Town of Fountain Hills

Investment Performance Review
Third Quarter 2012

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Summary

- During the third quarter, further easing measures by central banks around the world spurred investors' demand for riskier assets, resulting in strong performance for corporate bonds, mortgage-backed securities, and equities.
- While the U.S. housing recovery seemed to be building momentum, manufacturing activity and job growth have continued to show persistent weakness.
- The domestic economy will likely continue its sluggish recovery, despite uncertainties about the U.S. election and the looming fiscal cliff.

Economic Snapshot

- The unemployment rate fell to 7.8% in September. The economy added 437,000 jobs in the third quarter, up from 200,000 in the prior period.
- The S&P Case-Shiller Index of home prices for July marked a year-over-year increase that was more than consensus estimates predicted, reflecting a continued housing recovery.
- The Institute for Supply Management's manufacturing survey fell slightly below 50 for June, July, and August, indicating a weakening of the important manufacturing base, but rose to 51.5 in September, suggesting slow growth (a measure above 50 is the dividing point between growth and expansion).
- The Consumer Price Index increased by 0.6% in August on a seasonally adjusted basis, its largest gain since June 2009; this was primarily due to increases in food and energy prices.
- Most economists expect U.S. gross domestic product (GDP) to grow by 1.8% to a 2% total for the balance of the year

Interest Rates

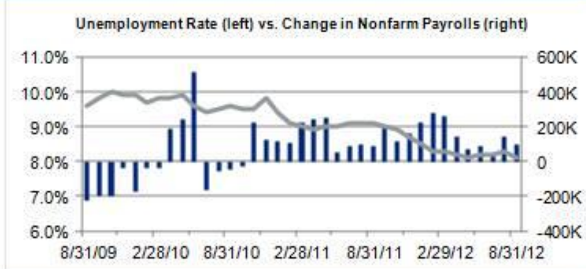
- Interest rates ended the quarter modestly lower, while yield spreads on Agencies, corporates, and mortgage-backed securities (MBS) tightened significantly.
- Long-term Treasury yields experienced significant intra-quarter volatility, while two-year Treasury yields remained in a tight range of 0.20% to 0.30% for the quarter.
- The Federal Reserve announced that it will keep short-term rates at extremely low levels through mid-2015, and initiated QE3, a new program to purchase $40 billion in agency MBS each month until employment conditions improve.

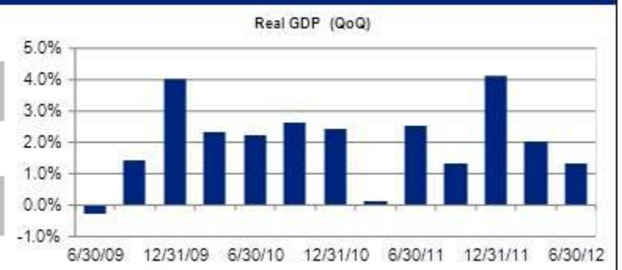
Sector Performance

- Returns of high-quality corporate bonds beat those of Treasuries and Agencies for the quarter as accommodative measures by global central banks prompted investors to search for additional yield. Financial issues did particularly well, outpacing those in the industrial and utility sectors.
- Supported by the new QE3 purchase program, Agency MBS performed well, but were tempered as a result of increased pre-payments, which shortened their average lives.
- While the Municipal sector lagged the corporate sector, it generated returns in excess of Treasuries and Agencies, and offered the additional value of diversification.
- Supply reductions should keep Agency spreads low, as Fannie Mae and Freddie Mac reduce their retained portfolios by 15% per year, as mandated by the Treasury Department.

Economic Snapshot

Labor Market		Latest	6/30/12	9/30/11
Unemployment Rate	Aug	8.1%	8.2%	9.0%
Change In Non-Farm Payrolls	Aug	96,000	45,000	202,000
Average Hourly Earnings (YoY)	Aug	1.7%	2.0%	2.0%
Personal Income (YoY)	Aug	3.5%	3.4%	4.6%
Initial Jobless Claims	Sep 28	367,000	376,000	402,000
Growth				
Real GDP (QoQ SAAR)	Q2	1.3%	2.0%	1.3%
GDP Personal Consumption (QoQ SAAR)	Q2	1.5%	2.4%	1.7%
Retail Sales (YoY)	Aug	4.7%	3.5%	8.5%
ISM Manufacturing Survey	Sep	51.5	49.7	52.5
Existing Home Sales (millions)	Aug	4.82	4.37	4.28
Inflation / Prices				
Personal Consumption Expenditures (YoY)	Aug 12	1.5%	1.5%	2.9%
Consumer Price Index (YoY)	Aug 12	1.7%	1.7%	3.9%
Consumer Price Index Core (YoY)	Aug 12	2.0%	0.7%	7.0%
Crude Oil Futures (WTI, per barrel)	Sep 30	$92.19	$84.96	$79.20
Gold Futures (oz)	Sep 30	$1,771	$1,604	$1,620



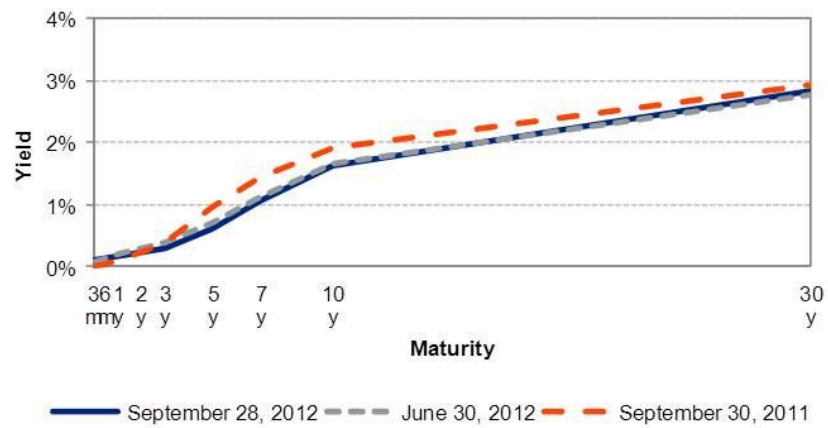


Source: Bloomberg

Interest Rate Overview

U.S. Treasury Note Yields

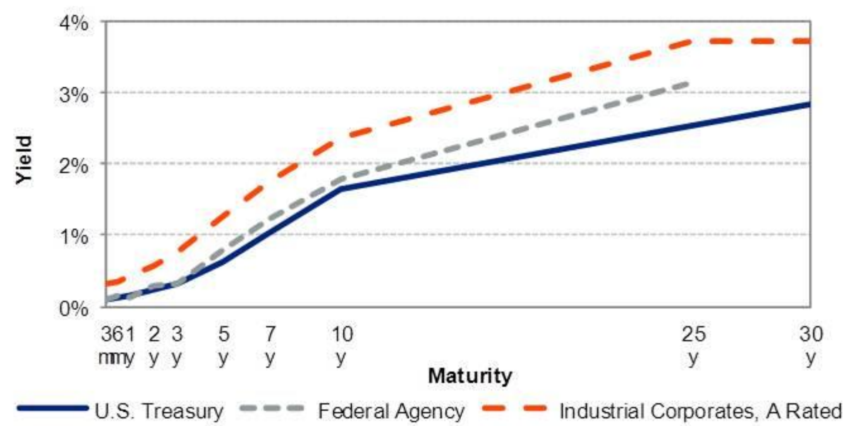
U.S. Treasury Note Yield Curve



U.S. Treasury Note Yields

Maturity	9/30/12	6/30/12	Change over Quarter	9/30/11	Change over Year
3-month	0.12%	0.11%	0.00%	0.02%	0.09%
1-year	0.16%	0.26%	(0.10%)	0.17%	(0.02%)
2-year	0.25%	0.32%	(0.08%)	0.28%	(0.04%)
5-year	0.63%	0.75%	(0.11%)	0.96%	(0.33%)
10-year	1.70%	1.73%	(0.04%)	2.01%	(0.31%)
30-year	2.82%	2.78%	0.04%	2.95%	(0.13%)

Yield Curves as of 9/30/12



Source: Bloomberg

B of A Merrill Lynch Index Returns

Periods Ended 9/30/2012

	Duration	Yield	3 Month	1 Year	3 Years
1-3 Year Indices					
U.S. Treasury	1.89	0.25%	0.26%	0.26%	1.43%
Federal Agency	1.60	0.31%	0.25%	0.25%	1.58%
U.S. Corporates, A-AAA Rated	1.98	1.02%	1.50%	1.50%	3.63%
Agency MBS (0 to 3 years)	1.78	0.87%	0.91%	0.91%	3.78%
Municipals	1.84	0.52%	0.33%	0.33%	1.75%
1-5 Year Indices					
U.S. Treasury	2.74	0.34%	0.47%	0.47%	2.58%
Federal Agency	2.24	0.42%	0.46%	0.46%	2.29%
U.S. Corporates, A-AAA Rated	2.79	1.26%	2.18%	2.18%	4.98%
Agency MBS (0 to 5 years)	1.83	0.91%	1.08%	1.08%	4.73%
Municipals	2.59	0.71%	0.62%	0.62%	2.65%
Master Indices					
U.S. Treasury	6.05	0.91%	0.58%	0.58%	5.46%
Federal Agency	3.69	0.79%	0.84%	0.84%	3.95%
U.S. Corporates, A-AAA Rated	6.78	2.38%	3.53%	3.53%	8.26%
Agency MBS	1.82	0.92%	1.13%	1.13%	5.06%
Municipals	7.39	2.48%	2.51%	2.51%	6.20%

Source: Bloomberg

Portfolio Review

Portfolio Summary

Total Portfolio Value	September 30, 2012	June 30, 2012
Market Value	**$15,114,758.23**	$15,078,333.35
Amortized Cost	**$15,065,638.31**	$15,050,304.47

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.
- Bond yields remained highly sensitive to headlines out of Europe. Weakening economic conditions in the Eurozone triggered a flight-to-quality that drove intermediate-term Treasury yields to new all-time record lows in July. The development of a European Central Bank sovereign debt purchase program reversed the trend, causing yields to rebound. Despite several periods of sharp temporary yield movements, Treasury yields ended the quarter only modestly lower in most maturities.
- While long-term yields were quite volatile during the quarter, yields of 1-5 year Treasuries were mostly range-bound within narrow bands. For example, the 2-year Treasury note traded between 0.20% and 0.30% during the quarter.
- In this range-bound market, we kept the portfolio's duration close to the benchmark, and added modestly to duration when rates moved toward the upper end of the trading range.
- Agency yields fell during the quarter when the Treasury Department accelerated the wind down of Fannie Mae's and Freddie Mac's investment portfolio holdings, an action which will shrink Agency bond and discount note supply by $1 trillion over the next few years. As spreads tightened, we reduced Agency allocations in favor of more U.S. Treasuries.
- The portfolio performed well for the quarter, in line with the benchmark. Historically, the portfolio continues to outperform and since inception is ahead of the benchmark by 23 basis points.

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Portfolio Summary - continued

PORTFOLIO STRATEGY

- With the ECB's sovereign debt support program in place, we are turning our attention away from Europe and focusing on domestic issues, such as U.S. economic conditions, the upcoming election and the looming fiscal cliff, and other global issues, like the troubling slowdown in China and turmoil in the Middle East. These conditions create uncertainties that are hard to handicap, and virtually impossible to predict with any degree of certainty.

- Since all of these factors have more downside risk to economic growth than upside potential, and thus a greater chance of keeping yields low in the fourth quarter, we plan to keep the portfolio's duration generally in line with the benchmark.

- With central banks around the globe pumping an unprecedented amount of liquidity into the market and embarking on new large scale bond purchase programs, we are faced with a scenario of more dollars chasing fewer assets. As a result, our outlook for most "spread sectors" remains positive. We anticipate relatively low volatility in yields and expect income to be a major component of total returns in the upcoming quarter.

- In this environment, our approach to security selection will employ more of a bottom-up analysis of individual issues, rather than a top-down approach of shifting sector allocations based on a macroeconomic view.

- The Fed's plan, announced September 13th, to buy $40 billion of MBS a month for an indefinite period has driven spreads in and reduced relative value in this sector.

- Over the previous 12 months, we have made a sizable shift away from Agencies into Treasuries. We continue to actively trade within the Treasury and Federal Agency sectors, seeking to identify those issues that offer the best combination of yield, yield spread and roll-down potential. We are comfortable with our current sector weightings, but will adjust our view as new developments in fiscal and monetary policy evolve.

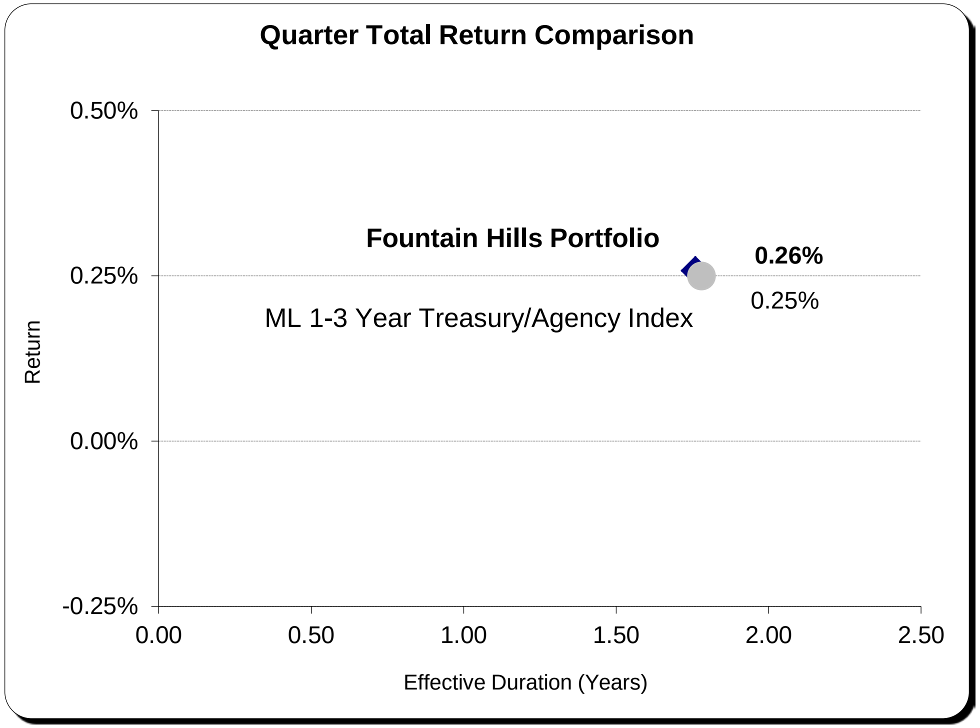
- As always, we strive to maintain safety of principal and appropriate liquidity, while seeking opportunities to add value through active management. Our strategy will remain flexible and may change in response to changes in interest rates, economic data, market outlook or specific opportunities that arise.

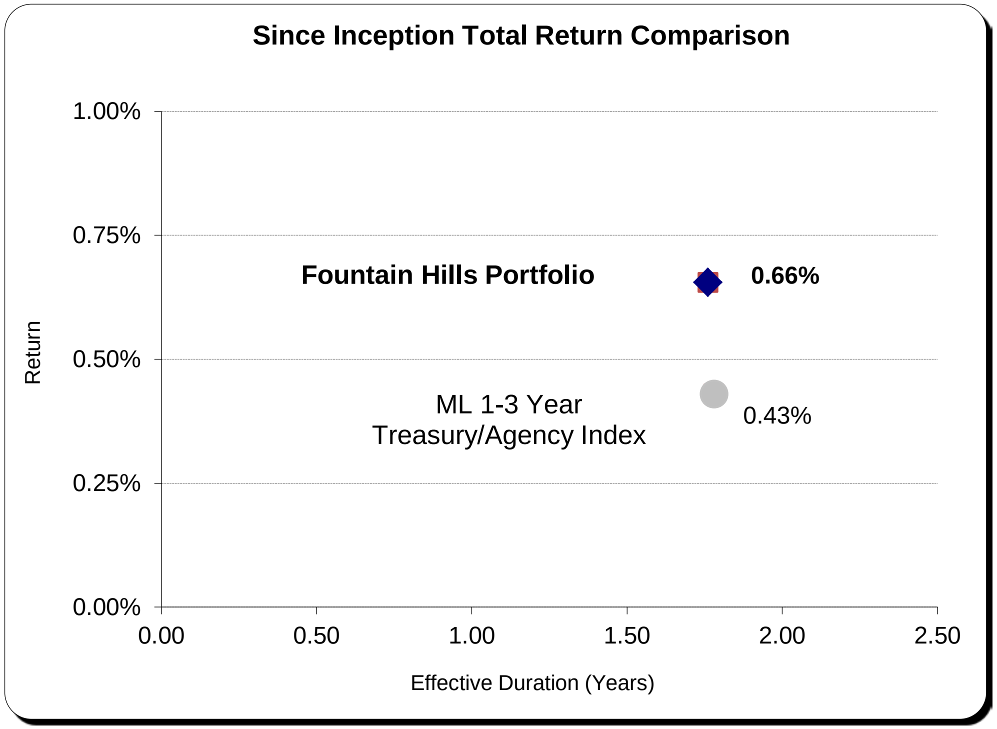
Operating Portfolio Performance

Total Return[1,2,3,4,5]	Quarter Ended September 30, 2012	Past 6 Months	Since Inception
Fountain Hills Portfolio	**0.26%**	**0.45%**	**0.66%**
ML 1-3 Year Treasury/Agency Index	0.25%	0.45%	0.43%

Effective Duration[5]	September 30, 2012	June 30, 2012
Fountain Hills Portfolio	**1.76**	**1.75**
ML 1-3 Year Treasury/Agency Index	1.77	1.78

Yields[5]	September 30, 2012	June 30, 2012
Yield at Market	0.26%	0.34%
Yield on Cost	0.45%	0.44%



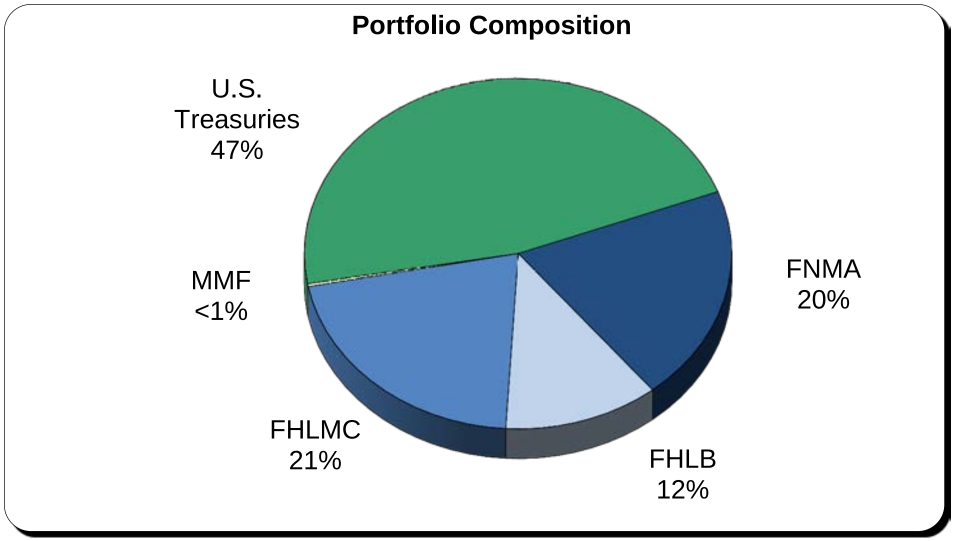


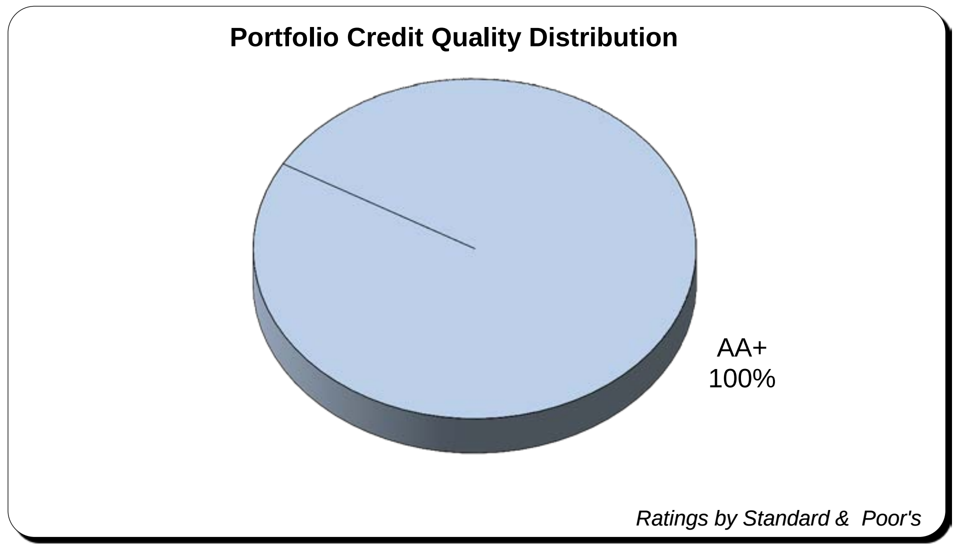
Notes:

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]	September 30, 2012	% of Portfolio	June 30, 2012	% of Portfolio	Permitted by Policy
U.S. Treasuries	**$7,108,045.40**	**47.0%**	$6,840,290.02	45.4%	**100%**
Federal Agencies	**$7,968,274.74**	**52.7%**	$8,178,136.64	*54.2%*	**100%**
FNMA	*$3,012,146.45*	*19.9%*	*$3,015,307.88*	*20.0%*	-
FHLB	*$1,776,875.92*	*11.8%*	*$1,774,562.92*	*11.8%*	-
FHLMC	*$3,179,252.37*	*21.0%*	*$2,728,498.00*	*18.1%*	-
FFCB	*$0.00*	*0.0%*	*$659,767.84*	4.4%	-
MMF	**$38,438.09**	**0.3%**	$59,906.69	0.4%	
Totals	**$15,114,758.23**	**100.0%**	$15,078,333.35	100.0%	



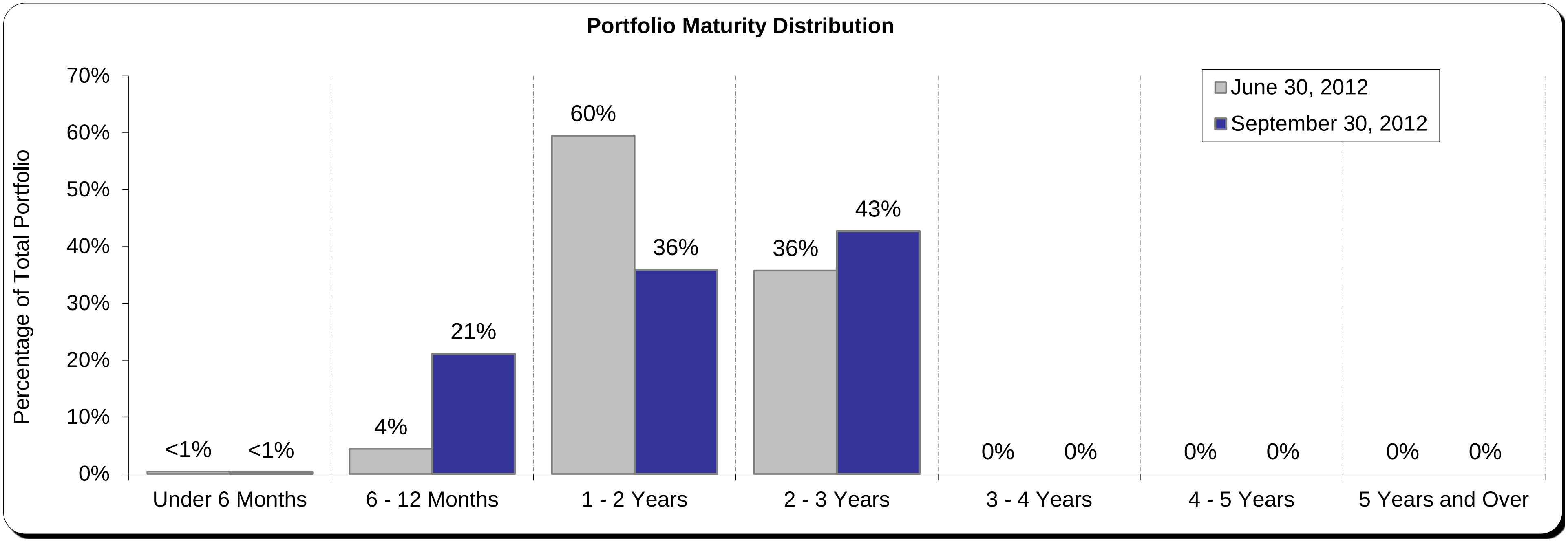


Notes:

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

Portfolio Maturity Distribution

Maturity Distribution[1]	September 30, 2012	June 30, 2012
Under 6 Months	**$38,438.09**	$59,906.69
6 - 12 Months	**$3,196,924.56**	$659,767.84
1 - 2 Years	**$5,428,610.23**	$8,966,714.68
2 - 3 Years	**$6,450,785.35**	$5,391,944.14
3 - 4 Years	**$0.00**	$0.00
4 - 5 Years	**$0.00**	$0.00
5 Years and Over	**$0.00**	$0.00
Totals	**$15,114,758.23**	$15,078,333.35



Economic Update

Economic and Market Conditions in Third Quarter

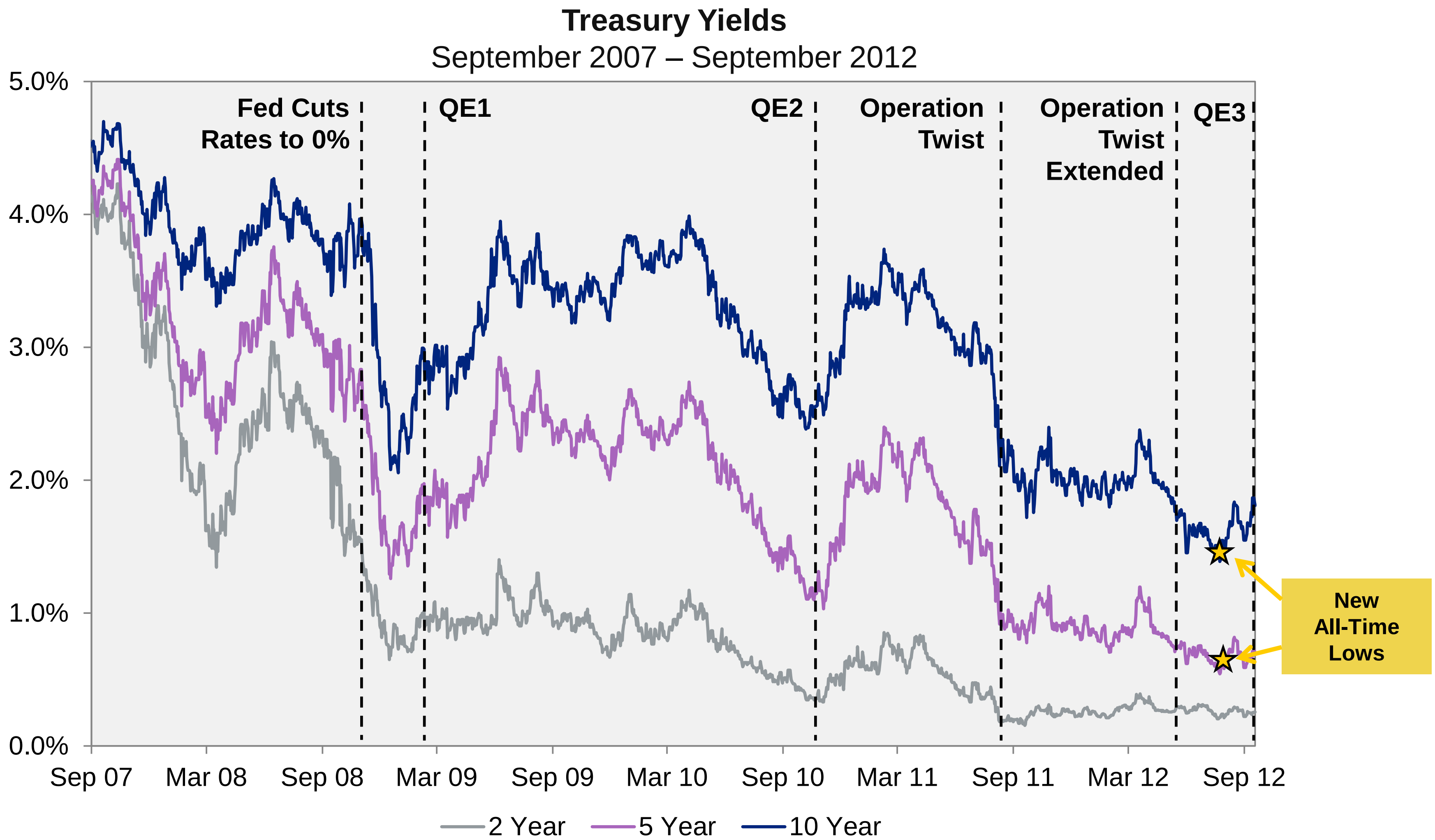
Economic Conditions

- U.S. GDP slowed to 1.3% in the second quarter and is forecast at 1.8% for the third quarter.
- Unemployment fell to 7.8% as a result of decreased workforce participation.
- The U.S. housing market quietly gained momentum.
- The European Central Bank's (ECB) sovereign debt purchase plan calmed markets.
- Global growth slowed, led by Europe and Asia.
- The U.S. economic growth, November election, "fiscal cliff," U.S. debt ceiling, and turmoil in Middle East continue to create uncertainty.

Market Reaction

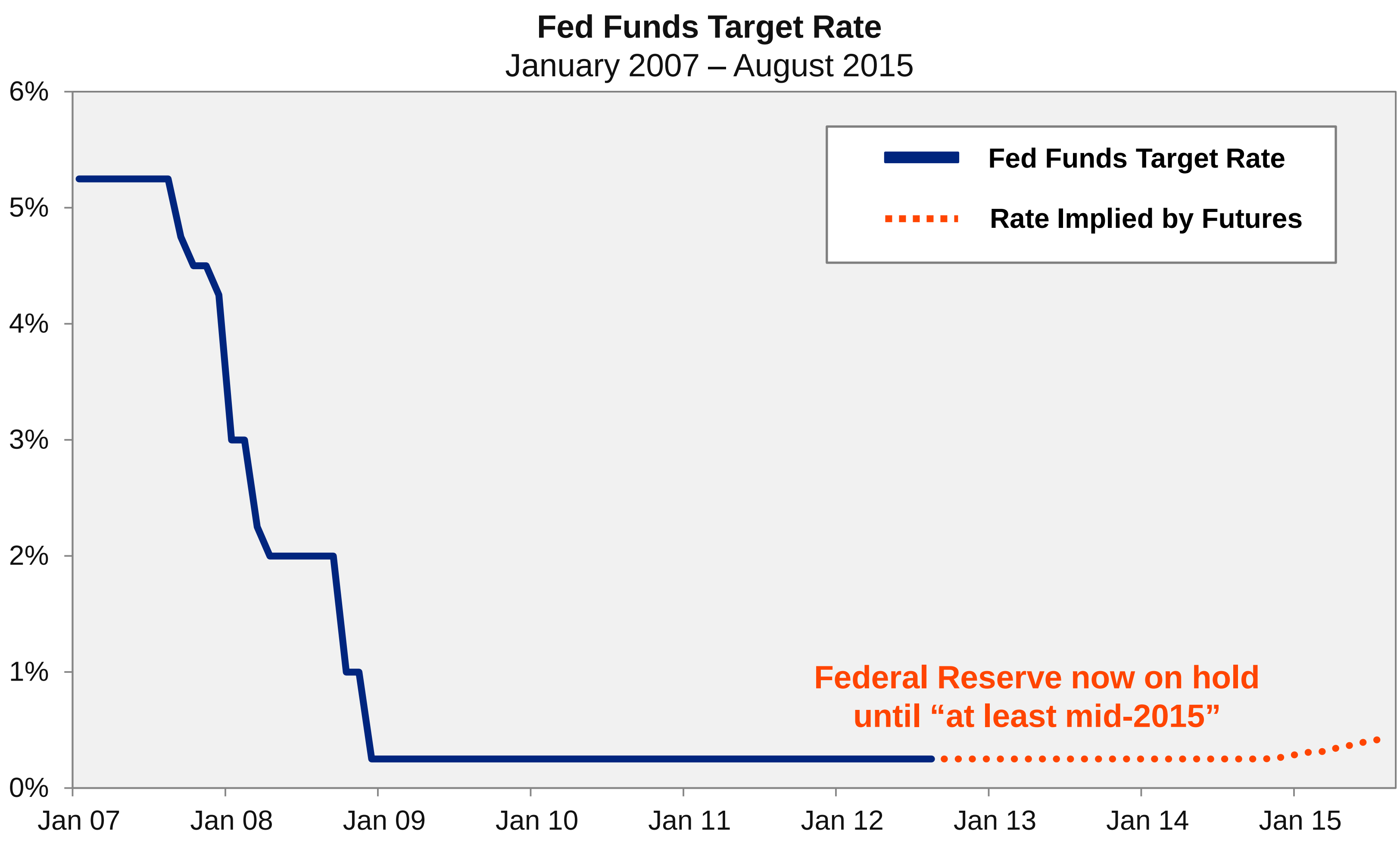
- U.S. Treasury yields plunged to new all-time record lows in July.
- Agency and corporate spreads narrowed sharply by the end of the third quarter after widening in April and May.
- Equity markets fell in the second quarter but rebounded strongly in the third quarter to highest level since 2007.
- Inflation expectations surged on Fed action, but have since moderated.

U.S. Treasury Yields Remain Very Low



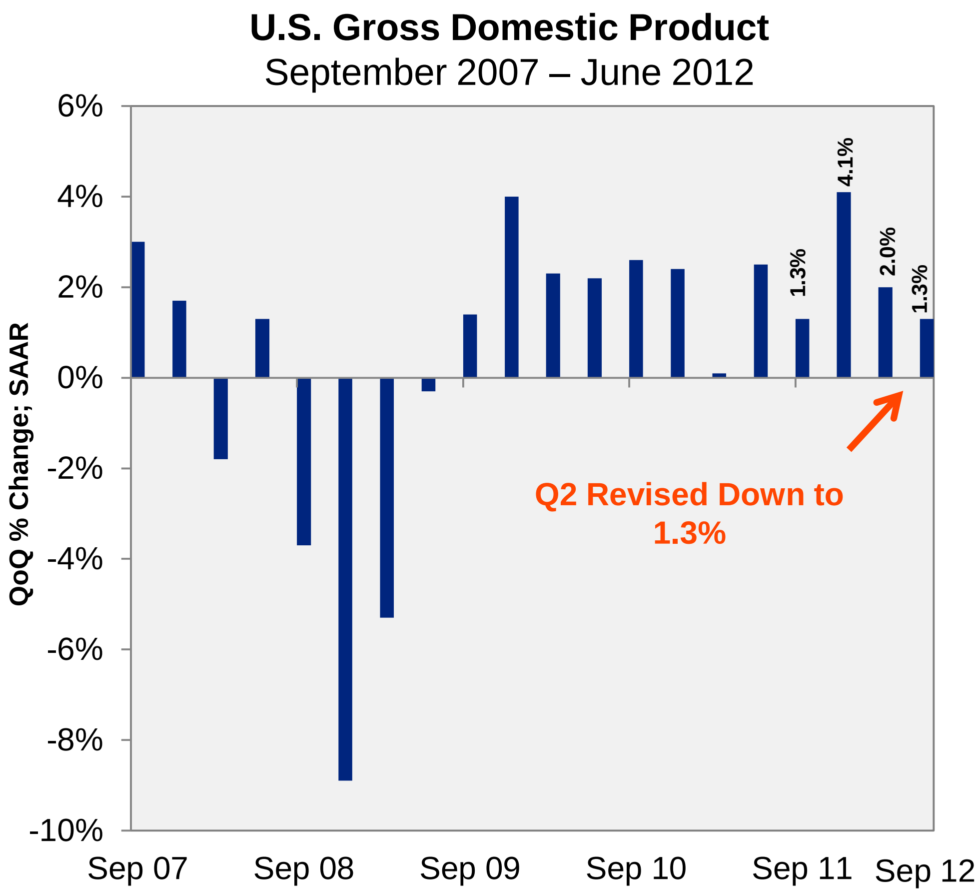
Source: *Bloomberg*

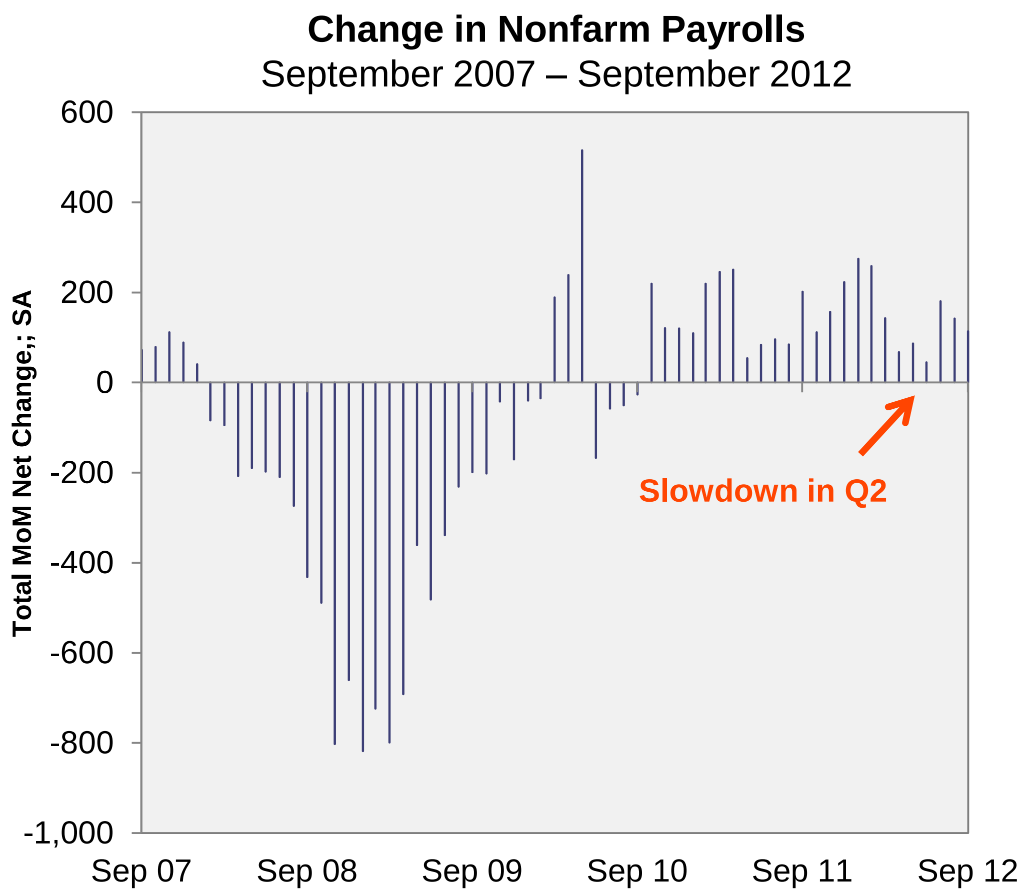
Short-Term Rates Will Remain Low



Source*: Bloomberg, as of 10/02/12*

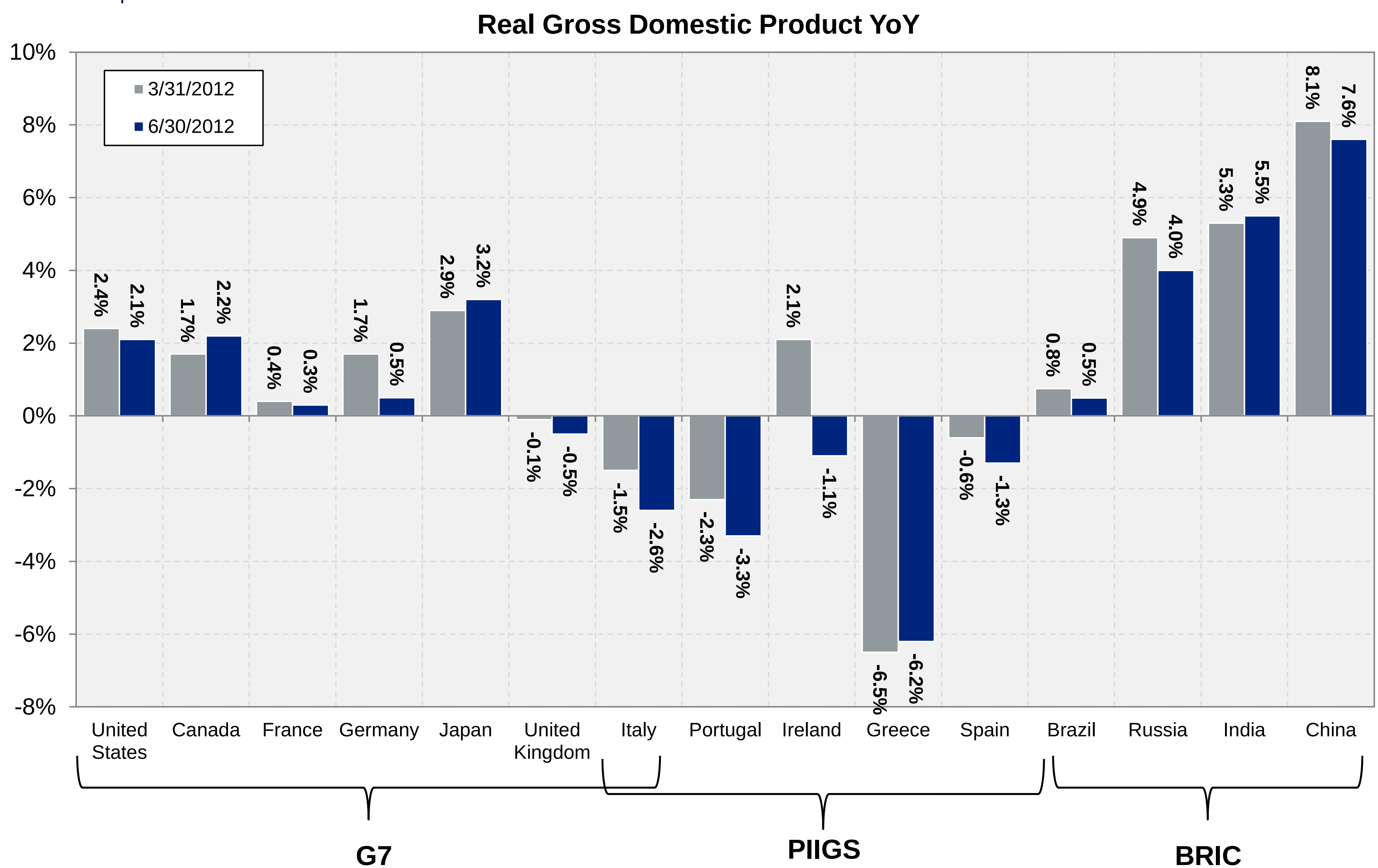
GDP Growth Is Too Slow to Reduce Joblessness



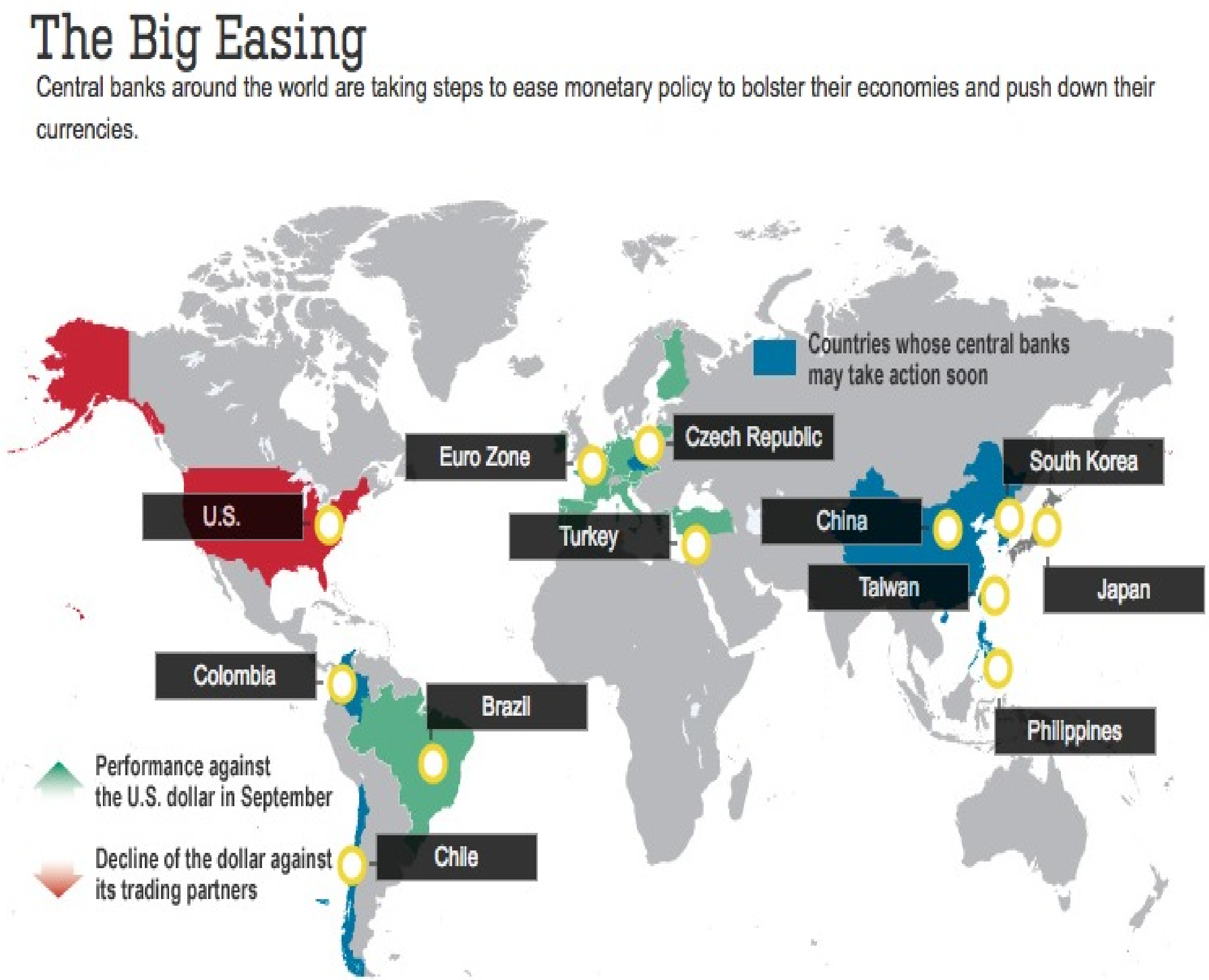


Source*: Bloomberg*

World GDP Growth is Slowing



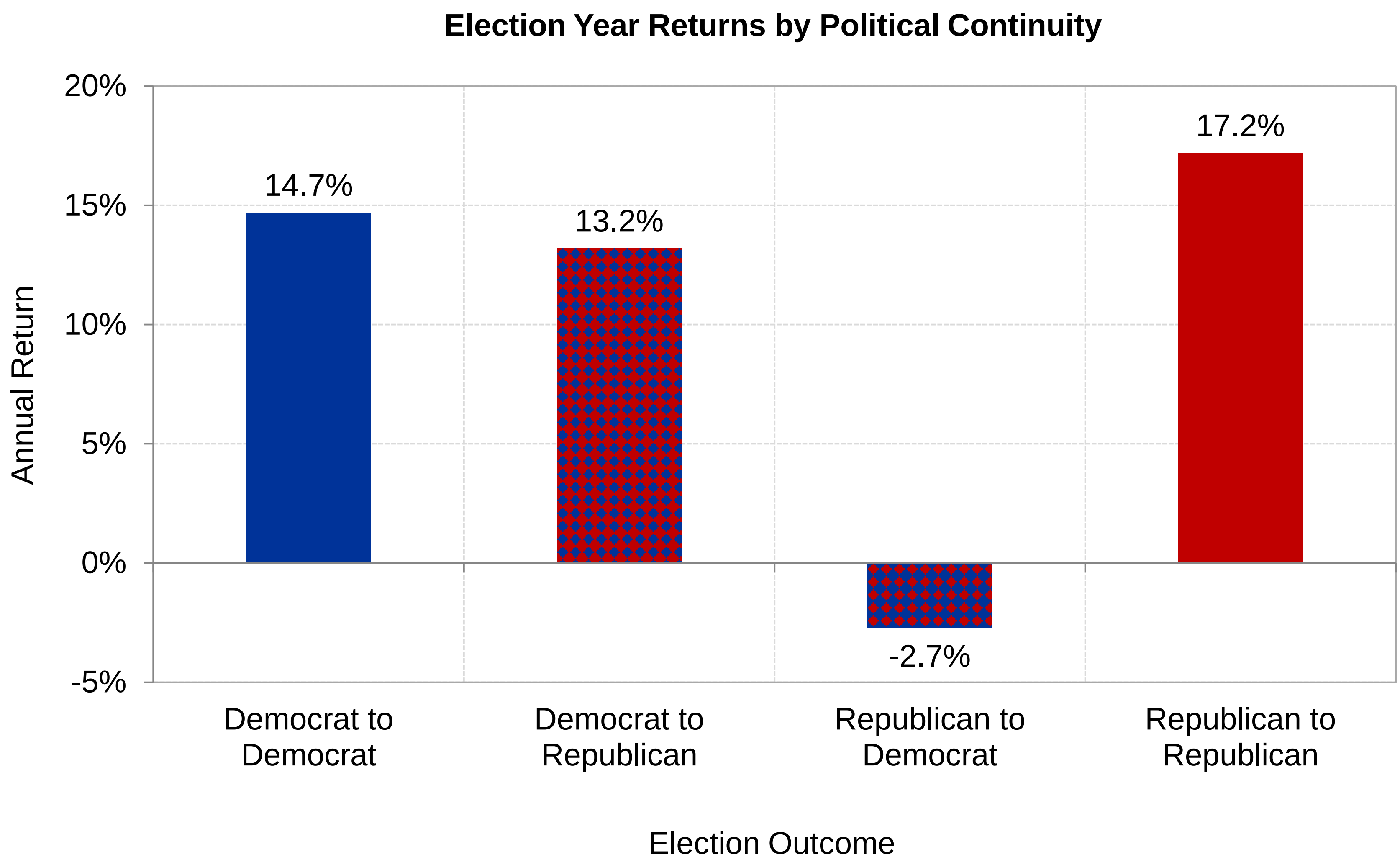
Global Stimulus Efforts



Source: *Bloomberg*

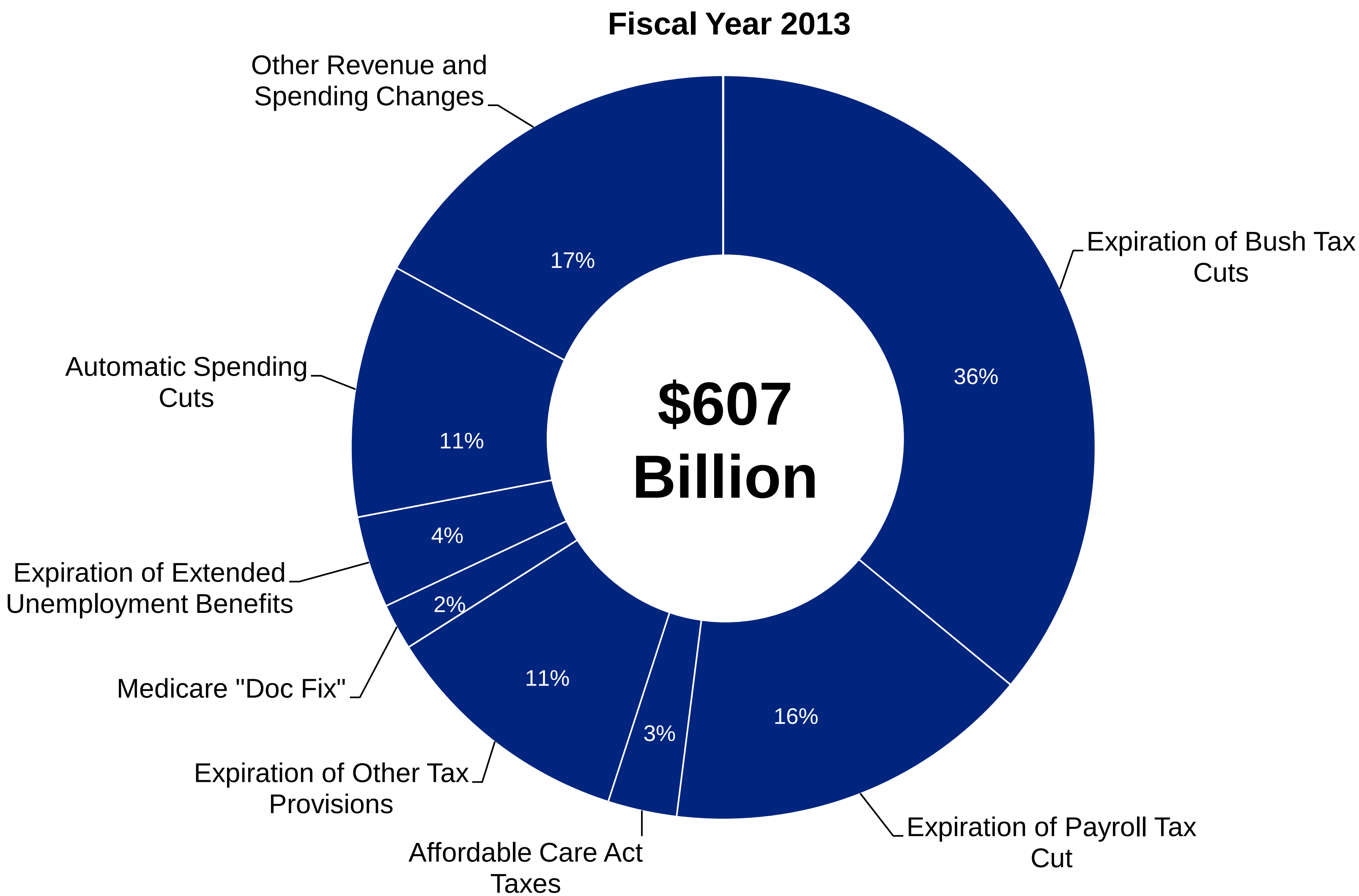
- ECB announced an unlimited bond-buying program to reduce member borrowing costs.
- Federal Reserve committed to purchasing $40 billion Agency MBS securities a month.
- China injected $58 billion into its financial system to stem a potential credit crunch.
- Bank of Japan will purchase $10 billion in securities to jumpstart flagging economy.
- Quantitative easing lowers interest rates and increases money supply/weakens currency:
  - A weak currency helps increase exports.
  - Lower interest rates encourage investment in risker sectors.

Historical S&P 500 Returns In Election Years



Source*: Credit Suisse Quantitative Equity Research*

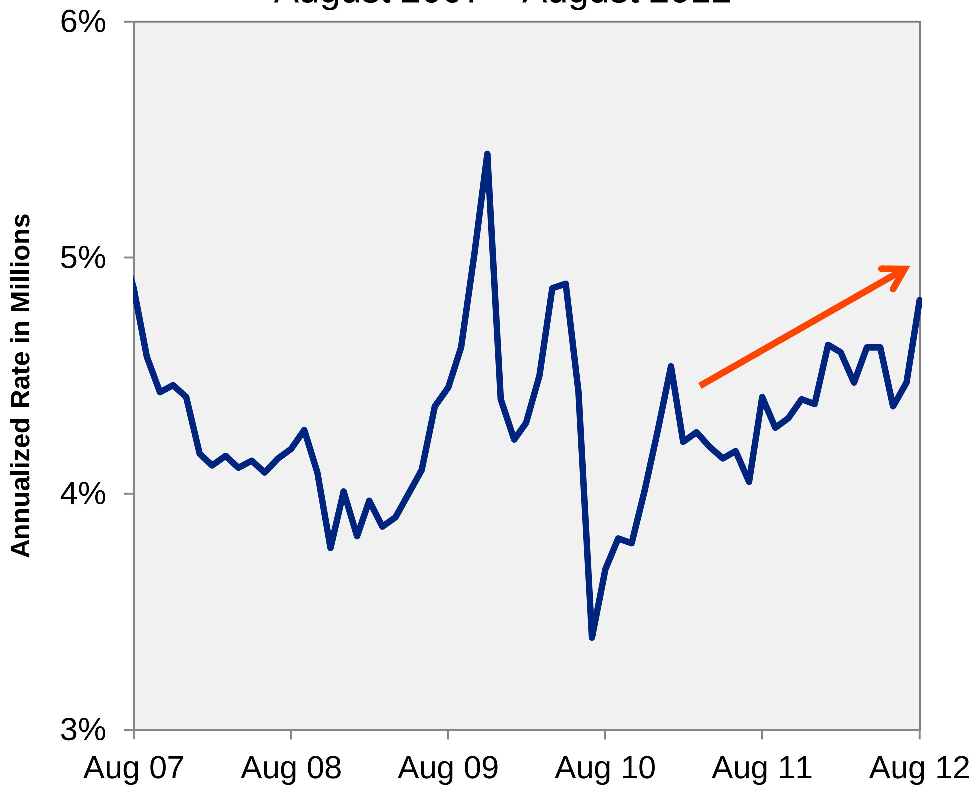
The Looming “Fiscal Cliff” Creates Uncertainty



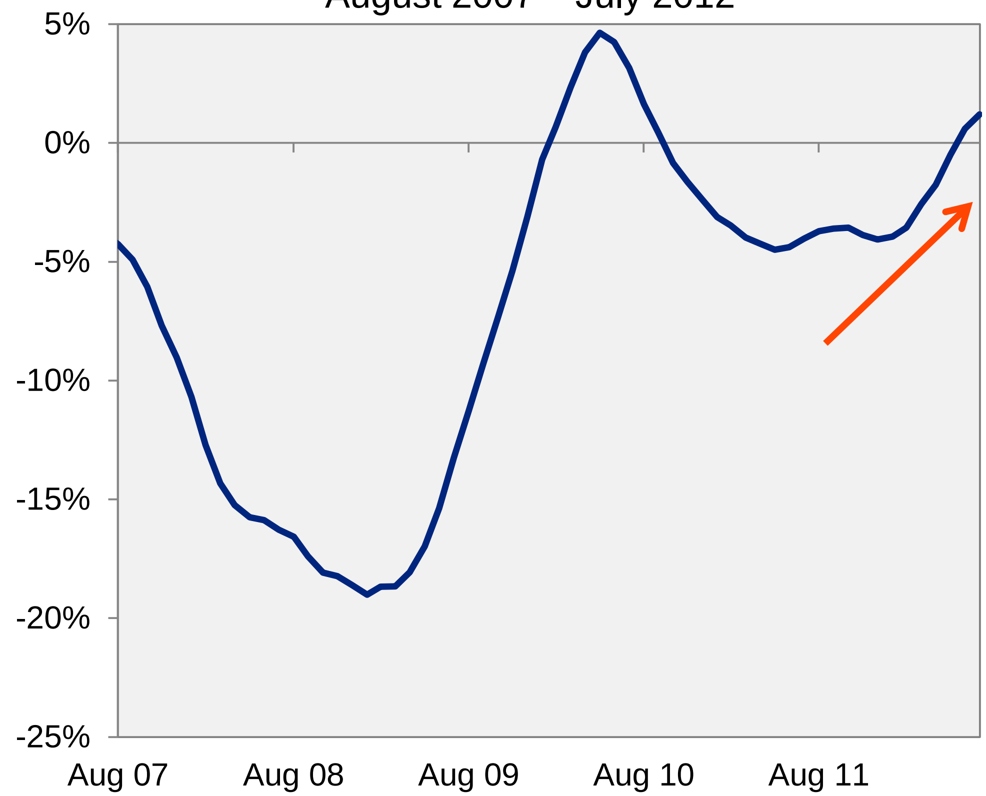
Source*: Congressional Budget Office*

Housing Market Beginning to Recover

U.S. Existing Home Sales
August 2007 – August 2012

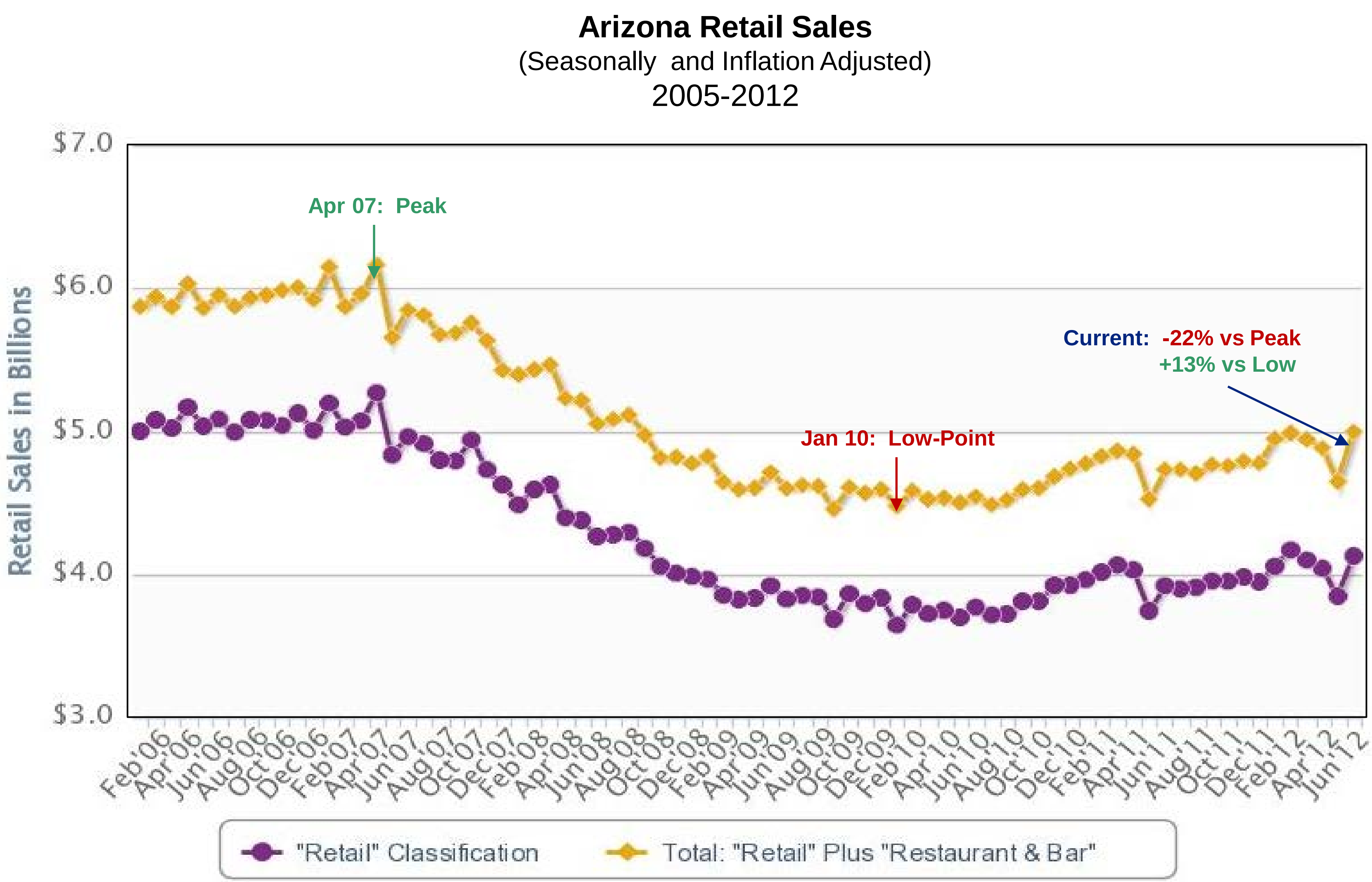


Case-Shiller U.S. Home Price Index YoY
August 2007 – July 2012



Source*: Bloomberg*

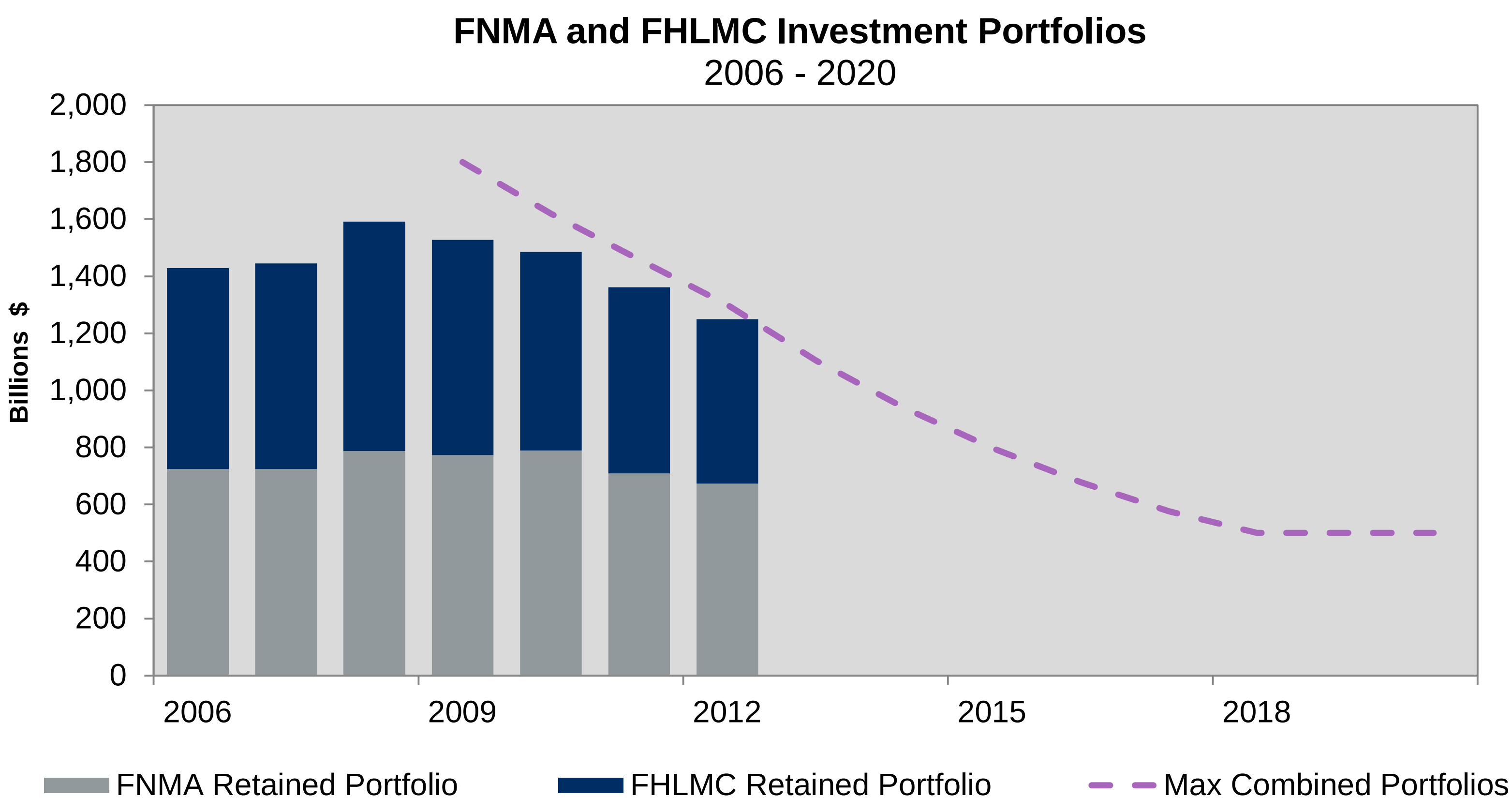
Arizona Retail Sales Continue to Improve



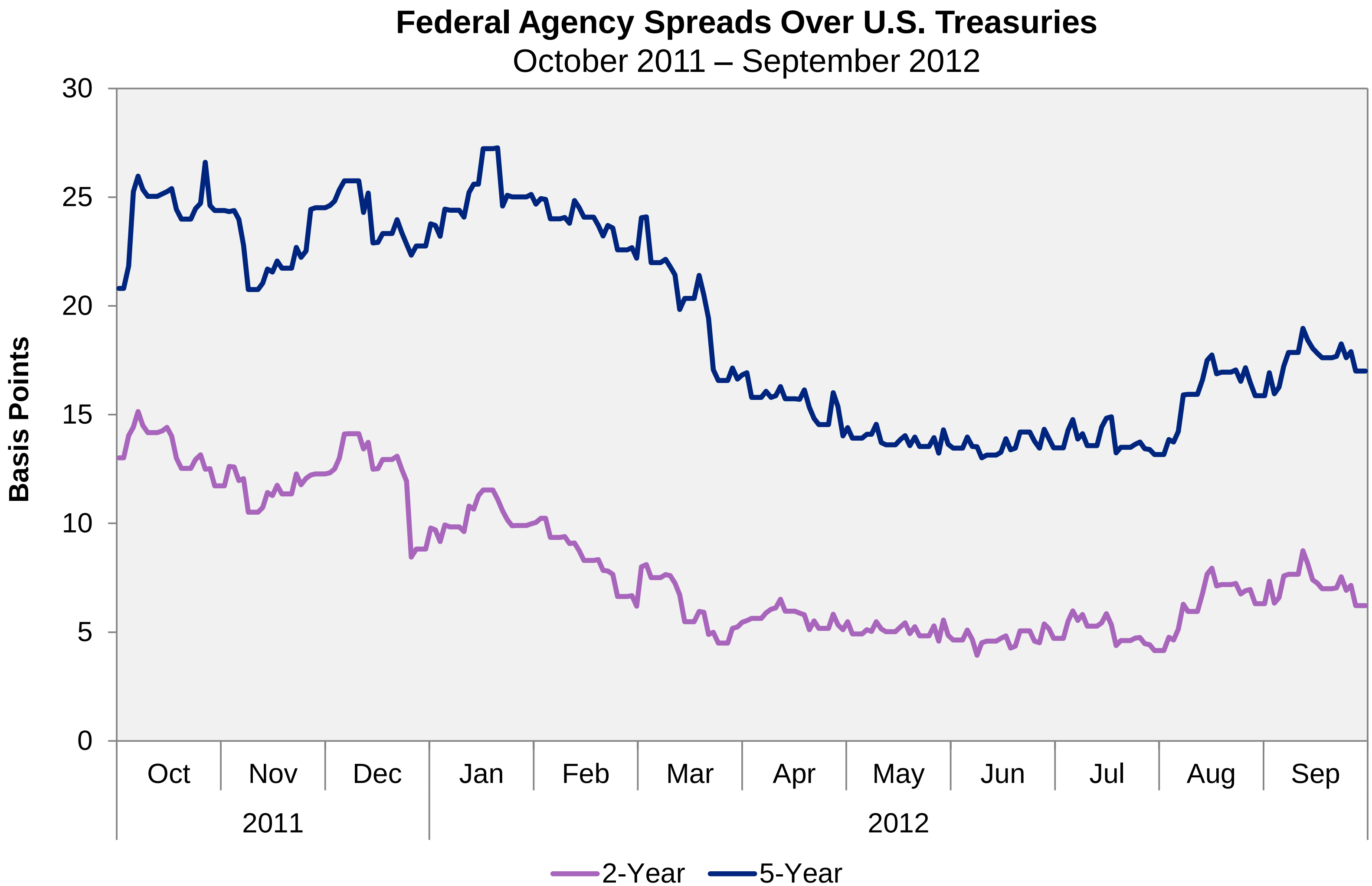
Source: *Arizona Department of Revenue and U.S. Bureau of Labor and Statistics*

Agency Supply Set to Decline

- On August 17, the Treasury Department mandated that Fannie Mae's and Freddie Mac's maximum allowable retained mortgage portfolio decline by 15% annually until their individual portfolios reach $250 billion – resulting in a $1 trillion reduction in Agency Supply over the next 6 years.



Agency Spreads Tighten on Accelerated Wind Down



Source: Bloomberg Fair Value Curve

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Market Review