

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 portfolios of high quality, fixed income securities. Chandler's mission is to provide fully customizable, client-centered portfolio management that preserves principal, manages risk and generates income in our client's portfolios.

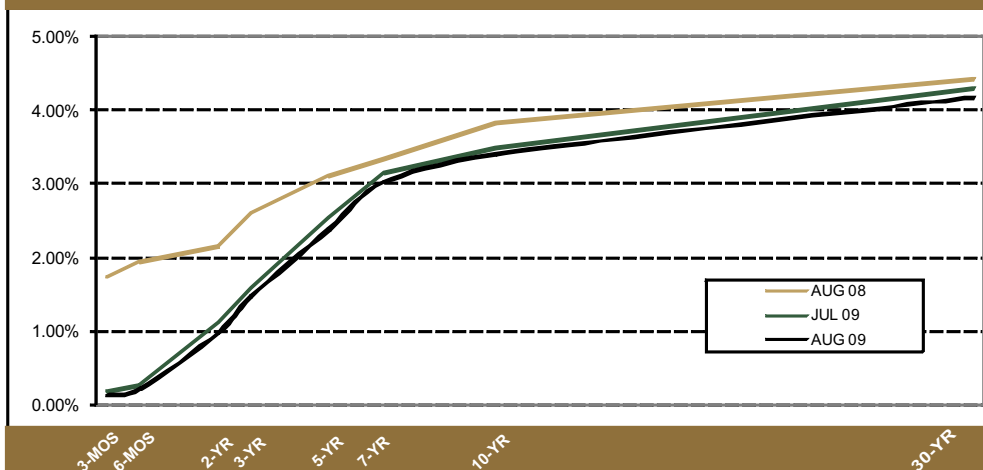
MARKET SUMMARY

It appears that the worst recession since World War II may be coming to an end as market participants have begun to focus on the strength and durability of the coming economic recovery. The combined effects of massive government stimulus, inventory rebuilding, and pent-up consumer demand have led many forecasters to predict strong third quarter economic growth both in the US and around the globe. However, concern remains about the sustainability of the recovery as the impact of government stimulus begins to fade and consumer activity remains weak.

Treasury bond yields were volatile in August as market participants debated the strength of the coming economic recovery. Investors also remain concerned about the very large volumes of Treasury bonds being issued. Treasury prices have been supported by forecasts that inflation is unlikely to rise in the near-term.

The Federal Reserve stated that "economic activity is leveling out" at their August 12 meeting. In anticipation of a gradual economic recovery, the Fed has begun to plan an exit from some of the emergency measures they have put in place over the past year, recently announcing that their Treasury purchase plan will come to an end in October. The next scheduled FOMC meeting is on September 23.

TREASURY YIELDS SLIGHTLY LOWER IN AUGUST



Treasury yields declined slightly in August as market participants debated the impact of increased levels of Treasury bond issuance and the strength and durability of the expected economic recovery. The yield curve remains steep as long-term interest rates are much higher than short-term rates.

YIELDS	8/31/09	7/31/09	Change
3 Month	0.12	0.17	(0.05)
2 Year	0.98	1.11	(0.13)
3 Year	1.47	1.59	(0.12)
5 Year	2.39	2.53	(0.14)
7 Year	3.03	3.15	(0.12)
10 Year	3.40	3.50	(0.10)
30 Year	4.18	4.31	(0.13)

YIELD SPREADS	8/31/09	7/31/09	Change
5yr - 2yr T-Note	1.41	1.42	(0.01)
10yr - 2yr T-Note	2.42	2.39	0.03

Source: Bloomberg

STICKING WITH A LONG-TERM INVESTMENT PLAN

Selecting a long term investment plan and maintaining it over time is the key to investment success. However, market conditions that are constantly changing can make this difficult to do. The current bond market environment, where yields are very low and memories of last fall's volatility still fresh, can tempt investors to deviate from their established investment plan. These investors are engaging in market timing, although they may not even realize they are doing so.

At first glance, market timing can appear to be a viable investment strategy. In fact, accurate market timers could generate returns in excess of those available to adherents of a more consistent investment strategy. Furthermore, the benefits of successful market timing go beyond financial rewards. There is a tremendous amount of emotional and psychological satisfaction that comes from correctly predicting market movements. The feeling that "I'm smarter than the market" is quite tempting and very appealing. Often times, these non-monetary rewards are so great that they cause a market timer to remember fondly those occasions when they have correctly predicted market moves. These instances are then used to justify further attempts at market timing. Unfortunately, this often leads the investor to avoid a realistic and rational measurement of the portfolio's long term performance.

If the investor did measure their portfolio performance against a market benchmark, they would probably find that over time their portfolio had performed relatively poorly. That is because, while market timing is a concept that sounds good in theory, it is nearly impossible to execute in the real world. "Trying to predict (the market's) direction over the near term is an exercise in futility." These words were spoken by the legendary mutual fund manager Peter Lynch, one of the most successful investors of all time.

When it comes to investing in the bond market, successfully forecasting future interest rate movements should result in superior long term investment returns. However, in order to be successful, the prognosticator must not only correctly determine the direction of interest rate movements, but also their magnitude and timing. The majority of academic studies, as well as many market participants, agree that doing this on a consistent basis is virtually impossible.

To make matters even worse, successful market timing requires the prognosticator to correctly forecast the market, not once, but twice. A market timer must successfully predict a market movement, which prompts them to deviate from their established investment strategy in an attempt to capture additional returns. Then, the market timer must make another correct prediction in order to decide when to return to their chosen long term investment strategy.

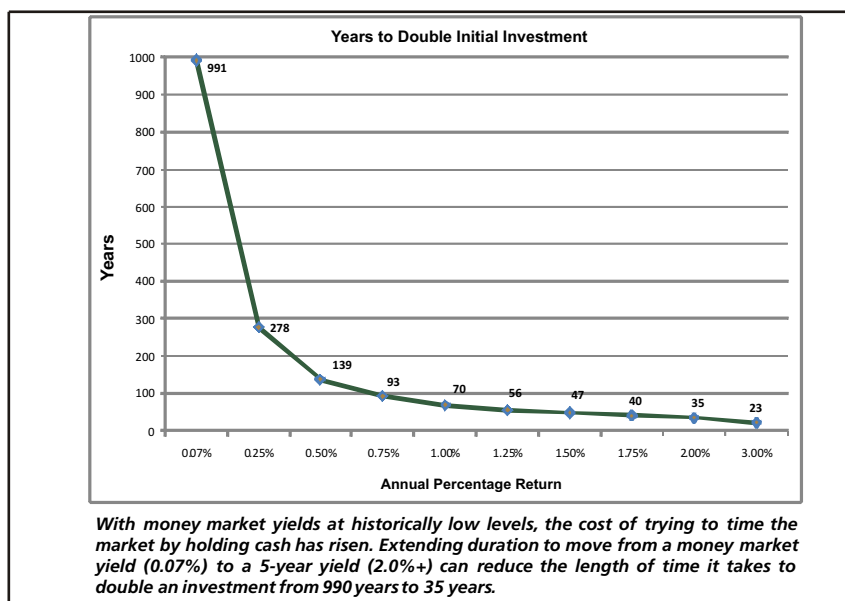
If the odds of correctly timing a market movement are 50/50, then the chances of correctly entering and reversing a market timing trade are 25%. The chances of correctly executing two market timing trades are 6 in 100, and the odds are only 1 in 1000 that a market prognosticator will be able to correctly time their entry and exit from the market on five separate occasions (this is a failure rate of 99.9%). While some market timers might

argue that their odds on any given trade are greater than 50/50, many studies indicate that this is unlikely to be the case. In fact, academic surveys that measure the predictions of many of Wall Street's leading economists and market strategists indicate that their actual success rate at predicting interest rate movements is less than 50%. In other words, some of the world's most successful economists are less accurate than a coin flip.

In order to enjoy long term success, an investor must have a process that works and that is repeatable. While correctly predicting one, or even two, or perhaps even ten market movements may be possible, an honest investor must ask themselves whether or not these predictions are truly and consistently repeatable. For most, the answer will be a resounding no.

One of the ways in which an investment manager can add value to a client's portfolio is by providing the discipline necessary to stick with a long term investment strategy. A good investment manager will have a track record based upon an easily explained, repeatable, consistent process. At those times when the client feels most tempted to search out the hottest new investment trend the manager can remind the client of why a particular investment strategy was implemented in the first place. In today's challenging environment, long term investment discipline is more important than ever.

Brian Perry, Vice President, Investment Strategist



CONSUMER PRICES

In July, the CPI showed that consumer prices decreased 2.1% on a year-over-year basis. The year-over-year Core CPI (CPI less food and energy) increased at a 1.5% y-o-y rate. Despite hopes for an economic recovery and an increased money supply, many economists believe that inflation will remain moderate over the next 12-18 months.

LABOR MARKETS

The August non-farm payroll employment report showed a less-than-expected decrease of 216,000 jobs but the unemployment rate increased to 9.7%. Although the payroll data reflected the twentieth consecutive month of negative job creation, the pace of losses has slowed. Nevertheless, even as the economy gradually begins to recover, the job market is expected to remain weak and the unemployment rate may rise further.

RETAIL SALES

In July, Retail Sales declined at a year-over-year rate of -8.3%, an improvement over the previous several months' readings. Consumers have increased their savings rate and slowed their spending in reaction to a general tightening of credit standards, job losses, and the housing market contraction.

HOUSING STARTS

Single-family housing starts increased 1.7% in July to 490,000, the fifth consecutive month-to-month increase and other housing market indicators appear to be demonstrating a stabilization in the housing market.

CREDIT SPREADS WIDER

CREDIT SPREADS	Spread to Treasuries (%)	One Month Ago (%)	Change
3-month top-rated commercial paper	0.17	0.11	0.06
2-year AA corporate note	0.61	0.75	(0.14)
5-year AA corporate note	0.80	0.94	(0.14)
5-year Agency note	0.43	0.33	0.10

Source: Bloomberg

Data as of 8/31/09

MIXED ECONOMIC DATA

ECONOMIC INDICATOR	Current Release	Prior Release	One Year Ago
Trade Balance	(27.01) \$Bln JUN 09	(25.97) \$Bln MAY 09	(60.18) \$Bln JUN 08
GDP	(1.00%) JUN 09	(6.4%) MAR 09	1.5% JUN 08
Unemployment Rate	9.70% AUG 09	9.40% JUL 09	6.20% AUG 08
Prime Rate	3.25% AUG 09	3.25% JUL 09	5.00% AUG 08
CRB Index	253.68 AUG 09	257.45 JUL 09	391.71 AUG 08
Oil (West Texas Int.)	\$69.96 AUG 09	\$69.45 JUL 09	\$115.46 AUG 08
Consumer Price Index (y/o/y)	(2.10%) JUL 09	(1.40%) JUN 09	5.60% JUL 08
Producer Price Index (y/o/y)	(6.80%) JUL 09	(4.60%) MAY 09	9.90% JUL 08
Dollar / EURO	1.43 AUG 09	1.43 JUL 09	1.47 AUG 08

Source: Bloomberg

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