

Town Of Fountain Hills

For the Month Ended December 31, 2012

The PFM Group
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PFM Advisors

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Summary

- In the fourth quarter, the markets were impacted by U.S. politics and policies—particularly the presidential election, the Federal Reserve's (Fed's) new round of quantitative easing (QE), and "fiscal cliff" negotiations.
- The U.S. housing market continued to show signs of improvement, and the unemployment rate was unchanged for the quarter at 7.8%.
- The domestic economy has seen modest growth over the past year, and while the resolution of the "fiscal cliff" talks has relieved investors, the federal debt ceiling must now be addressed.

Economic Snapshot

- New-home sales in the U.S. rose to their highest level in two-and-a-half years in November, jumping 15.3% higher from where they were a year ago.
- The Consumer Price Index rose 1.8% year over year in November before seasonal adjustment. Wage increases have been subdued as evidenced by the change in hourly earnings, which has averaged less than 2% in recent months.
- Fourth-quarter U.S. gross domestic product (GDP) growth is expected to be in a range of 1% to 2%, which is slower than GDP growth experienced in the third quarter.
- Hurricane Sandy, which blew through the East Coast in October, caused large amounts of damage, closed the markets for two days and depressed economic activity in about a third of the nation.
- European stock markets took an upward turn for the quarter, as the MSCI Europe Index rose 7.02% for the quarter in U.S. dollar terms.

Interest Rates

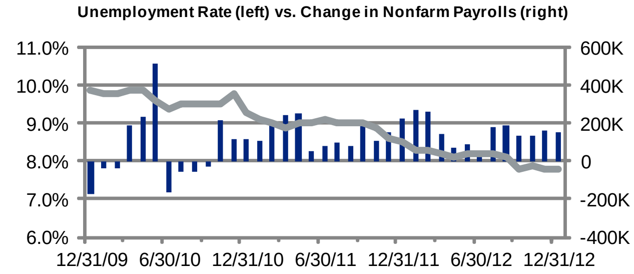
- Interest rates rose slightly for the quarter across most maturities, while yield spreads on Agencies, corporates, and mortgage-backed securities (MBS) remained narrow.
- Treasury yields fell in the first half of November, but then rose as investors turned away from fixed income to the rallying stock market.
- The Fed announced that it will keep short-term rates at extremely low levels until the unemployment rate falls below 6.5%, and the prospect remains for long-run inflation to stay below 2.5%. The Fed also initiated further QE with an open-ended program to buy $45 billion in Treasuries each month in addition to its monthly purchases of $40 billion in Agency mortgage-backed securities.

Sector Performance

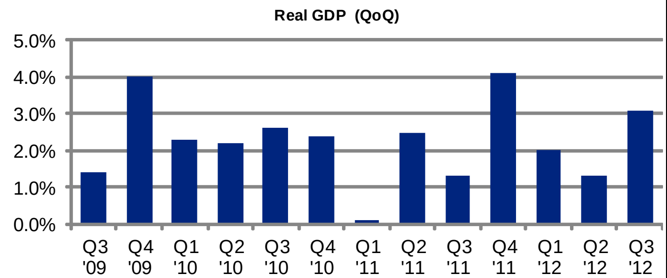
- Returns of high-quality corporate bonds (especially Financials) performed well for the quarter, as these issuers continued to be bolstered by global central bank support for financial markets. Security selection has been especially important when purchasing corporates.
- The Fed's QE3 purchase program initially caused Agency MBS to appreciate sharply on value, but that quickly reversed and Agency MBS underperformed other fixed-income sectors for the quarter.
- Municipal bonds struggled in the fourth quarter, as investors were uncertain whether their tax-exempt status would be changed as part of a "fiscal cliff"deal.
- Supply reductions kept Agency spreads at historically tight levels, and Agencies became relatively less attractive over the quarter.

Economic Snapshot

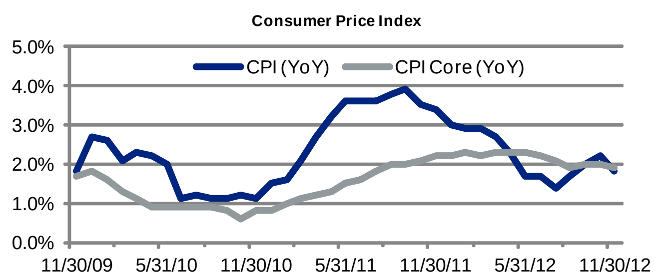
Labor Market		Latest	Sep 2012	Dec 2011
Unemployment Rate	Dec	7.8%	7.8%	8.5%
Change In Non-Farm Payrolls	Dec	155,000	132,000	223,000
Average Hourly Earnings (YoY)	Dec	2.1%	1.9%	2.1%
Personal Income (YoY)	Nov	4.1%	3.5%	3.6%
Initial Jobless Claims	Dec 28	372,000	369,000	383,000



Growth				
Real GDP (QoQ SAAR)	Q3	3.1%	1.3%[1]	4.1%[2]
GDP Personal Consumption (QoQ SAAR)	Q3	1.6%	1.5%[1]	2.0%[2]
Retail Sales (YoY)	Nov	3.7%	5.4%	6.8%
ISM Manufacturing Survey	Dec	50.7	51.5	53.1
Existing Home Sales (millions)	Nov	5.04	4.69	4.38



Inflation / Prices				
Personal Consumption Expenditures (YoY)	Nov	1.4%	1.6%	2.4%
Consumer Price Index (YoY)	Nov	1.8%	2.0%	3.0%
Consumer Price Index Core (YoY)	Nov	1.5%	2.1%	4.7%
Crude Oil Futures (WTI, per barrel)	Dec 31	$91.82	$92.19	$98.83
Gold Futures (oz)	Dec 31	$1,676	$1,771	$1,567



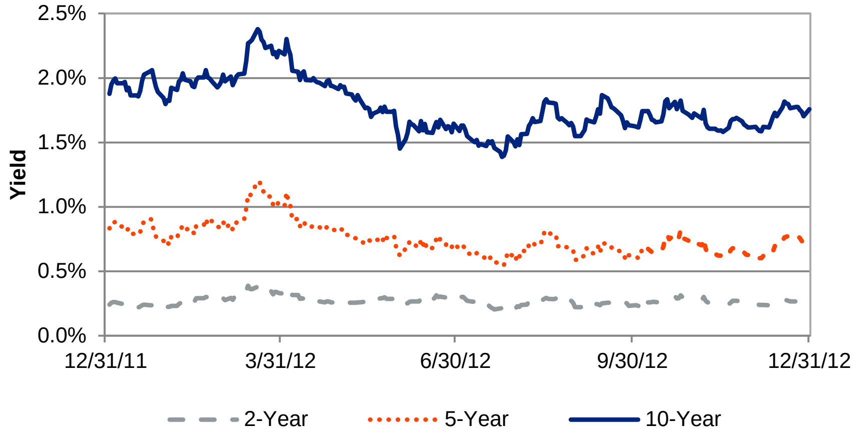
1. Data as of Second Quarter 2012 *2. Data as of Fourth Quarter 2011*

Note: YoY = year over year, QoQ = quarter over quarter, SAAR = seasonally adjusted annual rate, WTI = West Texas Intermediate crude oil

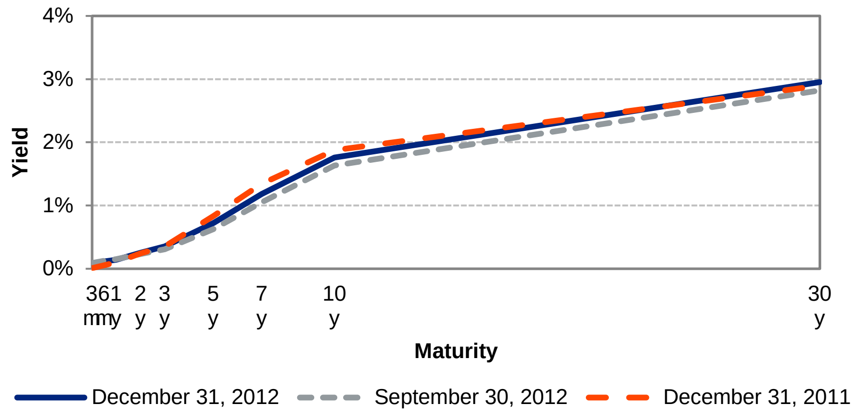
Source: Bloomberg

Interest Rate Overview

U.S. Treasury Note Yields

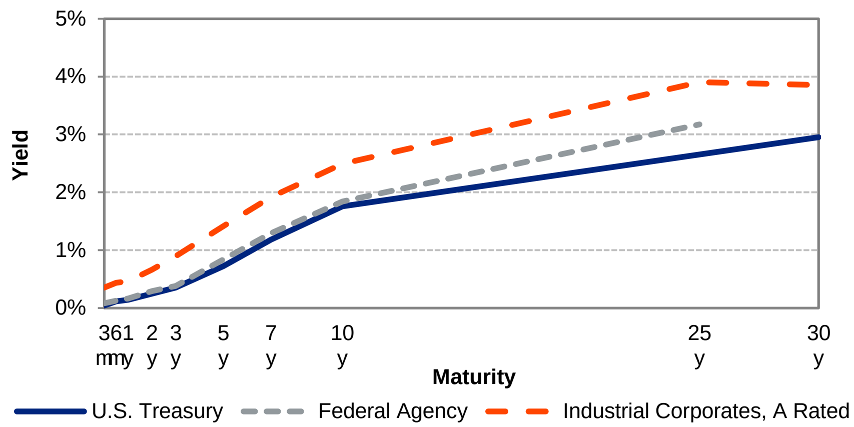


U.S. Treasury Note Yield Curve



Maturity	12/31/12	9/30/12	Change over Quarter	12/31/11	Change over Year
3-month	0.09%	0.12%	(0.03%)	0.02%	0.07%
1-year	0.14%	0.16%	(0.02%)	0.13%	0.01%
2-year	0.27%	0.25%	0.03%	0.28%	(0.00%)
5-year	0.74%	0.63%	0.11%	0.85%	(0.11%)
10-year	1.81%	1.70%	0.12%	1.96%	(0.14%)
30-year	2.94%	2.82%	0.12%	2.91%	0.03%

Yield Curves as of 12/31/12



Source: Bloomberg

B of A Merrill Lynch Index Returns

	As of 12/31/2012		Periods Ended 12/31/2012		
	Duration	Yield	3 Month	1 Year	3 Years
1-3 Year Indices					
U.S. Treasury	1.87	0.26%	0.07%	0.43%	1.44%
Federal Agency	1.70	0.31%	0.12%	0.85%	1.56%
U.S. Corporates, A-AAA Rated	1.94	0.95%	0.44%	4.02%	3.31%
Agency MBS (0 to 3 years)	1.85	1.37%	(0.31%)	1.60%	3.42%
Municipals	1.81	0.61%	0.02%	1.03%	1.56%
1-5 Year Indices					
U.S. Treasury	2.72	0.38%	0.04%	0.91%	2.62%
Federal Agency	2.36	0.44%	0.16%	1.38%	2.28%
U.S. Corporates, A-AAA Rated	2.80	1.22%	0.55%	5.85%	4.70%
Agency MBS (0 to 5 years)	2.11	1.45%	(0.26%)	2.50%	4.45%
Municipals	2.53	0.84%	(0.10%)	1.63%	2.37%
Master Indices					
U.S. Treasury	5.99	0.96%	(0.10%)	2.16%	5.89%
Federal Agency	3.84	0.85%	0.22%	2.44%	4.10%
U.S. Corporates, A-AAA Rated	6.80	2.32%	0.79%	9.19%	8.32%
Agency MBS	2.14	1.47%	(0.27%)	2.59%	4.78%
Municipals	7.47	2.59%	0.51%	7.26%	6.83%

Returns for periods greater than one year are annualized

Source: Bloomberg

Portfolio Summary

Total Portfolio Value	December 31, 2012	September 30, 2012
Market Value	**$15,127,981.66**	$15,114,758.23
Amortized Cost	**$15,083,880.50**	$15,065,638.31

- The portfolio complies with the Arizona Revised Statutes and the Town's investment policy. The portfolio is well diversified among the U.S. Treasury and Federal Agency sectors and among issuers.
- Bond yields remained hostage to external factors. Yields were driven lower by economic disruption due to Hurricane Sandy, Obama's re-election and the assured continuity at the accommodative Fed, an expansion of the Fed's bond purchase program, and fears the U.S. would go over the "fiscal cliff." Bond yields were pushed higher by stronger than expected job reports for September and November, a Greek debt buyback program, a global rally in stocks, and confidence that the "fiscal cliff" would be avoided.
- After all the ups and downs, Treasury yields finished the quarter modestly higher. Political turmoil may cause a transient flight-to-quality, but the more lasting effect is likely to come from the budding trend of equity fund inflows at the expense of bond fund outflows. The so-called "Great Rotation" is the reversal of fund flows from the past 4 years.
- Facing high political and policy risks, which do not lend themselves well to fundamental economic analysis, the portfolio was moved closer to the benchmark in terms of both duration and sector allocations. In particular, with Agency bonds at historically tight spreads, and consequently little remaining value, sector allocations were shifted into Treasuries, continuing the trend of the past several quarters.
- Agency notes had a solid quarter and provided half of PFM's excess returns, as Agency spreads tightened in early October and held on for much of the remainder of Q4

Portfolio Summary- Continued

- Nearly all the points made in last quarter's strategy still apply: difficult to predict political wranglings cloud our market view, central bank liquidity favors spread product, and idiosyncratic bottom-up analysis outshines our more usual macro economic top-down approach. The economy continues to slowly heal from the over-leveraged trauma of the Financial Crisis of 2008. Four years later, these aftereffects are expected to persist just a little while longer.

- The threat of at least a partial government shutdown and the possible delay of tax refunds due to limits on the debt ceiling sometime around late February / early March throws a wrench into the outlook for the first quarter. Uncertainties concerning fiscal policy are likely to push positive economic developments to the background.

- Fiscal drag caused by tax hikes on the wealthy and resumption of full payroll taxes, and concern over a possible government shutdown may be supportive of a counter-trend rally in the bond market. While our general view is that yields will eventually drift gradually higher, we intend to keep the portfolio's duration close to neutral to protect the portfolio against the regularly recurring flights into Treasuries.

- We will continue to look for opportunities to safety add yield to the portfolio. Spreads between Treasuries and Agencies remain narrow, favoring Treasuries. However, in certain instances spreads are wider and Agencies offer more value. PFM will continue to evaluate callable Agencies which may offer attractive yields.

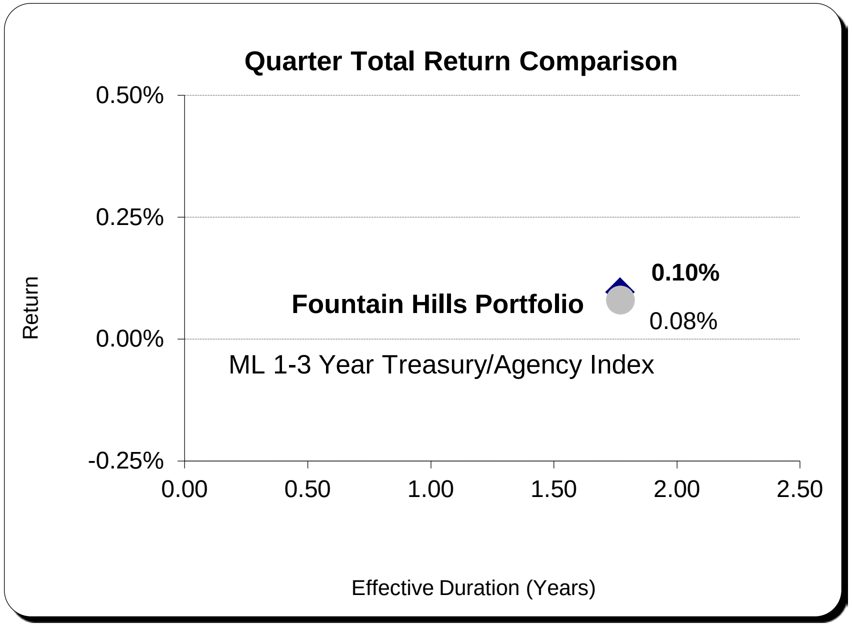
- As always, we strive to maintain safety of principal and appropriate liquidity, while seeking opportunities to add value through active management. Our strategy will remain flexible and may change in response to changes in interest rates, economic data, market outlook or specific opportunities that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

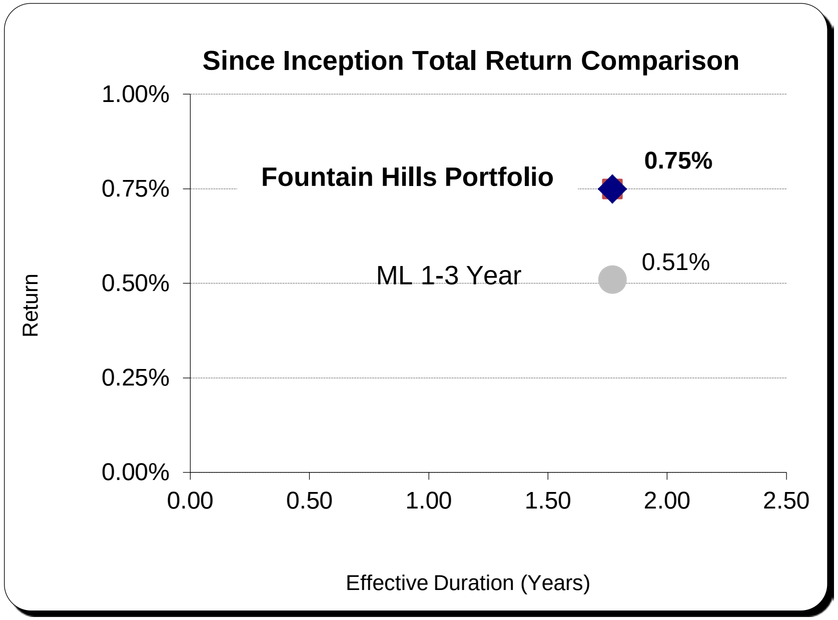
Operating Portfolio Performance

Total Return[1,2,3,4,5]	Quarter Ended December 31, 2012	Past 6 Months	Since Inception
Fountain Hills Portfolio	**0.10%**	**0.35%**	**0.75%**
ML 1-3 Year Treasury/Agency Index	0.08%	0.33%	0.51%

Effective Duration[5]	December 31, 2012	September 30, 2012
Fountain Hills Portfolio	**1.77**	**1.76**
ML 1-3 Year Treasury/Agency Index	1.77	1.77

Yields[5]	December 31, 2012	September 30, 2012
Yield at Market	0.26%	0.26%
Yield on Cost	0.46%	0.45%





1. Performance on trade date basis, gross (i.e., before fees), in accordance with the CFA Institute's Global Investment Performance Standards (GIPS).

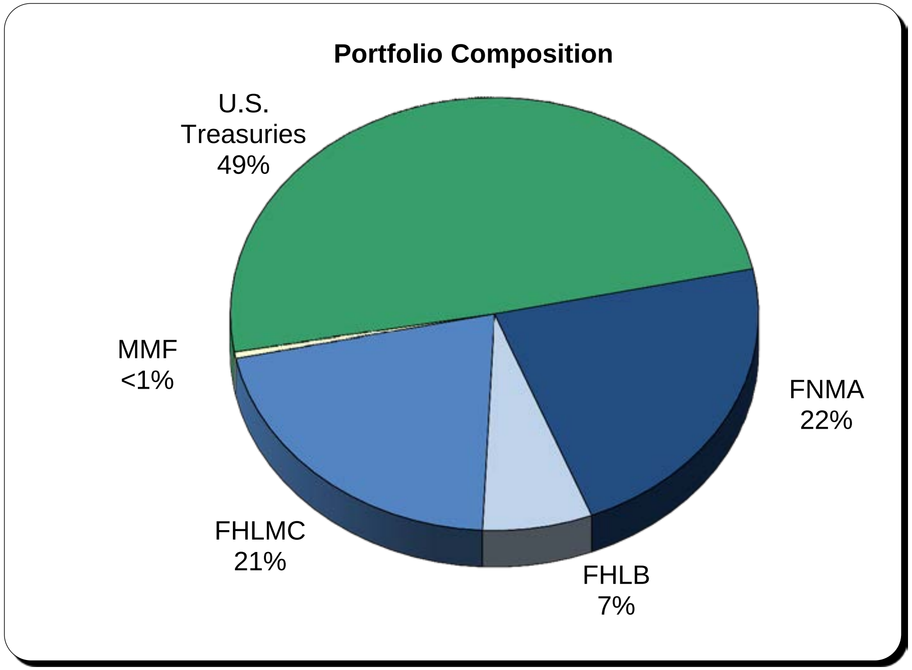
2. Merrill Lynch Indices provided by Bloomberg Financial Markets.

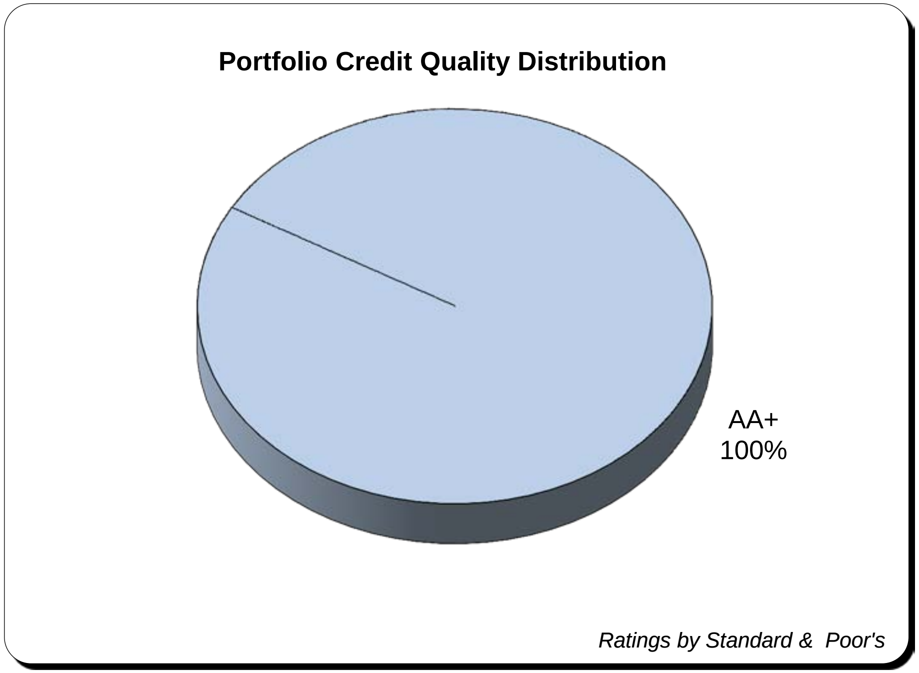
3. Quarterly returns are presented on an unannualized basis. Performance numbers for periods greater than one year are presented on an annualized basis.

4. Inception date is 12/31/2011.

Portfolio Composition and Credit Quality Characteristics

Security Type[1]	December 31, 2012	% of Portfolio	September 30, 2012	% of Portfolio	Permitted by Policy
U.S. Treasuries	**$7,478,015.93**	**49.4%**	$7,108,045.40	47.0%	**100%**
Federal Agencies	**$7,577,106.46**	**50.1%**	$7,968,274.74	*52.7%*	**100%**
FNMA	*$3,380,466.74*	*22.3%*	*$3,012,146.45*	*19.9%*	-
FHLB	*$1,018,359.42*	*6.7%*	*$1,776,875.92*	*11.8%*	-
FHLMC	*$3,178,280.30*	*21.0%*	*$3,179,252.37*	*21.0%*	-
MMF	**$72,859.27**	**0.5%**	$38,438.09	0.3%	
Totals	**$15,127,981.66**	**100.0%**	$15,114,758.23	100.0%	



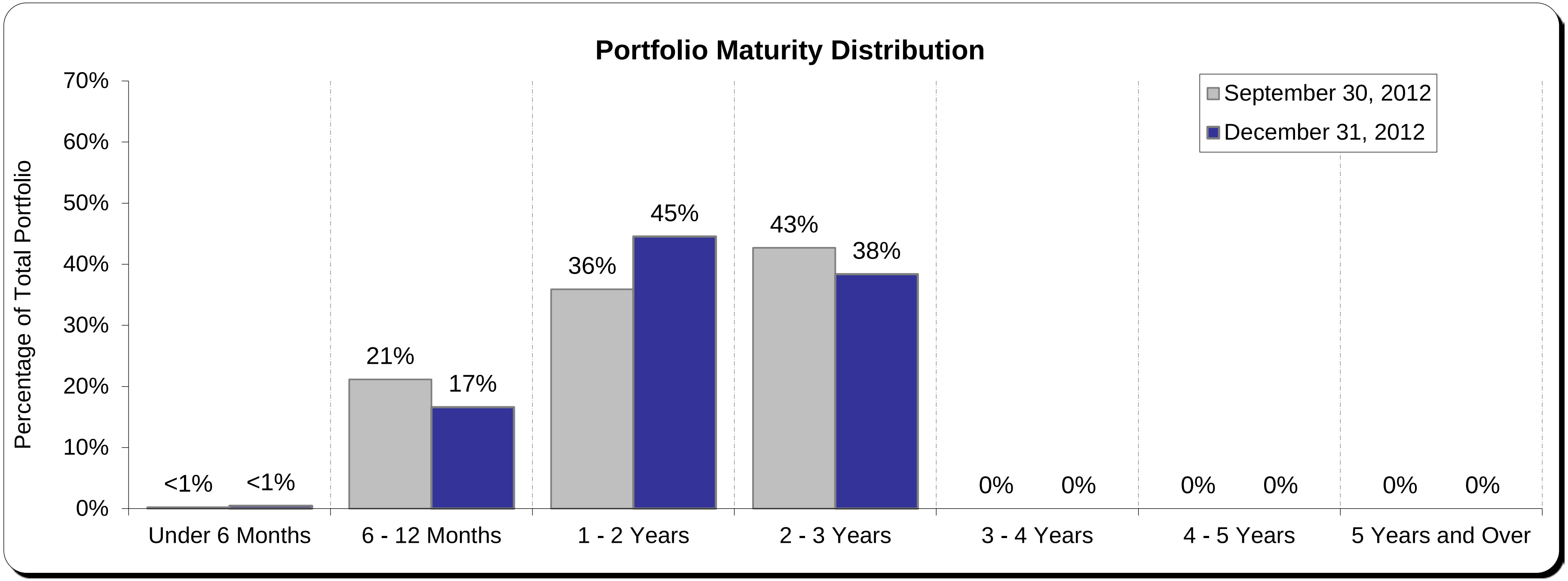


Notes:

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

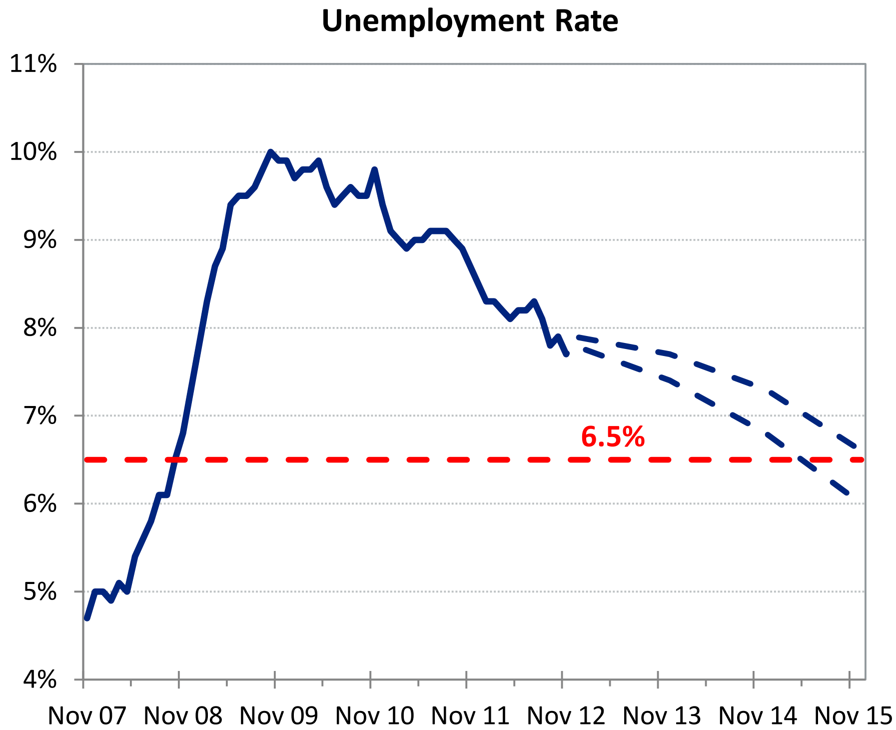
Portfolio Maturity Distribution

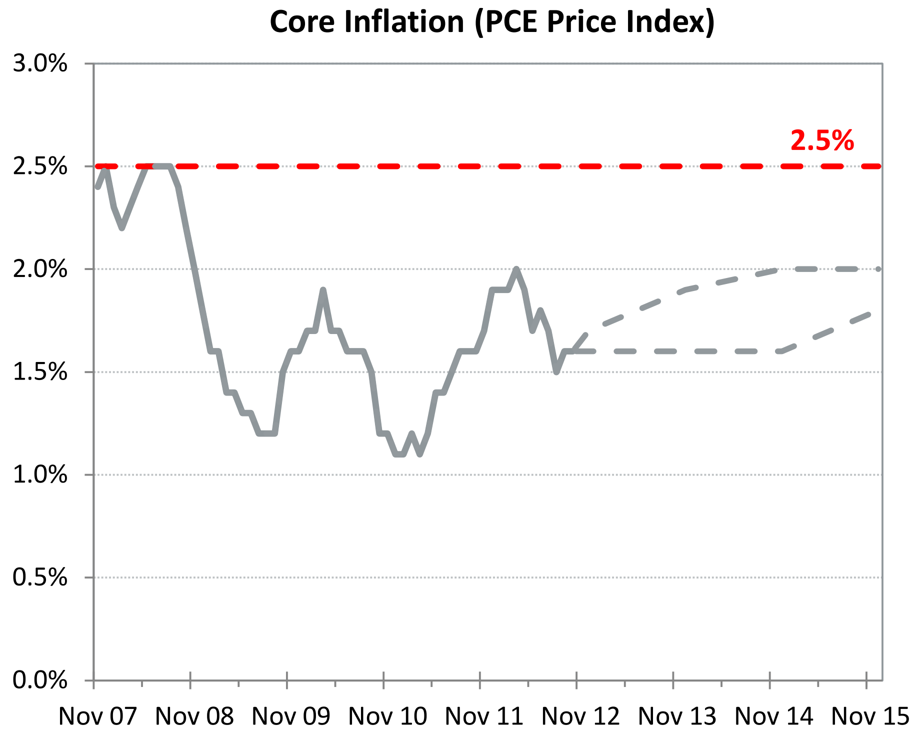
Maturity Distribution[1]	December 31, 2012	September 30, 2012
Under 6 Months	**$72,859.27**	$38,438.09
6 - 12 Months	**$2,514,935.75**	$3,196,924.56
1 - 2 Years	**$6,735,586.02**	$5,428,610.23
2 - 3 Years	**$5,804,600.62**	$6,450,785.35
3 - 4 Years	**$0.00**	$0.00
4 - 5 Years	**$0.00**	$0.00
5 Years and Over	**$0.00**	$0.00
Totals	**$15,127,981.66**	$15,114,758.23



Fed Establishes Employment and Inflation Guidance

- December 12: The Fed said that it will hold its target rate at between 0.00%-0.25% as long as the unemployment rate remains above 6.5% and 1-2 year projected inflation rates remain no more than 0.5% above their 2% target.
- While the Fed is not longer stating an explicit end date to their zero interest rate policy, based on expectations, it will likely be into 2015 before employment drops below 6.5%.





Source: Bloomberg; Federal Reserve

Strategy: Maintain Extended Duration

- With the Fed on hold likely into 2015 we are maintaining the portfolio's extended duration position. Purchasing longer-term investments allows the portfolio to take advantage of higher yields in longer maturities and the potential for roll down due to the steep yield curve.
- As the yield difference between Treasuries and Agencies remained narrow during the quarter, we favored Treasuries.

Trade Date	Trade Type	Security	Par	Maturity	Yield	Gain on Sale
11/1/12	Sell	FHLB Notes	100,000	8/28/13	0.21%	$173
11/1/12	Sell	U.S. Treasury Notes	925,000	7/15/13	0.19%	$469
11/1/12	**Buy**	**U.S. Treasury Notes**	**1,000,000**	**11/30/15**	**0.40%**	**-**
11/29/12	Sell	FHLB Notes	650,000	8/28/13	0.18%	$1,124
11/29/12	**Buy**	**U.S. Treasury Notes**	**625,000**	**11/30/15**	**0.35%**	**-**

Managed Account Detail of Securities Held

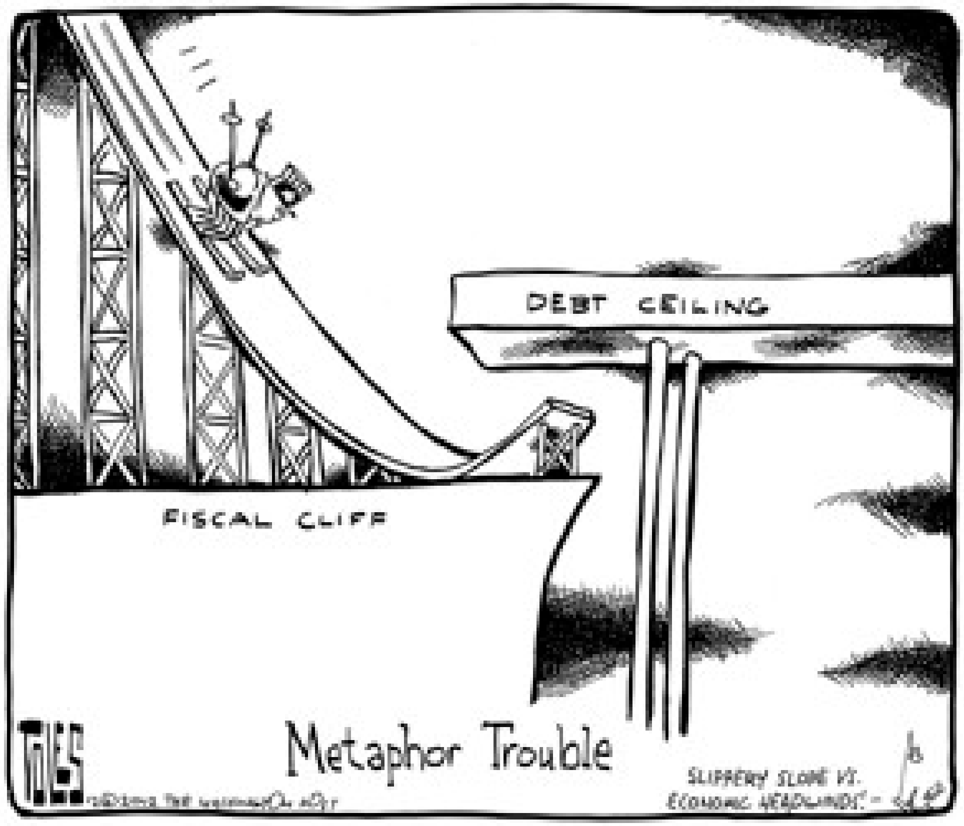
For the Month Ending **December 31, 2012**

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
U.S. Treasury Bond / Note											
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	3,729.28	1,010,806.85	1,012,421.88
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	973.76	756,381.63	758,027.25
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	84.65	723,114.91	725,000.00
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	2,353.94	259,567.05	260,234.50
US TREASURY NOTES 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	708.22	747,208.06	749,648.25
US TREASURY NOTES 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	335.64	299,258.99	300,609.30
US TREASURY NOTES 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	1,118.78	999,366.15	1,002,031.00
US TREASURY NOTES DTD 08/02/2010 1.750% 07/31/2015	912828NP1	450,000.00	AA+	Aaa	08/21/12	08/22/12	467,525.39	0.42	3,295.52	465,398.74	466,452.90
US TREASURY NOTES DTD 08/02/2010 1.750% 07/31/2015	912828NP1	850,000.00	AA+	Aaa	09/06/12	09/10/12	884,664.06	0.33	6,224.86	880,995.08	881,077.70
US TREASURY NOTES DTD 11/30/2010 1.375% 11/30/2015	912828PJ3	625,000.00	AA+	Aaa	11/29/12	12/05/12	644,018.55	0.35	755.49	643,548.23	643,359.38
US TREASURY NOTES DTD 11/30/2010 1.375% 11/30/2015	912828PJ3	640,000.00	AA+	Aaa	11/01/12	11/05/12	658,950.00	0.40	773.63	657,990.89	658,800.00
Security Type Sub-Total		**7,340,000.00**					**7,467,372.85**	**0.38**	**20,353.77**	**7,443,636.58**	**7,457,662.16**
Federal Agency Bond / Note											
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	1,506,279.11	1,508,688.00
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	635.42	999,344.86	1,001,529.00

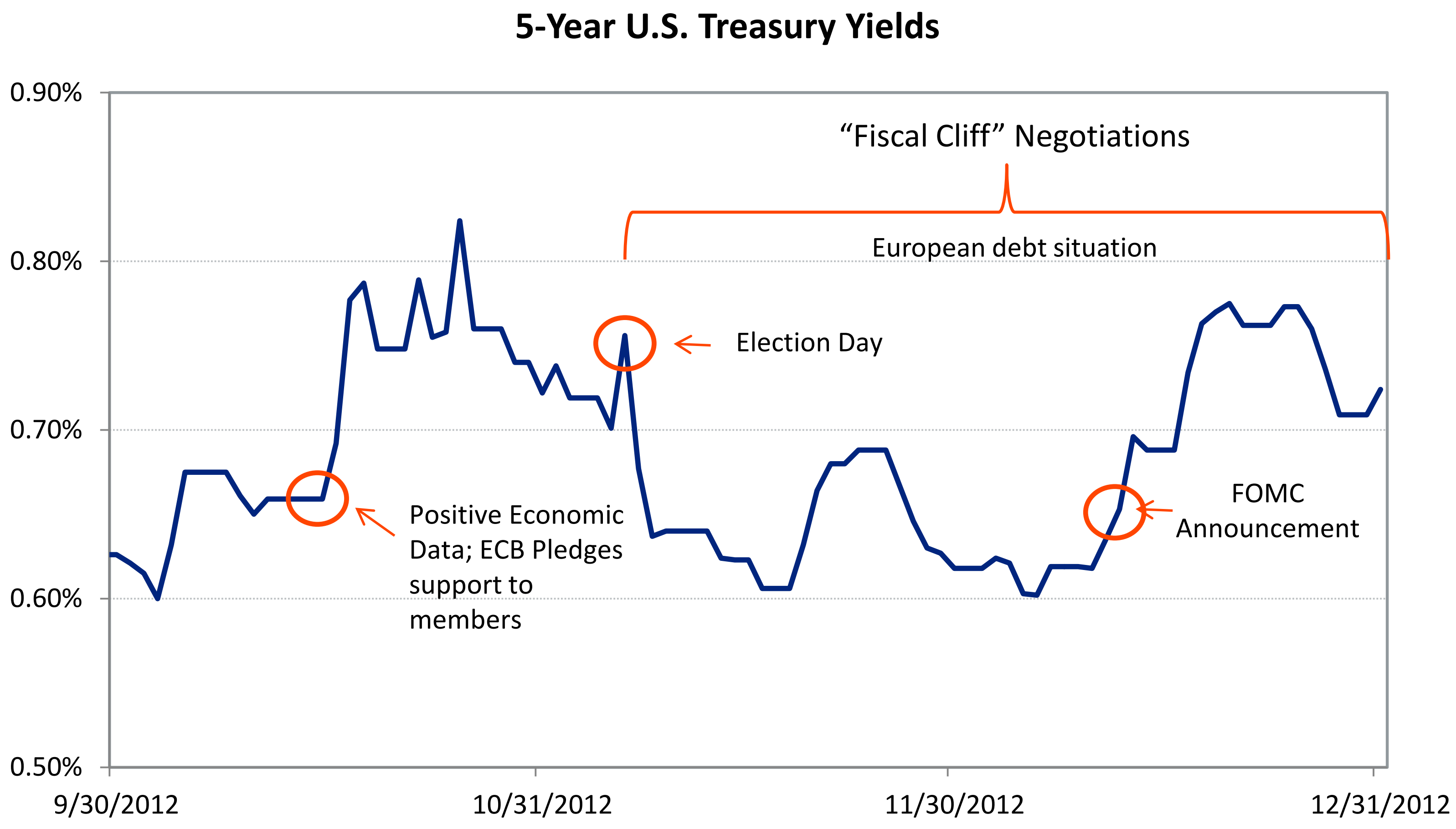
TOWN OF FOUNTAIN HILLS, OPERATING FUNDS

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											
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	857,595.79	861,424.85
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	1,011,252.47	1,017,099.00
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	752,787.86	757,551.75
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	725,319.56	731,234.70
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	853,985.75	857,715.45
FREDDIE MAC GLOBAL NOTES DTD 07/11/2012 0.500% 08/28/2015	3134G3ZA1	450,000.00	AA+	Aaa	07/30/12	07/31/12	450,525.15	0.46	768.75	450,454.30	451,478.70
FANNIE MAE GLOBAL NOTES DTD 11/16/2012 0.375% 12/21/2015	3135G0SB0	375,000.00	AA+	Aaa	11/14/12	11/16/12	374,126.25	0.45	39.06	374,161.17	374,535.00
Security Type Sub-Total		**7,475,000.00**					**7,577,721.40**	**0.53**	**15,850.01**	**7,531,180.87**	**7,561,256.45**
Managed Account Sub-Total		**14,815,000.00**					**15,045,094.25**	**0.46**	**36,203.78**	**14,974,817.45**	**15,018,918.61**
Securities Sub-Total		**$14,815,000.00**					**$15,045,094.25**	**0.46%**	**$36,203.78**	**$14,974,817.45**	**$15,018,918.61**
Accrued Interest											**$36,203.78**
Total Investments											**$15,055,122.39**



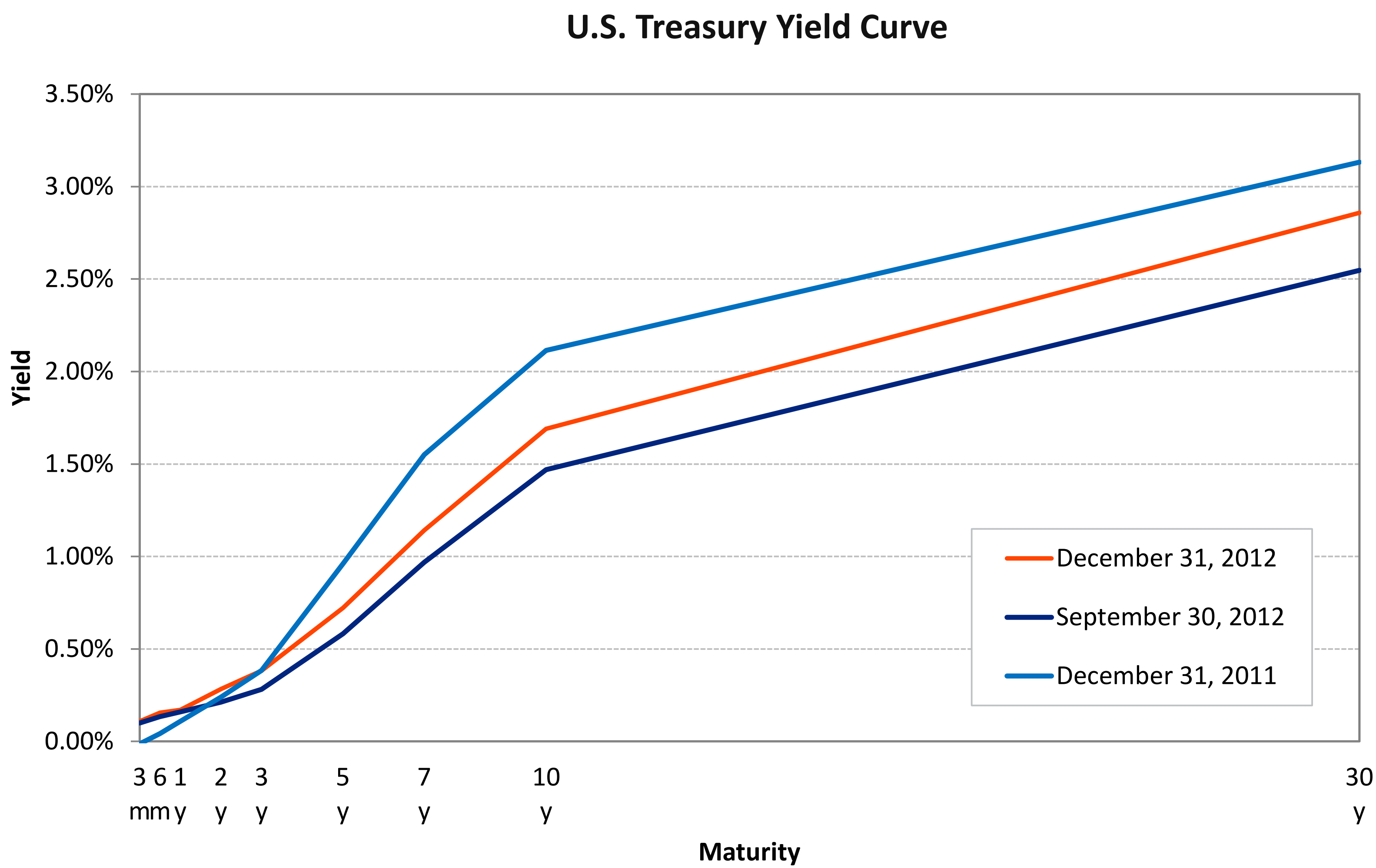
Economic Update

Fourth Quarter Market Volatility



Source: Bloomberg

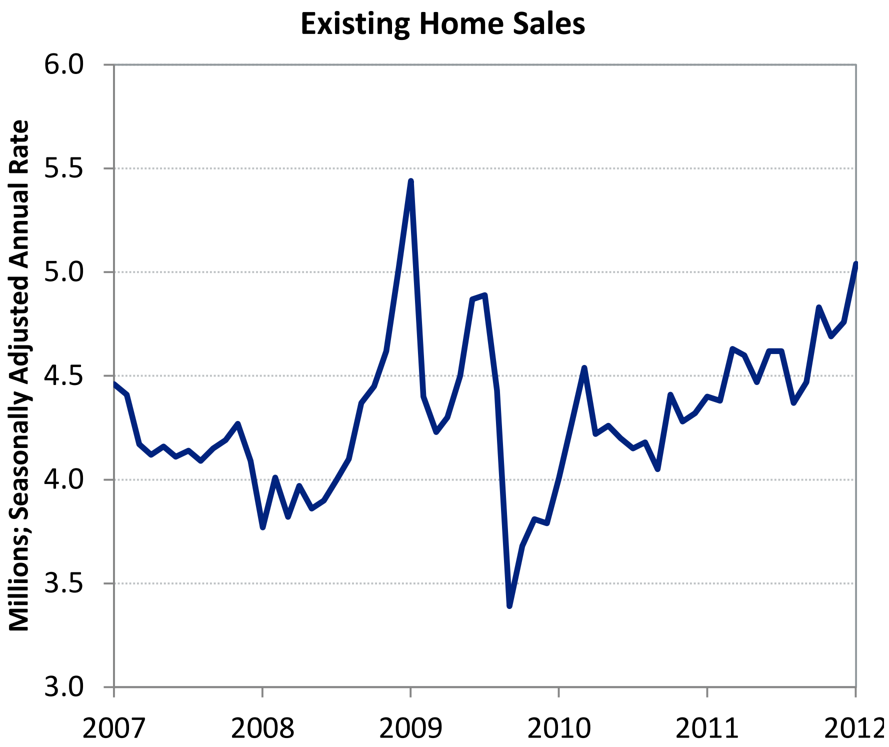
U.S. Treasury Yield Curve

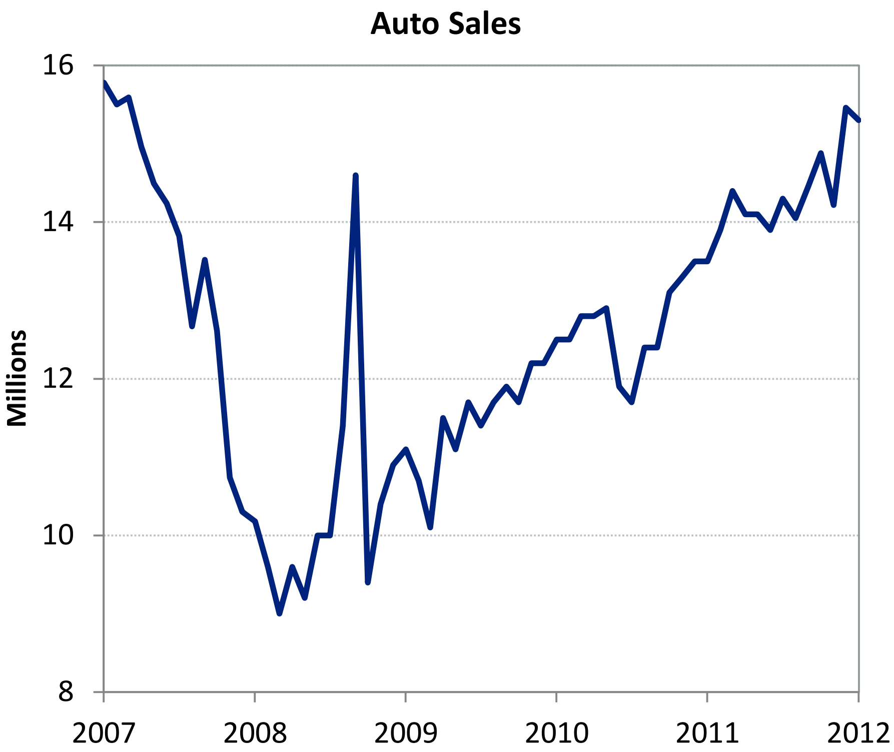


Source: Bloomberg

Cyclical Sectors Improving

- Cyclical economic sectors have begun to see improvement from their recession lows offering an encouraging indication of steady economic growth.





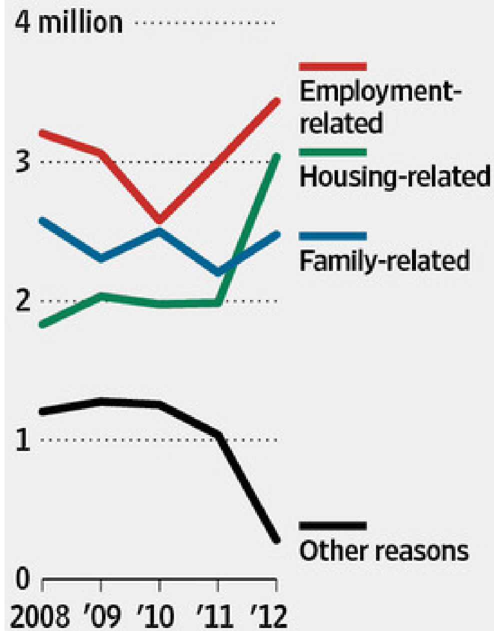
Source: U.S. Census Bureau, Bloomberg

Arizona Sees Influx of New Residents

- Americans, freed from their current locations by increased job prospects and a recovering housing market, once again began moving at a pace not seen since before the recession.
- Arizona's diverse economy and large housing market are likely contributors to the increase in population the state has seen recently.

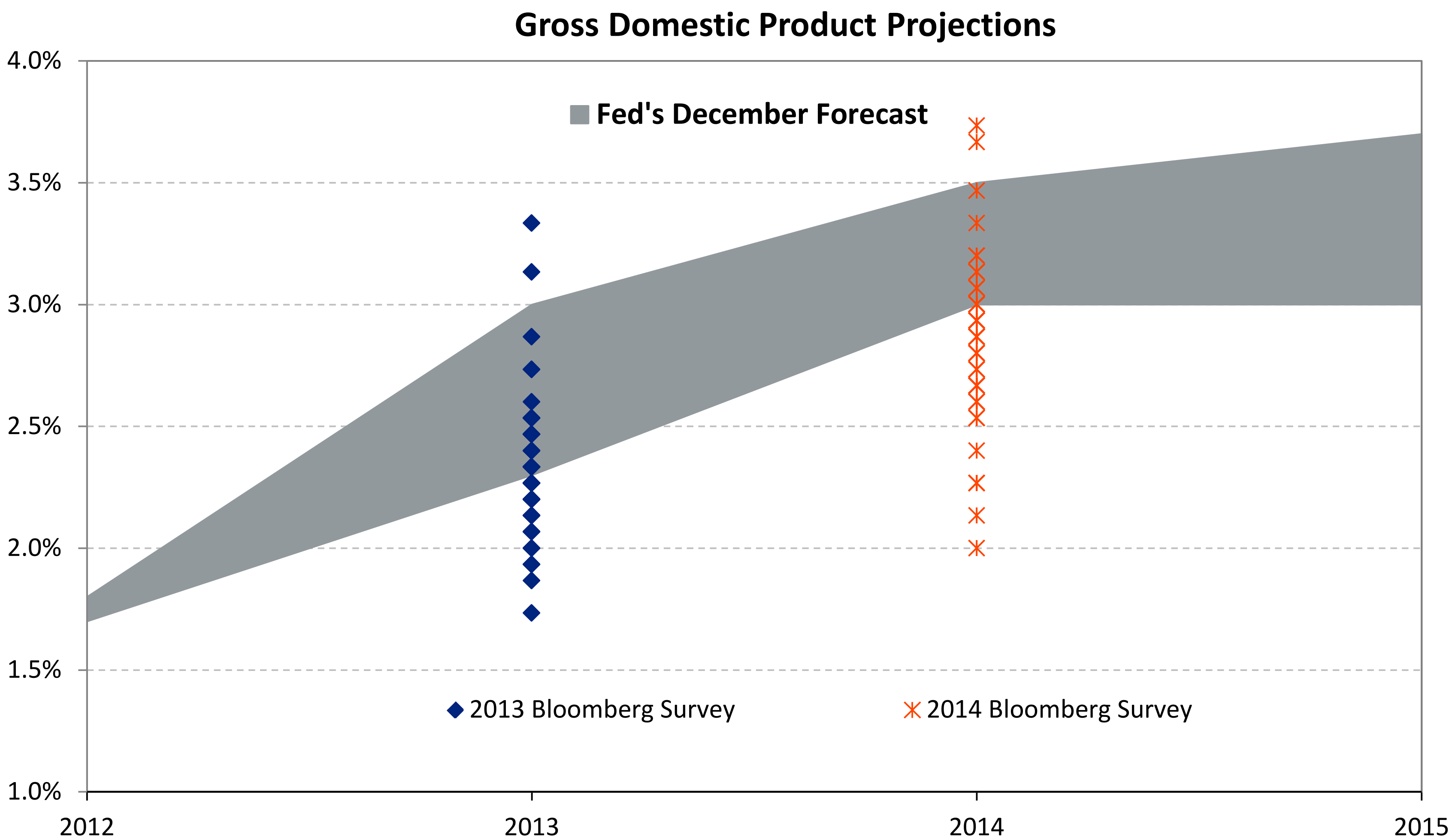
	Change in population due to domestic migration April 1, 2010 – July 1, 2012	
Top five	Texas	290,354
	Florida	219,003
	North Carolina	72,136
	Colorado	62,296
	Arizona	**48,259**
Bottom five	New York	-224,468
	Illinois	-156,197
	California	-104,093
	New Jersey	-103,252
	Michigan	-93,368

Broad reasons why Americans 16 years or older moved to a different county



The Wall Street Journal

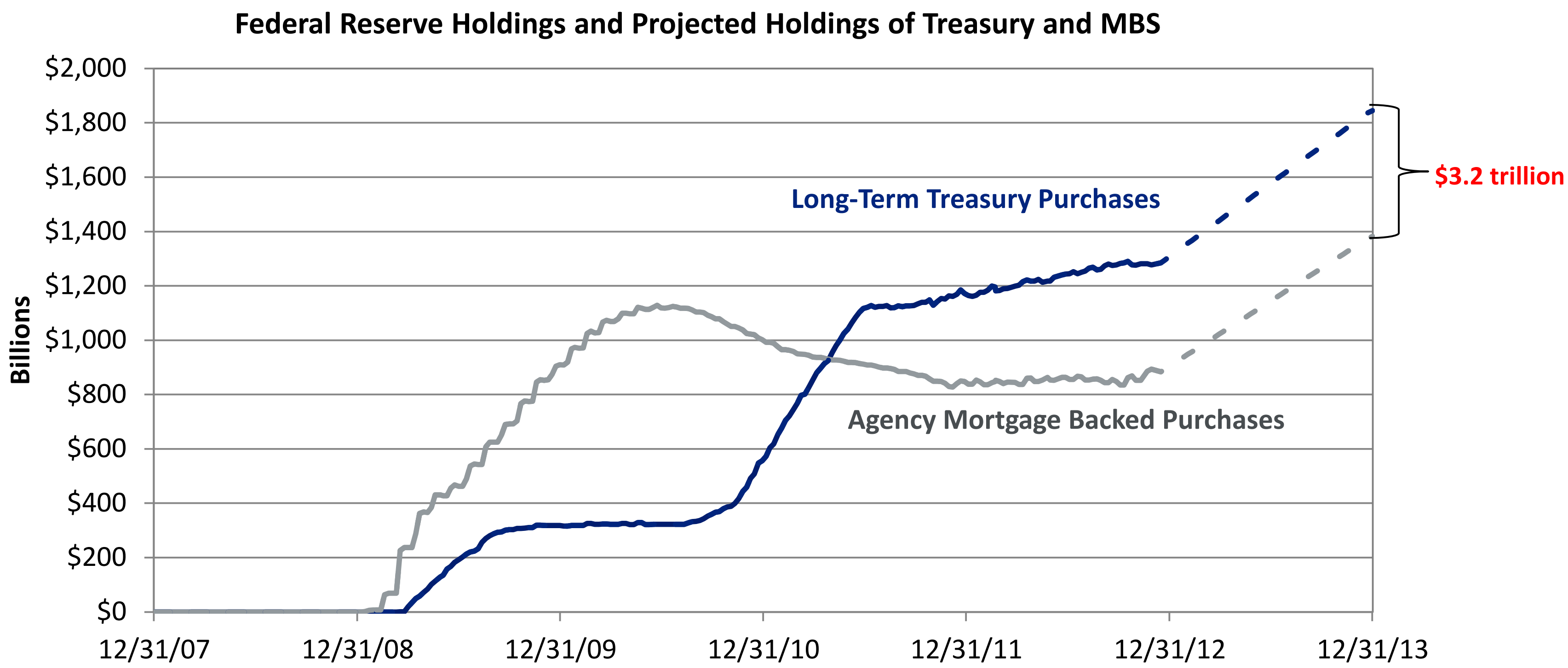
Fed Forecasts Gradual Improvement



1. Economic Projections of Federal Reserve Board Members and Federal Reserve Bank Presidents, December 2012
2. Estimates are the 'central tendency' which excludes the three highest and three lowest projections in each year

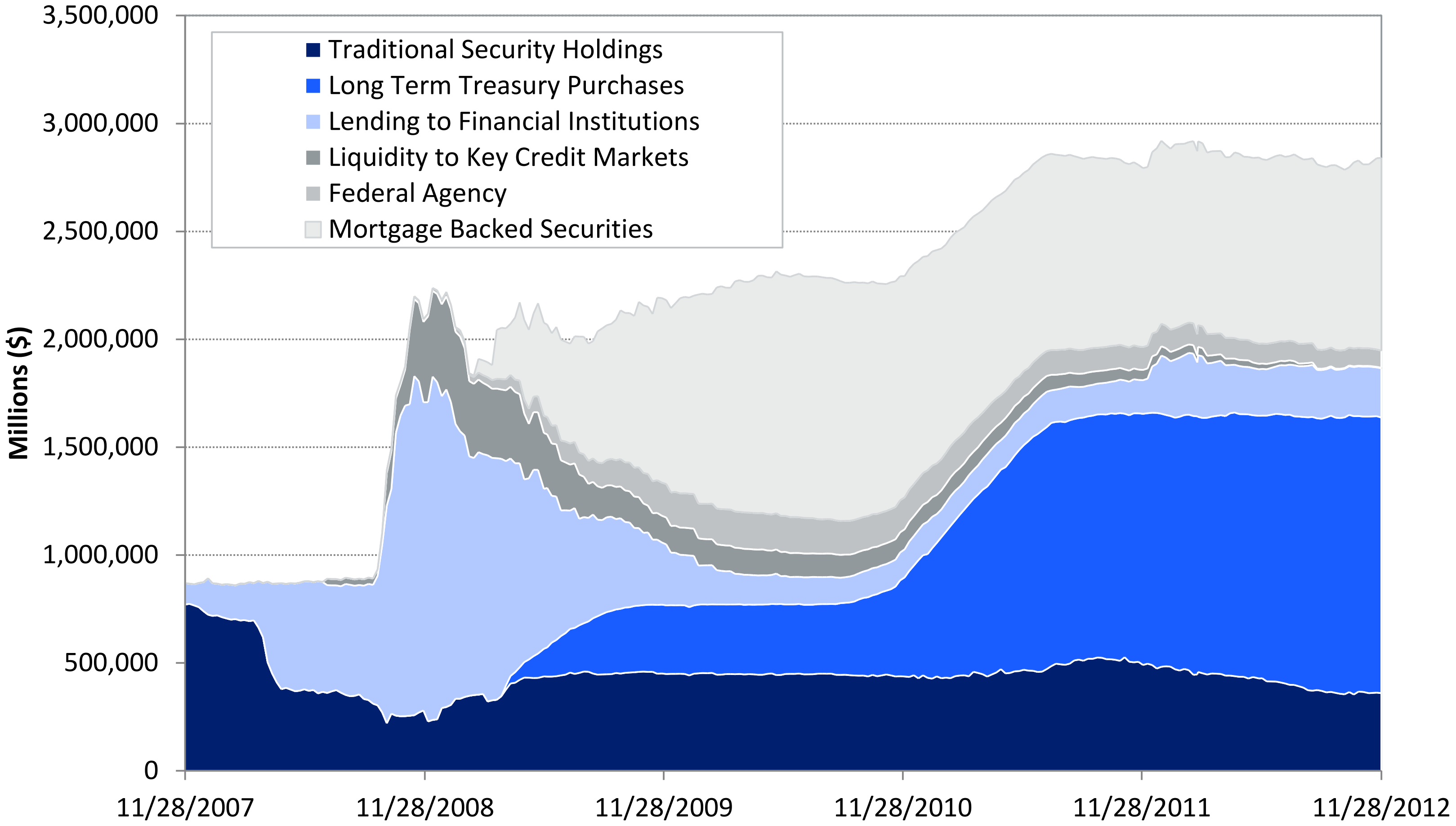
Fed to Continue Accommodation into 2013

- The December 12th Federal Reserve statement detailed additional accommodation:
  - Continue to purchase $40 billion per month of agency mortgage-backed securities
  - Continue to re-invest principal and interest payments of mortgage-backed securities
  - Begin purchasing $45 billion per month of long-term Treasuries beginning at year end
  - Resume rolling over Treasury maturities



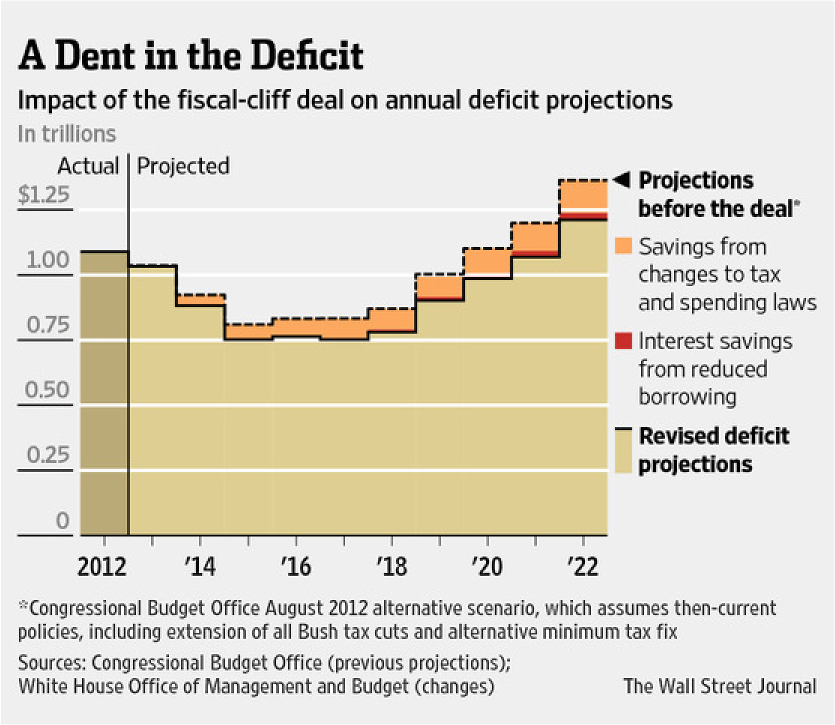
Source: http://www.clevelandfed.org/research/data/credit_easing/index.cfm

Federal Reserve Balance Sheet



Source: http://www.clevelandfed.org/research/data/credit_easing/index.cfm

Details of the "Fiscal Cliff" Deal



"Kicking the Can":

- Delayed the sequester for two months
- Did not raise the debt ceiling

Increased Revenue:

- Elimination of payroll tax holiday
- Higher tax rates for individuals earning over $400,000 and families earning more than $450,000
- Increased taxes on dividends and capital gains
- Additional limits on personal exemptions and deductions
- Increased estate taxes

Extended benefits:

- Nine month extension of the farm bill
- One year extension on Unemployment benefits
- 5 year extension on tax credits for college tuition
- The "doc fix" is included
- The Alternative Minimum Tax has been indexed to inflation
- 1 year extension of existing business tax benefits

Beyond the Fiscal Cliff

The Debt Ceiling

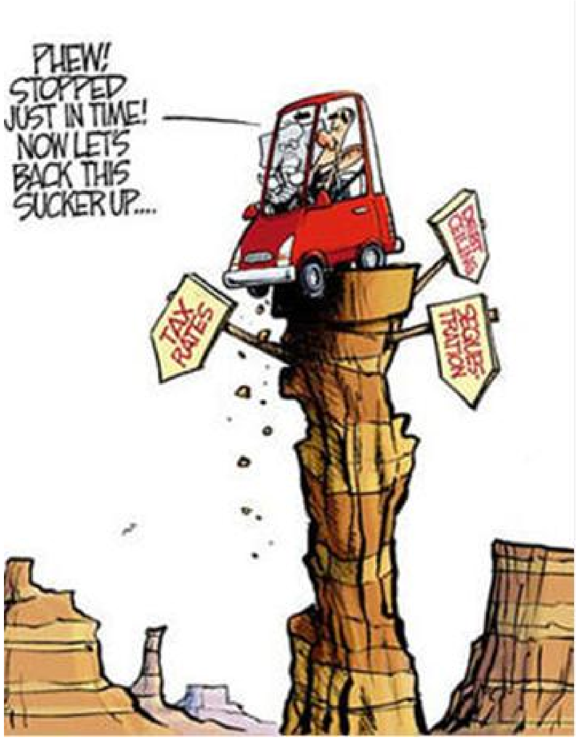
- The U.S. hit the debt ceiling, currently set at $16.394 trillion, on Dec. 31
- Using certain measures, Treasury will be able to pay its obligations for the next few months
- Will likely cause another battle with Congress
- Debt ceiling must be raised by late February to prevent default

The Sequester

- Created out of the 2011 fight over the debt ceiling
- Comprises cuts to discretionary appropriations and mandatory spending that add up to $1.2 trillion over nine years, beginning in 2013
- Cuts split between defense and domestic discretionary spending (with some exemptions)
- The fiscal cliff deal delayed the sequester by two months

Continuing resolution of the fiscal year 2013 budget

- Fiscal year 2013 began on October 1, 2012, yet Congress has not finalized the budget
- Instead has passed short-term “continuing resolutions” with current resolution expiring on March 27
- Congress will have to pass another continuing resolution to avoid a temporary shutdown of some government functions, worker furloughs and a pullback in programs



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