Chandler Asset Management

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

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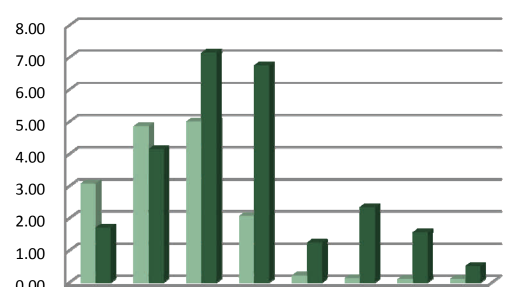
Since 1988, Chandler Asset Management has specialized in the management of fixed income portfolios.

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

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.

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.

Annualized Return Comparison*



	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

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

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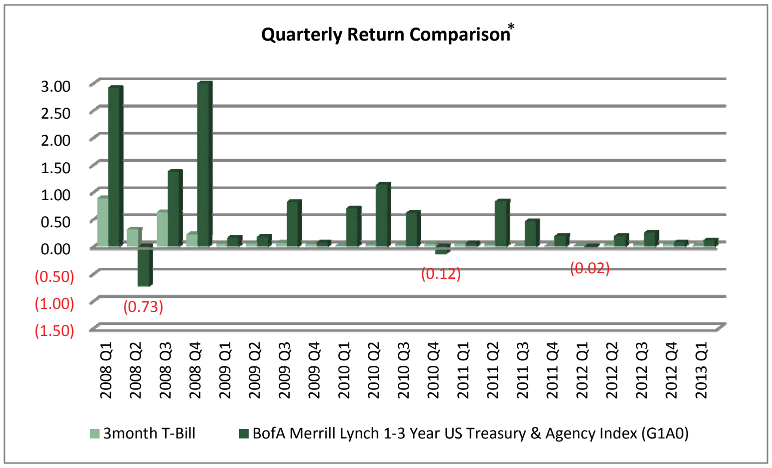
Graph Source: US Treasury and Band of America Merrill Lynch management culture can help to mitigate the 'negatives' of a short duration strategy compared to a money market fund. The benefits to investors using a short duration mandate as part of the overall liquidity strategy can provide more stability 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 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.

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

William Dennehy is a senior vice president and portfolio manager at Chandler Asset Management. He is responsible for implementing portfolio strategy and securities trading in client accounts and leads the Credit Committee.

*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.

Graph Source: US Treasury and Band of America Merrill Lynch

RISKS AND OTHER IMPORTANT CONSIDERATIONS
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