Town of Fountain Hills

Investment Performance Review
Second Quarter 2012

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Summary

- During the second quarter, investors searched for a safe place to hide amid weaker economic data and the ongoing European sovereign debt crisis. European efforts to stem contagion from its ongoing debt crisis resulted in higher volatility for European markets.
- U.S. economic data showed mixed results. While the labor market and the manufacturing sector looked weaker, the housing market showed signs of a rebound.
- PFM Asset Management LLC (PFMAM) believes the domestic economy will continue to expand, albeit at a slower pace, and aims to take advantage of the more volatile market environment by finding compelling yet undervalued investment opportunities.

Economic News

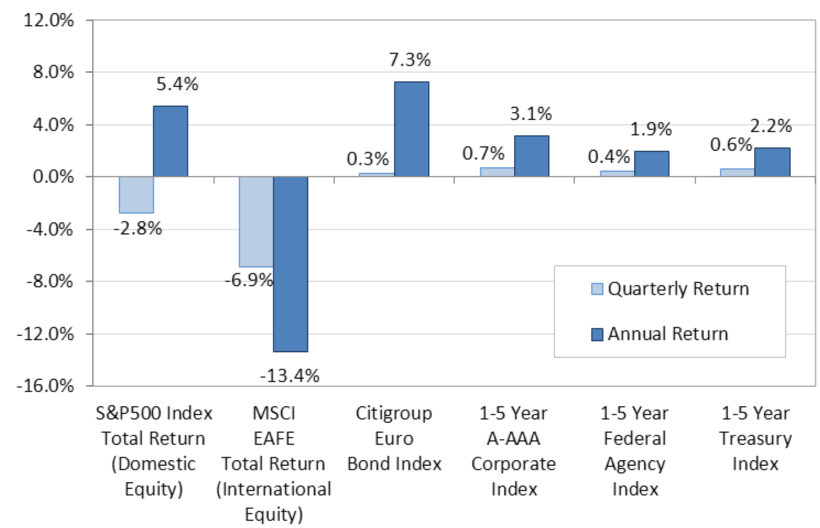
Economic data was weaker across the globe. Gross domestic product (GDP) in the U.S. for the first quarter of 2012 was 1.9%, compared to 3.0% for the fourth quarter of 2011. At the same time, the European economic picture worsened, as Spain fell into its second recession since 2009 and the European debt crisis continued to pose challenges. Emerging-markets economies also experienced slower growth, as China had its slowest pace of economic growth since 2009 and India reported first-quarter growth of 5.3% compared to a 6.1% rate of growth for the previous quarter. In response, central banks have kept accommodative policies in place and, in some cases, added further support to their economies.

U.S. job market conditions deteriorated during the quarter, as the unemployment rate had its first increase since June 2011, rising to 8.2% in May from 8.1% in April. However, the housing market has shown some improvements during the quarter. New-home sales in May exceeded economists' expectations, reaching their highest level since April 2010, and the S&P/Case-Shiller Index reported a third consecutive month of price gains for single-family homes.

Oil and other commodity prices fell for most of the quarter due to reports of slower growth in the global economy. However, they rebounded sharply at the end of June, with the S&P GSCI Index rising the most in three years when the European Union announced it would increase its aid to struggling member nations. The S&P 500 Index rallied on this positive news as well, after losing ground in the first two months of the quarter.

Total Returns of Various Asset Classes

Quarter ended June 30, 2012



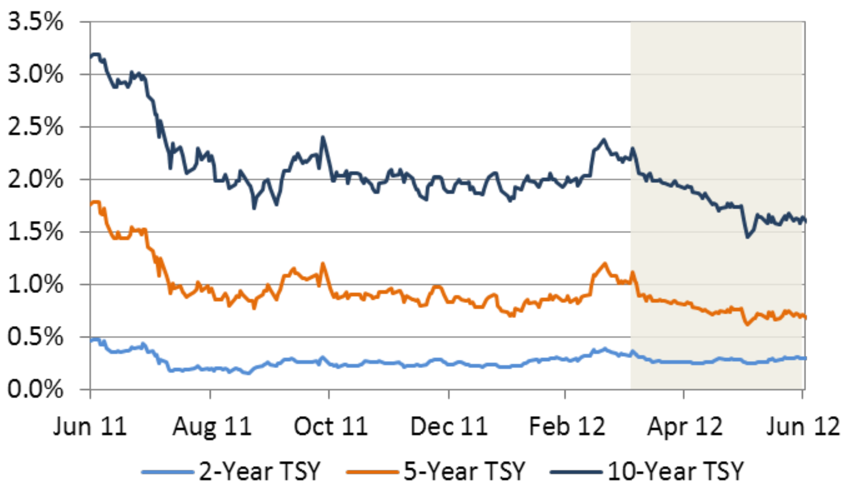
Sources: Bank of America Merrill Lynch, Citigroup, Bloomberg

Interest Rates

U.S. interest rates declined across the yield curve. Slowing growth, a decline in inflation, and a flight to quality all fed the decline. The Federal Reserve (the "Fed") maintained its commitment to keeping interest rates at low levels until at least late 2014, and the federal funds rate stayed within a band from zero to 0.25%. The central bank also stated that it would extend its program of buying longer-dated Treasuries while selling short-dated Treasuries, also known as "Operation Twist," until the end of the year. The Fed lowered its forecasts for domestic economic growth, while at the same time increasing its forecasts for unemployment.

2-Year, 5-Year, and 10-Year U.S. Treasury Note Yields

June 30, 2011 through June 30, 2012



Source: Bloomberg

Thirty-year mortgage rates fell to new lows, which drove some of the positive developments in the housing market. As shown in the charts on the following page, longer-dated Treasuries performed well for the quarter and 12-month period. Corporate bonds outperformed Treasuries and Agencies on a duration-adjusted basis for the quarter and 12-month period, and Treasuries beat Agencies for the quarter but not for the 12-month period. Agencies and corporate bonds had a difficult time during the month of May as the markets dealt with the uncertainties surrounding the European debt crisis; however, both sectors improved markedly in June as a result of Europe's new commitments to resolving its debt crisis.

Five- and ten-year Treasury yields dropped to record lows after the employment report was released on June 1, and then increased slightly during the month. Agency spreads remained mostly unchanged from May to June, and outperformed Treasuries in June due to their relatively higher yields. With Agency and corporate spreads narrowing, PFMAM believes that municipal and Agency mortgage-backed securities provide good value with acceptable levels of risk.

U.S. Treasury Yields – Quarter and Year-over-Year Changes

Date	3-month	1-year	2-year	5-year	10-year	30-year
30-Jun-12	0.08%	0.21%	0.30%	0.72%	1.65%	2.75%
31-Mar-12	0.07%	0.17%	0.33%	1.04%	2.21%	3.34%
Change over Quarter	0.02%	0.04%	-0.03%	-0.32%	-0.57%	-0.58%
30-Jun-11	0.02%	0.19%	0.46%	1.76%	3.16%	4.37%
Change over Year	0.07%	0.02%	-0.16%	-1.04%	-1.52%	-1.62%

Source data: Bloomberg

PFMAM Outlook

We believe that the domestic economy will continue to grow, despite weaker reports on the jobs market. Shorter-term rates are range-bound, while longer-term yields are declining, resulting in a flatter yield curve. Currently, we do not believe that rates will head substantially higher, as the Fed is maintaining a loose monetary policy and inflation remains within the Fed's mandate of 2% for core personal consumption expenditures.

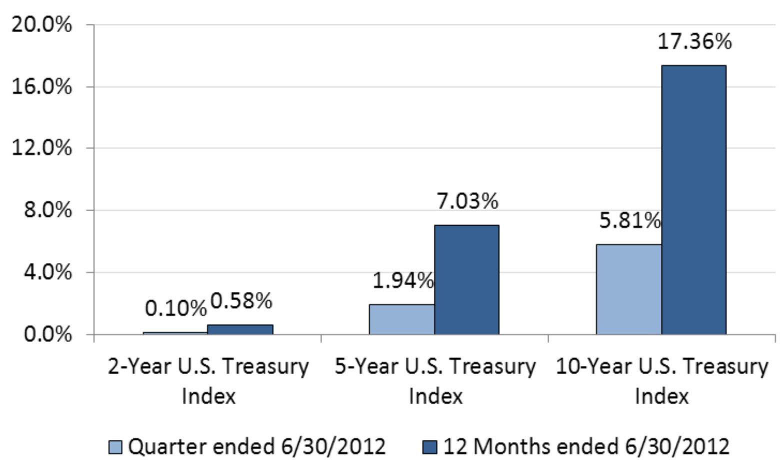
Lower oil prices may currently provide some relief to U.S. consumers. On the other hand, the gloomy employment picture is still weighing on consumer spending, as is higher core inflation.

The extension of "Operation Twist" announced by the Fed in June should place continued downward pressure on intermediate-term Treasury yields, as the Fed will buy up to $267 billion in securities over the coming months. The action should support rates for Treasuries with maturities of two years and under, as the Fed offsets its purchases by selling short-dated Treasuries.

Short-term yields have stayed within a narrow range for the quarter. There are also fewer opportunities for investment in the money market sector, as Fannie Mae and Freddie Mac reduce their short-term debt issuance. Agency and corporate spreads have been volatile and reactive to risk-on/risk-off psychology in the market, which creates opportunities for active management strategies to add value.

Returns for 2-Year, 5-Year, and 10-Year Treasuries

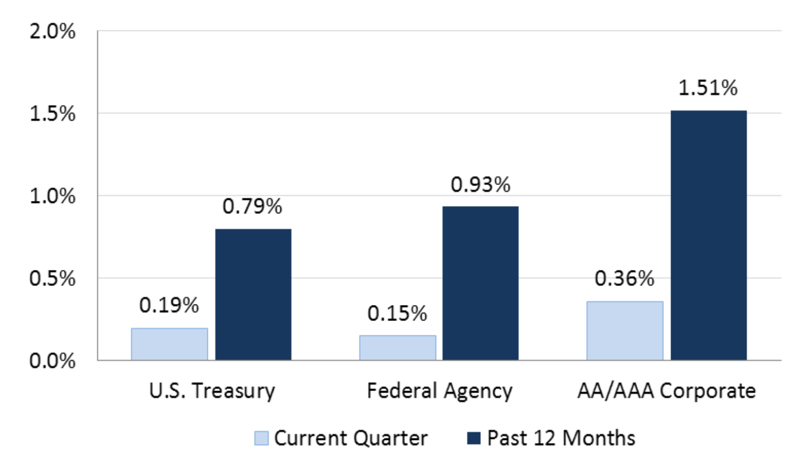
Quarter ended June 30, 2012



Source: Bloomberg, using Bank of America Merrill Lynch indexes.

Duration-Adjusted Returns for Fixed-Income Securities

Quarter ended June 30, 2012



Source: Bloomberg, using Bank of America Merrill Lynch 1-3 year indexes.

Portfolio Summary

Total Portfolio Value	**June 30, 2012**	March 31, 2012
Market Value	**$15,078,333.35**	$15,050,077.38
Amortized Cost	**$15,050,304.47**	$15,032,957.80

PORTFOLIO RECAP

- The portfolio complies with the Arizona Revised Statutes and the Town's investment policy. The portfolio is diversified among U.S. Treasury and Federal Agency securities.
- The pace of economic activity in the U.S. slowed further in the second quarter, kicking off a strong rally in the Treasury market. Weaker than expected economic data, the continuation of the Fed's "Operation Twist" program, and a flight-to-quality caused by worsening turmoil in the Euro-Zone pushed long-term yields sharply lower.
- After starting the quarter at a yield of 2.21%, the 10-year Treasury fell 76 basis points (0.76%), hitting an all-time low of 1.45% in early June. At that point, investors decided that getting just 145 pennies of interest each year for every $100 lent to the U.S. government was perhaps a bad deal, and rates moved modestly higher through June.
- In contrast to long-term maturities, 2-year Treasury yields stayed within a narrow range of 0.24% to 0.37% as the Federal Reserve's near-zero interest rate policy anchored the front end of the yield curve.
- The turmoil in Europe triggered a shift from the first quarter's "risk on" trade, which strongly favored agencies,, to the second quarter's "risk off" trade, which favored Treasuries in April and early May. Widening yield spreads created good investment opportunities, though, as market psychology reversed again in June. The quarter ended with a solid rally in spread product, benefitting portfolios with allocations to agency debt.
- The portfolio's allocations to Treasuries benefitted the portfolio early in the quarter as spreads widened and Treasuries outperformed. Mid-quarter, we gradually shifted our emphasis and began favoring agencies, which benefitted the portfolio again as spreads reversed and ended the quarter at narrow levels.

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Portfolio Summary - continued

PORTFOLIO STRATEGY

- The Euro-Zone debt crisis and decelerating growth across the globe will continue to drive the financial markets. Central banks around the world remain accommodative. Additional intervention by the ECB, and perhaps by the U.S. Federal Reserve as well, is likely if conditions weaken. Investments based in U.S. dollars and other non-Euro currencies are perceived as safe-havens, despite their very low yields.

- Another factor driving the U.S. bond market is the prognosis for weaker domestic growth. The U.S. economy will likely muddle through a slow period, but avoid a double dip recession. Consumer spending is expanding, energy costs have fallen, and borrowing costs at record lows have eased debt service burdens. With so much bad news priced into the markets, things could turn out better than expected, which would drive equity prices higher and corporate bond spreads narrower.

- A growth surprise in the U.S. could also kick-start a back-up in yields, but that risk is concentrated in longer maturities. With the Federal Reserve on hold through at least late 2014, shorter-term investments will likely remain range-bound near current levels.

- We currently favor extending maturities into the intermediate (2-4 year) range. We also plan to keep the portfolio's duration near the benchmark target as we begin the new quarter, using any bouts of market weakness to time monthly extensions advantageously.

- Agency-Treasury spreads are narrow, so we favor Treasuries in most shorter maturities. Callable agencies continue to underperform and will generally be avoided.

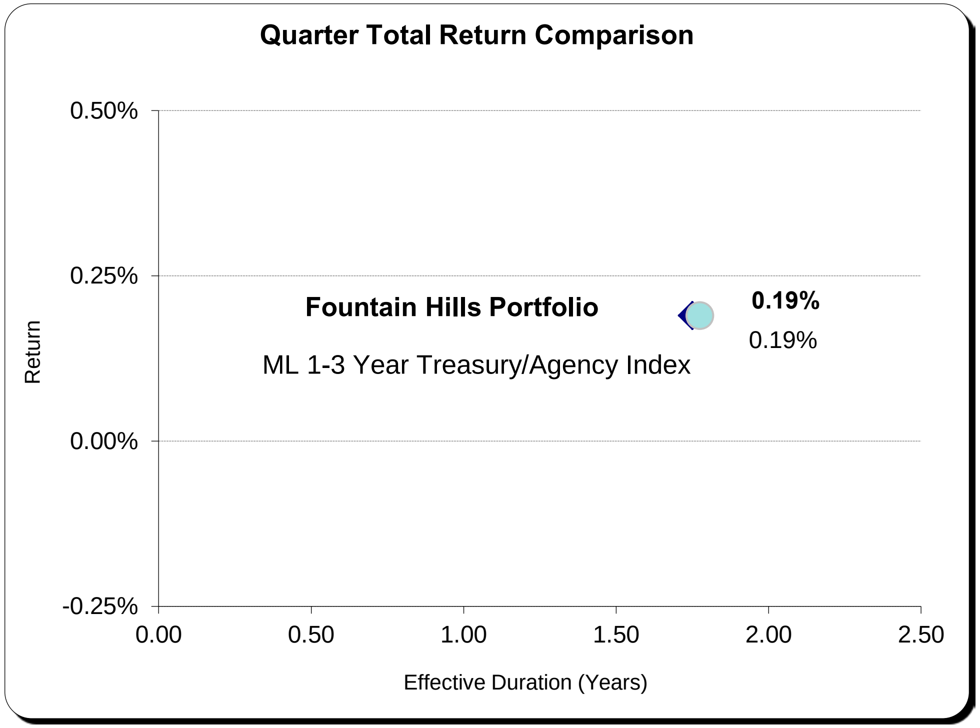
- As always, we strive to maintain the safety of principal while positioning the portfolio for growth and searching for tactical opportunities to enhance return. In these changing times, our strategy will remain flexible and may change in response to changes in interest rates, economic data, market outlook or specific opportunities that arise.

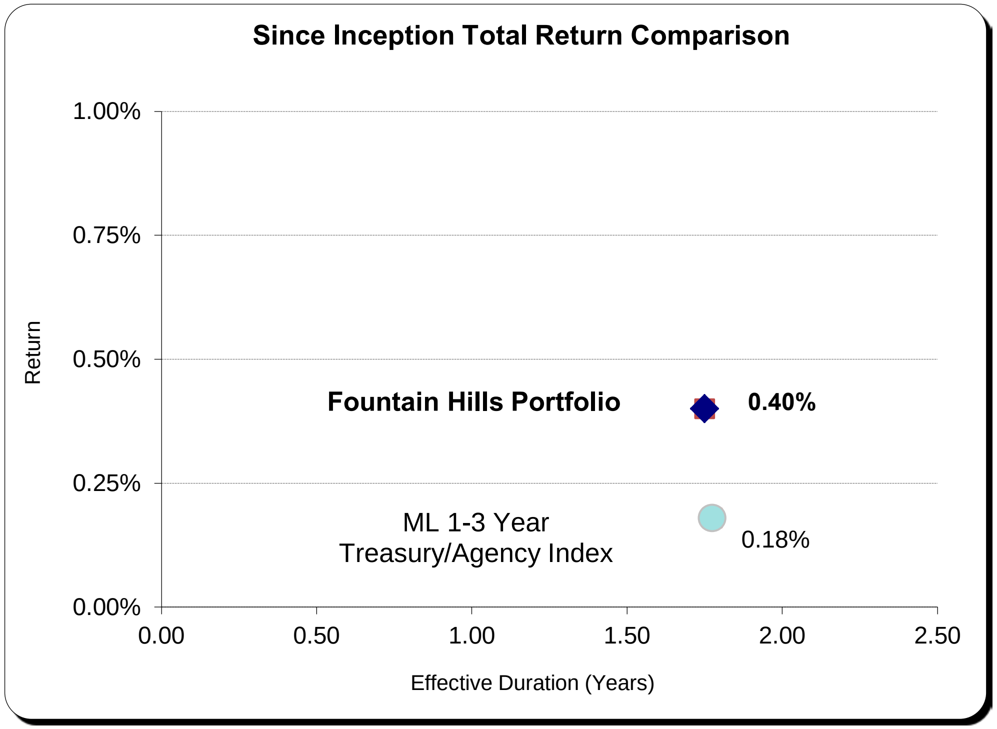
Operating Portfolio Performance

Total Return[1,2,3,4,5]	Quarter Ended June 30, 2012	Past 6 Months	Since Inception
Fountain Hills Portfolio	**0.19%**	**0.40%**	**0.40%**
ML 1-3 Year Treasury/Agency Index	0.19%	0.18%	0.18%

Effective Duration[5]	June 30, 2012	March 31, 2012
Fountain Hills Portfolio	**1.75**	**1.77**
ML 1-3 Year Treasury/Agency Index	1.78	1.77

Yields[5]	June 30, 2012	March 31, 2012
Yield at Market	0.34%	0.36%
Yield on Cost	0.44%	0.43%



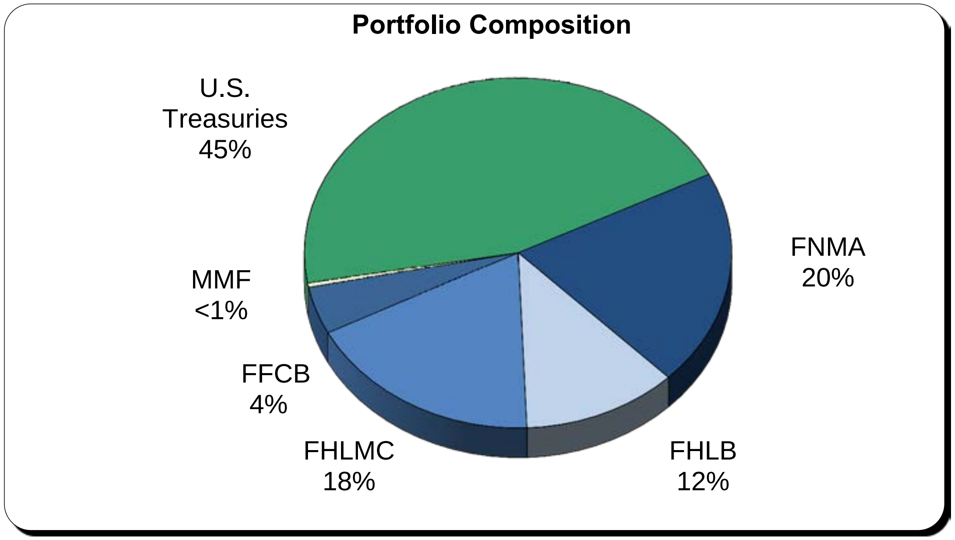


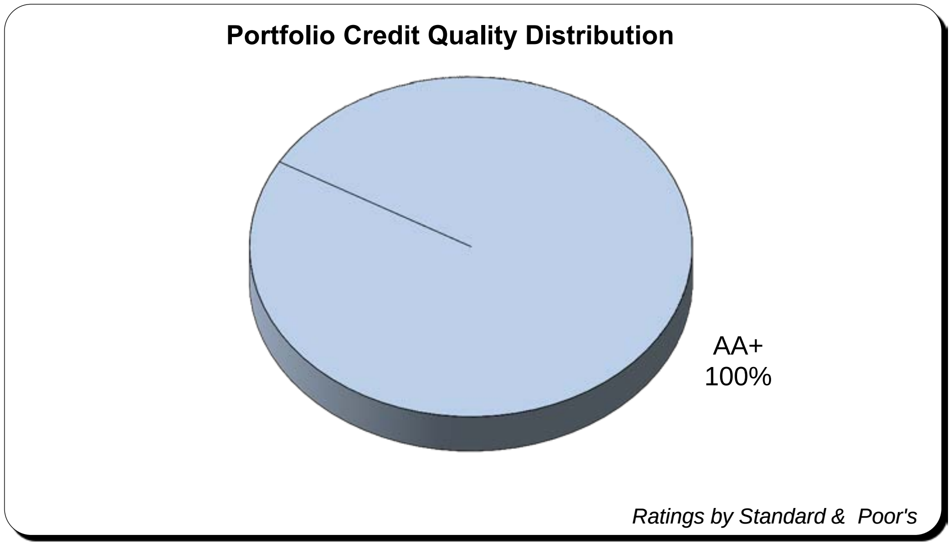
Notes:

1. Performance on trade date basis, gross (i.e., before fees), in accordance with the CFA Institute's Global Investment Performance Standards (GIPS).
2. Merrill Lynch Indices provided by Bloomberg Financial Markets.
3. Quarterly returns are presented on an unannualized basis. Performance numbers for periods greater than one year are presented on an annualized basis.
4. Inception date is 12/31/2011.

Portfolio Composition and Credit Quality Characteristics

Security Type[1]	June 30, 2012	% of Portfolio	March 31, 2012	% of Portfolio	Permitted by Policy
U.S. Treasuries	**$6,840,290.02**	**45.4%**	$5,831,622.47	38.7%	**100%**
Federal Agencies	**$8,178,136.64**	**54.2%**	$9,091,649.83	*60.4%*	**100%**
FNMA	*$3,015,307.88*	*20.0%*	*$3,016,451.30*	*20.0%*	-
FHLB	*$1,774,562.92*	*11.8%*	*$1,778,217.17*	*11.8%*	-
FHLMC	*$2,728,498.00*	*18.1%*	*$3,028,834.55*	*20.1%*	-
FFCB	*$659,767.84*	*4.4%*	*$1,268,146.81*	8.4%	-
MMF	**$59,906.69**	**0.4%**	$126,805.08	0.8%	
Totals	**$15,078,333.35**	**100.0%**	$15,050,077.38	100.0%	



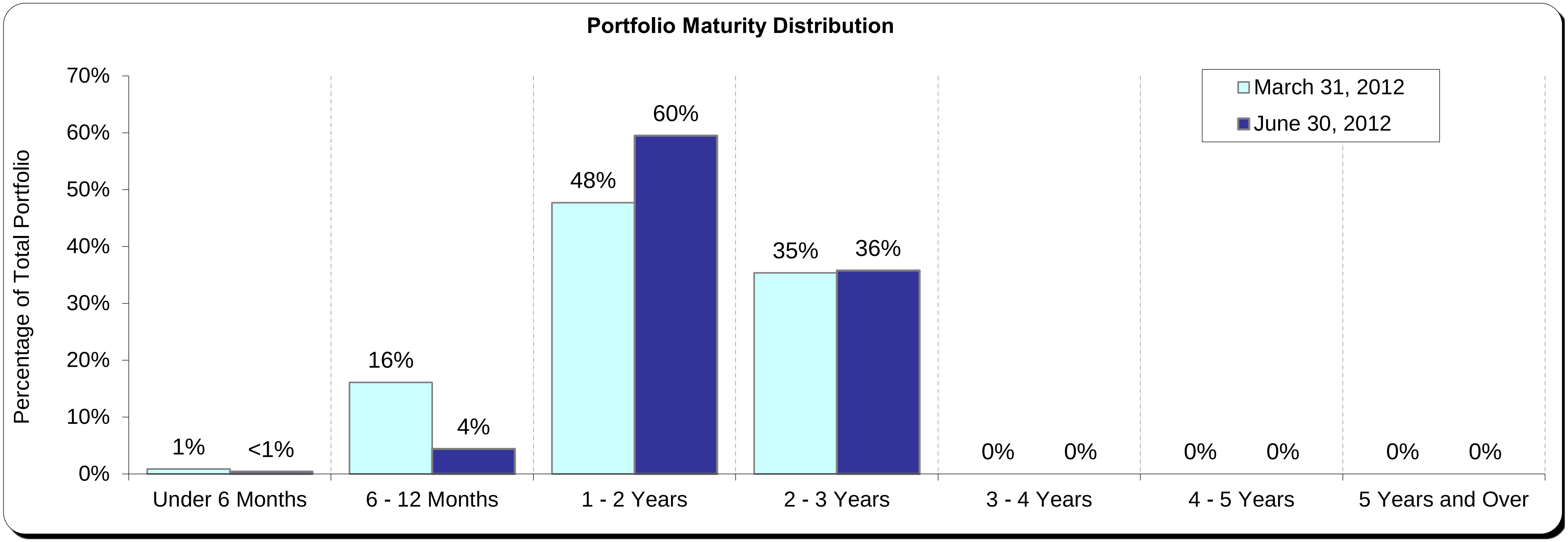


Notes:

1. End of quarter trade-date market values of portfolio holdings, including accrued interest.

Portfolio Maturity Distribution

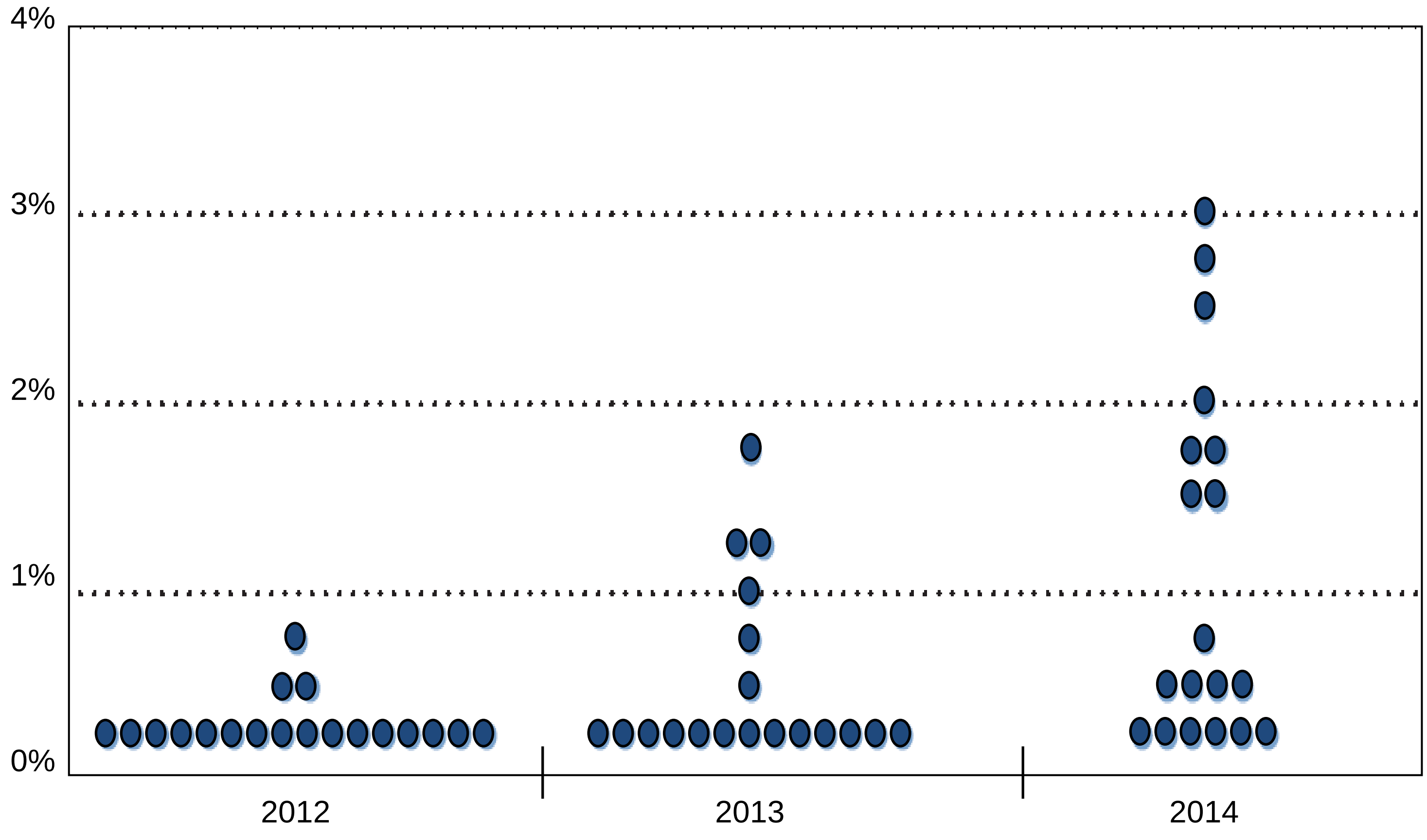
Maturity Distribution[1]	June 30, 2012	March 31, 2012
Under 6 Months	**$59,906.69**	$126,805.08
6 - 12 Months	**$659,767.84**	$2,424,016.99
1 - 2 Years	**$8,966,714.68**	$7,180,588.92
2 - 3 Years	**$5,391,944.14**	$5,318,666.39
3 - 4 Years	**$0.00**	$0.00
4 - 5 Years	**$0.00**	$0.00
5 Years and Over	**$0.00**	$0.00
Totals	**$15,078,333.35**	$15,050,077.38



Federal Reserve Likely on Hold Through 2014

- Over one half of FOMC members believe the target rate will be 0.50% or lower through 2014. The target rate has been 0.00%-0.25% since December 2008.
- The continuation of the Fed's accommodative interest rate policy will keep short-term rates low.

Targeted Federal Funds Rate at Year-End
FOMC Member Forecasts as of June 20, 2012



Source: Federal Reserve Open Market Committee

Portfolio Rebalancing At Month Ends – Maintained Extended Duration Position

- Because of the expectation for prolonged low rates, we performed duration extension trades at month ends to maintain our target duration position of approximately 95%-98% of the benchmark.

Trade Date	Trade Type	Security	Maturity	Par	Yield	Agency Spread over Treasury
5/31/12	Sell	FHLMC Notes	3/28/13	850,000	0.23%	-
5/31/12	**Buy**	**FHLMC Notes**	**11/25/14**	**850,000**	**0.50%**	**+0.18%**
6/27/12	Sell	FFCB Bonds	2/21/13	600,000	0.23%	-
6/27/12	Sell	FHLMC Notes	3/28/13	300,000	0.23%	-
6/27/12	**Buy**	**U.S. Treasury Notes**	**3/15/15**	**1,000,000**	**0.40%**	**+0.08%**

- Sector selection reflected capturing the most relative value available in the market at time of purchase. When spreads were wider we favored the Agency sector and as spreads narrowed during the end of the quarter we favored the Treasury sector.

Managed Account Detail of Securities Held

For the Month Ending **June 30, 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
U.S. Treasury Bond / Note											
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	9,230.77	2,015,216.60	2,015,234.00
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	3,668.48	1,015,334.18	1,015,742.00
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	957.88	758,712.20	759,258.00
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	79.23	722,631.76	723,130.86
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	2,348.90	261,857.42	261,953.00
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	705.70	746,552.15	747,363.00
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	330.16	299,090.18	299,812.50
US TREASURY N/B DTD 03/15/2012 0.375% 03/15/2015	912828SK7	1,000,000.00	AA+	Aaa	06/27/12	06/28/12	999,218.75	0.40	1,100.54	999,221.10	999,375.00
Security Type Sub-Total		**6,775,000.00**					**6,838,308.60**	**0.36**	**18,421.66**	**6,818,615.59**	**6,821,868.36**
Federal Agency Bond / Note											
FFCB BONDS DTD 01/15/2010 1.750% 02/21/2013	31331JBV4	650,000.00	AA+	Aaa	10/03/11	10/04/11	662,889.50	0.31	4,107.64	655,971.45	655,660.20
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	1,281.25	750,687.05	751,790.25
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	4,083.33	1,510,582.58	1,512,493.50
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	635.42	998,951.60	1,002,448.00
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	4,090.63	860,882.63	864,309.75

Managed Account Detail of Securities Held

For the Month Ending **June 30, 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
Federal Agency Bond / Note											
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	1,260.42	1,015,226.03	1,020,231.00
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	2,242.19	753,622.64	757,539.75
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	2,092.71	731,977.13	736,856.40
FREDDIE MAC GLOBAL NOTES DTD 10/06/2011 0.750% 11/25/2014	3137EACY3	850,000.00	AA+	Aaa	05/31/12	06/01/12	855,202.00	0.50	637.50	855,028.33	856,376.70
Security Type Sub-Total		**8,050,000.00**					**8,167,084.50**	**0.51**	**20,431.09**	**8,132,929.44**	**8,157,705.55**
Managed Account Sub-Total		**14,825,000.00**					**15,005,393.10**	**0.44**	**38,852.75**	**14,951,545.03**	**14,979,573.91**
Securities Sub-Total		**$14,825,000.00**					**$15,005,393.10**	**0.44%**	**$38,852.75**	**$14,951,545.03**	**$14,979,573.91**
Accrued Interest											**$38,852.75**
Total Investments											**$15,018,426.66**

Market Update
Quarter Ended June 30, 2012

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Economic and Market Conditions in 2nd Quarter

Economic Conditions

- U.S. job creation slowed
- European austerity measures curb growth
- China’s growth slowed as trade and manufacturing decelerated
- U.S. housing market quietly gained momentum
- Energy prices moderated

Market Reaction

- “Risk on” / “risk off” drove market volatility
- U.S. Treasury yields plunged to new all-time lows at the start of June
- Agency and corporate spreads widened in April and May, narrowed in June
- Equity market tumble but finish down modestly for the quarter

Yields Remain Low and Narrow

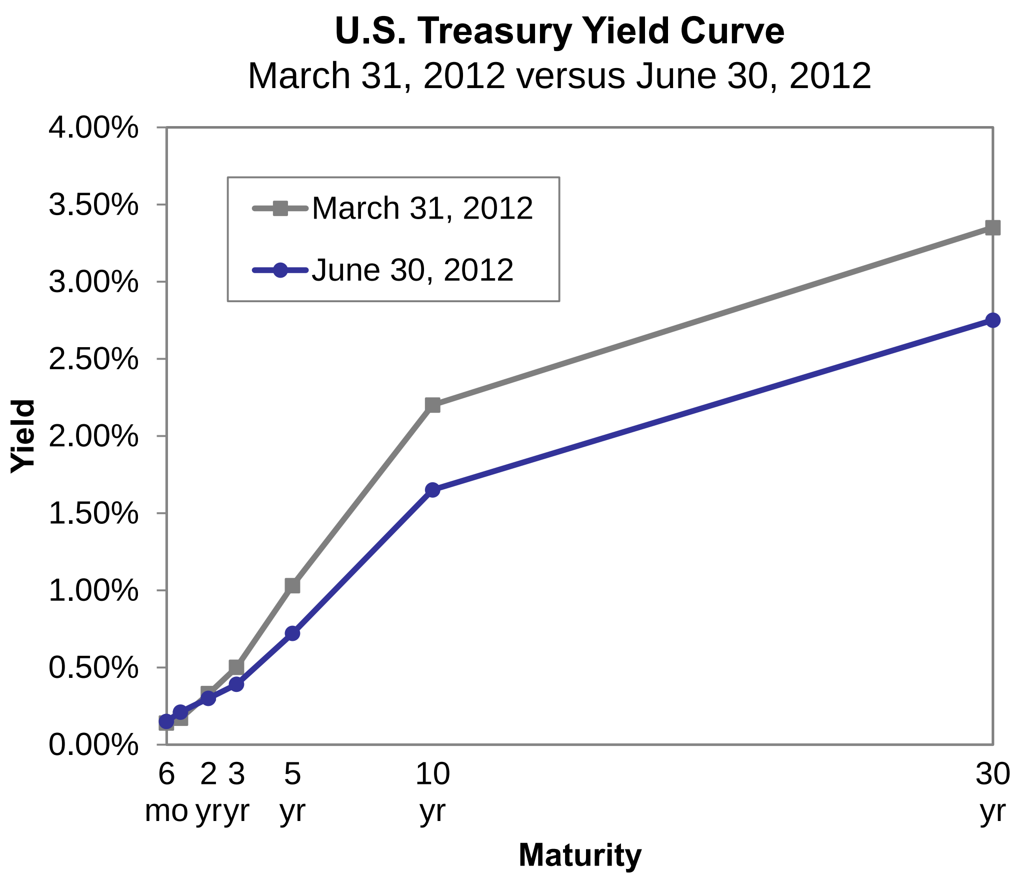
- The 2-year Treasury has averaged 0.44% for the past two years.
- Since August 2011, when the Federal Reserve first explicitly stated their expectation for low rates through mid-2013, the 2-year U.S. Treasury has traded between 0.20% and 0.35% and recently has been trading between an even narrower range.

2-Year U.S. Treasury Yields
July 2010 – June 2012

Source: Bloomberg

Longer-Term Yields Have Plummeted Due to Investor Flight-to-Quality

- Fears surrounding the future of Greece and other debt-ridden European countries such as Spain, Italy, and Ireland have pushed investors into the safety of U.S. Treasuries.
- The Fed's "Operation Twist" program has also put downward pressure on longer-term yields.



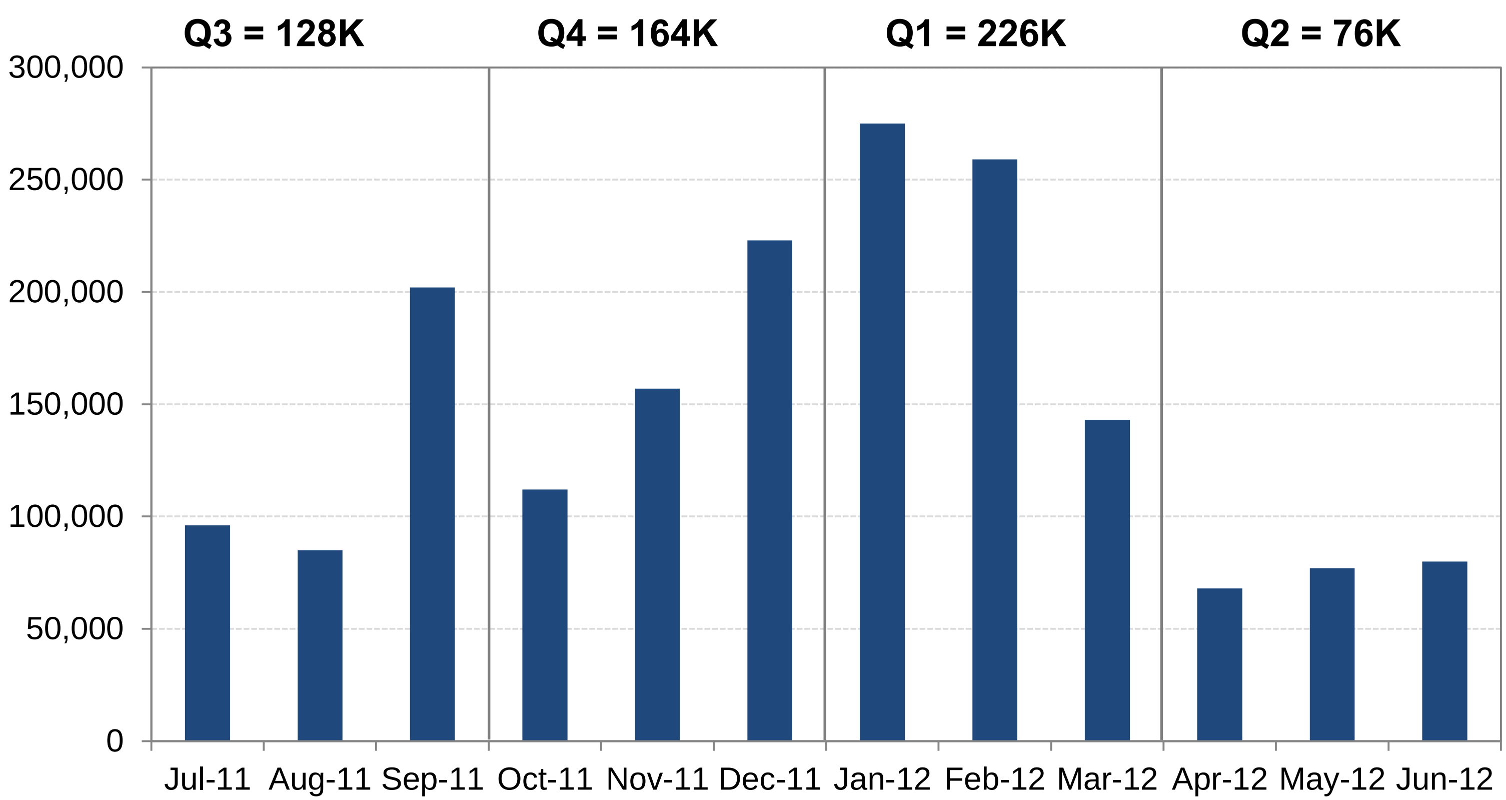
	March 31, 2012	June 30, 2012	Change
3 month	0.04%	0.08%	+0.04%
6 month	0.14%	0.15%	+0.01%
1 year	0.17%	0.21%	+0.04%
2 year	0.33%	0.30%	-0.03%
3 year	0.50%	0.39%	-0.11%
5 year	1.03%	0.72%	-0.31%
10 year	2.20%	1.65%	-0.55%
30 year	3.35%	2.75%	-0.60%

Source: Bloomberg

Monthly Job Gains Slow Sharply in Second Quarter

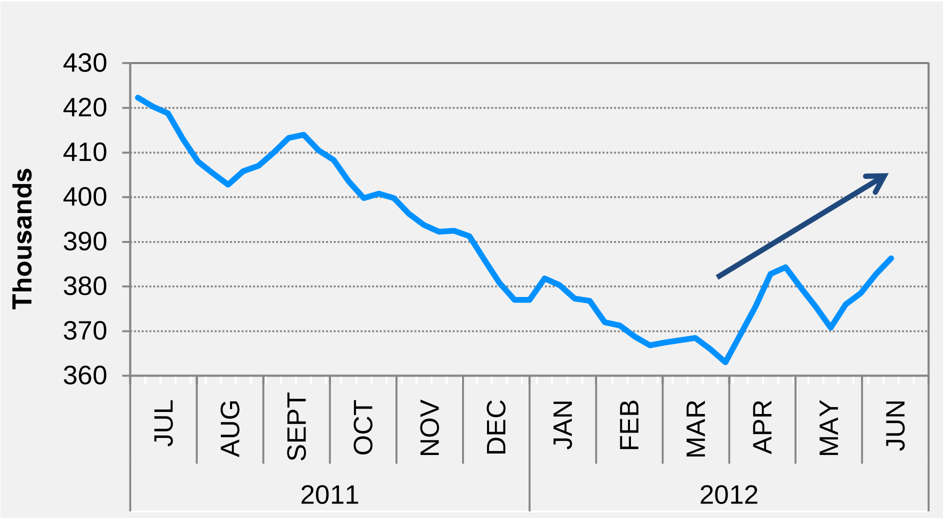
- The U.S. economy lost approximately 8.8 million jobs during the recession and its aftermath — to date only 3.8 million jobs have been added.
- At the recent three months average pace it will take more than five years to get employment back to pre-recession levels.
- The official unemployment rate remains at 8.2% while U-6 unemployment, a broader unemployment measure including individuals who have not been actively looking for a job recently but are willing to work as well as those who are employed part-time due to economic reasons, rose to 14.9% in June from 14.8% in May.

Quarterly Average Job Gain

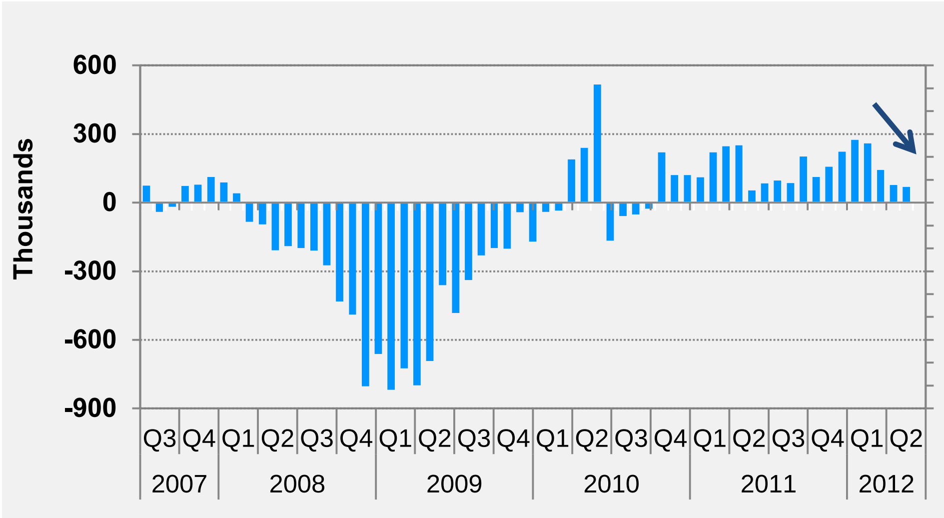


Things are Tough All Over

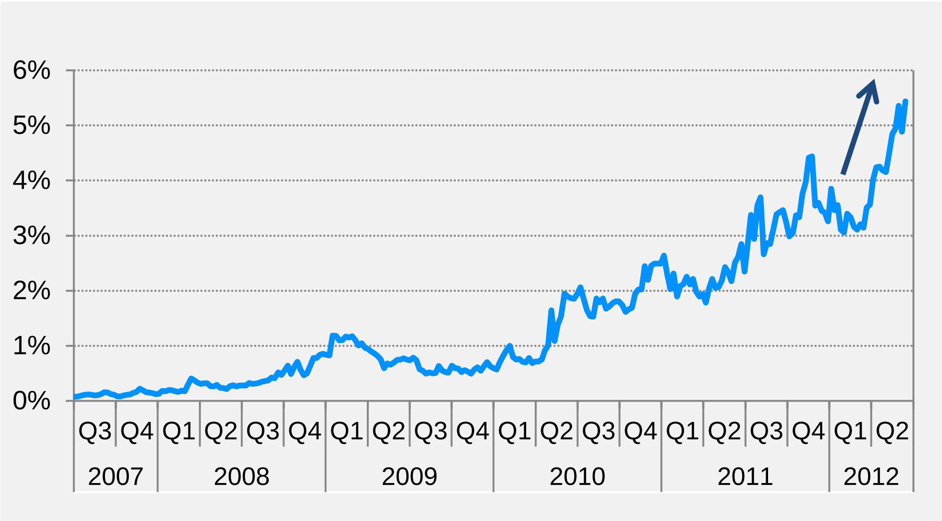
Jobless Claims 4-Week Moving Average



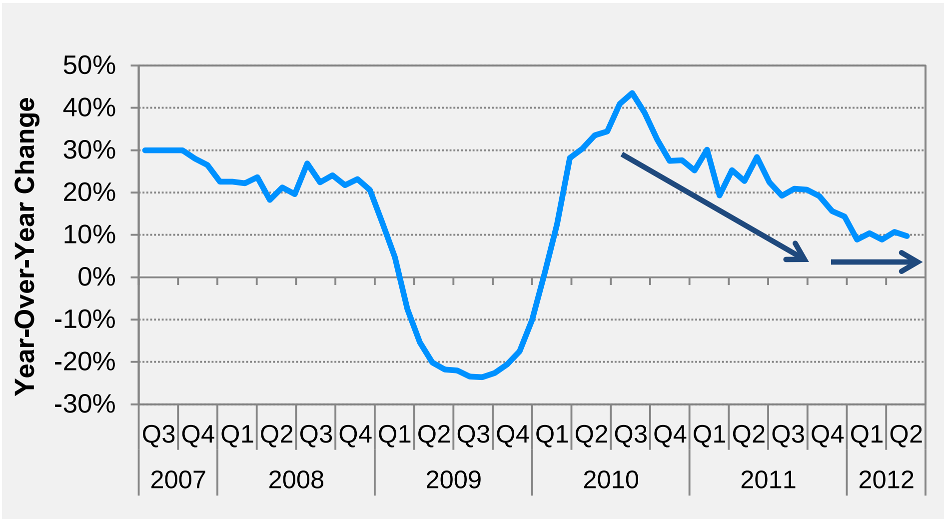
U.S. Nonfarm Payrolls



10-year Spanish Bond Spread over German Bunds



Chinese Exports 3-month Moving Average

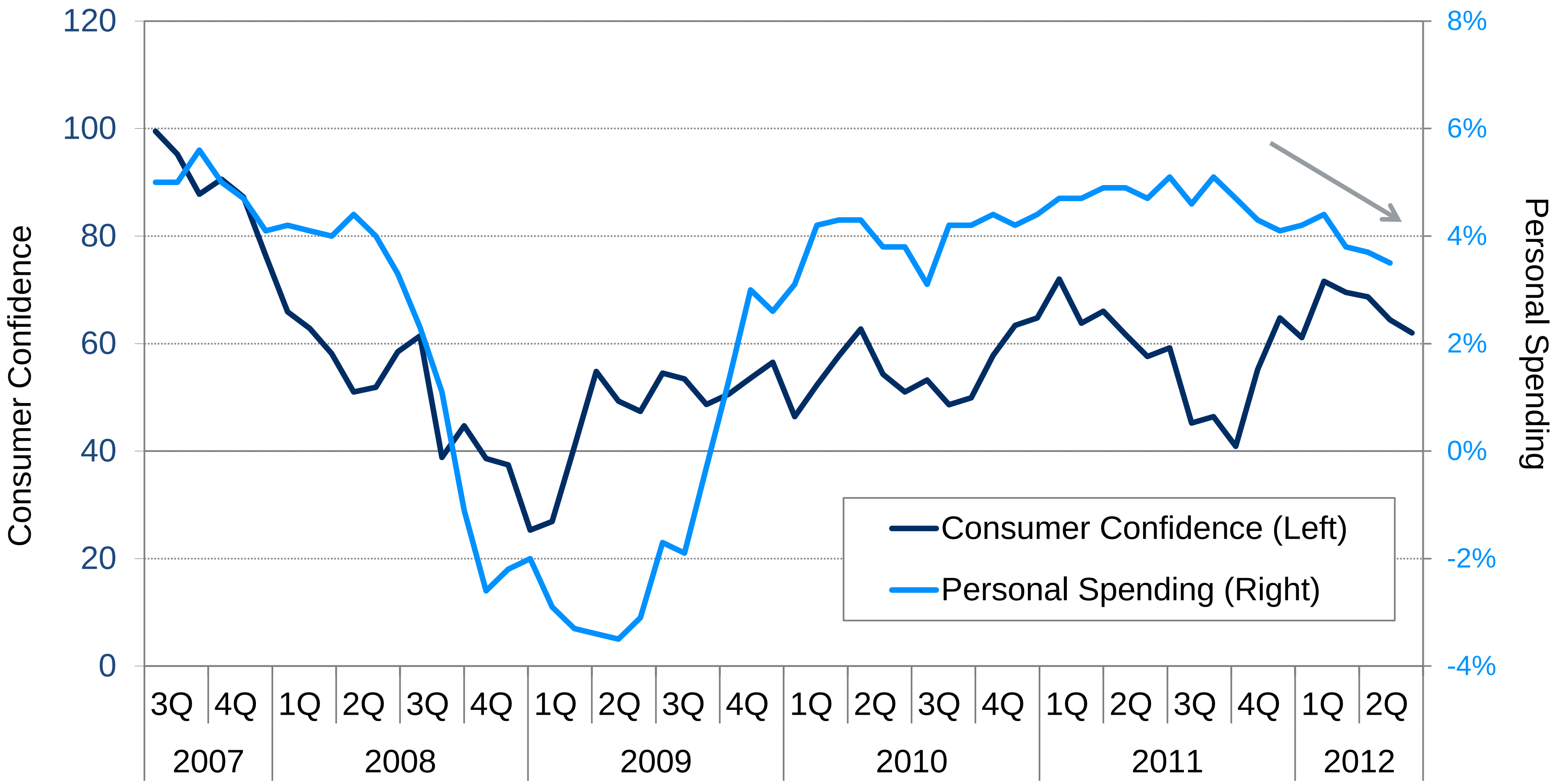


Source: Bloomberg

Lower Confidence Hit Spending

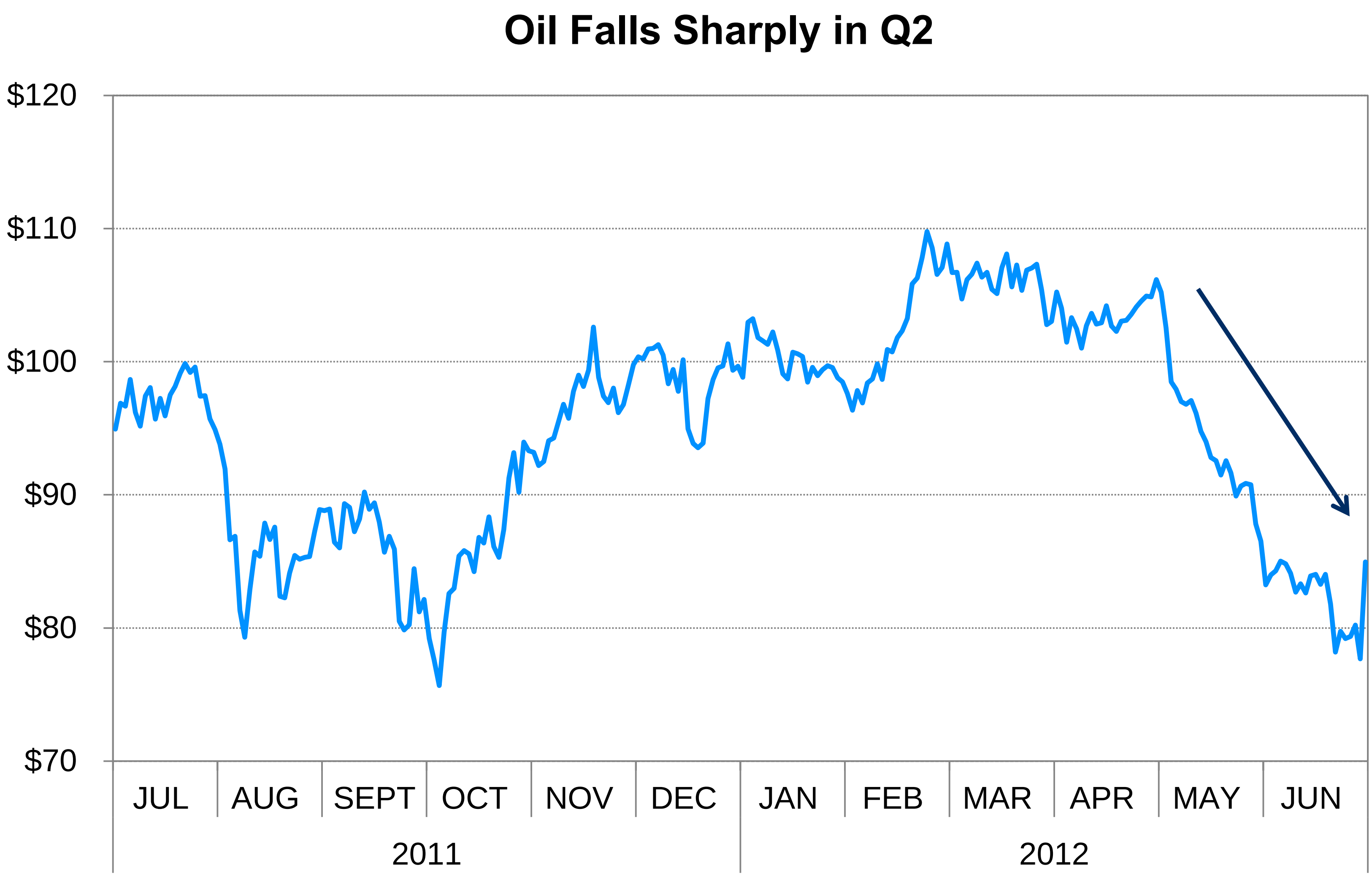
- While consumer sentiment and spending are not perfectly correlated and may diverge from time to time, low consumer confidence may point toward weaker spending in the near term.

Conference Board Confidence vs PCE



Source: Bloomberg

Cheaper Oil May Boost Future Consumer Spending



Source: Bloomberg

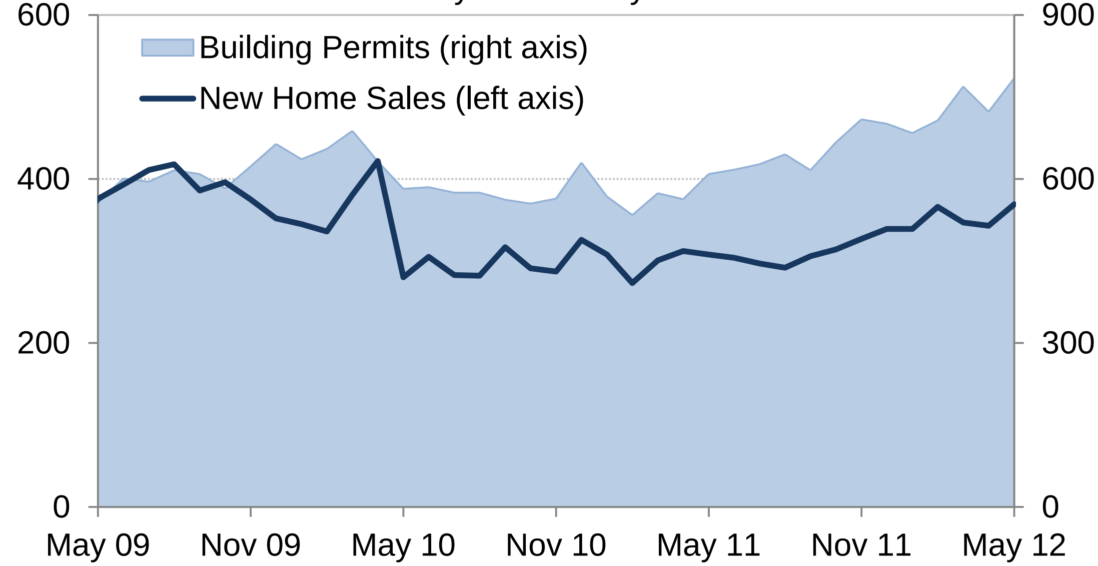
New Home Sales Unexpectedly Surge And Prices Increase

- In May, new home sales surprised on the upside, posting a solid and unexpected 7.6%. New homes sales rose to 369,000 units annually – the best rate in more than two years.

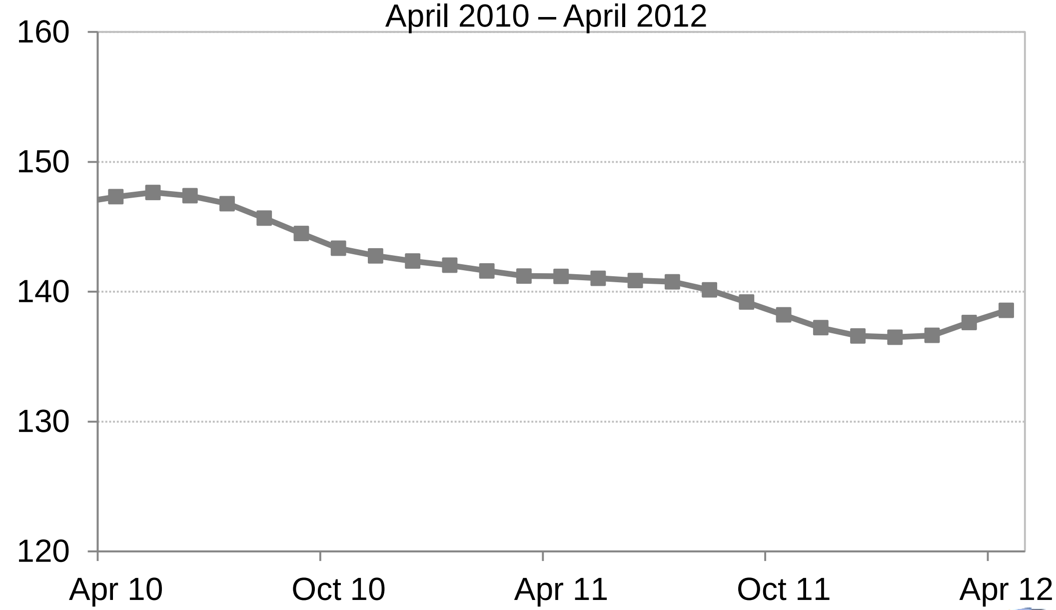
- The spike in new home purchases reduced supply on the market to 4.7 months, at the current sales pace.

- S&P/Case-Shiller Index reported a third consecutive month of price gains for single-family homes.

New Home Sales
May 2002 – May 2012

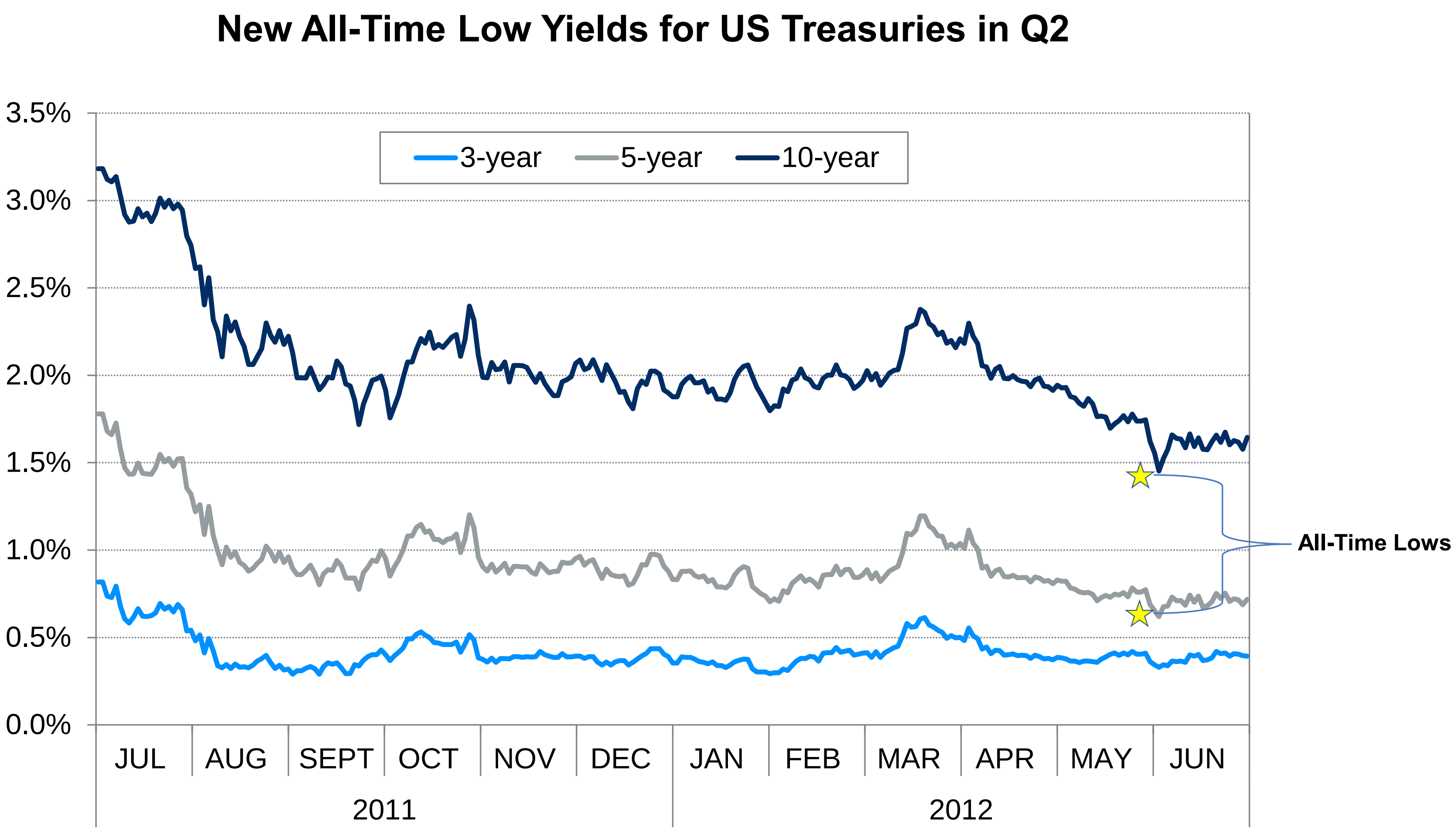


S&P Case-Shiller Index (seasonably adjusted)
April 2010 – April 2012



Source: Global-rates.com;

The Fed Doing All It Can - Kept Rates Low in Q2



Source: *Bloomberg*

Highlights of FOMC June 20 Meeting

- The FOMC announced that it would extend "Operation Twist" through the end of 2012.
  - Originally scheduled to end in June.
  - Represents an additional $267 billion of long-term Treasuries purchases.
  - Keeping "Operation Twist" in place "should put downward pressure on longer-term interest rates and help to make broader financial conditions more accommodative."
- Plan to hold overnight rate between 0.00%-0.25% and is expected to do so until late 2014. Only one of the 12 voting members voted against keeping the fed funds rate at this level.
- Lowered their assessment of several economic indicators, including employment, household spending, and inflation.
- The Committee expects economic growth "to remain moderate over coming quarters and then to pick up very gradually."

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