

# 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.

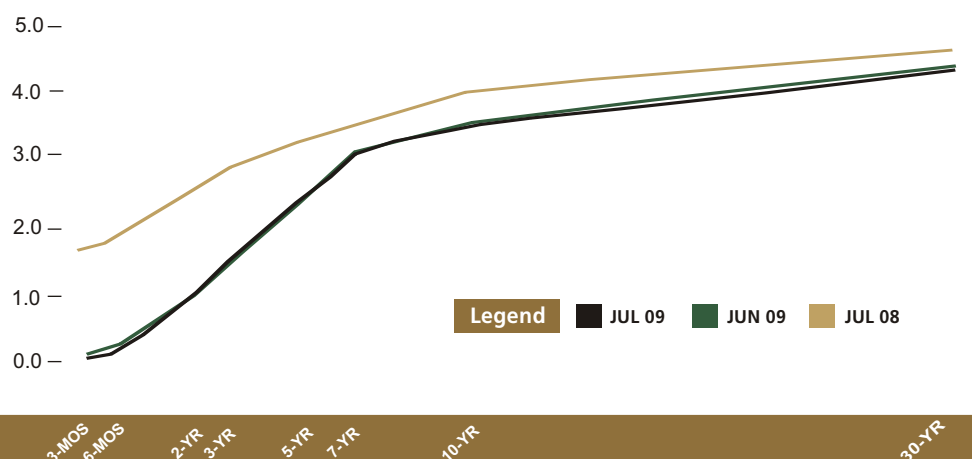
## MARKET SUMMARY

Many market participants believe that the worst global recession in a half century has come to an end. The combined effects of massive government fiscal and monetary stimulus, inventory rebuilding, and pent-up consumer demand have led many forecasters to predict reasonably strong third quarter economic growth both in the US and around the globe. However, concern remains about the strength and durability of the recovery, and the job market remains weak.

Treasury bond yields were volatile in July as market participants began to forecast an end to the severe global recession. Investors also remain concerned about the very large volumes of Treasury bonds being issued. However, the decline in Treasury prices has been limited by forecasts that inflation is unlikely to rise in the near-term.

The Federal Reserve announced that they remain more concerned with reinvigorating the economy than with short-term inflationary pressures, and they intend to keep the fed funds rate at exceptionally low levels for the foreseeable future. The next scheduled FOMC meeting is on August 12th.

### TREASURY YIELDS UNCHANGED IN JULY



Treasury yields were unchanged in July but yields fluctuated widely intra-month as market participants debated the impact of increased levels of Treasury bond issuance and the possibility that the global recession is nearing an end. The yield curve remains steep as long-term interest rates are much higher than short-term rates.

| YIELDS  | 7/31/09 | 6/30/09 | Change |
|---------|---------|---------|--------|
| 3 Month | 0.17    | 0.18    | (0.01) |
| 2 Year  | 1.11    | 1.11    | 0.00   |
| 3 Year  | 1.59    | 1.61    | (0.02) |
| 5 Year  | 2.53    | 2.56    | (0.03) |
| 7 Year  | 3.15    | 3.20    | (0.05) |
| 10 Year | 3.50    | 3.52    | (0.02) |
| 30 Year | 4.31    | 4.31    | 0.00   |

| YIELD SPREADS     | 7/31/09 | 6/30/09 | Change |
|-------------------|---------|---------|--------|
| 5yr - 2yr T-Note  | 1.42    | 1.45    | (0.03) |
| 10yr - 2yr T-Note | 2.39    | 2.41    | (0.02) |

Source: Bloomberg

Traditional finance theory is founded on the belief that individuals make rational decisions based on logical analysis of the risk/return characteristics of an investment. However, for years traditional finance has been confounded by instances in which markets display tendencies that are clearly irrational. Behavioral finance argues that individuals are not rational actors and instead views investors as human beings subject to a full range of emotions. Behavioral finance then attempts to explain seemingly irrational markets as a manifestation of investor behavior.

This article will discuss behavioral finance and define some of the most common behavioral traits that researchers have identified. We will then examine ways in which investors can mitigate the effects of behavioral biases. After reading this article, investors should have a better understanding of behavioral finance, and armed with this knowledge, be better prepared to manage their portfolio in an optimal manner.

### Defining behavioral finance

Behavioral finance was founded in the late 1960s in response to traditional finance and its belief in efficient markets and rational investors. Behavioral finance is based upon the fact that financial market prices are a manifestation of millions of unique decisions made by thousands of different individuals. These individuals are subject to emotional traits and biases that often result in less than optimally efficient investment decisions. Proponents of behavioral finance have been encouraged by seemingly irrational market events such as the stock market crash of October 1987, the technology stock bubble of the late 1990s, and the financial crisis of 2008.

As might be expected, some traditional finance theorists are critical of behavioral finance. Some argue that even if markets appear to behave irrationally in the short-term, in the long run, markets return to an efficient state. Others believe that even seemingly irrational behavior such as bidding stocks up to unsustainable prices is effectively a rational response to expectations that other investors will bid prices even higher in the future. However, despite these criticisms behavioral finance has been increasing in popularity and many experts agree that investors can benefit from an awareness of behavioral traits and methods for mitigating their effects.

### Common behavioral finance traits

“Anchoring” occurs in situations where investors do not fully incorporate new information into their analysis. Instead, an investor’s opinion is “anchored” to their original forecast. New information may alter the forecast, but not to the degree that it would if investors were entirely unbiased.

“Myopic loss aversion” occurs when investors become too cautious due to an overemphasis on short-term performance. This can cause investors to reject investment strategies that promise attractive risk-adjusted long-term returns. This can occur even if the investment portfolio is designed to meet long-term objectives and can withstand principal fluctuations in the interim.

“Confirmation bias” is present when investors actively seek out information that reinforces their existing opinion. Financial markets are constantly in flux, and investors can benefit from examining the variety of opinions available in the marketplace. This type of critical thinking is far more beneficial than seeking out information that corroborates what the investor already believes.

“Herd behavior” occurs when investors are afraid of missing the latest investment trend or fad. Herd behavior is at the root of nearly every market bubble that has ever occurred. A recent example was when many individuals purchased overvalued technology stocks in the late 1990s because they were afraid of missing out on the gains that their fellow investors appeared to be enjoying. While some individuals do profit from this sort of investing, it requires nearly perfect timing in order to be successful over the long run.

Many investors, especially professionals, fall prey to the “overconfidence” bias. Simply stated, overconfidence refers to situations in which investors place more faith in their ability than their track record justifies. Overconfidence can lead to excessive risk-taking, overly active trading, or a lack of proper diversification. Many studies have shown that male investors are more prone to the overconfidence bias than female investors.

“Prospect theory” refers to the concept that investors view gains and losses differently. In other words, the satisfaction that investors receive when they make money does not equal the unhappiness that they feel when they lose money. Prospect theory often manifests in a tendency for investors to sell their winners too soon and hold onto their losers too long.

### Correcting behavioral biases

Because behavioral biases represent deeply rooted psychological traits, correcting and overcoming them is difficult. Most investors are aware that they should attempt to avoid the emotions of greed or fear when it comes to managing their portfolio, and, ideally, individuals would prefer to invest in a rational and logical manner. However, because they are human beings it is impossible for investors to fully free themselves from their emotions. In spite of this, there are steps that investors can take in order to mitigate the negative effects of behavioral biases.

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### CONSUMER PRICES

In June, the CPI showed that consumer prices decreased 1.4% on a year-over-year basis. The year-over-year Core CPI (CPI less food and energy) increased at a 1.7% y-o-y rate. Despite hopes for an economic recovery and an increased money supply, many economists believe that inflation will remain manageable over the next 12-18 months.

### LABOR MARKETS

The July non-farm payroll employment report showed a decrease of 247,000 jobs and the unemployment rate declined to 9.4%. Although the payroll data reflected the nineteenth consecutive month of negative job creation, the pace of losses has slowed and July's report showed the fewest job losses since August 2008. Although employment is expected to remain weak for some time to come, July's report reinforced hope that the recession is ending.

### RETAIL SALES

In June, Retail Sales declined at a year-over-year rate of -9.0%, somewhat better than May's -9.8% annual rate of decline. 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 roughly 14.4% in June to 470,000, the fourth 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 | 0.11                     | 0.26              | (0.15) |
| 2-year AA corporate note           | 0.75                     | 1.12              | (0.37) |
| 5-year AA corporate note           | 0.94                     | 1.30              | (0.36) |
| 5-year Agency note                 | 0.33                     | 0.44              | (0.11) |

Source: Bloomberg

Data as of 7/31/09

## MIXED ECONOMIC DATA

| ECONOMIC INDICATOR           | Current Release      | Prior Release        | One Year Ago         |
|------------------------------|----------------------|----------------------|----------------------|
| Trade Balance                | (25.96) \$Bln MAY 09 | (28.79) \$Bln APR 09 | (60.53) \$Bln MAY 08 |
| GDP                          | (1.00%) JUN 09       | (6.4%) MAR 09        | 1.5% JUN 08          |
| Unemployment Rate            | 9.40% JUL 09         | 9.50% JUN 09         | 5.80% JUL 08         |
| Prime Rate                   | 3.25% JUL 09         | 3.25% JUN 09         | 5.00% JUL 08         |
| CRB Index                    | 257.45 JUL 09        | 249.96 JUN 09        | 416.40 JUL 08        |
| Oil (West Texas Int.)        | \$69.45 JUL 09       | \$69.89 JUN 09       | \$124.08 JUL 08      |
| Consumer Price Index (y/o/y) | (1.40%) JUN 09       | (1.30%) MAY 09       | 5.00% JUN 08         |
| Producer Price Index (y/o/y) | (4.60%) JUN 09       | (5.00%) MAY 09       | 9.10% JUN 08         |
| Dollar / EURO                | 1.43 JUL 09          | 1.40 JUN 09          | 1.56 JUL 08          |

Source: Bloomberg

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## WHAT'S NEW AT CHANDLER ASSET MANAGEMENT

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As Chandler Asset Management expands, we continue to add team members to assist us in providing our clients with superior service and attractive investment returns. Recently, we have had the pleasure of welcoming two new members to our team.

Shelly Henbest is the newest addition to Chandler's Portfolio Management Team. Ms. Henbest joins Chandler as a Credit Analyst and will be actively involved in analyzing and assessing the credit suitability of debt issuers and assisting Portfolio Managers in the investment management process. Ms. Henbest brings more than 8 years of experience in equity research and financial analysis, most recently working as an Associate Analyst at Bear, Stearns & Co. in New York.

Brian Prager is the newest member of Chandler's Operations Team. Mr. Prager joins Chandler as an Operations Associate and will contribute to the streamlining of our investment operations as our firm continues to grow. Mr. Prager brings more than 5 years of experience in operations and trading, most recently working as a Trader, and as the Director of Operations at JLF Asset Management in Del Mar.

Chandler employees consistently seek out opportunities to improve their skill sets and qualifications in order to better serve our clients. With that in mind, we are pleased to announce that Mike Ramos recently received an MBA in Finance from National University. This degree will assist Mike in his role as Systems Administrator by helping him analyze financial information and integrate it into our technological platforms. Brian Perry recently received an MA in International Affairs from the Fletcher School at Tufts University in July. In his role as Investment Strategist, this degree further enhances Brian's ability to evaluate global economic, political, and financial market developments.

## UNDERSTANDING BEHAVIORAL FINANCE (CONTINUED FROM PAGE 2)

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The first step in correcting behavioral biases is to be aware of them. As with any habit, it is impossible to correct the bias without first recognizing its presence and effects. Once investors are aware that they are subject to irrational biases, they will be alert for manifestations in their investment decisions. A second important step is to have an investment strategy and stick to that strategy. Investment policy statements can help in this regard by codifying and defining the objectives and constraints of the investment program as well as how success or failure will be measured. Having an objective framework in which to manage the investment program can prevent some of the worst manifestations of behavioral biases. For example, an investor whose policy limited them to holding 10% in technology stocks would have avoided overexposure to the sector during the bubble and subsequent crash of the late 1990s.

Finally, practice makes perfect when it comes to correcting behavioral biases. The more an investor practices acting rationally, the easier it will become.

### **Conclusion**

Behavioral finance concepts such as herd behavior, myopic loss aversion and prospect theory play an important role in investing. Unfortunately, simple knowledge of these concepts will not instantly relieve an investor of concern over short-term losses or fear of career damage resulting from such losses. However, knowledge will allow for a more sober assessment of the true level of risk in the portfolio and a reevaluation of the superior long-term returns that are often available without a substantial increase in risk. Employing these strategies can increase portfolio performance over time.

Brian Perry, Vice President, Investment Strategist