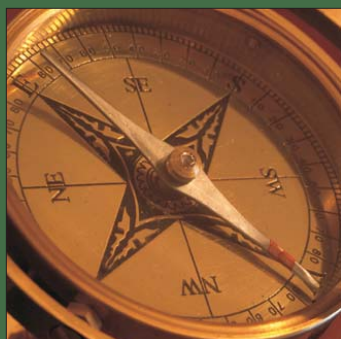


BOND MARKET REVIEW

A MONTHLY REVIEW OF
FIXED INCOME MARKETS



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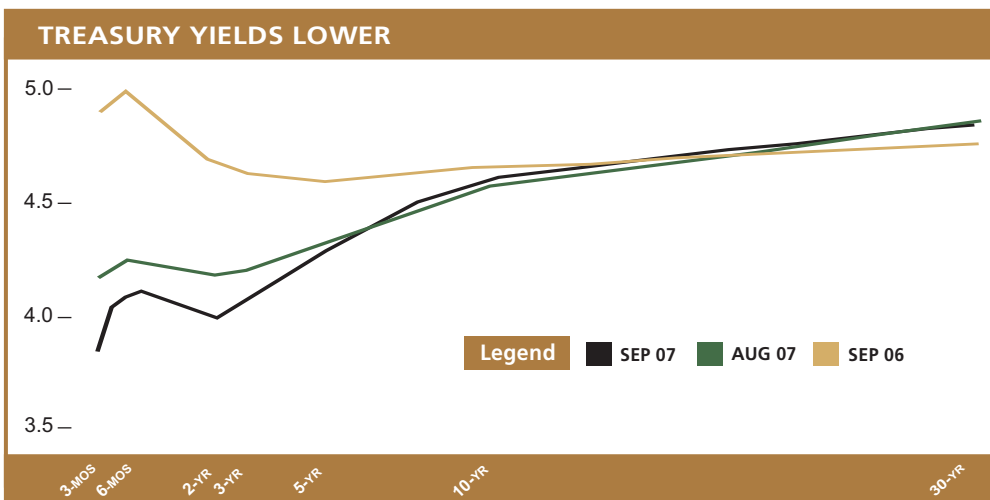
ECONOMIC INDICATORS

MARKET SUMMARY

Bond yields were slightly lower in September. The market's recent activity stems from concerns that difficulties in the housing and mortgage market will result in slower economic growth going forward. The yield curve steepened, as yields on short-term treasuries declined more than those on longer-term securities. The global market volatility witnessed in August diminished, and normalcy began to return to the financial markets.

The economy displayed moderate growth in September. The Non-Farm Payroll number was much stronger than expected, showing an increase of 110,000. The previous two months' numbers were revised much higher. Housing data has continued to weaken. Inflation readings have moderated, although they remain at the high end of the Federal Reserve's comfort zone. Going forward, market participants will continue to look for signs as to whether or not weakness in the housing and mortgage markets is reflected in the broader economy.

The FOMC lowered the federal funds rate and the discount rate 50 basis points at its September 18th meeting. The next scheduled FOMC meeting is on October 31st and most market participants are anticipating a cut in the federal funds rate.



The yield curve shifted lower in September as rates declined and the yield curve steepened in response to worries about an economic slowdown

YIELDS	9/30/07	8/31/07	Change
3 Month	3.80	4.12	(0.32)
2 Year	3.95	4.15	(0.20)
3 Year	3.99	4.16	(0.17)
5 Year	4.23	4.27	(0.04)
10 Year	4.58	4.55	0.03
30 Year	4.83	4.84	(0.01)

YIELD SPREADS	9/30/07	8/31/07	Change
5yr - 2yr T-Note	0.28	0.12	0.16
10yr - 2yr T-Note	0.63	0.40	0.23

Source: Bloomberg

In part one of our series on risk management, published in the August newsletter, we discussed how investors can manage interest rate risk in order to optimize their portfolio's risk-adjusted returns. While interest rate movements are the number one factor affecting the performance of fixed income portfolios, there are a number of other risks that an investor must consider. Credit risk, liquidity risk, and reinvestment risk can all affect the performance of a fixed income portfolio. With that in mind, let's examine some strategies that an investor can employ in order to manage these risks and optimize the performance of their portfolio.

Credit Risk

Credit risk refers to the possibility that a security will not repay its principal upon maturity. While historically only a small percentage of fixed income securities have defaulted, prudent investors will carefully evaluate their individual risk tolerance and return objectives before deciding upon an appropriate strategy for managing credit risk. The most risk-averse investors will choose to purchase only government guaranteed US Treasury bonds or FDIC insured certificates of deposit (CDs.) Treasury bonds and CDs guarantee that an investor will not lose principal, but offer commensurately low returns.

Investors willing to accept slightly higher levels of credit risk in order to achieve higher returns will consider investing in US government agency bonds or mortgage-backed securities. While not guaranteed by the US government, these securities are extremely safe and the possibility of default is considered remote. Agency and mortgage-backed bonds offer higher returns than default-free treasuries or CDs.

Corporate bonds are issued ratings based upon their ability to generate cash flow to pay back their debts. These ratings can range anywhere from "AAA" to "D," with higher ratings implying less credit risk. Many investment policies stipulate that corporate securities must carry a certain minimum rating to be considered.

Investors should not seek to completely avoid credit risk. Instead, they should carefully consider their risk and return objectives and then make appropriate decisions as to the level of credit risk to accept. This credit risk should then be prudently managed through diversification, which simply means holding a variety of issuers in the portfolio. Many investors choose to set limits upon what percentage of their portfolio may be held in the securities of an individual issuer.

Liquidity Risk

One of the functions of an investment portfolio is to provide liquidity to meet future cash flow needs. The possibility that the portfolio may be unable to meet these needs is called liquidity risk. Liquidity risk can be avoided by investing in only the shortest securities available; this assures that cash is always available when needed. There is a trade off though, because avoiding liquidity risk will result in a portfolio that produces less than optimal returns over time. A better practice is to manage liquidity

risk in order to produce a portfolio that provides for cash flow needs while also producing superior returns.

One strategy that some investors use to manage liquidity risk is a laddered portfolio. A laddered portfolio consists of securities across a wide range of maturities. This ensures that the portfolio will have both short term securities to meet cash flow needs and longer term securities to generate higher returns. Investors without the ability or inclination to accurately forecast cash flow needs and manage multiple portfolios may want to consider a laddered portfolio. When implementing a laddered portfolio, it is still important to ensure that there are sufficient short-term securities maturing to meet any cash flow needs.

Investors with the resources to pursue a segmented portfolio strategy will find it to be more effective for managing liquidity risk and producing optimal investment returns. A segmented portfolio consists of a short term portfolio designed to meet future cash flow needs and a longer term portfolio designed to provide greater growth opportunities. A segmented portfolio requires confidence in cash flow forecasts, as well as the ability to manage the portfolio to optimize returns in the growth portion of the portfolio.

Reinvestment Risk

The possibility that bond maturities or interest payments may need to be reinvested at a lower rate of return is known as reinvestment risk. For instance, if an investor has a six percent bond that matures, and the current market environment only provides for five percent returns, the investor will have to reinvest their proceeds at a lower rate.

One of the most effective ways to manage reinvestment risk is to own securities across a wide range of maturities. By doing so, an investor can avoid having to reinvest a large segment of their portfolio at an inopportune time. Additionally, limiting the percentage of callable bonds and mortgage-backed securities (both of which have uncertain cash flow patterns) will also help to manage reinvestment risk, by providing for more consistent and easily forecasted cash flows.

Most importantly an investor should avoid trying to forecast future interest rate movements and reinvesting based upon these forecasts. Academic studies and most market participants are in agreement that it is impossible to forecast interest rate movements accurately and consistently. Once an overall portfolio strategy has been set, reinvestment of cash flows should occur regardless of an investor's perception of overall market conditions.

Safe and Effective Portfolio Management

It is important for investors to avoid the natural assumption that risk is a bad thing. Risk should be managed, not avoided. By managing interest rate risk, credit risk, liquidity risk, and reinvestment risk, investors can enhance their ability to optimize risk-adjusted returns. Remember, risk management is portfolio management.

Brian Perry, Vice President, Portfolio Specialist

CONSUMER PRICES

During August, the economy's headline inflation reading increased at a 2.0% year over year rate, slower than July's 2.4% rate. The year-over-year Core CPI (CPI less food and energy) rose at a 2.0% rate, lower than July's 2.1% rate. While Core CPI remains at the upper-end of the Federal Reserve's comfort range, the trend in inflation data has been relatively positive over the last several months.

RETAIL SALES

During August, Retail Sales moved slightly higher as the year-over-year growth rose to 3.7% from a revised growth rate of 3.6% in July. Over the last several months, Retail Sales trends are reflecting moderate consumer spending and most likely are showing the effects of the slowdown in the housing market and the tightening of credit standards.

LABOR MARKETS

The September non-farm payroll employment report showed an increase of 110,000 jobs, which was significantly above consensus expectations. Last month's jobs report was also revised much higher, from negative 4,000 to positive 89,000. The six-month average for non-farm payroll employment is now 111,000 jobs. September's employment report has lessened concern that the jobs market is weakening.

HOUSING STARTS

Single-family housing starts declined by 7.1% in August, to a 0.99 million annual pace. This follows July's reading of 1.06 million. Single family housing permits also declined for the fifth straight month. Recent data has supported the financial market concern that the decline in the housing market has not yet run its course.

CREDIT SPREADS WIDER

CREDIT SPREADS	Spread to Treasuries (%)	One Month Ago (%)	Change
3-month top-rated commercial paper	1.13	1.27	(0.14)
2-year AA corporate note	0.76	0.68	0.08
5-year AA corporate note	0.86	0.80	0.06
5-year Agency note	0.47	0.46	0.01

Source: Bloomberg

Data as of 9/30/07

MIXED ECONOMIC DATA

ECONOMIC INDICATOR	Current Release	Prior Release	One Year Ago
Trade Balance	(59.2) \$Bln JUL 07	(59.4) \$Bln JUN 07	(67.6) \$Bln JUL 06
GDP	3.8% JUN 07	0.6% MAR 07	2.4% JUN 06
Unemployment Rate	4.60% AUG 07	4.6% JUL 07	4.7% AUG 06
Prime Rate	7.75% SEP 07	8.25% AUG 07	8.25% SEP 06
CRB Index	333.67 SEP 07	308.76 AUG 07	305.58 SEP 06
Oil (West Texas Int.)	\$81.66 SEP 07	\$74.04 AUG 07	\$62.91 SEP 06
Consumer Price Index (y/o/y)	2.0% AUG 07	2.4% JUL 07	3.8% AUG 06
Producer Price Index (y/o/y)	2.2% AUG 07	4.0% JUL 07	3.8% AUG 06
Dollar / EURO	1.43 SEP 07	1.36 AUG 07	1.27 SEP 06

Source: Bloomberg

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