CHANDLER ASSET MANAGEMENT

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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.

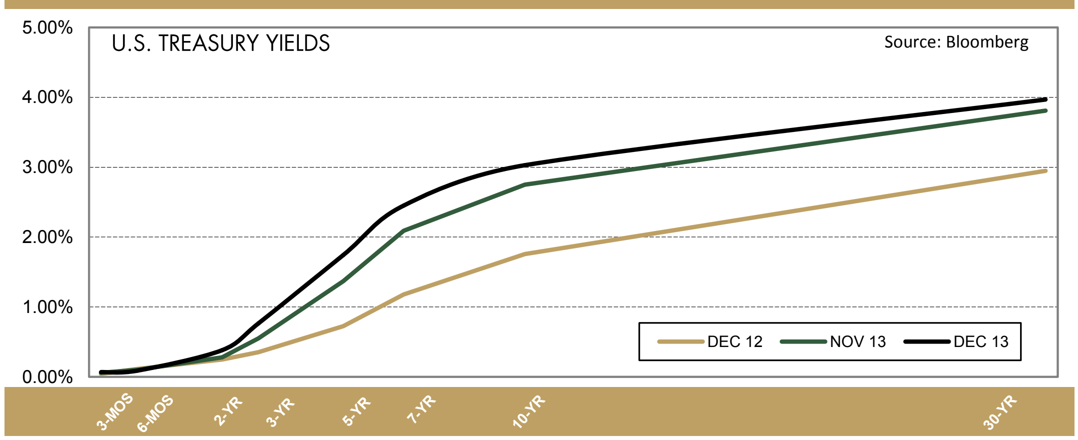
Market Summary

Overall, we believe the economy continues to be on a slow growth trajectory driven by modest ongoing improvement in the labor market. The December employment report was disappointing, but unfavorable weather may have been a contributing factor. Nonfarm payroll jobs grew just 74,000 in December (versus expectations of 200,000). Average nonfarm payroll growth during the fourth quarter of 2013 was about 172,000 per month, compared with average monthly growth of about 167,000 during the third quarter of 2013. The unemployment rate dropped to 6.7% in December from 7.0% in November, but the decline was largely driven by a decline in the labor force. The labor participation rate fell to 62.8% in December, matching the level in October which was the lowest since 1978. Meanwhile, manufacturing, housing, and consumer data has been mixed.

The FOMC began tapering its asset purchases by $10 billion (evenly split between Treasuries and MBSs) this month, after announcing the decision to begin tapering at the December FOMC meeting. The Fed continues to purchase MBSs at a pace of $35 billion per month (down from $40 billion) and longer-term Treasuries at a pace of $40 billion per month (down from $45 billion). The path toward winding down quantitative easing continues to be data dependent, and we believe the process of unwinding will likely continue at a steady pace throughout most of 2014. However, if the next labor report for January is equally as disappointing as December, it could raise questions about the path the Fed will take toward unwinding quantitative easing. The minutes from the December FOMC meeting indicated that there was already significant debate about the timing and pace of tapering. The next FOMC meeting will be held on January 28-29. Either way, we expect that the Fed will continue to support economic growth with low policy rates throughout the coming year.

Treasury yields have continued to be somewhat volatile, as market participants have reacted to economic data releases and speculation about the pace of the Fed's tapering.

TREASURY YIELDS REMAIN VOLATILE IN DECEMBER



During the past three months, the yield curve steepened with speculation about the timing of Federal Reserve's tapering, which was finally answered at the Fed's December meeting.

TREASURY YIELDS	12/31/2013	11/30/2013	CHANGE
3 Month	0.07	0.06	0.01
2 Year	0.38	0.28	0.10
3 Year	0.77	0.55	0.22
5 Year	1.74	1.37	0.37
7 Year	2.45	2.09	0.36
10 Year	3.03	2.75	0.28
30 Year	3.97	3.81	0.16

Source: Bloomberg

Economic Roundup

Consumer Prices
In November, overall CPI inflation rose slightly to 1.2% on a year-over-year basis from 1.0% in October. The year-over-year Core CPI (CPI less food and energy) was unchanged at 1.7%. 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 November, Retail Sales rose 4.7% on a year-over-year basis up from 4.1% in October. On a month-over-month basis, Retail Sales rose 0.7% in November, which exceeded the consensus forecast.

Labor Markets
The December employment report was weaker than expected as payrolls rose by just 74,000 versus the 200,000 consensus estimate. Unfavorable weather may have been a contributing factor. The unemployment rate declined to 6.7% from 7.0%, but the decline was largely driven by a drop in the labor participation rate. Net revisions for job growth in October and November were +38,000. Average nonfarm payroll growth during the fourth quarter 2013 was about 172,000 per month. Private payrolls increased by 87,000 in December while government jobs contracted by 13,000.

Housing Starts
Single-family housing starts jumped 20.8% in November after rising 3.8% in October. Housing starts have recently regained some momentum.

Credit Spreads Tightened

CREDIT SPREADS	Spread to Treasuries (%)	One Month Ago (%)	Change
3-month top-rated commercial paper	0.08	0.07	0.01
2-year A corporate note	0.55	0.56	(0.01)
5-year A corporate note	0.55	0.73	(0.18)
5-year Agency note	0.29	0.31	(0.02)

Source: Bloomberg Data as of 12/31/13

Economic Data Points to Slow Growth

ECONOMIC INDICATOR	Current Release	Prior Release	One Year Ago
Trade Balance	(34.3) $Bln NOV 13	(39.3) $Bln OCT 13	(46.4) $Bln NOV 12
GDP	4.1% SEP 13	2.5% JUN 13	2.8% SEP 12
Unemployment Rate	6.7% DEC 13	7.0% NOV 13	7.9% DEC 12
Prime Rate	3.25% DEC 13	3.25% NOV 13	3.25% DEC 12
CRB Index	280.17 DEC 13	274.88 NOV 13	295.01 DEC 12
Oil (West Texas Int.)	$98.42 DEC 13	$92.72 NOV 13	$91.82 DEC 12
Consumer Price Index (y/o/y)	1.2% NOV 13	1.0% OCT 13	1.8% NOV 12
Producer Price Index (y/o/y)	0.7% NOV 13	0.3% OCT 13	1.5% NOV 12
Dollar/EURO	1.37 DEC 13	1.36 NOV 13	1.32 DEC 12

Source: Bloomberg

The Volcker Rule: How It Could Affect the Corporate Bond Market

Paul Volcker Distilled

Paul Volcker, who served as Chairman of the Federal Reserve under Presidents Carter and Reagan, is credited with taming the high, double-digit inflation of the 1970s and early 1980s.

Known as the "Gentle Giant," he is 6-foot, 7-inches tall.

At age 85, he told the Britain newspaper The Telegraph in 2012, his big regret was that he wasn't five years younger so he could do more to reform financial systems: "If I was 80 again I would definitely take care of all this."

Volcker apparently has little regard for bankers or financial innovation. He is fond of saying, "The only useful banking innovation was the invention of the ATM."

A new federal regulation intended to prohibit banks from making speculative investments in the wake of the 2008 financial crisis, was enacted in December and will take effect starting April 1. Although the regulation, known as the Volcker Rule, was designed to make banks and the entire financial system more stable and transparent, some market analysts contend that it could lead to an array of unintended market consequences.

In particular, some believe that the Volcker Rule could affect the market for corporate bonds -- securities that are often used to positively affect yields in fixed income portfolios -- by decreasing liquidity and increasing trading costs.

We at Chandler are actively monitoring fixed-income markets for potential fall-out from the Volcker Rule and will be communicating our observations and insights. As part of this effort, we thought we'd start with a few Frequently Asked Questions:

How did the Volcker Rule come about?

The rule, named for former Federal Reserve Chairman Paul Volcker, is part of the Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010, the most significant financial reform passed since the Great Depression. The broad goal of Dodd-Frank is to protect taxpayers from financial institutions deemed "too big to fail."

The Volcker Rule, as a key component of Dodd-Frank, seeks to prevent banks with federally insured deposits from taking excessive risks by trading securities for their own profit. Volcker, who was appointed by President Obama to chair the President's Economic Recovery Advisory Board in 2009, championed the ban, saying that such speculation by banks contributed to the financial crisis. Other financial experts, however, have described their role as minor.

What took so long?

The three-year delay implementing the Volcker Rule is blamed on a combination of intensive lobbying by the financial industry and squabbling among the five regulatory agencies involved.

What does the Volcker Rule prohibit?

It bans banks, such as Bank of America, JPMorgan Chase, Citibank, Goldman Sachs and Morgan Stanley, from "proprietary trading," that is, trading conducted for their own gain rather than that of their customers. Specifically excluded from this ban, however, is trading of U.S. Treasuries and the bonds of government-backed agencies such as Fannie Mae and Freddie Mac.

In addition, the rule prohibits banks from holding any interests in hedge funds or private equity funds.

What does it permit?

The Volcker Rule allows securities trading intended to meet demand from customers. Just how banks will determine which trades are proprietary and which are for customers is unknown and likely to take years to unfold.

What effects could it have on the corporate bond market?

We believe that the market may experience:

- **Decreased liquidity** — With banks forced to act more as "agents" (having a willing buyer and seller on both sides of the transaction) and not as "principals" (effectively putting one side of the transaction on the bank's balance sheet), market liquidity will decrease in our opinion. Credit market liquidity has already declined since the onset of the financial crisis in anticipation of the rule's requirements that banks hold fewer securities and hold only those of high quality. As the Volcker Rule takes hold (full compliance takes effect July 21, 2015), banks will have even less incentive to maintain a large inventory of bonds, thereby shrinking inventories.

- **Higher trading costs** — Bid/ask spreads, the difference between the price a buyer is willing to pay and the price a seller is willing to sell, will likely widen as dealers hold less inventory. In particular, the cost of trading seasoned bonds (those issued more than one year ago) could increase as dealers and investors seek to be compensated for the decrease in liquidity due to the length of time passed since issuance. Investors who trade portfolios less frequently could incur higher costs, because such portfolios are more likely to have more seasoned bonds that could over time become more expensive to trade.

- **Shifting trade platforms** — Investors are adapting to the changing market by trading directly with one another using third-party platforms such as MarketAxess. Such peer-to-peer trading requires a thorough understanding of market dynamics on a continuous basis. The process is time consuming, as investors need to "wait out" willing buyers and/or sellers rather than have a bank act as an intermediary.

- **Greater volatility** — Markets may become more volatile at turning points as dealers have little incentive to keep markets orderly when market sentiment changes. While such volatility might prove difficult for investors who trade infrequently, it could benefit full time investors who understand the risks and opportunities.

These predictions are preliminary. The full effects of the Volcker Rule are as yet unknown and will likely take years to play out. It's also important to keep in mind that the aim of the rule is to create less risk in the markets. One thing is certain: We will watch the markets carefully and keep you updated on the Volcker Rule as needed throughout the year.

- Ann Perry

Marketing & Communications Writer

"The full effects of the Volcker Rule are as yet unknown..."

RISKS AND OTHER IMPORTANT CONSIDERATIONS

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.