CHANDLER ASSET MANAGEMENT

June 2013

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.

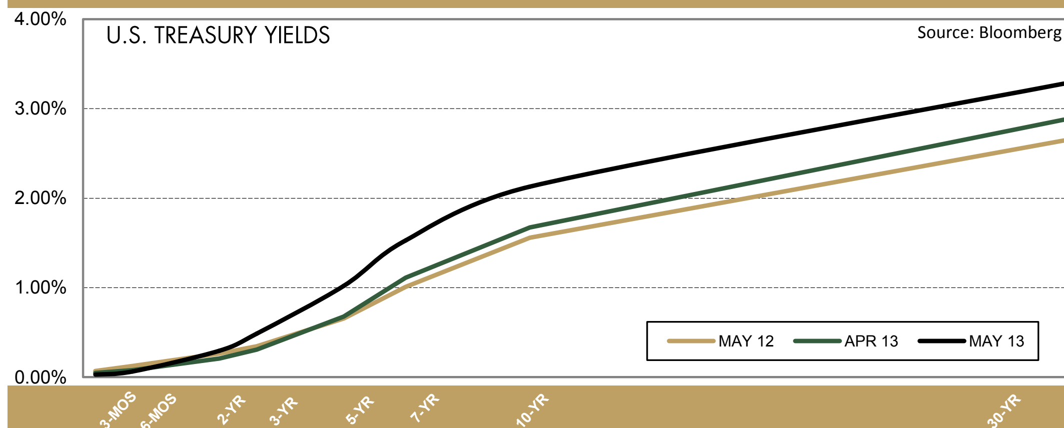
Market Summary

Recent economic data continues to point to modest growth. Nonfarm payrolls rose 175,000 in May, slightly better than the consensus forecast, but the unemployment rate rose to 7.6% from 7.5% in April. Average nonfarm payroll growth over the past 3 months has been about 155,000 per month. Meanwhile, recent manufacturing trends have deteriorated modestly. Housing trends remain mixed, but we believe the overall trajectory remains positive. Consumer spending seems to be holding up in spite of this year's increase in payroll taxes. Overall, the economy continues to muddle along.

The Treasury yield curve steepened in May, driven by a slight decline in short-term yields and a more meaningful increase in intermediate and long-term yields. The move in intermediate and longer-term rates has been influenced by a modest improvement in economic data, as well as increased speculation that the Fed could begin tapering its bond purchases.

At a congressional hearing in May, Fed Chairman Bernanke said the Fed could take its first step toward winding down its quantitative easing (QE) program at one of its "next few meetings," but he also cautioned against reducing QE too quickly or aggressively. Minutes from the April 30-May 1 FOMC meeting indicated that some members were prepared to start pulling back on bond purchases as early as this month, while others remained hesitant. The modest growth in May payrolls probably wasn't enough to persuade Fed officials to announce a tapering of bond purchases at this month's FOMC meeting, in our view. There isn't a clear consensus among Fed officials about when to begin unwinding QE. The next FOMC meeting is scheduled for June 18-19.

TREASURY YIELD CURVE STEEPENED IN MAY



The yield curve steepened in May as economic data improved modestly and policymakers at the Fed began to discuss the possibility of winding down quantitative easing.

TREASURY YIELDS	5/31/2013	4/30/2013	CHANGE
3 Month	0.03	0.05	(0.02)
2 Year	0.30	0.21	0.09
3 Year	0.49	0.31	0.18
5 Year	1.02	0.68	0.34
7 Year	1.53	1.11	0.42
10 Year	2.13	1.67	0.46
30 Year	3.28	2.88	0.40

Source: Bloomberg

Economic Roundup

Consumer Prices
In April, overall CPI inflation declined to 1.1% on a year-over-year basis from 1.5% in March. The year-over-year Core CPI (CPI less food and energy) edged down to 1.7% from 1.9%. The core inflation rate is trending below the Fed's long-term goal of 2.0% and remains below the trigger rate for policy action of 2.5%.

Retail Sales
In April, Retail Sales rose 3.6% on a year-over-year basis. On a month-over-month basis, Retail Sales increased 0.1% in April. Overall, recent consumer spending trends have held up well in spite of headwinds from higher payroll taxes, rising gas prices, a delay in tax refunds, and ongoing uncertainty about the government's fiscal policy. However, recent data may indicate these trends may be decelerating.

Labor Markets
The May employment report showed that payrolls increased by 175,000 (slightly better than the 167,000 consensus estimate). However, the unemployment rate rose to 7.6% in May from 7.5% in April, driven by an increase in the labor force. Private payrolls increased 178,000 (in line with expectations), while government jobs fell 3,000 in May. The net revisions in nonfarm payrolls for March and April were down 12,000. Overall, improvement in the labor market remains modest.

Housing Starts
Single-family housing starts declined 2.1% in April to 610,000 from 623,000 in March. Housing permits increased 3.0% in the month which was stronger than expected. Recent housing data suggests that the housing market may have lost some momentum after a relatively strong start to the year.

Credit Spreads Were Stable in May

CREDIT SPREADS	Spread to Treasuries (%)	One Month Ago (%)	Change
3-month top-rated commercial paper	0.12	0.11	0.01
2-year A corporate note	0.54	0.51	0.03
5-year A corporate note	0.79	0.81	(0.02)
5-year Agency note	0.16	0.17	(0.01)

Source: Bloomberg Data as of 5/31/13

Economic Data Continues to Indicate Slow Growth

ECONOMIC INDICATOR	Current Release	Prior Release	One Year Ago
Trade Balance	(40.3) $Bln APR 13	(37.1) $Bln MAR 13	(46.6) $Bln APR 12
GDP	2.4% MAR 13	0.4% DEC 12	2.0% MAR 12
Unemployment Rate	7.6% MAY 13	7.5% APR 13	8.2% MAY 12
Prime Rate	3.25% MAY 13	3.25% APR 13	3.25% MAY 12
CRB Index	281.85 MAY 13	288.13 APR 13	272.97 MAY 12
Oil (West Texas Int.)	$91.97 MAY 13	$93.46 APR 13	$86.53 MAY 12
Consumer Price Index (y/o/y)	1.1% APR 13	1.5% MAR 13	2.3% APR 12
Producer Price Index (y/o/y)	0.6% APR 13	1.1% MAR 13	1.8% APR 12
Dollar/EURO	1.30 MAY 13	1.32 APR 13	1.24 MAY 12

Source: Bloomberg

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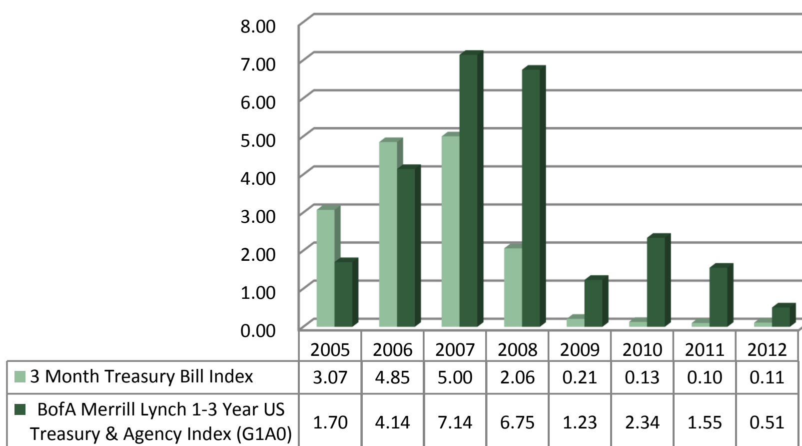
Money Market Funds, Floating Rate NAVs, and Short Duration Alternatives

The Securities and Exchange Commission (SEC) recently moved forward with a recommendation to require some types of Money Market Funds to drop the fixed $1.00 share price in favor of a floating rate NAV (Net Asset Value). Unlike legislation passed in the United States Congress over the past few years the vote was bipartisan as the recommendation passed with a unanimous 5-0 vote (SEC mandates that no more than three Commissioners can belong to the same political party). The motivation of the SEC for yet another level of regulation is to help eliminate the need for the government to have to step in to provide support to money market funds in times of heightened financial stress. The proposal details two reforms that could be adopted on a stand-alone basis or a combination of both. The first reform requires a floating NAV for prime institutional money market funds. Prime money market funds have the ability to invest in short-term corporate debt and are considered to contain more risk than a government only money market fund. The second reform would impose liquidity fees and redemption restrictions in times of market stress. The mutual fund industry as a whole has been reluctant to embrace the latest proposals by the SEC. The mutual fund industry contends one of the most important elements to investors in money market funds is the ability to continuously transact at a stable NAV, on any given day, thereby not risking any reduction in principal invested. A floating NAV could compromise the protection of principal. The recommendation by the SEC currently excludes government and retail money market funds, but based on the long-run objectives of the SEC this is unlikely a permanent reprieve in our opinion.



	2005	2006	2007	2008	2009	2010	2011	2012
3 Month Treasury Bill Index	3.07	4.85	5.00	2.06	0.21	0.13	0.10	0.11
BofA Merrill Lynch 1-3 Year US Treasury & Agency Index (G1A0)	1.70	4.14	7.14	6.75	1.23	2.34	1.55	0.51

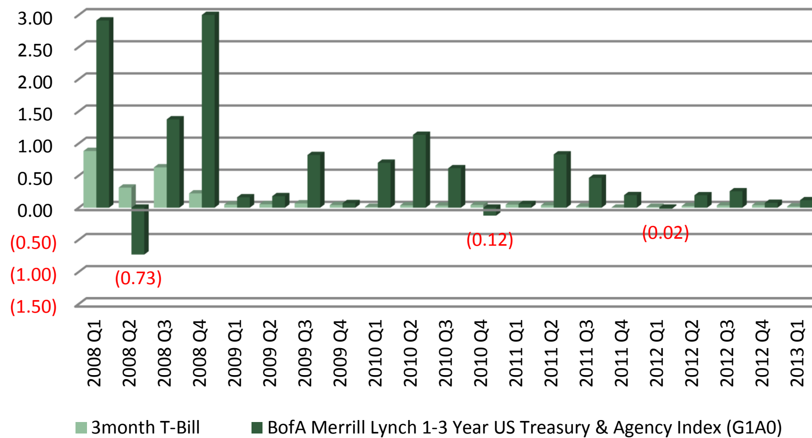
If the NAV of a Money Market fund floats and restrictions are placed on withdrawals, what do investors get in return? Since the onset of the financial crisis increased financial regulation has required money market funds to become more conservative, both in the types of assets they can purchase and the overall interest rate sensitivity of the portfolio. Most would argue this has been a good thing as it mandated a more conservative investment style providing additional safety of principal. The lower risk profile of money market funds does have a downside; lower income generation. Despite the more stringent requirements for money market funds implemented since the financial crisis the SEC is still moving forward with floating rate NAVs. Due to the extraordinary measures taken during the financial crisis of 2007-2008 to stabilize money market funds, the SEC is going to great lengths to enhance money market funds ability to manage potential financial market contagion from high levels of redemptions. Unfortunately, the recently proposed regulatory enhancements appear to be at the expense of investors in money market funds.

We think conservative investors who are utilizing a money market strategy could benefit by taking on a modest amount of additional interest rate and sector risk by utilizing a short duration investment strategy for a portion of their liquid assets. In our view, the pros outweigh the cons for those investors who have stability in their cash flow requirements and have the internal resources to manage the additional risk of a short duration investment strategy. We think astute cash management forecasting and a strong risk management culture can help to mitigate the 'negatives' of a short duration strategy compared to a money market fund. The benefits to investors using a short duration mandate as part of the overall liquidity strategy can provide more stability of cash flows. Stability in cash flows comes from the structure of the portfolio with notes maturing on various dates across the term structure of the portfolio. Additionally, we find it beneficial at times to match an investment against a known liability, thus immunizing the interest rate risk associated with the specific liability. Another benefit to investors who utilize a short duration strategy is the ability to take advantage of market anomalies. We find certain securities deviate from the fundamental value by both becoming too cheap (price too low and attractive) and too expensive (price too high and unattractive). A short duration strategy run by a skilled practitioner is more likely to be able to take advantage of these price movements to the benefit of the portfolio.

There are additional risks to investors who take advantage of a short duration strategy primarily realized by having to generate liquidity (i.e. sell a security) at an inopportune

Graph Source: US Treasury and Band of America Merrill Lynch

time when yields have moved higher and prices lower. We chose two market benchmarks to illustrate the additional risks investors would incur over various market cycles. Keep in mind an actively managed strategy could generate returns that were higher or lower than the market proxies, depending on the skill of the manager and the overall interest rate environment. We used the return of the 3-month Treasury Bill to represent the returns available in a money market fund and the Bank of America Merrill Lynch 1-3 Year Treasury and Agency Index to represent the returns available in a short duration strategy.



On a year-over-year basis both benchmarks generate positive returns in every year looking back over the past eight years. In six of the eight years illustrated the short duration proxy outperforms the money market proxy. The two years of relative underperformance in 2005 and 2006 were periods when monetary policy was being tightened and interest rates in general were on the rise. Typically during periods of flat or declining interest rates the performance of the short duration proxy is going to exceed the money market proxy. Notably the annualized returns of the Short Duration proxy were well in excess of the Money Market proxy in 2007 and 2008, two years of heightened investor risk aversion.

Over shorter quarterly time horizons negative returns do occur and we highlighted those risks in the chart depicting quarterly returns of the respective market proxies. Since the first quarter of 2008 there have been three quarters of negative returns for the short duration benchmark with the largest decline coming in the second quarter of 2008. Keep in mind a negative quarterly return is often followed up by a positive quarter, leading to positive annualized results as illustrated in the first chart.

Graph Source: US Treasury and Band of America Merrill Lynch

For investors with liquidity needs but stable cash flows we think the benefits of utilizing a short duration strategy to enhance the total income of a portfolio over an investment cycle are favorable. In our view six attributes are of crucial importance to successfully implement a short duration mandate:

1. Conservative Approach: Investment objective should be consistent, steady returns versus the risk benchmark
2. Transparency: Holdings need to meet the requirements of the statutes of the governing body and the investment policy
3. Diversification: A broad mix of securities across eligible sectors and term structure
4. Technology: Access to real time information is imperative to ensure best in class idea generation and trade execution
5. Experience of Team: Portfolio Managers with expertise navigating varied market cycles
6. Manage Risk: Generate risk adjust out-performance over an intermediate time horizon

Investing in the fixed income markets always requires an analysis of risk. We think the modest incremental risk of a short duration mandate as part of a liquidity portfolio warrants consideration.

- William Dennehy II, CFA
SVP, Portfolio Manager

*Past performance is not indicative of future results. Index returns assume reinvestment of all distributions and unlike mutual funds, do not reflect fees or expenses which would have the effect of decreasing historical performance results. It is not possible to invest directly in an index. All investment strategies have the potential for profit or loss. Different types of investments involve varying degrees of risk, and there can be no assurance that any specific investment will either be suitable or profitable for a client's investment portfolio. Economic factors, market conditions and investment strategies will affect the performance of any portfolio and there are no assurances that it will match or outperform any particular benchmark.

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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.