CHANDLER ASSET MANAGEMENT

November 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.

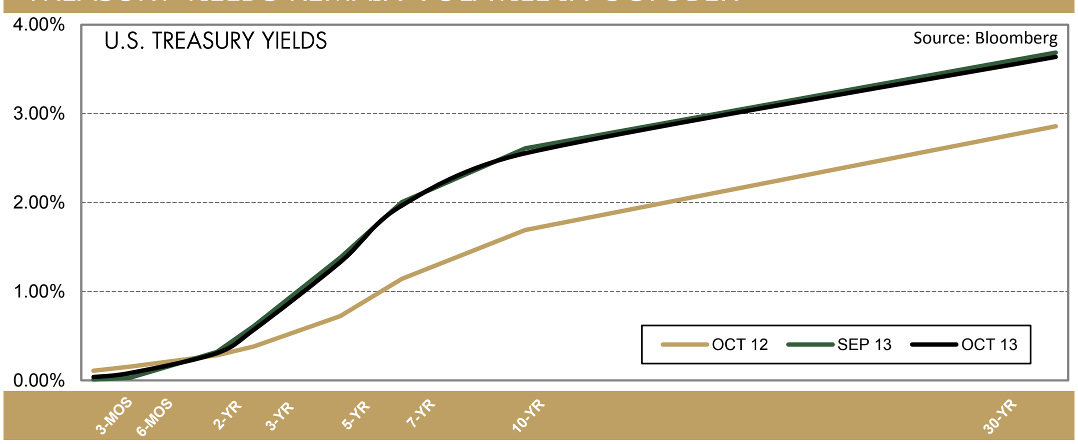
Market Summary

Economic data has been mixed. Job growth was stronger than expected in October, but the unemployment rate edged up to 7.3% from 7.2%, reflecting a rise in temporary layoffs during the government shutdown. Nonfarm payrolls increased by 204,000 in October versus the consensus forecast of 120,000. In addition, the net revisions for job growth in August and September were +60,000. Average nonfarm payroll growth over the past three months has been about 201,000 per month. Overall, employment growth has been favorable. Manufacturing data has also been relatively healthy. However, there are signs that consumer spending may be softening and the housing sector has slowed in recent months. Overall, we believe the economy remains on a slow growth trajectory.

Treasury yields have remained volatile in the past few months as the outlook on Fed policy and long-term fiscal policy remains uncertain.

The FOMC left policy rates unchanged at its October meeting and did not announce any changes to the pace of its bond purchases. The Fed continues to indicate that policy changes will be data dependent and that the general thresholds are an unemployment rate of 6.5% and/or expectations of 2.5% inflation. The timing of Fed tapering remains unclear, but we believe uncertainty about the country's longer-term fiscal policy will delay the unwinding of quantitative easing by the Federal Reserve until sometime next year. The next FOMC meeting is scheduled for December 17-18.

TREASURY YIELDS REMAIN VOLATILE IN OCTOBER



During the past three months, the yield curve flattened slightly, but rates experienced volatility during this time period. Economic data has been mixed and the timing of when the Fed will begin tapering its bond purchases is uncertain.

TREASURY YIELDS	10/31/2013	9/30/2013	CHANGE
3 Month	0.04	0.01	0.03
2 Year	0.31	0.32	(0.01)
3 Year	0.57	0.61	(0.04)
5 Year	1.33	1.38	(0.05)
7 Year	1.97	2.01	(0.04)
10 Year	2.56	2.61	(0.05)
30 Year	3.64	3.69	(0.05)

Source: Bloomberg

Economic Roundup

Consumer Prices
In September, overall CPI inflation rose to 1.2% on a year-over-year basis from 1.5% in August. The year-over-year Core CPI (CPI less food and energy) fell slightly to 1.7% from 1.8%. The core inflation rate is still 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 September, Retail Sales rose 3.2% on a year-over-year basis down from 4.6% in August. On a month-over-month basis, Retail Sales fell 0.1% in September which was slightly below the consensus forecast. At the core level (excluding autos and gas), retail sales rose 0.4% in September on a month-over-month basis.

Labor Markets
The October employment report was better than expected as payrolls rose by 204,000 versus the 120,000 consensus estimate. However, the unemployment rate edged up to 7.3% from 7.2%, reflecting a rise in temporary layoffs during the government shutdown. Net revisions for job growth in August and September were +60,000. Average nonfarm payroll growth over the past 3 months has been about 201,000. Private payrolls increased 212,000 in October while government jobs declined 8,000.

Housing Starts
Single-family housing starts rose 7.0% in August to 628,000 from 587,000 in July. Housing permits fell 3.8% in July. Recent housing data has been mixed but mostly favorable.

Credit Spreads Tightened

CREDIT SPREADS	Spread to Treasuries (%)	One Month Ago (%)	Change
3-month top-rated commercial paper	0.09	0.12	(0.03)
2-year A corporate note	0.54	0.60	(0.06)
5-year A corporate note	0.72	0.80	(0.08)
5-year Agency note	0.36	0.33	0.03

Source: Bloomberg Data as of 10/31/13

Economic Data Has Been Mixed

ECONOMIC INDICATOR	Current Release	Prior Release	One Year Ago
Trade Balance	(38.8) $Bln AUG 13	(38.6) $Bln JUL 13	(44.0) $Bln AUG 12
GDP	2.8% SEP 13	2.5% JUN 13	2.8% SEP 12
Unemployment Rate	7.3% OCT 13	7.2% SEP 13	7.9% OCT 12
Prime Rate	3.25% OCT 13	3.25% SEP 13	3.25% OCT 12
CRB Index	277.86 OCT 13	285.54 SEP 13	295.84 OCT 12
Oil (West Texas Int.)	$96.38 OCT 13	$102.33 SEP 13	$86.24 OCT 12
Consumer Price Index (y/o/y)	1.2% SEP 13	1.5% AUG 13	2.0% SEP 12
Producer Price Index (y/o/y)	0.3% SEP 13	1.4% AUG 13	2.1% SEP 12
Dollar/EURO	1.36 OCT 13	1.35 SEP 13	1.30 OCT 12

Source: Bloomberg

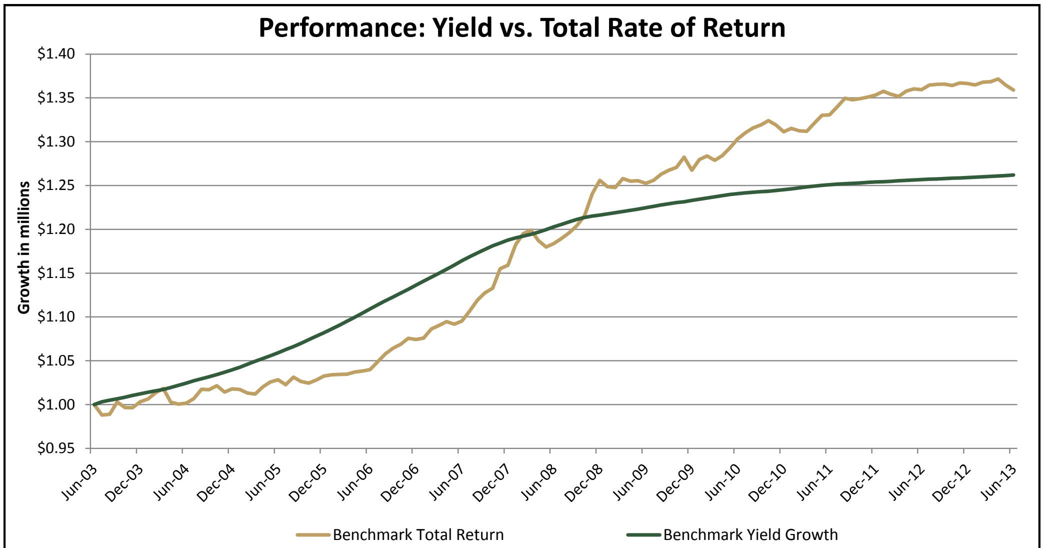
Picking the Right Tool to Measure Investment Performance

At Chandler, we specialize in working with clients who seek safety and liquidity foremost from their bond investments. In fact, public agencies we serve are often legally required to rank safety and liquidity ahead of investment yield when managing money on behalf of their constituents.

It's only natural, however, to fix attention on yield. Most of us have experience with yield because we've borrowed money for a car or a home, or because we've put money into savings with the expectation of receiving interest. If you invest in a one-year bank certificate of deposit, for example, you know that you'll receive a set interest rate, as long as you keep your money invested there for 12 months.

Once you know what your yield is likely to be, you can factor the expected cash flow into your budget, whether it's for running a household or a city government.

Comparisons to benchmarks are more than just report cards on investment managers. Ideally, they provide investment discipline and lead to critical questions about how and why a portfolio is performing as it is.



Source: Bank of America/Merrill Lynch 1-5 US Treasury & Agency Index. Performance is gross of any management or transaction fees. It is not possible to invest directly in an index. Past performance is not indicative of future results.

"Yield is very easy to understand," says Jayson Schmitt, CFA, Chandler Senior Vice President and Portfolio Manager. However, he adds, it's just one way to measure performance. Measures of a portfolio are "like tools in a toolbox. They are used for different things."

Ted Piorkowski, CFA, Senior Vice President and Portfolio Manager, says that while yield is an important part of a portfolio's performance, it is limited: "With yield, you don't know how your investment program is working."

For that reason, Chandler relies on an industry standard to measure portfolio performance, known as total rate of return. Total return is defined as interest paid plus capital appreciation, that is, the change in market price of a given security or portfolio. While most people associate changes in market price with stocks, bonds also vary in price as interest rates rise and fall. "Total return measures the value of the portfolio," says Schmitt. "It's about having all the pieces of the puzzle, not just one."

By calculating the total rate of return on the bond portfolios we manage over time, we can then compare them to industry standards, or benchmarks, that also measure performance using total rate of return. Market indices are commonly used as benchmarks. An index is an unmanaged basket of securities that has specific guidelines and aligns with an overall investment strategy. Financial institutions have created literally hundreds of indices, such as the stock market's widely known Dow Jones Industrial Average Index and S&P 500 Index.

We measure our investment performance against benchmarks that have characteristics similar to our portfolios. These characteristics include:

- Types of bonds, such as US Treasuries, US agencies or corporate securities;
- Creditworthiness, or ability to pay,
- Maturities, the length of time before the bonds are repaid, for example one to three years

We compare the Chandler Short Term Bond composite, our most commonly used investment style, to the Bank of America/Merrill Lynch 1-5 Year US Treasury and Agency Index because it reflects the level of risk and the types of bonds that our public agency clients are authorized to include in their portfolios. Comparisons to benchmarks are more than just report cards on investment managers. Ideally, they provide investment discipline and lead to critical questions about how and why a portfolio is performing as it is.

If the annual total return on a given portfolio is 5% while the benchmark is only 2%, that's not necessarily cause for celebration. It could be a sign that the portfolio is taking on relatively more risk by investing in bonds with longer maturities that exceed the limits set by an investment policy. Or the portfolio could be buying bonds whose issuers are relatively less creditworthy. There's nothing wrong with longer maturities or somewhat lower credit ratings per se, but there would be if the portfolio is veering off-course from its specified requirements.

Conversely, if a portfolio is consistently performing below the benchmark, that could mean the investments are too cautious, that clients are missing out on returns that their risk profiles permit. Those returns could help pay for additional government services or provide greater financial security. No one wants to leave money on the table and we certainly don't want that for our clients.

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>
> - Jayson Schmitt, SVP, Portfolio Manager

Comparing the total rate of returns in the portfolios that we manage to established benchmarks is a best practice that we discuss with our clients when they hire us, says firm founder Kay Chandler, CFA. This practice helps give structure and discipline to investment strategies, so that we can seek to control risks and meet objectives. Our goal, says Chandler, is "to try to have returns consistently better than the benchmark, without taking on more market risk."

- Ann Perry

Marketing & Communications Writer