September
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Chandler Asset Management

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Since 1988, Chandler Asset Management has specialized in the management of fixed income portfolios.

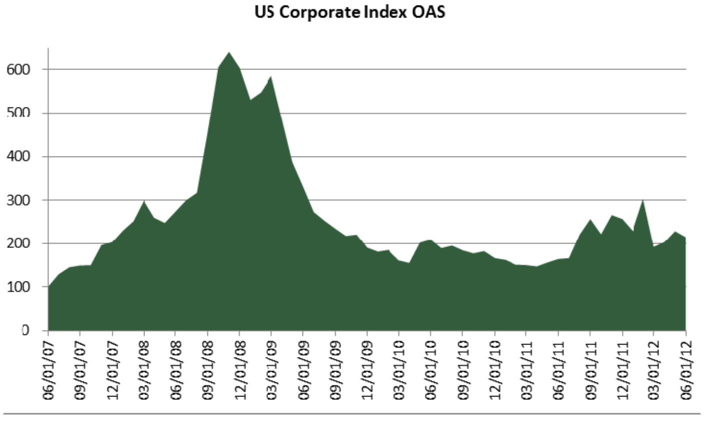
Chandler's mission is to provide fully customizable, client-centered portfolio management, which preserves principal, manages risk, and generates income in our clients' portfolios.

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-government 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.

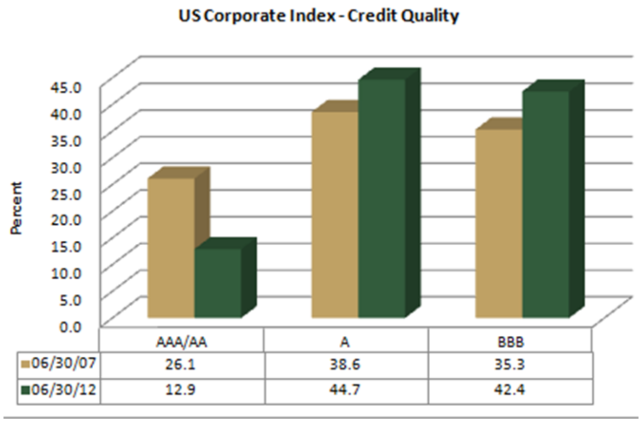
The Corporate sector of the market remains a keen area of focus for most fixed income investors as it is the only large non-Treasury sector of the market not shrinking (Agencies) or having valuations distorted by the Federal Reserve's balance sheet holdings (Mortgage Backed Securities). Despite the strong 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 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 1,503.35 versus a Fed Funds rate of 0.25% and the S&P 500 of 1,362.16 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 chart).



Source: Bank of America Merrill Lynch Indices

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). 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.



	AAA/AA	A	BBB
🟫06/30/07	26.1	38.6	35.3
🟩06/30/12	12.9	44.7	42.4

Source: Bank of America Merrill Lynch Indices

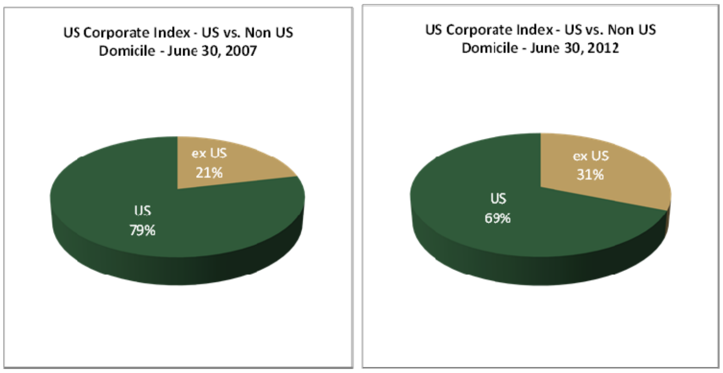
We also considered the degree of spread compensation for the various tiers of risk in the market. Back in June 2007 the AAA/AA, A, and BBB components of the market has an average OAS of 71, 95, and 127 respectively, while the overall index had an OAS of 100. In June 2012, the AAA/AA, A, and BBB components 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.

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% (93/100) 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 quality 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.



Source: Bank of America Merrill Lynch Indices

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Mr. Dennehy joined Chandler in 2011 and is responsible for implementing portfolio strategy and securities trading in client accounts.

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