require a higher level of income from their portfolio are left to adjust two primary risk levers in order to increase the total return potential of a portfolio. Invest in securities with longer maturities and/or take additional credit risk, both of which at the outset appear to be tenuous. Prior to the financial crisis, interest rates in the US Treasury two-, three-, and five-year securities easily outpaced core inflation. One could argue the additional yield available in the credit sector was not necessarily compelling enough to warrant the additional risk (see chart) given an investment mandate of principal preservation and liquidity, with yield being the third consideration.

The chart highlights the total universe of each asset class in the 1-5 year maturity range and the yields available on a historical market weighted basis. At the December 2006 data point the additional yield benefit offered by the Credit sector was not terribly compelling. Looking ahead to year-end 2008, when the financial crisis was in full swing, most investors were predominately concerned about return "OF" principal, not return "ON" principal, thus the severe dislocation between the Credit universe and the Agency and Treasury universe.

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Today, despite corporate balance sheets being much stronger on multiple metrics than prior to the financial crisis, the yield pick up offered in the Credit sector is very favorable.

The Federal Reserve is artificially depressing interest rates and we have a difficult time identifying a catalyst to materially move Treasury rates higher in the short to intermediate term. Unfortunately for bond market investors longer term interest rates already reflect this reality. In market parlance we would say low Treasury yields are "priced in" to market valuations. At Chandler we are forecasting interest rates to remain stable looking out over an intermediate time horizon. Although the domestic economic recovery to date is not robust there is some underlying momentum in the US economy. The national unemployment rate recently ticked down to 8.5% compared to 9.4% a year earlier. Domestic corporate balance sheets are strong and many companies have become more conservative in the management of their finances since the onset of the financial crisis, a positive for investors investing in corporate fixed income securities. When looking at the opportunities available for investors in the high quality sectors of the fixed income market highlighted in the chart, credit sector valuations look attractive in the current low rate environment.

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Investing in the credit sector of the market requires as independent credit review process. It is simply not enough to rely on the rating agencies to determine whether an investment is appropriate for a high quality portfolio. At Chandler we like to think of the rating agencies as defining the investment opportunity set for a given level of risk but having minimal influence on whether or not an investment is appropriate for a portfolio under our purview. An internal, independent, and robust investment process to evaluate new corporate securities and continually monitor existing positions to ensure they remain an appropriate investment is required. Provided the team managing your fixed income assets is equipped to effectively analyze the corporate sector of the market we think investors should be scrutinizing this sector of the market to identify attractively valued securities to enhance the total return opportunity for a given level of risk.

- William Dennehy II, CFA
VP, Portfolio Manager