



# Town of Fountain Hills

## Investment Performance Review First Quarter 2012

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# Market Review

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# Yields Reached 8-Month Highs in First Quarter

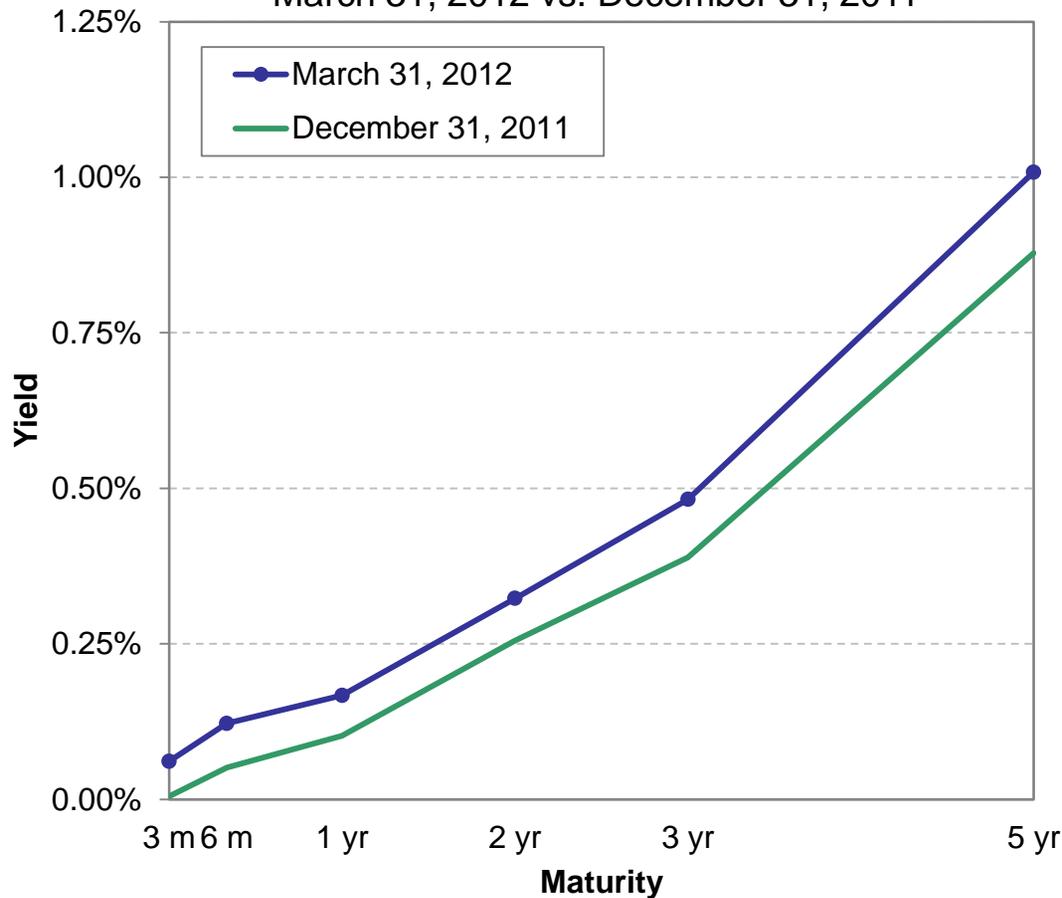
**2-Year U.S. Treasury Yield**  
March 31, 2011 – March 31, 2012





# As Yields Rose, Yield Curve Steepened

**U.S. Treasury Yield Curve**  
March 31, 2012 vs. December 31, 2011



	12/31/11	3/31/12	Change
3 Month	0.01%	0.06%	+0.06%
6 Month	0.05%	0.12%	+0.07%
1 Year	0.10%	0.17%	+0.07%
2 Year	0.26%	0.32%	+0.07%
3 Year	0.39%	0.48%	+0.09%
5 Year	0.88%	1.01%	+0.13%

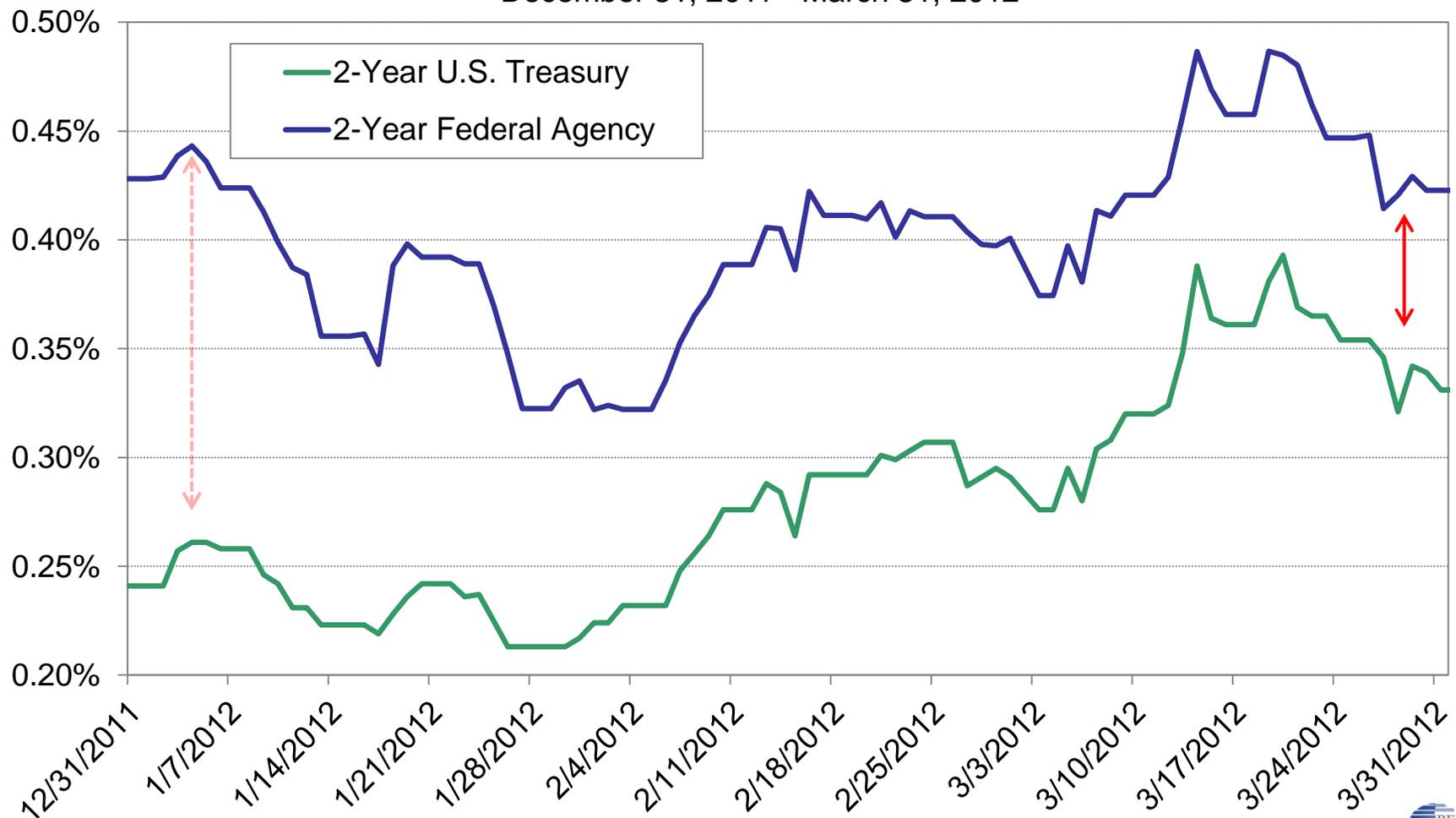


## Yield Spreads Have Contracted

- Agency spreads have narrowed due to a reduction in Agency supply, combined with improving economic data and resolution of the longstanding Greek debt crisis.

### 2-Year Federal Agency vs. 2-Year U.S. Treasury

December 31, 2011 - March 31, 2012



# Portfolio Summary

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## First Quarter Overview

- In the first quarter, the so called “risk-on” trade benefited investors across the board—to a general extent, the riskier the asset, the better the performance (“risk-on investment”). As risk aversion waned in the first quarter, spreads narrowed considerably.
- For most of the first quarter, Treasury yields stayed within the established ranges they had been in since August 2011. However, in mid-March, yields moved up sharply, reaching an 8-month high. Because rates rose in the quarter, most U.S. Treasury indices posted negative returns, making them the poorest performing sector.
- Performance was enhanced this quarter by holding longer maturities, which have higher initial yields and benefit from “roll down.” Throughout the quarter we exchanged Treasury and Agencies that had shorter maturities with longer, higher yielding maturities to capture a yield advantage and roll-down potential.
- Yield spreads on Federal Agencies relative to comparable maturity U.S. Treasuries narrowed sharply during the quarter. As this reduced the relative attractiveness of Agencies, PFMAM began to actively reallocate investments from the Agency sector into Treasuries.



# Town's Portfolio Complies with State Statutes and Investment Policy

Security Type	Market Value as of March 31, 2012	Percentage of Portfolio	In compliance
<b>U.S. Treasuries</b>	<b>5,822,204.43</b>	<b>39%</b>	√
<b>Federal Agencies</b>	<b>9,073,743</b>	<b>60%</b>	√
<i>FNMA</i>	<i>3,008,830</i>	<i>20%</i>	-
<i>FHLB</i>	<i>1,773,176</i>	<i>12%</i>	-
<i>FHLMC</i>	<i>3,026,021</i>	<i>20%</i>	-
<i>FFCB</i>	<i>1,265,716</i>	<i>8%</i>	-
<b>Money Market Fund</b>	<b>126,805</b>	<b>&lt;1%</b>	√
<b>Totals</b>	<b>\$15,022,752</b>	<b>100%</b>	

*Excludes accrued interest*



# First Quarter Performance Summary

- The Town's portfolio achieved strong performance for the quarter ended March 31, 2012.
- A sharp contraction of Federal Agency yield spreads in the first quarter of 2012, as well as proactive duration management, resulted in 23 basis points (0.23%) of out-performance relative to the Town's benchmark.

## Total Return for period ending March 31, 2012

	Duration (years)	Total Return Past Quarter	Annualized Total Return
<b>Town of Fountain Hills</b>	<b>1.77 years</b>	<b>0.21%</b>	<b>0.84%</b>
Merrill Lynch 1-3 Year U.S. Treasury/Agency Index	1.77 years	-0.02%	-0.08%

- Performance on trade date basis, gross (i.e., before fees), in accordance with the CFA Institute's Global Investment Performance Standards (GIPS).
- Merrill Lynch Indices provided by Bloomberg Financial Markets.
- Returns for periods less than one year are presented on an unannualized basis.
- Inception date of current strategy is December 31, 2011.
- Merrill Lynch 1-3 Year U.S. Treasury/Agency Index is the portfolio benchmark.



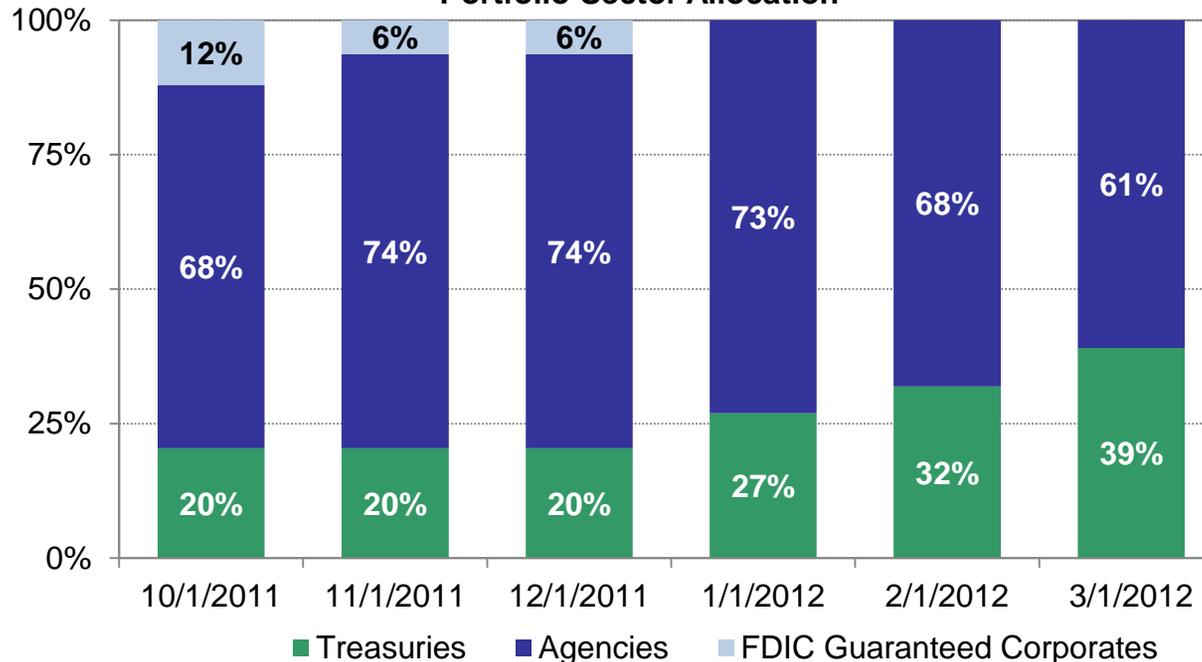
# PFM Proactively Managed Town's Sector Allocation as Spreads Narrowed

Yield Spread Between 2-Year Treasury and Agency Securities



- The difference in yield, or spread, between Treasuries and Agencies contracted to record lows over the past few months.
- Spreads narrowed due to a reduction in Agency supply, combined with improving economic data and resolution of the longstanding Greek debt crisis.

Portfolio Sector Allocation



- While previously keeping a modest allocation to Treasuries in the portfolio, we gradually increased our allocation, by swapping from Agencies to Treasuries, as spreads narrowed.



## Value Adding Trades: Agencies to Treasuries

Trade Date	Trade Type	Security Description	Par	Maturity	Yield	Gain on Sale
2/22/12	Sell	FFCB Bonds	\$750,000	2/21/13	0.21%	\$717
<b>2/22/12</b>	<b>Buy</b>	<b>U.S. Treasury Notes</b>	<b>\$750,000</b>	<b>2/21/15</b>	<b>0.43%</b>	-
3/13/12	Sell	FHLMC Notes	\$350,000	3/28/13	0.24%	\$358
<b>3/13/12</b>	<b>Buy</b>	<b>U.S. Treasury Notes</b>	<b>\$300,000</b>	<b>3/15/15</b>	<b>0.49%</b>	-
3/27/12	Sell	FHLB Global Bonds	\$750,000	8/28/13	0.30%	\$1,284
<b>3/27/12</b>	<b>Buy</b>	<b>U.S. Treasury Notes</b>	<b>\$750,000</b>	<b>5/15/14</b>	<b>0.38%</b>	-

- PFM always buys securities with the intent to hold them until maturity. However, opportunities may arise during the life of an investment that make selling the security prior to maturity a viable strategy to add value to the portfolio.
- The trades executed above add value to the portfolio by:
  - Increasing diversification
  - Increasing portfolio yield
  - Taking advantage of steepness of yield curve and providing roll down potential.



## Value Adding Trades: FDIC Corporates to Treasuries

- Earlier in the quarter we swapped from shorter-term FDIC guaranteed corporate holdings into longer U.S. Treasuries.
- Purchased Treasuries have yields well above where we sold the FDIC notes and will continue to benefit the portfolio with roll down as they near their maturity dates.

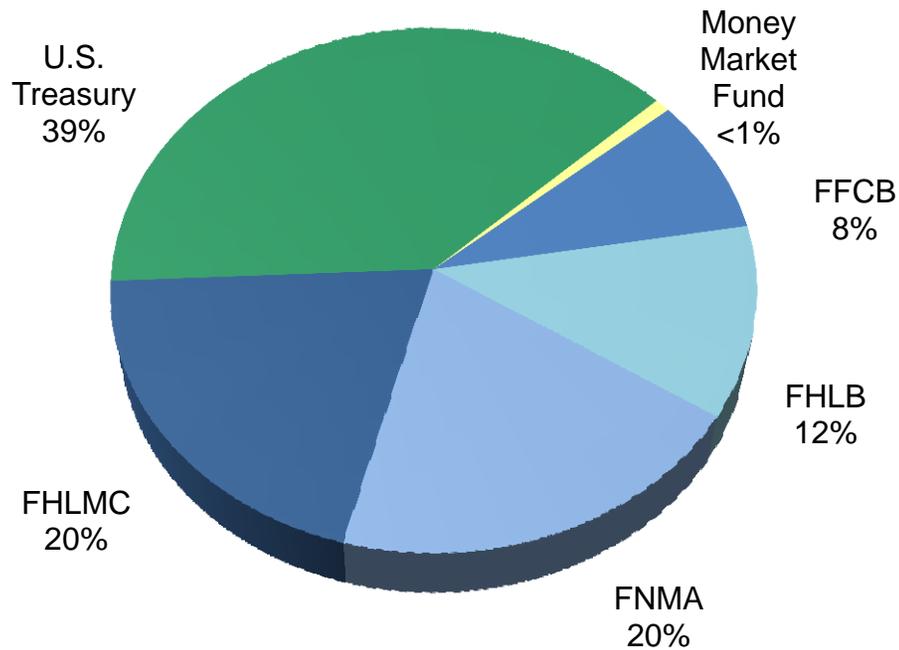
Trade Date	Trade Type	Security Description	Par	Maturity	Yield	Gain on Sale
1/5/12	Sell	CitiGroup Funding Inc (FDIC) Note	\$700,000	11/15/12	0.16%	\$757
<b>1/5/12</b>	<b>Buy</b>	<b>U.S. Treasury Notes</b>	<b>\$725,000</b>	<b>12/15/14</b>	<b>0.38%</b>	<b>-</b>
1/24/12	Sell	CitiGroup Funding Inc (FDIC) Note	\$225,000	11/15/12	0.16%	\$231
<b>1/24/12</b>	<b>Buy</b>	<b>U.S. Treasury Notes</b>	<b>\$250,000</b>	<b>1/31/15</b>	<b>0.40%</b>	<b>-</b>



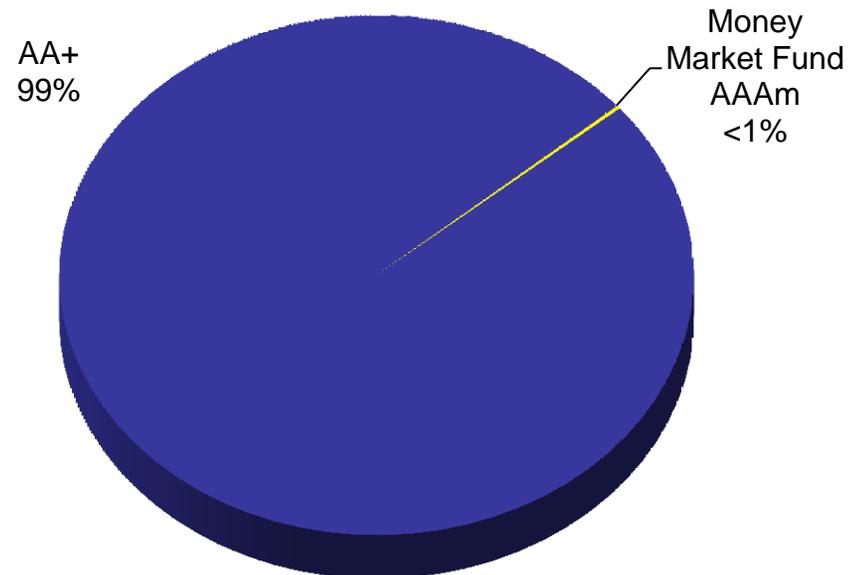
# Town's Portfolio Is Well Diversified and Has Excellent Credit Quality

- The portfolio is well diversified among investment sectors and issuers.
- The portfolio maintains excellent credit quality.

**Issuer Distribution**



**Credit Quality**

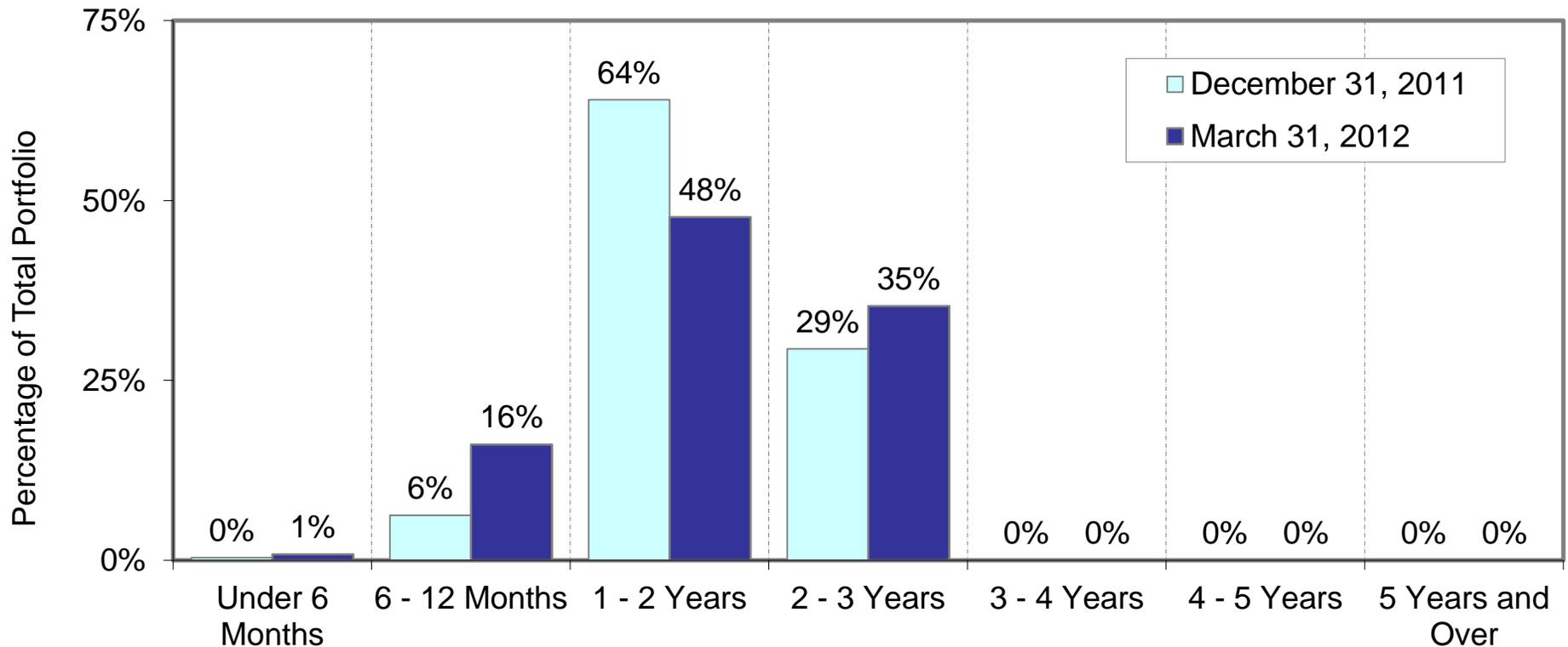




# Town's Portfolio Is Diversified by Maturity

- The portfolio is concentrated in the 1 to 3 year maturity area, the steepest part of the yield curve.
- By concentrating new purchases in the 2- to 3-year range, we lengthened the portfolio's duration from 97% to 100% of the benchmark duration.

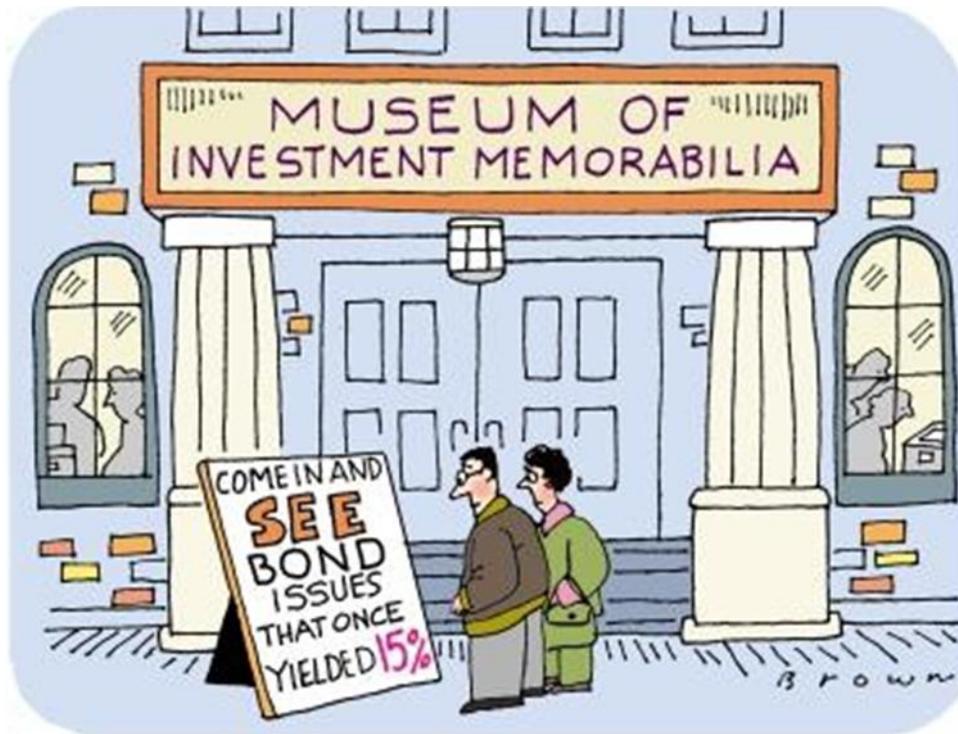
**Maturity Distribution**  
March 31, 2012 vs December 31, 2011





## Second Quarter Outlook

- With short-term investments pegged near zero percent, and interest rates likely to stay within a range, investments with longer maturities are attractive for their higher income generation and roll-down potential.
  - Roll-down has remained a significant contributor to performance over time, and we think that trend will continue.
  - We plan to keep the portfolio duration near that of the benchmark for the foreseeable future.
- Since Agency spreads are near record narrow levels, especially in maturities under three years, we anticipate continuing to favor Treasuries over Agencies.
- Our primary objective is to preserve the principal of the Town's portfolio, while seeking opportunities to add value. Our strategy will remain flexible and may be modified in response to changes in the Town's cash flow needs, interest rates, economic data, market outlook or specific opportunities that arise.



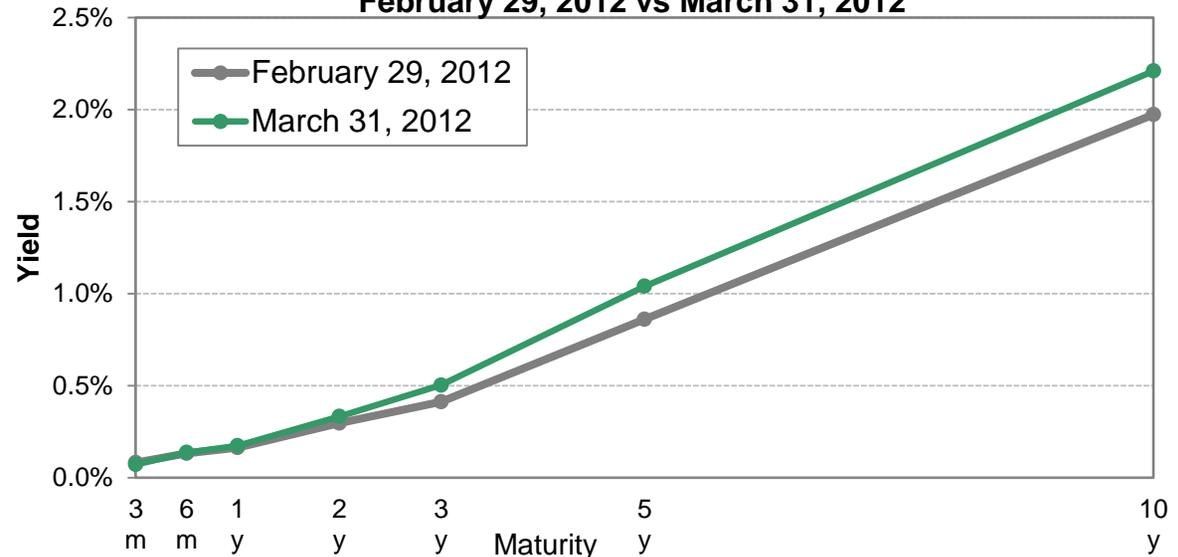
## Economic Outlook



## Yields Up Over Month End and For Quarter

- Very short-term yields remain unchanged from last month, held down by the Fed's zero interest rate policy.
- Longer-term investments increased on good news from Europe, positive U.S. economic data, and diminished expectations for Fed stimulus.
- After trading in a narrow range for many months, 2-3 year Treasury yields moved up in March to 8-month highs.
- Despite the move higher we do not believe this represents a fundamental change in the market place or warrants a significant change in strategy.
- The Fed has committed to keep low rates through late 2014 and economic conditions continue to reflect only moderate growth.

**U.S. Treasury Yield Curve  
February 29, 2012 vs March 31, 2012**



**2-Year U.S. Treasury Yield  
December 31, 2011 – April 9, 2012**

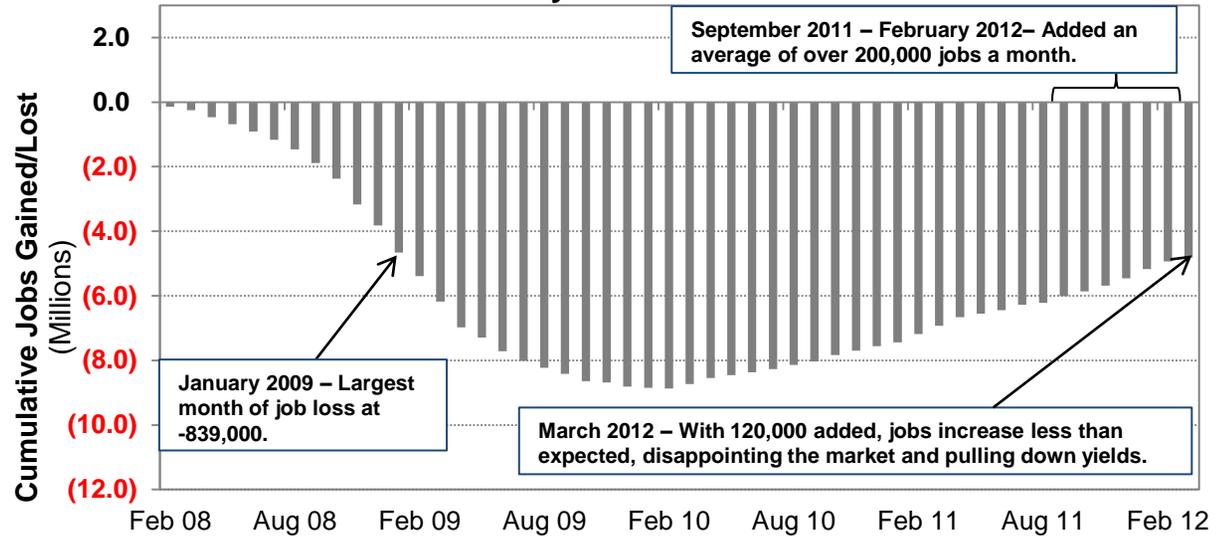




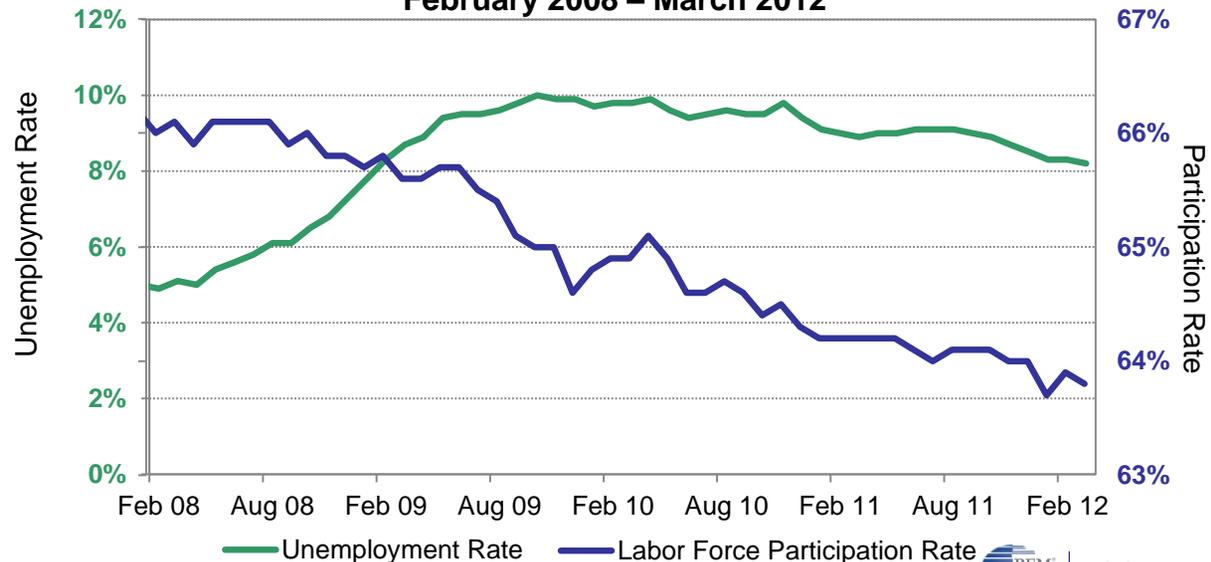
# Job Data Improving But Has a Ways To Go

- Beginning February 2008, the U.S. experienced 25 months of decreasing jobs, totaling 8.8 million jobs lost.
- Since March 2012, the U.S. has added jobs for 25 straight months, totaling 4 million gained.
- From February 2008 to March 2012, the result is a net loss of 4.8 million jobs.
- The Unemployment Rate declined in March to 8.2%, the lowest level in three years.
- However, the labor force participation rate also declined, suggesting the decrease in unemployment was a result of people leaving the labor force.
- On the bright side, baby boomers retiring are a big reason for the declining participation rate and not frustrated job seekers.

**Cumulative Jobs Gained and Lost  
February 2008 – March 2012**



**Unemployment Rate vs. Labor Force Participation Rate  
February 2008 – March 2012**

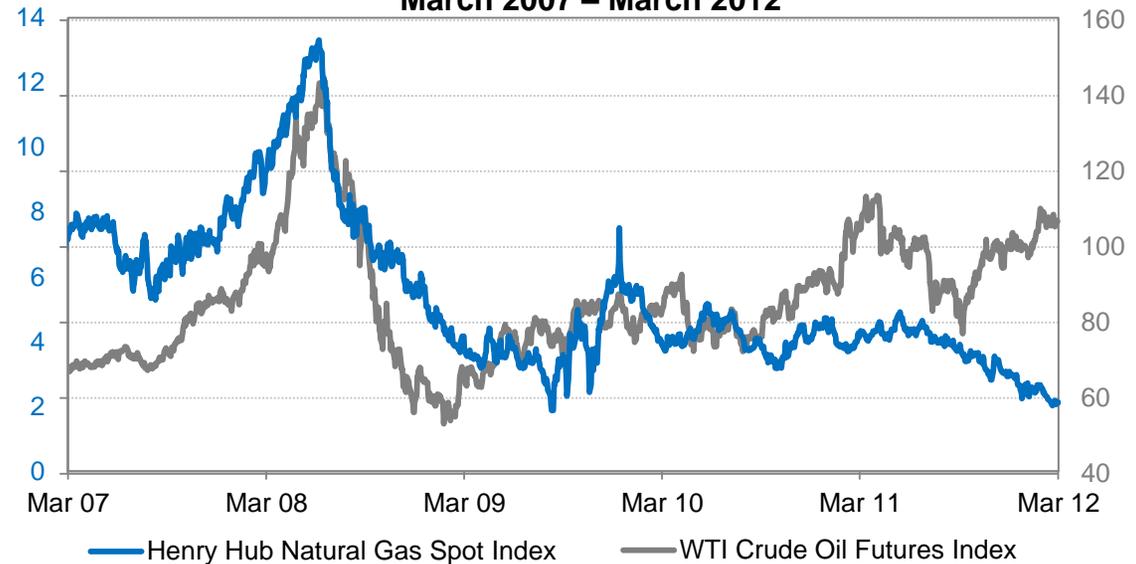




# With High Oil Prices Countered By Low Natural Gas Prices Confidence Remains Strong

- While oil prices, and therefore gas at the pump, has been on the rise, natural gas prices and a mild winter have helped ease the consumer's burden.

**Henry Hub Natural Gas Spot Index vs. WTI Crude Oil Futures Index  
March 2007 – March 2012**



- This could help explain why consumer confidence has not declined as gas prices have risen.
- Employment growth, income gains and higher stock prices are helping sustain the improvement in confidence that may help lift consumer spending.

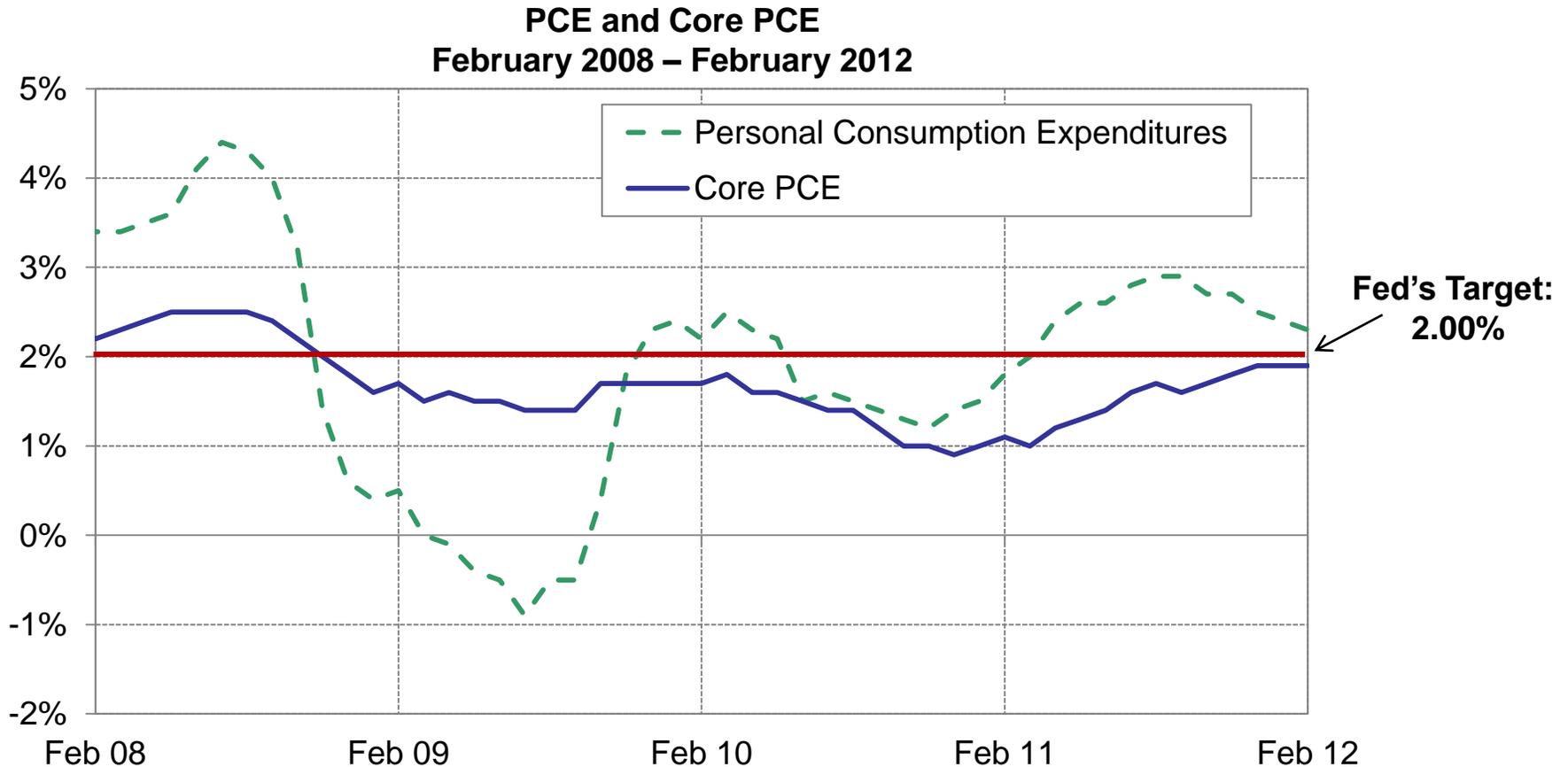
**Consumer Confidence  
March 2007 – March 2012**





# Fed Remains Unconcerned About Inflation

- While the price of food in the grocery store and the price of gas at the pump are on the rise, Core Personal Consumption Expenditures (PCE), the Fed's preferred measure of inflation, is low and slightly below the Fed's target.
- Core PCE, which excludes the price of food and energy, was at 1.9% at the end of February. Including the more volatile food and energy, inflation is slightly higher, however very close to the Fed's target.

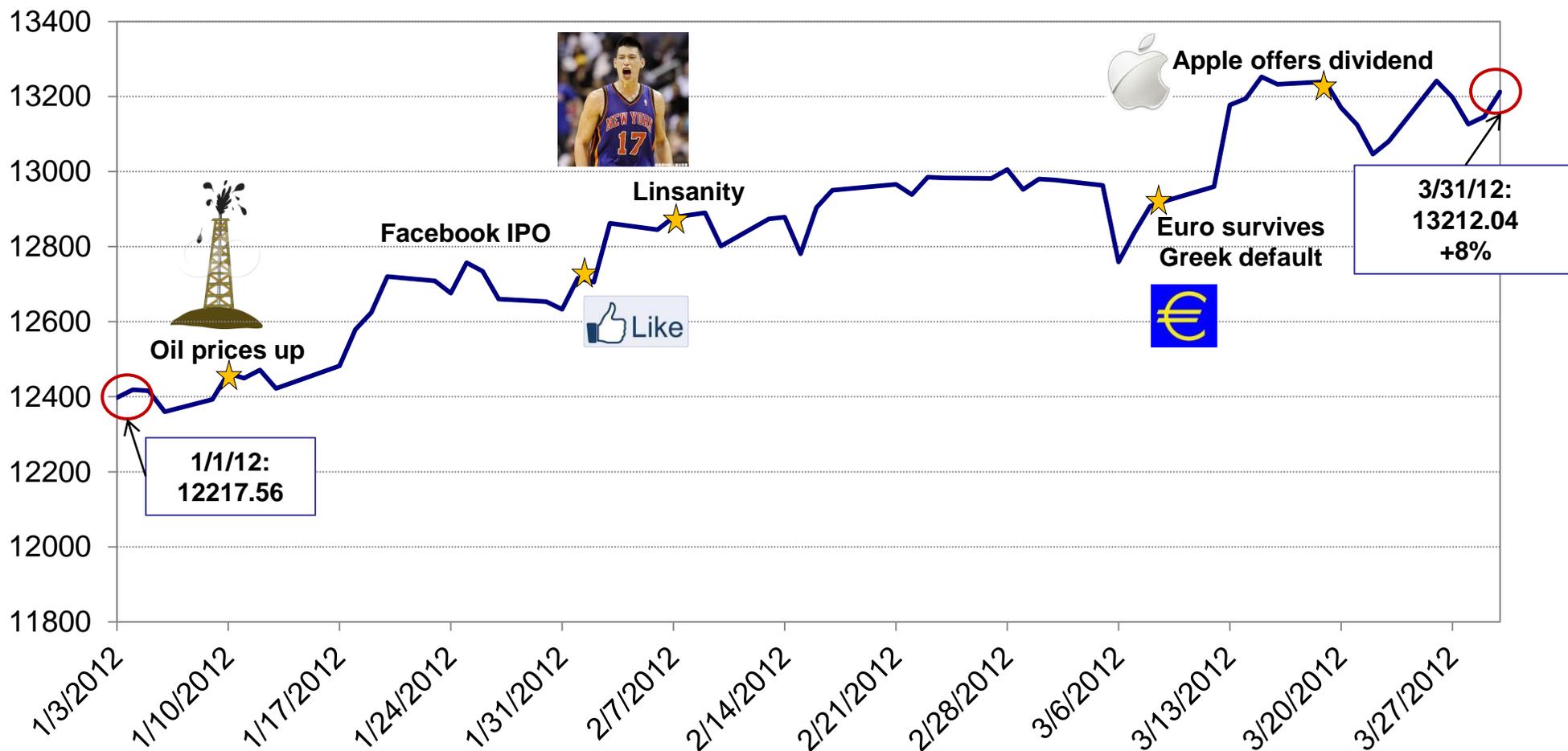




# Good News: Stock Market and Corporate Earnings

- The Dow Jones recorded its best first quarter since 1998, up 8% from January 1 to March 31.
- Corporate earnings, which are just beginning to be released, are expected to come in strong.

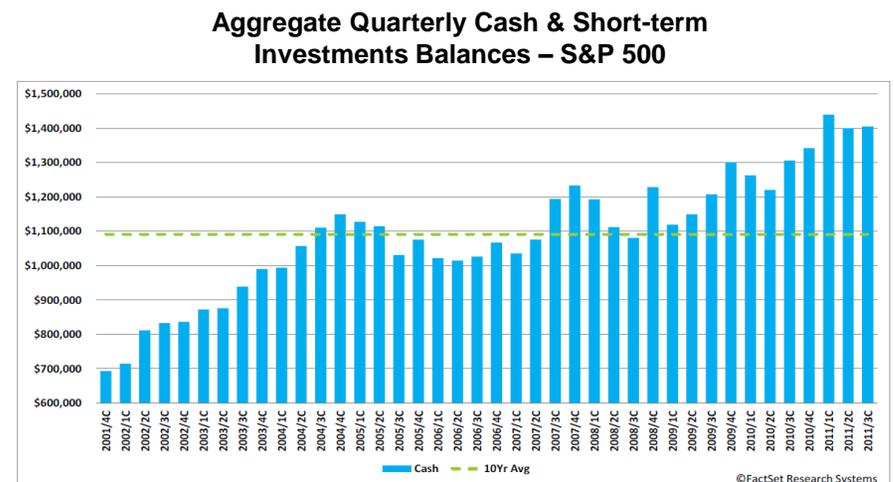
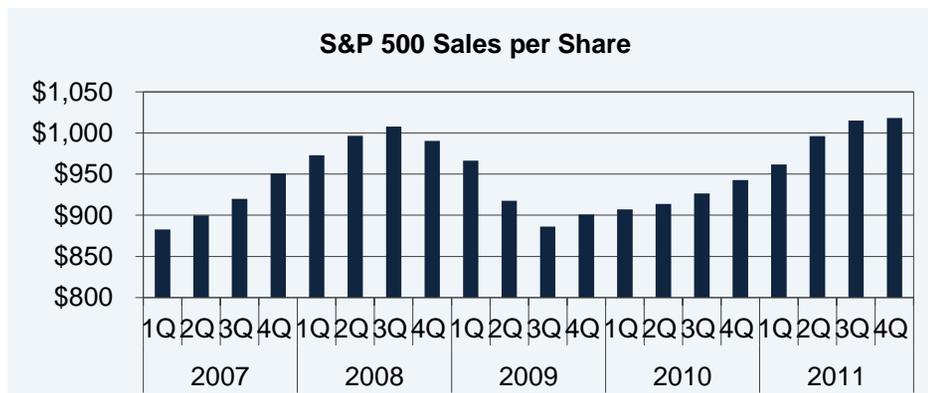
## Dow Jones





# Despite Stronger Balance Sheets, Persistent Downward Trend in Ratings

- Although corporate balance sheets are strong, credit ratings continue to decline.





## Why Credit Ratings Are Being Downgraded

- Standard & Poor's has changed the rating methodology for banks.
- Moody's has changed their view on the risks associated with banks.
- Credit rating criteria is now a moving target for managers.
- The string of sovereign rating downgrades has impacted bank ratings.
- Management views high credit ratings as less important.
- Shareholder friendly activities have negatively impacted credit ratings.

Despite the trend toward lower ratings in the banking sector, more stringent regulation likely makes the banking sector more stable.

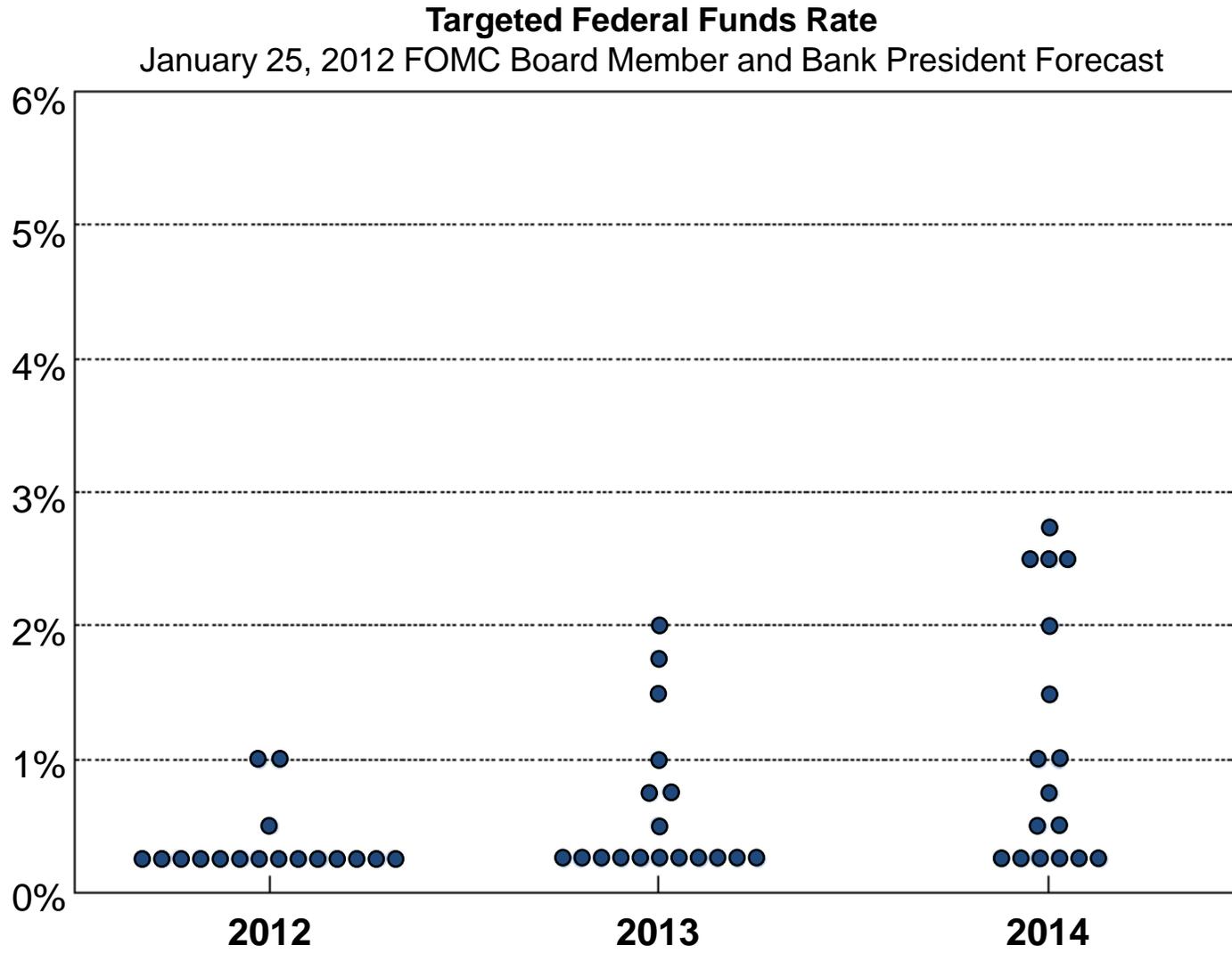


## Downgrades Will Continue

- The trend of lower credit ratings will continue.
- Changes primarily due to changing methodologies at rating agencies.
- It will take years, if ever, for ratings to return to previous levels.
- Fewer companies will have ratings high enough to meet statutes.
- There are highly rated investable foreign issuers.



# Federal Reserve Likely on Hold Through 2014





## Managed Account Detail of Securities Held

For the Month Ending **March 31, 2012**

### TOWN OF FOUNTAIN HILLS, OPERATING FUNDS

Security Type/Description Dated Date/Coupon/Maturity	CUSIP	Par	S&P Rating	Moody's Rating	Trade Date	Settle Date	Original Cost	YTM at Cost	Accrued Interest	Amortized Cost	Market Value
<b>U.S. Treasury Bond / Note</b>											
US TREASURY NOTES DTD 07/15/2010 1.000% 07/15/2013	912828NN6	2,000,000.00	AA+	Aaa	10/03/11	10/03/11	2,026,093.75	0.27	4,230.77	2,018,872.82	2,018,593.75
US TREASURY NOTES DTD 03/15/2011 1.250% 03/15/2014	912828PZ7	1,000,000.00	AA+	Aaa	10/03/11	10/03/11	1,021,992.19	0.35	577.45	1,017,549.39	1,017,500.00
US TREASURY NOTES DTD 05/16/2011 1.000% 05/15/2014	912828QM5	750,000.00	AA+	Aaa	03/27/12	03/29/12	759,902.34	0.38	2,843.41	759,864.20	759,843.75
US TREASURY NOTES DTD 12/15/2011 0.250% 12/15/2014	912828RV4	725,000.00	AA+	Aaa	01/05/12	01/06/12	722,167.97	0.38	534.84	722,393.28	720,638.40
US TREASURY NOTES DTD 02/01/2010 2.250% 01/31/2015	912828MH0	250,000.00	AA+	Aaa	01/24/12	01/25/12	263,837.89	0.40	942.65	262,998.64	262,167.97
US TREASURY N/B DTD 02/15/2012 0.250% 02/15/2015	912828SE1	750,000.00	AA+	Aaa	02/22/12	02/27/12	746,103.52	0.43	236.95	746,225.54	744,609.00
US TREASURY N/B DTD 03/15/2012 0.375% 03/15/2015	912828SK7	300,000.00	AA+	Aaa	03/13/12	03/15/12	298,992.19	0.49	51.97	299,007.62	298,851.56
<b>Security Type Sub-Total</b>		<b>5,775,000.00</b>					<b>5,839,089.85</b>	<b>0.35</b>	<b>9,418.04</b>	<b>5,826,911.49</b>	<b>5,822,204.43</b>
<b>Federal Agency Bond / Note</b>											
FFCB BONDS DTD 01/15/2010 1.750% 02/21/2013	31331JBV4	1,250,000.00	AA+	Aaa	10/03/11	10/04/11	1,274,787.50	0.31	2,430.56	1,265,971.68	1,265,716.25
FHLMC NOTES DTD 02/04/2011 0.750% 03/28/2013	3137EACS6	1,150,000.00	AA+	Aaa	10/03/11	10/04/11	1,156,808.00	0.35	71.88	1,154,555.37	1,155,798.30
FHLB GLOBAL NOTES DTD 07/21/2011 0.500% 08/28/2013	313374Y61	750,000.00	AA+	Aaa	10/03/11	10/04/11	751,125.00	0.42	343.75	750,834.93	751,864.50
FANNIE MAE GLOBAL NOTES DTD 08/06/2010 1.000% 09/23/2013	31398A2S0	1,500,000.00	AA+	Aaa	10/03/11	10/04/11	1,516,950.00	0.42	333.33	1,512,731.84	1,514,181.00
FREDDIE MAC GLOBAL NOTES DTD 09/19/2011 0.375% 10/30/2013	3137EACX5	1,000,000.00	AA+	Aaa	10/03/11	10/04/11	998,370.00	0.45	1,572.92	998,755.26	1,002,252.00
FHLMC NOTES DTD 01/06/2011 1.375% 02/25/2014	3137EACR8	850,000.00	AA+	Aaa	11/28/11	11/30/11	864,722.00	0.59	1,168.75	862,522.63	867,970.70



**Managed Account Detail of Securities Held**

For the Month Ending **March 31, 2012**

**TOWN OF FOUNTAIN HILLS, OPERATING FUNDS**

<b>Security Type/Description</b> <b>Dated Date/Coupon/Maturity</b>	<b>CUSIP</b>	<b>Par</b>	<b>S&amp;P Rating</b>	<b>Moody's Rating</b>	<b>Trade Date</b>	<b>Settle Date</b>	<b>Original Cost</b>	<b>YTM at Cost</b>	<b>Accrued Interest</b>	<b>Amortized Cost</b>	<b>Market Value</b>
<b>Federal Agency Bond / Note</b>											
FEDERAL HOME LOAN BANK GLOBAL NOTES DTD 04/15/2011 1.375% 05/28/2014	313373JR4	1,000,000.00	AA+	Aaa	10/03/11	10/03/11	1,021,120.00	0.57	4,697.92	1,017,208.18	1,021,311.00
FNMA NOTES DTD 07/18/2011 0.875% 08/28/2014	3135G0BY8	750,000.00	AA+	Aaa	10/03/11	10/03/11	754,860.00	0.65	601.56	754,039.11	756,375.75
FNMA GLOBAL NOTES DTD 10/26/2009 2.625% 11/20/2014	31398AZV7	700,000.00	AA+	Aaa	10/03/11	10/03/11	741,846.00	0.69	6,686.46	735,297.06	738,273.20
<b>Security Type Sub-Total</b>		<b>8,950,000.00</b>					<b>9,080,588.50</b>	<b>0.47</b>	<b>17,907.13</b>	<b>9,051,916.06</b>	<b>9,073,742.70</b>
<b>Managed Account Sub-Total</b>		<b>14,725,000.00</b>					<b>14,919,678.35</b>	<b>0.42</b>	<b>27,325.17</b>	<b>14,878,827.55</b>	<b>14,895,947.13</b>
<b>Securities Sub-Total</b>		<b>\$14,725,000.00</b>					<b>\$14,919,678.35</b>	<b>0.43%</b>	<b>\$27,325.17</b>	<b>\$14,878,827.55</b>	<b>\$14,895,947.13</b>
<b>Accrued Interest</b>											<b>\$27,325.17</b>
<b>Total Investments</b>											<b>\$14,923,272.30</b>



## Disclaimer

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