CHANDLER ASSET MANAGEMENT

May 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

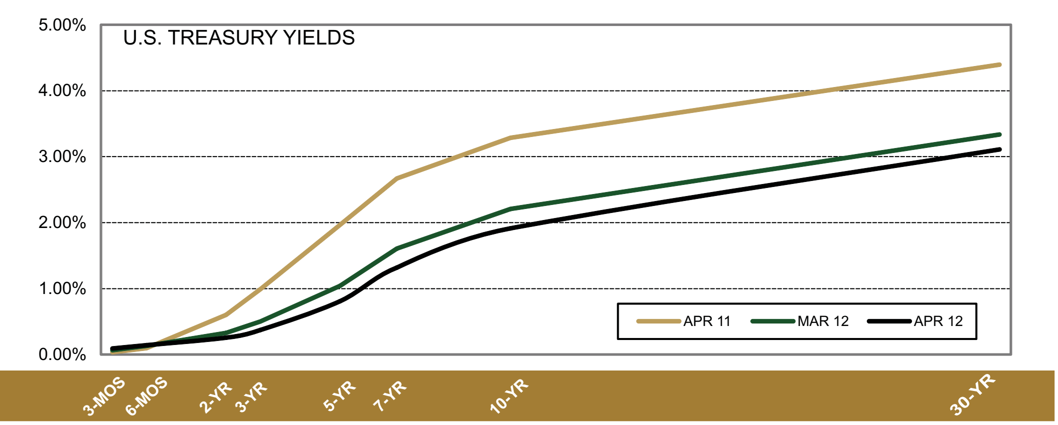
Treasury rates moved lower in April as economic data was slightly weaker than expected. Oil prices also subsided in the month, abating some concerns about accelerating inflation. In addition, Operation Twist (which expires at the end of June) continues to put downward pressure on longer-term interest rates.

Though some recent domestic economic data has been weaker than expected, we continue to believe the data is consistent with a slow growth environment. The labor market continues to improve (albeit at a slow pace), consumer spending trends have been healthy and the manufacturing sector remains strong. First quarter corporate earnings have also been generally better than expected. While it seems the pace of the domestic economic recovery has recently moderated, we believe the overall trajectory remains positive. Meanwhile, political turmoil related to the sovereign debt crisis in Europe, along with growing concerns about slowing economic growth in China, continues to create volatility in the global financial markets.

In April, The Federal Reserve Open Market Committee kept policy rates unchanged, with the fed funds target rate remaining in the range of 0.0-0.25%. The FOMC statement was virtually unchanged from March. There was no change to the Fed's assurance that the fed funds rate will remain exceptionally low through late 2014. Overall, the Fed continues to see the economy as "expanding moderately." However, comments about the labor market were somewhat cautionary. The Fed held off announcing any additional forms of quantitative easing, and we expect that the Fed will remain on hold for at least the next few months. The next FOMC meeting is scheduled for June 19th and 20th.

TREASURY YIELDS FELL IN APRIL

Source: Bloomberg



Treasury yields declined in April as economic data was slightly weaker than expected.

TREASURY YIELDS	4/30/12	3/31/12	CHANGE
3 Month	0.09	0.07	0.02
2 Year	0.26	0.33	(0.07)
3 Year	0.37	0.50	(0.13)
5 Year	0.81	1.04	(0.23)
7 Year	1.32	1.61	(0.29)
10 Year	1.91	2.21	(0.30)
30 Year	3.11	3.34	(0.23)

Source: Bloomberg

Consumer Prices
In March, the CPI showed consumer prices increased 2.7% on a year-over-year basis. The year-over-year Core CPI (CPI less food and energy) increased at a 2.3% rate. Improvement in the domestic economy, coupled with rising oil prices, raised investors' concerns about accelerating inflation.

Retail Sales
In March, Retail Sales rose 6.8% on a year-over-year basis. Consumer spending rebounded from the depths of the recession and recent activity has been healthy. Nevertheless, elevated unemployment levels continue to restrain consumer spending to some degree.

Labor Markets
The April employment report showed the economy added 115,000 jobs. The report was disappointing though the unemployment rate declined slightly to 8.1%. Although the unemployment rate remains elevated, current economic data suggests that the labor market is improving at a slow but steady pace.

Housing Starts
Single-family housing starts edged down slightly in March to 462,000, compared to 463,000 in February. The housing market remains under pressure, 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	0.08	0.15	(0.07)
2-year AA corporate note	0.31	0.24	0.07
5-year AA corporate note	0.59	0.36	0.23
5-year Agency note	0.27	0.26	0.01

Source: Bloomberg

Data as of 4/30/12

Economic Data Slightly Weaker

ECONOMIC INDICATOR	Current Release	Prior Release	One Year Ago
Trade Balance	(46.0) $Bln FEB 12	(52.5) $Bln JAN 12	(45.4) $Bln FEB 11
GDP	2.2% MAR 12	3.0% DEC 11	0.4% MAR 11
Unemployment Rate	8.1% APR 12	8.2% MAR 12	9.0% APR 11
Prime Rate	3.25% APR 12	3.25% MAR 12	3.25% APR 11
CRB Index	305.95 APR 12	308.46 MAR 12	370.56 APR 11
Oil (West Texas Int.)	$104.87 APR 12	$103.02 MAR 12	$113.93 APR 11
Consumer Price Index (y/o/y)	2.7% MAR 12	2.9% FEB 12	2.7% MAR 11
Producer Price Index (y/o/y)	2.8% MAR 12	3.3% FEB 12	5.6% MAR 11
Dollar / EURO	1.32 APR 12	1.33 MAR 12	1.48 APR 11

Source: Bloomberg

Ongoing Debate: Money Market Funds

Debate about how to strengthen money market funds (MMFs) has raged since the Reserve Fund repriced its securities under $1 a share, known as "breaking the buck", in September 2008. This occurrence ignited a run on MMFs that threatened to freeze capital markets. Since then, regulators, investors, short-term credit issuers, financial intermediaries and various other concerned parties have deliberated ways to strengthen MMFs to avoid a similar crisis in the future.

By investing only in very short-term, high-quality fixed income securities, MMFs sought to maintain the value of their shares at a stable $1 per share. The stable value of these funds makes them attractive to investors – individuals, businesses and governmental entities - who want to avoid risk and manage their cash investments without principal variation. At the same time, MMFs have also provided a cost-effective credit option for businesses, financial institutions and governmental entities in need of short-term funding. The fact that MMFs held approximately 40% of outstanding commercial paper, 67% of short-term state and local government debt and significant portions of outstanding short-term Treasury and federal agency securities in late 2010 highlights the vital funding role MMFs play in the United States economy.[1]

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When the Reserve Fund "broke the buck", an extremely rare event, investors withdrew their funds at a dramatic pace while issuers struggled to refinance their short-term debt. With investors cashing out, the nation's short-term credit markets virtually froze, threatening businesses and government entities. Some argue, without urgent stabilizing actions by the Federal Reserve and Treasury, the negative consequences to the economy and capital markets would have been far worse.

The Securities and Exchange Commission (SEC) adopted new rules in January 2010 to enhance MMFs' stability and resiliency, and to ultimately stave off future stress in MMFs. The changes included raising credit quality, shortening maturity, increasing liquidity and enhancing transparency of MMFs.

Continuing Area of Disagreement

Since the financial crisis, the SEC has grappled with whether to permit MMFs to maintain their net asset value (NAV) at a stable price without valuing their holdings using current market prices. The SEC believes stable value MMFs leave investors with a false sense of confidence, and that eliminating this feature would lead to more informed investors who would be less likely to panic the next time a MMF is unable to maintain a stable NAV.

Although MMFs seek to maintain price stability, there has never been a guarantee. Fluctuations in NAV have always been possible, but rare. MMFs typically do not value the securities in the fund at the current market value when calculating the NAV. Rather, they use the amortized cost method for valuing securities (securities are valued at cost, plus or minus any accreted discount or amortized premium). The rationale for maintaining stable NAVs is that a portfolio of high credit quality and short maturities of securities, limits significant volatility in the NAV. Nonetheless, MMFs 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, MMFs must reprice shares at less than one dollar. Historically, sponsors of MMFs have supported the funds if the value of the fund has fallen below $1. There is no obligation to do so, however, and in the case of the Reserve Fund, the sponsor did not have the financial resources needed to provide such support.

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(1) Money Market Fund Reform Options report by President Obama's Working Group on Financial Markets, dated October 2010.

Many investors along with the mutual fund industry are opposed to a floating net asset value. In general, investors in MMFs are conservative and use MMFs for cash management purposes. They also argue the accounting and tax issues involved with purchases and sales of shares of fluctuating value MMFs would unreasonably burden cash managers and treasurers. Further, many state and municipal government investors are required by statute to use MMFs as an investment tool for cash management because of their stable net asset value feature. If a floating net asset value is imposed upon MMFs, then government entities may be forced out of these funds or incur unneeded expenses related to legislative changes.

An alternative perspective postulates that since MMFs are not guaranteed, changing to a floating NAV is merely an accounting convention and would not alter the underlying investments held by MMFs. By reflecting the current market value, fluctuating NAV MMFs would provide investors with more transparent disclosure of their holdings.

Next Phases

The SEC has continued to evaluate various ways to strengthen MMFs while making them less susceptible to irrational investor behavior in times of crisis and less of a source of systemic risk to the capital markets and economy. The SEC is expected to submit proposals for public comment in the Spring of 2012. While the final form is not yet fully known, there are various options being considered to strengthen MMFs.

Under one alternative, MMFs could continue to use the stable NAV accounting convention if the MMF builds up a capital buffer and imposes “redemption restrictions”, both intended to diminish large redemptions. There are costs associated with each change. A capital buffer could squeeze MMF yields. Any negative effect on yield would be exacerbated by the current low yield environment. The size and scope of such a cushion is not known. A challenge to this approach is how to establish a capital buffer that offers meaningful protection without unnecessarily interfering with the efficiency of the market. The proposed redemption restrictions, a freeze on 3% to 5% of an account's assets for 30 days after each redemption, would bar investors from making full use of their assets, limiting liquidity.

Under an alternative option, MMFs could simply abandon the stable NAV accounting convention. The change would drive home the point to investors that money funds are not federally insured, nor is their share price guaranteed. This explicit acknowledgement might discourage panic if a fund's share price fell below $1. The change could make every money fund transaction into a taxable event, forcing investors to calculate even small gains and losses in share prices.

Deadlock?

Opposition to additional regulation of MMFs from various directions appears to have made it difficult for the SEC to reach a defined course of action. If the SEC is unable to reach an agreement, the Financial Stability Oversight Council established by the 2010 Dodd-Frank Act to monitor large risks to the economy may decide to officially designate money funds as “systemically important.” Such a move would increase pressure on the SEC to overcome disagreements to the new rules.

We believe it is likely that many MMFs would continue to maintain their stable value, by investing in a conservative portfolio of securities, making it less likely that the fund's share price would fall below $1. These new rules may lead to a stratification of money market funds, with those more likely to have fluctuating net asset values offering higher yields, while those geared toward the most conservative investors with higher quality, shorter maturity funds offering lower yields.

Any of the approaches currently being considered would meaningfully affect MMFs. Investors in MMFs should stay current with information from the SEC and consider how the eventual changes will affect their liquidity.

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