CHANDLER ASSET MANAGEMENT

March 2014

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.

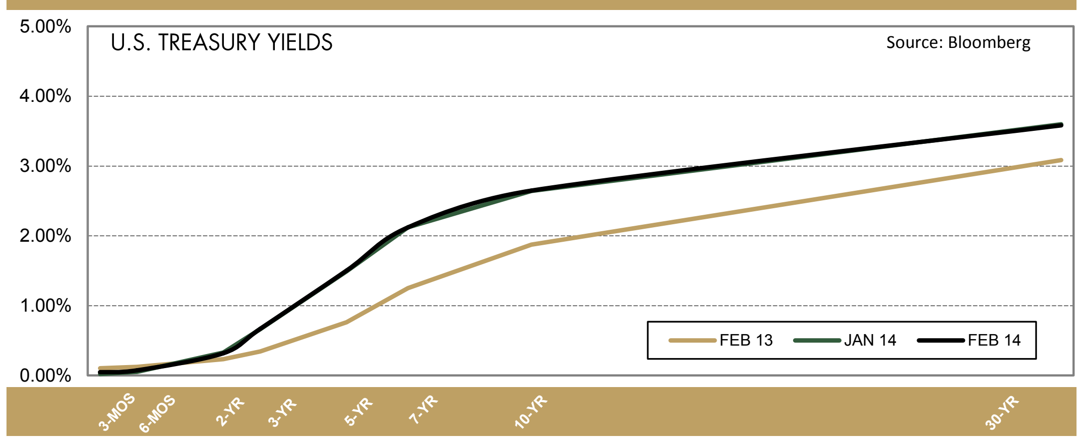
Market Summary

Harsh winter weather has skewed some of the recent economic data, but we believe the economy continues to grow at a slow pace. In spite of the weather, the February employment report was stronger than expected. Nonfarm payroll jobs grew by 175,000 in February, versus expectations of 150,000. Private payrolls grew by 162,000 and government jobs grew by 13,000. Although payrolls were stronger than expected, the unemployment rate rose to 6.7% in February from 6.6% in January, driven by new entrants to the labor force. Wage growth rose 0.4%. The weather continued to be unusually severe during the month of February, so we believe the underlying trend in employment may be stronger than the past few months of payroll data suggest. Meanwhile, manufacturing, housing, and consumer data has been mixed. We expect economic data to improve in the spring and hope to get a better read on underlying economic trends as the weather normalizes.

We believe the February employment report was more than strong enough to keep the Fed on track with tapering its asset purchases. The next FOMC meeting will be held on March 18-19, at which time we expect the Fed will announce another $10 billion reduction in asset purchases. At its January 28-29 meeting, the FOMC announced that it would trim its asset purchases in February to a pace of $30 billion per month in MBSs and $35 billion per month in longer-term Treasuries. We believe the process of unwinding will likely continue at a steady pace throughout 2014, and that the trajectory of economic growth would have to deteriorate meaningfully for the Fed to change course.

The yield on the two-year Treasury note decreased in February, driven by weaker domestic economic data coupled with fears about emerging markets and currencies which has been fueling a flight to quality.

TREASURY YIELDS REMAIN VOLATILE IN FEBRUARY



During the past three months, the Treasury yield curve has flattened even as the Fed has been tapering its purchases of long-term Treasury bonds. Market participants have reacted to weaker domestic economic data (unfavorable winter weather is likely at least partially to blame), as well as fears about emerging market currencies which has fueled a flight to quality.

TREASURY YIELDS	2/28/2014	1/31/2014	CHANGE
3 Month	0.05	0.02	0.03
2 Year	0.32	0.33	(0.01)
3 Year	0.67	0.67	0.00
5 Year	1.50	1.49	0.01
7 Year	2.12	2.12	0.00
10 Year	2.65	2.65	0.00
30 Year	3.58	3.60	(0.02)

Source: Bloomberg

Economic Roundup

Consumer Prices
In January, overall CPI inflation rose to 1.6% on a year-over-year basis from 1.5% in December. The year-over-year Core CPI (CPI less food and energy) declined to 1.6% in January from 1.7% in December. 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 January, Retail Sales rose 2.6% on a year-over-year basis versus up 3.6% in December. On a month-over-month basis, Retail Sales excluding autos and gas fell 0.2% in January which was below the consensus forecast of +0.2%. Adverse weather likely hindered retail sales during the month.

Labor Market
The February employment report was stronger than expected as payrolls rose by 175,000 versus the 150,000 consensus estimate. Net revisions for job growth in January and December were +25,000. Private payrolls increased by 162,000 in February and government jobs increased by 13,000. Although payrolls were stronger than expected in February, the unemployment rate rose to 6.7% from 6.6% in January, driven by new entrants to the labor force.

Housing Starts
Single-family housing starts fell 16.0% in January after falling 4.0% in December. Unfavorable weather may have been at least partially to blame for the declines.

Credit Spreads Tightened

CREDIT SPREADS	Spread to Treasuries (%)	One Month Ago (%)	Change
3-month top-rated commercial paper	0.08	0.11	(0.03)
2-year A corporate note	0.48	0.51	(0.03)
5-year A corporate note	0.54	0.59	(0.05)
5-year Agency note	0.24	0.27	(0.03)

Source: Bloomberg   Data as of 2/28/14

Unfavorable Weather Has Impacted Economic Data

ECONOMIC INDICATOR	Current Release	Prior Release	One Year Ago
Trade Balance	(39.1) $Bln JAN 14	(39.0) $Bln DEC 13	(42.1) $Bln JAN 13
GDP	2.4% DEC 13	4.1% SEP 13	0.1% DEC 12
Unemployment Rate	6.7% FEB 14	6.6% JAN 14	7.7% FEB 13
Prime Rate	3.25% FEB 14	3.25% JAN 14	3.25% FEB 13
CRB Index	302.43 FEB 14	283.31 JAN 14	292.95 FEB 13
Oil (West Texas Int.)	$102.59 FEB 14	$97.49 JAN 14	$92.05 FEB 13
Consumer Price Index (y/o/y)	1.6% JAN 14	1.5% DEC 13	1.6% JAN 13
Producer Price Index (y/o/y)	1.5% JAN 14	1.2% DEC 13	1.5% JAN 13
Dollar/EURO	1.38 FEB 14	1.35 JAN 14	1.31 FEB 13

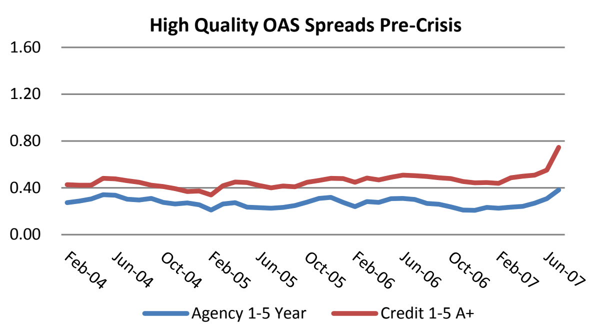
Source: Bloomberg

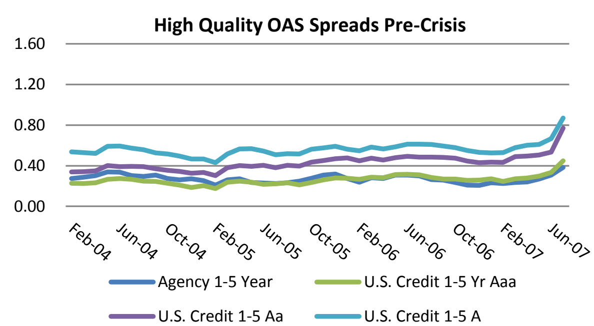
Short Maturity Corporate Notes—Worth the Risk?

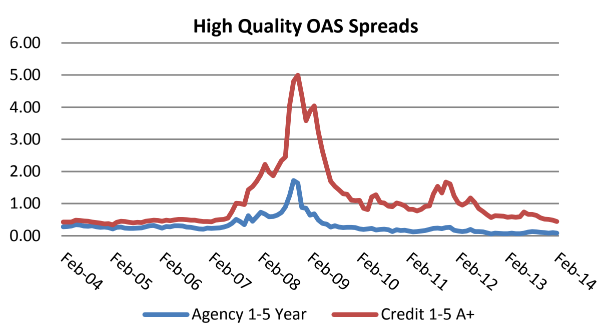
The US Corporate bond market has rewarded investors over the past few years, and the team at Chandler wanted to take a step back and evaluate the Corporate sector from a quantitative perspective. Broad sector spread differentials between the financial and industrial sectors have dissipated, driven partly by improvement in bank sector balance sheets and the overall trajectory of the US economy. The financial sector is no longer materially dislocated from the industrial sector, a large positive for the economic recovery, as banks are now able to provide disintermediation to lower rated Corporate entities. The dramatic improvement in spreads has come about in the face of a lackluster economic recovery and some investors are starting to question the overall risk and return characteristics of the high quality investment grade market.

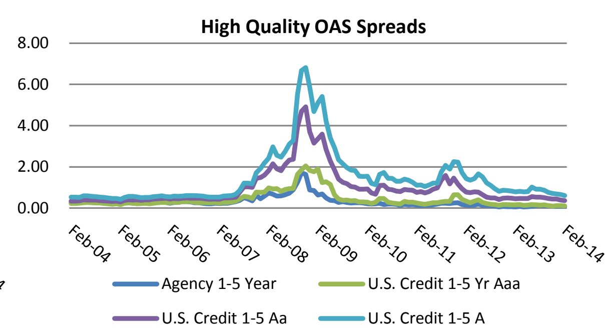
Many classes of investors appear to be tactically allocating assets to the short maturity spectrum of the investment grade market in anticipation of the Federal Reserve tightening traditional monetary policy sometime in 2015 or later. The Federal Reserve commenced removing some of the extraordinary accommodation to help stimulate the US economy and is approximately 25% complete with the "tapering" of the asset purchase program. We expect the tapering process to be complete early in the 4th quarter of this year, however, we (and the market) are less certain as to when and to what magnitude traditional monetary policy will be adjusted to be less accommodative. The uncertainty regarding the change to traditional monetary policy is leading investors to gravitate to shorter maturity assets in Chandler's view.

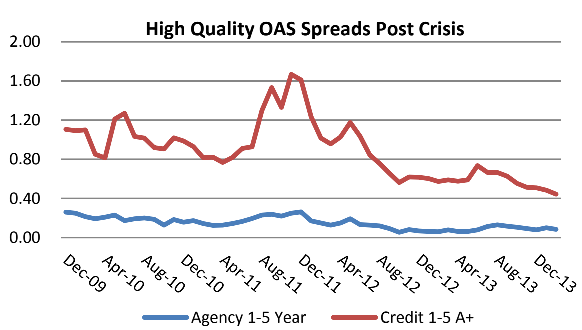
In order to better ascertain the relative value of short maturity high quality spreads we broke down the sector components of the Barclays 1-5 year Indices between Agency and Credit securities, A rated or better. We also broke down the A or better Credit index into 'AAA', 'AA', and 'A' rated cohorts to better understand the changes that have taken place over the past decade. The data is grouped into pre- and post-crisis periods, and contains a snapshot of the entire period as well, to better understand the potential volatility of spreads and to illustrate past periods when spreads were very low and contained for long stretches of time. We utilized monthly Option Adjusted Spread (OAS) data from the Barclay's family of indices starting in February 2004 and ending February 2014. The data is displayed in graphical form (below) as well as in a table (back page) to help validate our analysis. The scale on the charts was kept the same in the pre-crisis (February 2004 to July 2007, top two charts) and post-crisis (December 2009 to present, bottom two charts) to better demonstrate some of the relative value differentials between the various credit quality tiers under evaluation. The two middle charts, depicting the entire 10 year spread history, have a scale all their own. The spread widening during the crisis was so severe and unprecedented that it should serve as a deterrent from becoming too complacent regarding the potential risks in all investment grade sectors.

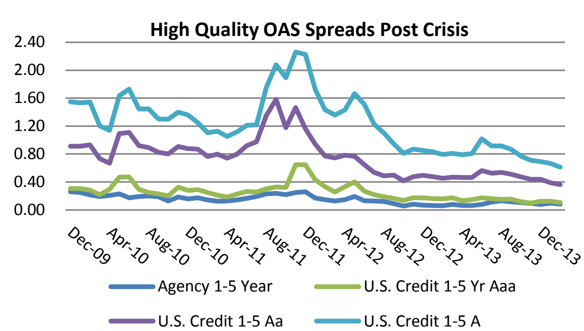












Source: Barclay's Live

Relative Value Matrix - Option Adjusted Spreads (OAS)					
	Agency 5 Year	1- Credit 5 A+	1- US Credit 1-5 Yr Aaa	US Credit 1-5 Aa	US Credit 1-5 A
Pre Crisis (February 2004 - July 2007)					
Max	0.38	0.74	0.45	0.77	0.87
Min	0.21	0.34	0.17	0.30	0.43
Average	0.27	0.46	0.26	0.43	0.56
Median	0.27	0.45	0.26	0.43	0.56
Std Dev	0.04	0.06	0.05	0.08	0.07
Terminal (Jul 07)	0.38	0.74	0.45	0.77	0.87
Entire Period (February 2004 - February 2014)					
Max	1.71	5.00	2.05	4.92	6.81
Min	0.05	0.34	0.10	0.30	0.43
Average	0.31	1.09	0.43	0.98	1.46
Median	0.25	0.76	0.27	0.56	1.05
Std Dev	0.27	0.97	0.40	0.90	1.31
Current (Feb 14)	0.08	0.44	0.11	0.36	0.61
Post Crisis (December 2009 to February 2014)					
Max	0.26	1.67	0.65	1.58	2.26
Min	0.05	0.44	0.10	0.36	0.61
Average	0.15	0.89	0.25	0.75	1.23
Median	0.14	0.85	0.23	0.76	1.21
Std Dev	0.06	0.30	0.12	0.29	0.41
Current (Feb 14)	0.08	0.44	0.11	0.36	0.61

Source: Barclay's Live

The post-crisis charts effectively illustrate the 1-5 year Agency index has an OAS that is very aggressive. Qualitatively this makes sense to us as both Fannie Mae and Freddie Mac remain under conservatorship and are essentially a liability of the US Treasury Department. Additionally, despite the continued efforts of various constituencies within the US Government, the likelihood of Fannie Mae and Freddie Mac becoming quasi public/private entities again is very low in our estimation. Agency index OAS valuations reflect both the very high credit quality and scarcity value of the sector as both Fannie Mae and Freddie Mac are being forced to shrink as part of the conservatorship agreement.

The 1-5 year Credit A or better index has clearly performed well in the post-crisis period (see charts) and remains more attractively valued than the pre-crisis period, which we view as a positive for the credit sector. The current OAS of 0.44 is the tightest valuation in the post-crisis period but 0.10 wide of the all time tight valuation of 0.34. In light of the demand for spread securities, particularly in shorter maturity assets, as well as the improvement in corporate balance sheets and fundamentals since the financial crisis, we think the overall valuation of the 1-5 Year Credit A or better index is fair. We are however concerned about the current valuation in the two highest rated cohorts within the 1-5 Year Credit A or better index.

Focusing on the post-crisis period the 'AAA' rated cohort currently has an OAS of 0.11, only 1 basis point away from the all time lowest level of 0.10 and just 0.03 greater than the average Agency OAS. In our estimation, the average spread is too tight and does not provide any cushion for the possibility of deteriorating fundamentals which could lead to OAS widening and subsequent underperformance. The current OAS valuation for the 'AA' cohort is also on the expensive side but at least appears to offer investors some form of compensation in excess of the Agency sector with a current OAS of 0.36 versus 0.08 for the Agency sector. The current valuation is the tightest since the post-crisis period but is also 6 bps wider versus the all time OAS tight level of 0.30.

The A rated cohort, with a current valuation of 0.61 OAS appears more appropriate in light of the currently yield starved investing environment and earlier mentioned improvement in corporate fundamentals. Investors need to keep in mind the possibility that some of the credits represented in this group have the potential to improve their underlying credit quality over the investment horizon, potentially providing some form of spread tightening relative to the overall investment universe represented in the graphs and tables. The higher rated cohorts don't have this opportunity and thus could be looked at as having an extra element of risk as the distribution of the spread movement is skewed to stay the same or move wider as spreads are unlikely to trade at negative spreads versus Treasury notes.

At Chandler, we continuously focus on managing risk on behalf of our clients. A strong investment culture focusing on identifying both improving credits to add to portfolios and deteriorating credits to remove from portfolios is a key prerequisite to utilizing the credit asset class. A well diversified portfolio across sectors, maturities, and credit quality is required in order to navigate the challenging investing environment. For those investors with the risk tolerance to invest in the credit sector, we think the better opportunities exist in 'A' rated securities and would urge extra caution when purchasing securities with excellent fundamentals but little spread compensation for the risk of not owning a risk-free Treasury security.

- William Dennehy II, CFA
SVP, Portfolio Manager

RISKS AND OTHER IMPORTANT CONSIDERATIONS