CHANDLER ASSET MANAGEMENT

October 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.

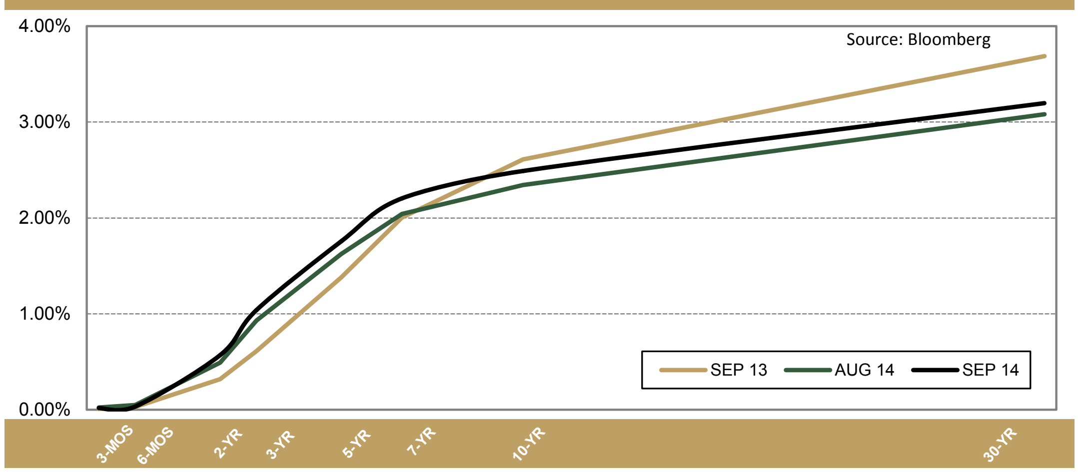
Market Summary

The economy remains on a slow growth trajectory, fueled by job growth. The September employment report was better than expected as payrolls rose by 248,000 versus expectations of 215,000. The unemployment rate declined to 5.9% from 6.1%, but wage growth and the labor participation rate remained weak. The manufacturing sector continues to be strong, with the ISM manufacturing index at 58.6 in September. Consumer spending also remains healthy, and ongoing job growth should support this trend. Housing, on the other hand, has shown the most volatility and is lagging behind other sectors of the economy.

In September, the Federal Open Market Committee left policy rates unchanged and continued to reduce asset purchases, as expected. The Fed noted inflation is running below target, signaling their ongoing capacity to keep interest rates low. More recently, the stronger than expected September employment report gives hawkish Fed members a compelling argument for raising interest rates. However, we believe the majority of FOMC voting members are dovish and will be reluctant to raise rates before the economy is on a sustainable growth path. We continue to believe the Fed isn't likely to start raising rates until the second half of 2015. However, the Fed may remove the "considerable period" language from its next statement. The Fed remains on course to complete the unwinding of quantitative easing this month and the next FOMC meeting is scheduled for October 28-29.

The yield on the two-year Treasury note increased in September, following a modest decline in August. The unwinding of quantitative easing, favorable economic data, and the anticipation of a potential fed funds rate hike next year have put upward pressure on rates, but this has been somewhat offset by geopolitical tensions and sluggish economic growth in Europe.

THE YIELD CURVE FLATTENED IN SEPTEMBER



During the past three months, the yield curve has flattened. Favorable domestic economic data and the anticipation of a potential fed funds rate hike have put upward pressure on shorter rates, while mixed global economic data and geopolitical tensions have kept downward pressure on longer yields.

TREASURY YIELDS	9/30/2014	8/31/2014	CHANGE
3 Month	0.02	0.02	(0.00)
2 Year	0.57	0.49	0.08
3 Year	1.04	0.93	0.11
5 Year	1.76	1.63	0.13
7 Year	2.20	2.04	0.16
10 Year	2.49	2.34	0.15
30 Year	3.20	3.08	0.12

Source: Bloomberg

Economic Roundup

Consumer Prices
In August, overall CPI inflation was 1.7% on a year-over-year basis down from 2.0% in July. The year-over-year Core CPI (CPI less food and energy) declined to 1.7% in August from 1.9% in July.

Retail Sales
In August, Retail Sales rose 5.0% on a year-over-year basis versus a gain of 4.2% in July. On a month-over-month basis, Retail Sales were up 0.6% in July, which was in line with expectations. Overall, Retail Sales appear healthy, but not robust.

Labor Market
The September employment report was stronger than expected as nonfarm payrolls rose by 248,000, following gains of 180,000 and 243,000 in August and July, respectively. The consensus forecast for September was 215,000. The net revisions for August and July were +69,000. For the third quarter, payrolls rose 224,000 per month, on average, compared to average growth of 267,000 per month during the second quarter. Private payrolls rose by 236,000 in September while government jobs rose by 12,000. The unemployment rate declined to 5.9% from 6.1%, but the participation rate also ticked down to 62.7% from 62.8%. Wage growth was flat in September, missing expectations for a 0.2% gain.

Housing Starts
Recent housing data has been volatile. Single-family housing starts declined 2.4% in August to 643,000 following an 11.1% gain in July. Multifamily starts declined 31.7% in August after increasing 44.9% in July.

Credit Spreads Widened

CREDIT SPREADS	Spread to Treasuries (%)	One Month Ago (%)	Change
3-month top-rated commercial paper	0.14	0.11	0.03
2-year A corporate note	0.50	0.44	0.06
5-year A corporate note	0.54	0.45	0.09
5-year Agency note	0.05	0.16	(0.11)

Source: Bloomberg Data as of 9/30/2014

Economic Data Remains Indicative of Modest Growth

ECONOMIC INDICATOR	Current Release	Prior Release	One Year Ago
Trade Balance	(40.1) $Bln AUG 14	(40.3) $Bln JUL 14	(39.5) $Bln AUG 13
GDP	4.6% JUN 14	(2.1)% MAR 14	1.8% JUN 13
Unemployment Rate	5.9% SEP 14	6.1% AUG 14	7.2% SEP 13
Prime Rate	3.25% SEP 14	3.25% AUG 14	3.25% SEP 13
CRB Index	278.55 SEP 14	292.75 AUG 14	285.54 SEP 13
Oil (West Texas Int.)	$91.16 SEP 14	$95.96 AUG 14	$102.33 SEP 13
Consumer Price Index (y/o/y)	1.7% AUG 14	2.0% JUL 14	1.5% AUG 13
Producer Price Index (y/o/y)	2.3% AUG 14	2.9% JUL 14	1.3% AUG 13
Dollar/EURO	1.26 SEP 14	1.31 AUG 14	1.35 SEP 13

Source: Bloomberg

Supranational Securities: A Panacea for California Code?

At Chandler Asset Management we think it is imperative to review risk tolerance, liquidity needs, and return objectives of the overall investment policy of a program on a regular basis. This year, the annual review process takes on a heightened importance as California Code is expanding the list of eligible investments. In an effort to broaden the types of high quality securities available to investors who follow California Government Code new legislation has been passed, effective January 1, 2015, to allow for investments in Washington DC based Supranational securities. The Supranational asset class has a long history and is imbedded within the Yankee or non corporate component of credit index benchmarks. A Supranational is a multi-national organization whereby member states transcend national boundaries or interests to share in the decision making to promote economic development in the member countries. The statue and a descriptive table are listed below.

Assembly Bill 1933 section 53601 (q): *United States dollar denominated senior unsecured unsubordinated obligations issued or unconditionally guaranteed by the International Bank for Reconstruction and Development, International Finance Corporation, or Inter-American Development Bank, with a maximum remaining maturity of five years or less, and eligible for purchase or sale within the United States. Investments under this subdivision shall be rated "AA" or better by an NRSRO and shall not exceed 30 percent of the agency's moneys that may be invested pursuant to this section.*

decreased yields, relative to the Treasury asset class, in both bullet and callable structures. The focus of our analysis is on index eligible bonds (250m in par or greater outstanding), but the conclusions regarding valuations and liquidity, in our view, are concurrent regardless of whether the security is index eligible or not. The opportunity set of investments in the Agency asset class has declined materially and the Agency asset class is likely to continue to have a modest presence in broad fixed income indices going forward. Both Fannie Mae and Freddie Mac remain under conservatorship and are mandated by their regulator, the Federal Housing Finance Agency (FHFA), to continue to reduce their size and impact on the residential mortgage market. Over the past several years, the US Congress has introduced numerous bi-partisan bills to transform Fannie Mae and Freddie Mac, but no material progress has been made. In Chandler's opinion, the FHFA will only make small adjustments to the current operations of Fannie Mae and Freddie Mac and the long-term direction of respective Agencies will be determined by the next presidential administration, at the earliest.

Investors beholden to California Code should consider utilizing all the asset classes eligible under California Code consistent with their individual risk tolerance or be resigned to a portfolio that has a higher percent allocation to the US Treasury sector versus historical norms. We think an investment in the Supranational asset class is very consistent with the overriding theme of safety,

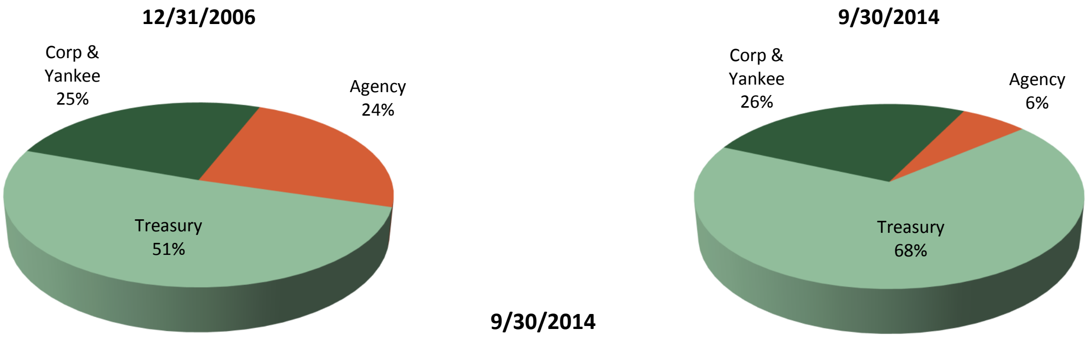
Name	Ticker	Part of World Bank Group	Ownership	Mission	Rating
Inter-American Development Bank	IADB	No	48 Member Countries	Lending operations in the agricultural, energy, and transportation industries	Aaa / AAA / AAA
International Bank for Reconstruction and Development	IBRD	Yes	188 Member Countries	Loans to middle-income developing and low-income countries	Aaa / AAA / AAA
International Finance Corporation	IFC	Yes	184 Member Countries	Lending to the private sector in developing countries	Aaa / AAA

The team at Chandler has highlighted over the past several years the impact of the contracting Agency sector from a safety, liquidity, and yield perspective (*see our Newsletters from: March 2014: Short Maturity Corporate Notes – Worth the Risk? October 2013: An Investors Perspective on the Contracting Agency Sector, and January 2012: Investing High Quality Portfolios in a Low Interest Rate Environment*). The contracting supply of the Agency sector has pushed up prices and

liquidity, and yield, and would encourage all investors to consider adopting language consistent with Assembly Bill 1933 Section 53601 (q). In Chandler's opinion, the underlying credit quality of the three new issuers highlighted in the table above is very strong. The Supranational entities becoming eligible within California Code, as of the beginning of the year, are part of the Yankee sub sector within the credit universe of the

Source: Bloomberg

Market Value Weight
1-5 Year, Treasury, Agencies, and Corporate & Yankee A-AAA Index



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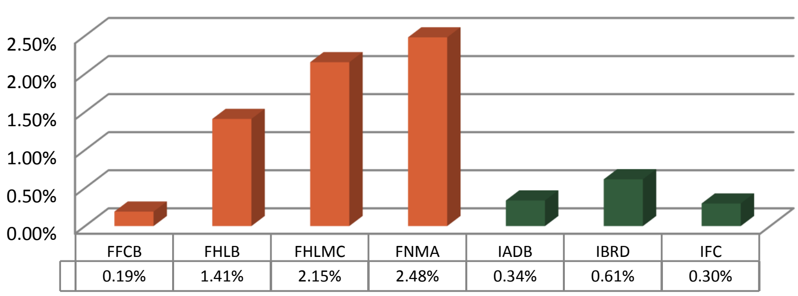

Bank of America Merrill Lynch Family of indices. The aggregate market weight of the three issuers within the Corporate & Yankee portion of the 1-5 year index is 4.9%, whereas the largest Agency issuers (Fannie Mae, Freddie Mac, Federal Home Loan Bank, and the Federal Farm Credit Bank) make up 95.8% of the Agency 1-5 year index. The percentage weights are heavily diluted down when looking at the combined 1-5 year index (see above bar chart). We take some comfort in the larger allocation of Fannie Mae, Freddie Mac, and Federal Home Loan Bank within the Agency only index (see orange slices in above pie charts), where they make up 38.1%, 33.1%, and 21.7%, respectively, despite the 6% weight in the overall 1-5 Year benchmark.

Although California Code will allow a total allocation of 30% of a portfolio into the Supranational asset class, Chandler would advocate for a more modest allocation to the sector. In our view, given the 'footprint' of the respective securities in the sub and aggregate indices represented in the graphs above, we are correlating Supranational securities with a very high quality Corporate issuer, as opposed to an Agency security. We would limit the total exposure to each of the Supranational entities to be consistent with the maximum exposure to the highest quality Corporate issuer within an investment policy. For example, if the maximum exposure for a 'AA' rated Corporate issuer is 5% in an investment policy, a similar maximum exposure would be appropriate for a Supranational entity. At Chandler, we are pleased to see the modest expansion of eligible securities within California Code, but do not view the addition as a 'panacea' to offset the well documented contraction of the Agency sector.

- William Dennehy II, CFA
SVP, Portfolio Manager

Source: Bank of America Merrill Lynch 1-5 Year Treasury, Agency, and US Corporate and Yankee Index