January
2012

Chandler Asset Management

Investing High Quality Portfolios in a Low Interest Rate Environment

Chandler Asset Management

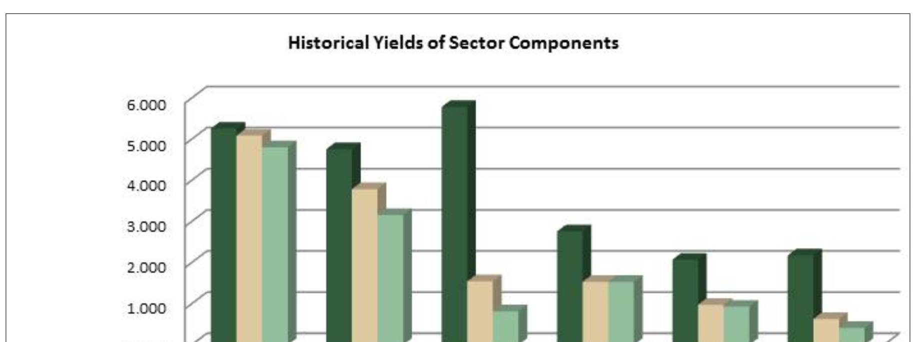
Since 1988, Chandler Asset Management has specialized in the management of fixed income portfolios.

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

The asymmetric risk profile for fixed income investors is a challenge compounded by the low interest rate environment employed by the Federal Reserve. The Federal Funds rate, the primary tool used by the Federal Reserve to implement monetary policy, has been set at a range of 0.00% - 0.25% since December 2008. In an effort to encourage investors to invest in assets outside of ultra-safe, high quality, short maturity government securities, the Federal Reserve has stated it expects to maintain exceptionally low interest rates until at least mid-2013, 18 months from now. Despite the subtle strengthening in domestic economic data, the global economic backdrop remain uncertain, in particular the sovereign debt issues facing Europe. Current levels of two-, five-, and ten-year U.S. Treasury securities imply monetary policy will remain highly accommodative beyond midyear 2013.

Although the Federal Reserve attempts to be agnostic when it comes to politics and avoid picking "winners and losers," fixed income investors might feel otherwise. Short maturity investments in U.S. Treasury and Agency securities are well below the annualized core inflation rate which was 2.2% as of November 2011. Multiple factors outside of U.S. monetary policy are contributing to the low rate environment. The supply of short maturity fixed income securities away from the market for U.S. Treasury securities is persistently shrinking as consumers and banks continue to deleverage. Both Fannie Mae and Freddie Mac remain under "conservatorship" with a mandate to continue to contract, in turn reducing supply of a highly rated asset class for conservative investors. Additionally, all of the global angst and uncertainty has created international demand for deep and transparent markets like US dollar based assets, further depressing yields.

Fixed income investors that depend on their bond portfolios to generate a certain level of income on a year over year basis continue to face challenges. The annual income currently generated is much lower than historical norms. Investors who require a higher level of income from their portfolio are left to adjust two primary risk levers in order to increase the total return potential of a portfolio. Invest in securities with longer maturities and/or take additional credit risk, both of which at the outset appear to be tenuous. Prior to the financial crisis, interest rates in the US Treasury two-, three-, and five-year securities easily outpaced core inflation. One could argue the additional yield available in the credit sector was not necessarily compelling enough to warrant the additional risk (see chart) given an investment mandate of principal preservation and liquidity, with yield being the third consideration.



	12/31/06	12/31/07	12/31/08	12/31/09	12/31/10	12/31/11
Credit 1-5 yrs A-AAA	5.259	4.757	5.784	2.757	2.071	2.174
Agencies 1-5 yrs	5.087	3.785	1.544	1.533	0.975	0.629
US Treasury 1-5 yrs	4.803	3.158	0.814	1.531	0.929	0.413

Source: Bloomberg / Bank of America Merrill Lynch Global Bond Indices

6225 Lusk Boulevard
San Diego, CA 92121
(800) 317-4747
www.chandlerasset.com

The chart highlights the total universe of each asset class in the 1-5 year maturity range and the yields available on a historical market weighted basis. At the December 2006 data point the additional yield benefit offered by the Credit sector was not terribly compelling. Looking ahead to year-end 2008, when the financial crisis was in full swing, most investors were predominately concerned about return "OF" principal, not return "ON" principal, thus the severe dislocation between the Credit universe and the Agency and Treasury universe.

Today, despite corporate balance sheets being much stronger on multiple metrics than prior to the financial crisis, the yield pick up offered in the Credit sector is very favorable.

> Although the domestic economic recovery to date is not robust, there is some underlying momentum in the US economy.

The Federal Reserve is artificially depressing interest rates and we have a difficult time identifying a catalyst to materially move Treasury rates higher in the short to intermediate term. Unfortunately for bond market investors longer term interest rates already reflect this reality. In market parlance we would say low Treasury yields are "priced in" to market valuations. At Chandler we are forecasting interest rates to remain stable looking out over an intermediate time horizon. Although the domestic economic recovery to date is not robust there is some underlying momentum in the US economy. The national unemployment rate recently ticked down to 8.5% compared to 9.4% a year earlier. Domestic corporate balance sheets are strong and many companies have become more conservative in the management of their finances since the onset of the financial crisis, a positive for investors investing in corporate fixed income securities. When looking at the opportunities available for investors in the high quality sectors of the fixed income market highlighted in the chart, credit sector valuations look attractive in the current low rate environment.

Investing in the credit sector of the market requires as independent credit review process. It is simply not enough to rely on the rating agencies to determine whether an investment is appropriate for a high quality portfolio. At Chandler we like to think of the rating agencies as defining the investment opportunity set for a given level of risk but having minimal influence on whether or not an investment is appropriate for a portfolio under our purview. An internal, independent, and robust investment process to evaluate new corporate securities and continually monitor existing positions to ensure they remain an appropriate investment is required. Provided the team managing your fixed income assets is equipped to effectively analyze the corporate sector of the market we think investors should be scrutinizing this sector of the market to identify attractively valued securities to enhance the total return opportunity for a given level of risk.

William Dennehy, CFA
Vice President, Portfolio Manager

Bill Dennehy recently joined Chandler Asset Management as a portfolio manager, responsible for implementing portfolio strategy and securities trading in client accounts.

Prior to joining Chandler, Mr. Dennehy worked at Northern Trust Global Investments in Chicago, most recently as senior portfolio manager and vice president, with a wide range of responsibilities in asset allocation, quantitative and qualitative analysis.

Mr. Dennehy earned his B.S. in Business Administration, option in finance, at California State University, Chico. He is a holds the designation of Chartered Financial Analyst.

RISKS AND OTHER IMPORTANT CONSIDERATIONS

This report is provided for general information purposes only and should not be construed as specific legal, tax, or financial planning advice. All opinions and views constitute judgments or relevant information as of the date of writing and such information may become outdated or superseded at any time without notice. This report is not intended to constitute an offer, solicitation, recommendation or advice regarding any securities or investment strategy. This information should not be regarded by recipients as a substitute for the exercise of their own judgment. 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.