

BOND MARKET REVIEW

A MONTHLY REVIEW OF
FIXED INCOME MARKETS



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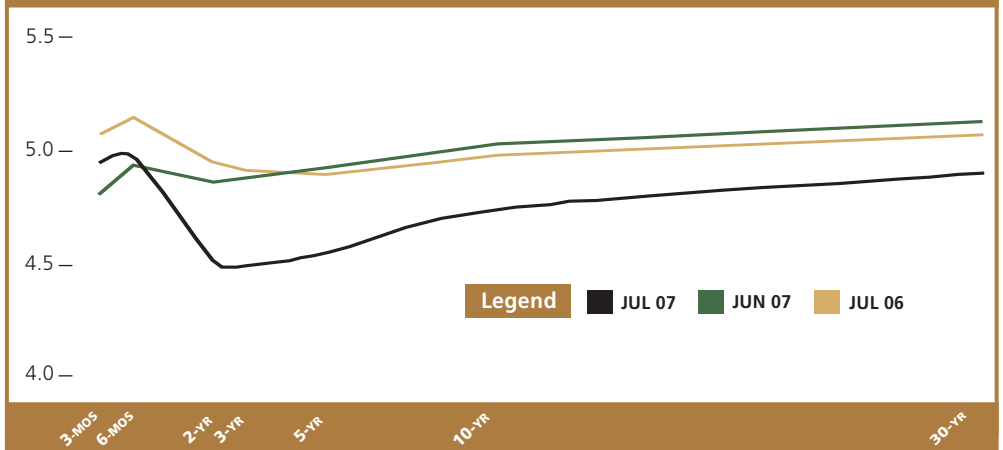
MARKET SUMMARY

Bond yields were much lower in July. The market's recent activity stems from concerns that difficulties in the housing and mortgage market will result in slower economic growth going forward. Additionally, volatility in the equity markets resulted in a "flight to quality" as market participants rushed to the relative safety of treasury securities. Last month's market movements caused the front end of the curve to resume an inverted shape, although longer dated securities retain a positive slope.

The economy continued to display mixed signals in July. The Non-Farm Payroll number was weaker than expected, showing an increase of 92,000 new jobs, and the unemployment rate rose to 4.6 percent. While employment continues to display moderate growth, there is some concern that the jobs market has begun to slow. Inflation readings remain higher than the FOMC would prefer. Housing data weakened during the month, prompting concern that the housing sector has not yet completed its decline. Going forward, market participants will continue to look for signs as to whether or not trouble in the housing and mortgage markets is reflected in the broader economy.

The FOMC took no action at its August 7th meeting, leaving its fed funds target at 5.25%. The next FOMC meeting is on September 18th.

TREASURY YIELDS LOWER



The yield curve shifted lower in July as rates declined on concerns about housing market weakness.

YIELDS	7/31/07	6/30/07	Change
3 Month	4.94	4.80	0.14
2 Year	4.52	4.86	(0.34)
3 Year	4.50	4.88	(0.38)
5 Year	4.56	4.92	(0.36)
10 Year	4.74	5.02	(0.28)
30 Year	4.90	5.12	(0.22)

YIELD SPREADS	7/31/07	6/30/07	Change
5yr - 2yr T-Note	0.04	0.06	(0.02)
10yr - 2yr T-Note	0.22	0.16	0.06

Source: Bloomberg

How do you view risk? Is it something that you try to avoid, minimize, or manage? Every investor has their own answers to these questions and those responses influence their investment decisions. This article is the first in a series of articles where we will examine various investment risks and steps that investors can take to properly manage them. In this article we will discuss interest rate risk, the risk component that makes the greatest contribution to both return and volatility in a fixed income portfolio.

The goal of nearly every investor is to manage risk and optimize performance by focusing upon safety, liquidity, and return. It is for good reason that safety comes first in the list of priorities. Safety, or the management of risk, is the key to structuring an effective investment program. In essence, portfolio management is risk management. By identifying and quantifying the appropriate level of risk, an investor can then devise a strategy for managing risk while still producing strong returns. The final goal of this process is to produce the highest possible **risk-adjusted returns**.

Interest Rate Risk

Interest rate risk, also called "market risk," is the risk that movements in the level of market interest rates will adversely affect the value of an investor's securities holdings. In fixed income portfolios, when interest rates rise, portfolio market value falls; when rates fall, portfolio value rises. Historically, these changes in the level of market interest rates have been responsible for approximately 90% of the fluctuation in the value of fixed income portfolios.

Measuring Interest Rate Risk

The most commonly used measure of interest rate risk is duration. **Duration** is the weighted average maturity of a security's cash flows, and is often used as a measure of a security's (or a portfolio's) sensitivity to changes in the level of interest rates. The higher (lower) the duration, the more (less) the price of the security moves when interest rates change.

Managing Interest Rate Risk

Portfolio risk in general, and interest rate risk in particular, can never be completely avoided. To use an absurd example, even if an "investor" chose to hide their money under the mattress, the house could still burn down. The key to successful investing is not risk avoidance, but risk management. Successful risk management and successful portfolio management are really the same thing.

The simplest technique for avoiding fluctuations in the value of a portfolio is to invest in securities with the shortest maturities available, thereby minimizing

interest rate risk. Unfortunately, this also forces the investor to accept lower returns over time, which can result in the portfolio not generating sufficient cash flow to meet future liabilities. Therefore, a better strategy for optimizing risk-adjusted returns is to extend the duration of a portfolio to match whatever risk tolerance is appropriate for a particular investor.

The first step in this process is to accurately identify risk tolerances by measuring cash flow needs, liquidity constraints, loss restrictions, and political considerations. Once the risk tolerance has been identified, determining appropriate portfolio duration becomes a math exercise. First, loss constraints should be measured against a base-case and worst-case scenario in order to determine how the portfolio is likely to perform in a variety of circumstances. With this information in hand, benchmark portfolio duration can be calculated.

The fixed income portfolio should then be managed with the aim of maintaining a portfolio duration that closely tracks the chosen benchmark duration. Small deviations from the benchmark duration may be appropriate depending upon market conditions or other factors; wild deviations resulting from speculations on the future direction of interest rates should be avoided. If this program is followed consistently, the interest rate risk of the portfolio should prove to be relatively constant, and unpleasant surprises should be avoided.

Safe and Effective Portfolio Management

Managing interest rate risk by identifying and maintaining appropriate portfolio duration is the key to safe and effective fixed income portfolio management. With this foundation established, the fixed income investor can then begin analyzing the other factors that are likely to affect their portfolio's returns. In next month's article, we'll examine how an investor can manage these other risks in order to accomplish the goal of optimizing risk-adjusted returns.

Brian Perry, Vice President, Portfolio Specialist

Risk-Adjusted Returns - A portfolio's performance after taking into account its level of risk. This measure takes into account the fact that the goal of portfolio management is not to take excessive risk in an attempt to maximize returns, but rather to produce optimal results while strictly managing risk.

Duration - The weighted average maturity of a security's (or portfolio's) cash flows. Duration is a commonly used tool for measuring the interest rate, or "market," risk of a portfolio.

CONSUMER PRICES

During June, the economy's headline inflation reading increased at a 2.7% year over year rate, the same as in May. The year-over-year Core CPI (CPI less food and energy) rose at a 2.2% rate, also the same as in May. While Core CPI remains above the FOMC's comfort level, the trend has been relatively positive over the past six months. Going forward, market observers will watch carefully to see if there is a trend towards higher or lower inflation.

RETAIL SALES

During June, Retail Sales declined as the year-over-year growth decreased to 3.8% after a revised growth rate of 5.0% in May. The number was somewhat weaker than expected, and reflected lower levels of spending on durable goods. Nevertheless, it currently appears that the trend in consumer spending is still relatively positive.

LABOR MARKETS

The July non-farm payroll employment report showed an increase of 92,000 jobs, which was below consensus expectations. The unemployment rate rose to 4.6%. The six-month average for non-farm payroll employment is now 132,000 jobs. July's employment report indicates continued moderate growth in the labor market. However, the slightly weaker than expected numbers have caused some concern that perhaps the employment sector is poised to slow.

HOUSING STARTS

Single-family housing starts declined by 0.2% in June, to a 1.151 million annual pace. This follows May's reading of 1.153 million. Single family housing permits also declined for the third straight month. While the housing sector has not shown signs of a strong rebound, the pace of decline has slowed. Going forward, market participants will watch closely to see whether or not the decline in the housing market has run its course.

CREDIT SPREADS WIDER

CREDIT SPREADS	Spread to Treasuries (%)	One Month Ago (%)	Change
3-month top-rated commercial paper	0.26	0.41	(0.15)
2-year AA corporate note	0.47	0.39	0.08
5-year AA corporate note	0.69	0.62	0.07
5-year Agency note	0.52	0.36	0.16

Source: Bloomberg

Data as of 7/31/07

MIXED ECONOMIC DATA

ECONOMIC INDICATOR	Current Release	Prior Release	One Year Ago
Trade Balance	(60.0) \$Bln MAY 07	(58.7) \$Bln APR 07	(65.7) \$Bln MAY 06
GDP	3.4% JUN 07	0.6% MAR 07	2.4% JUN 06
Unemployment Rate	4.6% JUL 07	4.5% JUN 07	4.8% JUL 06
Prime Rate	8.25% JUL 07	8.25% JUN 07	8.25% JUL 06
CRB Index	324.10 JUL 07	315.74 JUN 07	349.83 JUL 06
Oil (West Texas Int.)	\$78.21 JUL 07	\$70.68 JUN 07	\$74.40 JUL 06
Consumer Price Index (y/o/y)	2.7% JUN 07	2.7% MAY 07	4.3% JUN 06
Producer Price Index (y/o/y)	3.3% JUN 07	4.1% MAY 07	4.9% JUN 06
Dollar / EURO	1.37 JUL 07	1.35 JUN 07	1.28 JUL 06

Source: Bloomberg

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