CHANDLER ASSET MANAGEMENT

September 2012

BOND MARKET REVIEW

A MONTHLY REVIEW OF FIXED INCOME MARKETS

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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

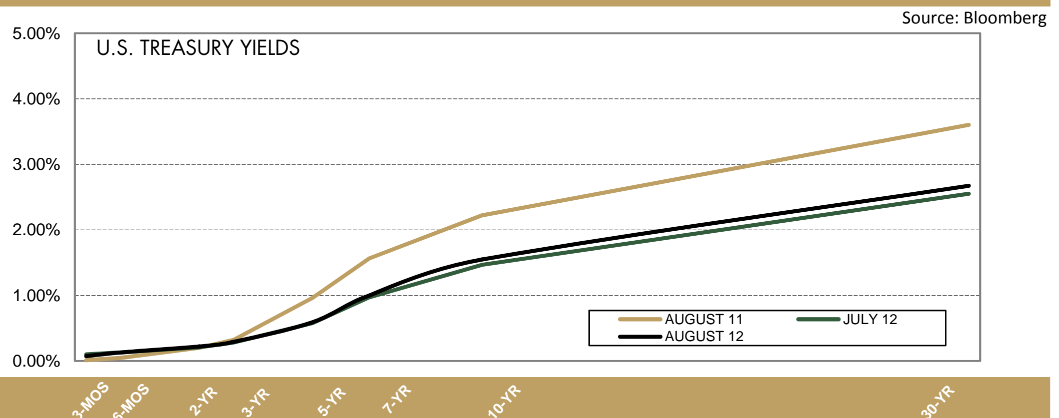
Treasury rates were little changed in August amidst a still sluggish domestic economic environment and ongoing concerns about Europe. Overall, rates continue to be influenced by the Federal Reserve's accommodative monetary policy and their desire to keep interest rates contained.

The domestic economy continues to grow at a slower than desired pace. Meanwhile, concerns about the European debt crisis continue to create volatility in the financial markets, and unease about the U.S. potentially reaching a "fiscal cliff" at the end of this year is building. The August employment report showed that the economy added just 96,000 jobs, lower than the consensus forecast.

As largely expected by market participants, the Federal Open Market Committee left policy rates unchanged at its September meeting and announced additional economic stimulus measures in the form of "QE3". The Federal Reserve will purchase additional agency mortgage-backed securities at a pace of $40 billion per month, for an open-ended period of time. The Fed also expects to keep the fed funds rate at an exceptionally low level through at least mid-2015 (vs. previous guidance of through late 2014). The Fed continues to reinvest principal payments from its holdings of agency debt and agency mortgage-backed securities, and said that "Operation Twist" will continue as planned through the end of this year. Overall, the Fed's actions are aimed at putting downward pressure on long-term interest rates and fueling stronger economic growth. In its statement, the FOMC's overall assessment of the economy was more upbeat compared to its August statement. Despite this improvement, the Committee's decision to move forward with QE3 is consistent with its mandate of fostering maximum employment and price stability.

TREASURY YIELDS WERE LITTLE CHANGED IN AUGUST

Source: Bloomberg



Treasury rates were little changed in August amid a still sluggish domestic economic environment and ongoing concerns about Europe. Overall, rates continue to be influenced by the Federal Reserve's accommodative monetary policy and their desire to keep interest rates contained.

TREASURY YIELDS	8/31/12	7/31/12	CHANGE
3 Month	0.07	0.10	(0.03)
2 Year	0.22	0.21	0.01
3 Year	0.29	0.28	0.01
5 Year	0.59	0.58	0.01
7 Year	1.00	0.97	0.03
10 Year	1.55	1.47	0.08
30 Year	2.67	2.55	0.12

Source: Bloomberg

Economic Roundup

Consumer Prices

In July, overall CPI inflation eased to 1.4% on a year-over-year basis. Consumer prices remained soft, reflecting a decline in energy prices. The year-over-year Core CPI (CPI less food and energy) edged down to 2.1% in July, from 2.2% in June. The core inflation rate remains slightly higher than the Fed's inflation target of 2.0%.

Retail Sales

In July, retail sales rose 4.1% on a year-over-year basis. On a month-over-month basis, retail sales rose 0.8% in July, exceeding the consensus forecast of 0.3%. Consumer spending has rebounded from the depths of the recession, but recent activity has slowed down. Elevated unemployment levels and a recent decline in consumer confidence are likely restraining consumer spending.

Labor Markets

The August employment report showed that the economy added just 96,000 new jobs, below the 125,000 consensus estimate. In addition, the net revisions for June and July were down 41,000. The unemployment rate dropped to 8.1% in August from 8.3% in July, but this was mainly due to a decline in the labor force. The employment report continues to reflect an overall slow pace of growth in the domestic economy.

Housing Starts

Single-family housing starts declined 6.5% to 502,000 in July, following a 4.7% rise in June. July starts were close to expectations. The housing market appears to have stabilized and some data has surprised to the upside this year.

Credit Spreads Contracted

CREDIT SPREADS	Spread to Treasuries (%)	One Month Ago (%)	Change
3-month top-rated commercial paper	0.13	0.09	0.04
2-year A corporate note	0.35	0.48	(0.13)
5-year A corporate note	0.69	0.83	(0.14)
5-year Agency note	0.27	0.31	(0.04)

Source: Bloomberg Data as of 8/31/12

Economic Data Continues to Indicate Slow Growth

ECONOMIC INDICATOR	Current Release	Prior Release	One Year Ago
Trade Balance	(42.9) $Bln JUN 12	(48.0) $Bln MAY 12	(50.3) $Bln JUN 11
GDP	1.7% JUN 12	2.0% MAR 12	2.5% JUN 11
Unemployment Rate	8.1% AUG 12	8.3% JUL 12	9.1% AUG 11
Prime Rate	3.25% AUG 12	3.25% JUL 12	3.25% AUG 11
CRB Index	309.59 AUG 12	299.51 JUL 12	342.57 AUG 11
Oil (West Texas Int.)	$96.47 AUG 12	$88.06 JUL 12	$88.81 AUG 11
Consumer Price Index (y/o/y)	1.4% JUL 12	1.7% JUN 12	3.6% JUL 11
Producer Price Index (y/o/y)	0.5% JUL 12	0.7% JUN 12	7.1% JUL 11
Dollar/EURO	1.26 AUG 12	1.23 JUL 12	1.44 AUG 11

Source: Bloomberg

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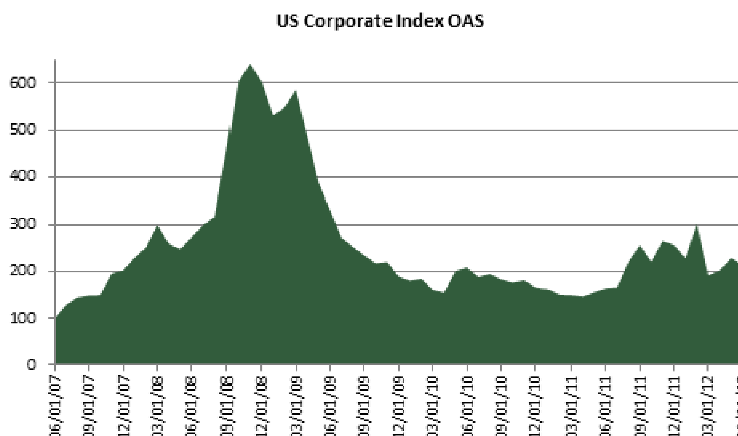
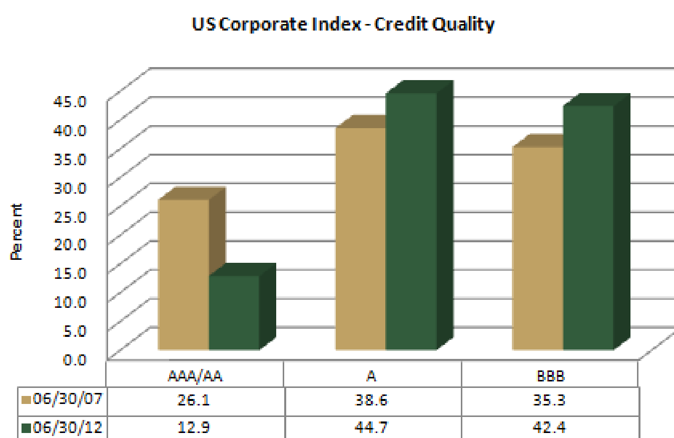
Considerations for Moving Down in Corporate Credit Quality

At Chandler we think it is imperative for investors to take a step back periodically and evaluate the markets they invest in from a top down perspective. The historically low rate environment across U.S. domestic fixed income markets continues to be a challenge for most investors. In light of the overall soft global economic backdrop, coupled with the dual mandate of the Federal Reserve (price stability and full employment), we believe low interest rates in domestic high quality fixed income markets are likely to stay in place over an intermediate time horizon. Despite the overall low level of interest rates, the total return of non-governmental assets in 2012 has been quite strong year-to-date. Through the first eight months of 2012 the S&P 500 returned 11.85%, the Bank of America Merrill Lynch Broad Investment Grade Fixed Income Index (i.e. Domestic Master) returned 4.05%, and the Bank of America Merrill Lynch U.S. All Corporate Index returned 8.25%. With regards to the solid fixed income returns, the year-to-date performance has been driven both by lower Treasury yields across the yield curve, and a broad tightening of spreads in the Agency, Securitized (MBS/ABS/CMBS), and Corporate sectors of the market.



The Corporate sector of the market remains a keen area of focus for most fixed income investors as it is the only large non-Treasury sector of the market not shrinking (Agencies) or having valuations distorted by the Federal Reserve's balance sheet holdings (Mortgage Backed Securities). Despite the strong move year-to-date, Corporate spreads are still wide compared to their historical averages, even if spreads appear more fully priced based on the financial turmoil of the past five years (see top chart). As of June 30, 2007 the U.S. Corporate Index was valued with an OAS (option adjusted spread) of 100 basis points versus the spread as of June 30, 2012 of 215 basis points. We consciously chose a June 2007 starting point for our analysis as in our view it represents the last quarter prior to the beginnings of the financial crisis. At the end of June 2007 the Fed Funds rate was 5.25% and the S&P 500 was priced at 1,503 versus a Fed Funds rate of 0.25% and the S&P 500 of 1,362 as of June 2012.

Looking back over the past five years, from June 2007 through June 2012, we observe some interesting changes to the underlying constituents of the investment grade corporate universe. Evaluated strictly from a credit rating perspective, we believe the investment grade universe as of June 30, 2012 is riskier than the universe of June 30, 2007. We draw this conclusion from two perspectives, one more obvious than the other. The percentage of AAA/AA Corporate assets in the dollar denominated U.S. credit universe has contracted materially, dropping from 26% as of June 30, 2007 to 13% as of June 30, 2012 (see bottom chart).



The not so obvious shift in the underlying constituents of the universe is the subtle changes in the bonds represented in the universe domiciled in the U.S. versus those issuers domiciled outside of the U.S. but issued in dollars (see chart on page four). Investors have a shrinking AAA/AA Corporate sector of the market to invest in coupled with an increase in issuing companies not domiciled in the U.S. presenting a myriad of challenges for investors, including different accounting standards, additional exposure to currency exchange rate risk, and less frequent corporate filings detailing financial performance.

Source for all three charts: Bank of America Merrill Lynch Indices

We also considered the degree of spread compensation for the various tiers of risk in the market. Back in June 2007 the AAA/AA, A, and BBB components of the market has an average OAS of 71, 95, and 127 respectively, while the overall index had an OAS of 100. In June 2012, the AAA/AA, A, and BBB components of the market had an OAS of 124, 184, and 275 respectively, while the overall index had an OAS of 215. The U.S. Corporate Master Index table highlights the various valuations but the spread compensation for owning AAA/AA portion of the market in June 2007 was 71% (71/100) versus only 58% in June 2012 (124/215). For investors looking at broad credit categories one needs to move down in credit quality and/or consider more non-U.S. domiciled issuers to construct a portfolio that captures the overall spread available in the Corporate market.

US Corporate Index - US vs. Non US Domicile - June 30, 2007

Domicile	Share
US	79%
ex US	21%

US Corporate Index - US vs. Non US Domicile - June 30, 2012

Domicile	Share
US	69%
ex US	31%

We also broke down the market across the Financial, Industrial, and Utility categories to better ascertain how valuations have evolved over the past five years. The Financial sector has contracted by 11% but the overall relative OAS compensation has increased from 92% (92/100) to 127% (272/215). This looks to be somewhat of a historical anomaly as typically a smaller supply of an asset class will lead to tighter valuations, all else the same. The Industrial sector as a percentage of the overall Corporate universe has increased by 10% to 61% while relative valuations have contracted from 106% of the index in June 2007 (106/100) versus only 88% of the index in June 2012 (188/215). The Utility sector spread movement mirrored the Industrial sector with spread compensation dropping from 101% of the Corporate index in June 2007 (101/100) to 88% in June 2012 (188/215).

We believe there is an opportunity to take advantage of the greater percentage of A-rated Corporate debt available in the market, particularly in the Financial sector. It appears the underlying credit quality of the Financial sector is lower when evaluating the two distinct time periods as the amount of AAA/AA has contracted from 22% to 7% and the amount of A exposure has increased from 17% to 18%. We would argue the underlying credit fundamentals of the financial sector as a whole is higher in June 2012 versus June 2007; the rating agency deterioration is broadly related to the reduction in implied government support to various financial institutions. We feel balance sheets in the financial sector are stronger in 2012 than in 2007 based on the increased regulatory oversight of the sector, increases in loss absorbing capital, decrease in leverage, and the overall lower level of risk embedded within financial sector balance sheets.

In the Industrial and Utility space, although the absolute change in spreads between the two periods of 82 and 87 is compelling, the spread compensation relative to the index is less so (see table on page five). Despite the less attractive valuations we continue to recommend a diversified portfolio across sectors and thus would still seek out relative value opportunities even in the less attractively valued Industrial and Utility sectors.

Although the rating agencies define the investment opportunity set for a given level of risk, we have always strongly advocated an independent credit review process to ensure fulfillment of fiduciary responsibility. In light of the overall prospects in the fixed income markets, we think opportunities remain by moving slightly down in credit quality to take advantage of the wider historical spread valuation available in the respective sectors of the Corporate market. In order to take advantage of this opportunity, an internal, independent, and robust investment process to evaluate new corporate securities and continually monitor existing positions is required to ensure the securities remain an appropriate investment.

- William Dennehy II, CFA
Portfolio Manager

RISKS AND OTHER IMPORTANT CONSIDERATIONS
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Fixed income investments are subject to interest, credit, and market risk. Interest rate risk: the value of fixed income investments will decline as interest rates rise. Credit risk: the possibility that the borrower may not be able to repay interest and principal. Low rated bonds generally have to pay higher interest rates to attract investors willing to take on greater risk. Market risk: the bond market in general could decline due to economic conditions, especially during periods of rising interest rates.

U.S. Corporate Master Index (Investment Grade)

	June 30 2007			June 30 2012			OAS Change
	% of index	OAS	OAS pct of total	% of index	OAS	OAS pct of total	
Total Credit Quality Universe	100.0	100.1	100%	100.0	214.5	100%	114.5
AAA/AA	26.1	71.2	71%	12.9	123.6	58%	52.3
ex US	4.0	71.4	71%	5.0	135.8	63%	64.4
US	22.1	71.2	71%	7.9	115.7	54%	44.5
A	38.6	95.3	95%	44.7	183.5	86%	88.2
ex US	8.4	106.3	106%	12.5	196.0	91%	89.7
US	30.2	92.3	92%	32.1	178.6	83%	86.4
BBB	35.3	126.6	127%	42.4	274.8	128%	148.2
ex US	9.1	122.6	123%	13.4	346.9	162%	224.3
US	26.2	128.0	128%	29.0	241.5	113%	113.5
Total Domicile Universe	100.0	100.1	100%	100.0	214.5	100%	114.5
ex US	21.5	106.6	107%	31.0	251.5	117%	144.9
US	78.5	98.3	98%	69.0	197.9	92%	99.7
Total Sector Universe	100.0	100.1	100%	100.0	214.5	100%	114.5
Financial	42.7	92.5	92%	31.7	271.5	127%	179.0
AAA/AA	22.0	71.6	72%	6.5	151.9	71%	80.2
A	16.9	102.0	102%	17.5	259.2	121%	157.2
BBB	3.8	169.5	169%	7.7	398.9	186%	229.4
Financial ex US							
AAA/AA	3.0	72.7	73%	3.2	147.5	69%	74.8
A	3.5	117.4	117%	4.3	280.9	131%	163.5
BBB	1.2	167.3	167%	3.0	467.1	218%	299.8
Financial US							
AAA/AA	18.9	71.4	71%	3.2	156.2	73%	84.8
A	13.4	98.0	98%	13.2	252.1	118%	154.1
BBB	2.7	170.5	170%	4.8	356.4	166%	185.9
Industrial	50.7	106.4	106%	60.8	188.2	88%	81.8
AAA/AA	3.9	69.2	69%	6.3	94.9	44%	25.7
A	19.4	89.9	90%	23.3	133.0	62%	43.1
BBB	27.4	123.4	123%	31.1	248.5	116%	125.1
Industrial ex US							
AAA/AA	0.9	68.2	68%	1.8	114.8	54%	46.6
A	4.6	98.2	98%	7.5	144.7	67%	46.5
BBB	7.4	116.7	117%	9.8	307.5	143%	190.7
Industrial US							
AAA/AA	3.0	69.5	69%	4.5	87.1	41%	17.6
A	14.8	87.3	87%	15.8	127.4	59%	40.1
BBB	19.9	125.9	126%	21.3	221.4	103%	95.6
Utility	6.5	100.9	101%	7.6	188.1	88%	87.2
AAA/AA	0.3	69.9	70%	0.1	109.9	51%	40.0
A	2.2	91.7	92%	3.9	146.1	68%	54.5
BBB	4.1	107.8	108%	3.6	235.3	110%	127.5
Utility ex US							
AAA/AA	0.1	60.5	60%	0.0	136.0	63%	75.5
A	0.2	100.4	100%	0.7	224.1	104%	123.7
BBB	0.4	103.0	103%	0.6	391.1	182%	288.1
Utility US							
AAA/AA	0.2	74.8	75%	0.1	102.1	48%	27.3
A	2.0	90.6	91%	3.1	128.7	60%	38.0
BBB	3.7	108.4	108%	3.0	201.2	94%	92.8

Source: Bank of America Merrill Lynch Indices