INVESTMENT REVIEW AND STRATEGY
March 31, 2012

The economy displayed modest strength during the quarter ending March 31, 2012 and offered confirmation that the two year economic recovery is gradually accelerating. Gross domestic product, the value of all goods and services produced by the U.S., rose at a 2.2 percent annual rate after advancing 3 percent in the previous three months. Consumer spending undoubtedly boosted the economy’s growth. Several factors accounted for strong spending including unseasonably mild temperatures, resilience to higher gas prices and recent improvements in the labor market which gave consumers the confidence and means to spend. Total spending increased by 2.9 percent. Stocks moved higher along with the economy in the first quarter. The Standard & Poor’s 500 Index increased 12.5 percent indicating the strongest three month start to a year since the first quarter of 1998. Amid signs of an improving economy, Federal Reserve policy makers appear to be holding off on launching additional programs to reduce market interest rates but as expected, will continue their policy of keeping interest rates near zero and “exceptionally low” at least through late 2014. Treasury bond yields drifted modestly higher during the quarter and since quarter-end have reversed and moved lower. The two and ten year treasury notes increased by 7 and 23 basis points and ended the quarter yielding 0.33 and 2.21 percent, respectively.

In March, the unemployment rate fell to 8.2 percent from 8.3 percent. Even though the addition of only 120,000 jobs in March was much lower than projected and somewhat disappointing, general agreement exists that labor markets have improved. Payrolls increased by 635,000 from January through March. This was the largest quarterly gain since the first three months of 2006. The downward trend in applications for unemployment benefits also indicates improvement. Part of the slowdown in March may have resulted from a warmer winter, which prompted some employers (i.e. construction) to hire and/or retain more workers than they otherwise would have done. Hiring was flat in many industries. Retail-store employment dropped by 34,000 despite a recent rise in consumer spending, while construction payrolls decreased by 7,000. Temporary-help jobs, often seen as a harbinger of labor market trends, fell by 7,500 after rising by nearly 55,000 in February.

Consumer spending, which accounts for approximately 70% of the domestic economy, picked up steam. Based on recent indicators, leadership in the current economic recovery appears to be shifting from spending by businesses to consumer spending. Consumer confidence has trended higher. Retail sales in the U.S. increased more than expected in March. The 0.8 percent gain was almost three times as large as projected and followed a 1 percent increase in February according to the Commerce Department. New vehicle sales surged in January and February but slowed slightly in March. Sales in department stores, clothing shops, home improvement centers and restaurants displayed improvement. Strength in consumer spending was surprising given that fuel costs climbed. According to AAA, the biggest U.S. motoring club, regular fuel in March averaged $3.84 a gallon. Prices have risen 20 percent this year and are 6.8 percent above a year ago. The last time gas was at $4.00 a gallon in 2008, consumers did not have many alternatives to improve mileage in the face of higher gasoline prices. In contrast to earlier
periods, even SUVs and light trucks get considerably better mileage providing consumers with greater insulation from higher pump prices. Sluggish income growth remains a concern. Growth in spending cannot be sustained without income growth. Real per capita after-tax income has declined in three of the past four months and is essentially unchanged over the past year.

Production at U.S. factories is a key indicator that explains spending trends. Manufacturing, which makes up about 75 percent of industrial output and accounts for about 12 percent of the U.S. economy, decreased 0.2 percent in March primarily as a result of cutbacks from appliance and furniture makers. The slight decline followed a revised 3.4 percent gain from December through February that marked the biggest three-month jump since 1984. Production reports also showed auto making climbed 0.6 percent in March after a 0.8 percent rise the prior month. Cars last quarter sold at the fastest pace in four years, according to industry data. The strength of the U.S. is very different than the weakness in manufacturing globally, particularly in Europe. Early in the recovery, global demand helped U.S. manufacturers compensate and offset weak domestic demand at home. The increase of 0.2 percent in the production of business equipment is a reminder that domestic capital investment along with other U.S. based demand continues to spur manufacturing.

Home prices in 20 U.S. cities dropped at a slower pace in February, possibly indicating some degree of stabilization in the real estate market. The S&P/Case-Shiller index of property values fell 3.5 percent from a year earlier, the smallest 12-month drop since February 2011. Milder weather, an improving labor market and low borrowing costs supported demand. The average rate on a 30-year fixed mortgage reached an all-time low of 3.87 percent in February and was just slightly higher at 3.88 percent in the week ending April 12, according to data from Freddie Mac. Of note, home buyers have shifted their interest away from new construction to existing properties. Existing homes are currently a cheaper alternative to new properties. The difference between the median price of an existing and new single-family house was more than $76,000 in February, near the widest gap on record and more than $50,000 larger than when the recession began. Nevertheless, housing starts (the number of new structures beginning construction in the multifamily sector) continue to strengthen. Multi-family properties posted an 85.4 percent year-over-year increase primarily driven by strong demand in the apartment market.

The European debt crisis, even after recent initiatives, continues as a concern for global credit markets. The emergency three year loans distributed to 800 European banks by the European Central Bank (ECB) along with the restructuring of Greek debt calmed markets but many fundamental problems remain unaddressed. Bank and sovereign debt levels in many countries remain uncomfortably high and most recently, political backlash has emerged over fiscal austerity and other perceived unfair government budget cutbacks. In addition, a great deal of attention has recently focused on rising interest rates, a reversal in direction in both Spain and Italy, particularly since the increase is accompanying weaker economic growth. The latest economic reports confirm that the economies of both Spain and the U.K have entered into recession.

Our portfolio strategy remains focused on the purchase of high quality assets and on those issuers whose credit strength is bolstered by U.S. government support which we still view as our best credit alternative. The quality standards set by the investment policy, under which the Pool is managed, for
most of our securities, are higher than those required by state code. Government sponsored enterprises (GSEs) FHLMC, FNMA and FHLB will remain core holdings. Legislation enacted in July 2008 reaffirmed and strengthened the support available from the U.S. government for the GSEs. Furthermore, the significant ownership stake (80 percent) in FNMA and FHLMC that has been assumed by the U.S. Treasury provides senior debt holders with ample credit support. Currently, FNMA and FHLMC guarantee $5.5 trillion of U.S. home mortgages. We also like bank debt that is secured by FDIC and NCUA guarantees. This debt benefits from the full faith and credit of the U.S. government for timely return of both principle and interest.

Given that the Fed has projected that Fed Funds will remain in its target range of 0.0% to .25% until the winter of 2014, we now believe that in general interest rates will stay at trough levels at least over the next two to three years. The amount of time it takes for the economy to attain a more adequate rate of growth will solely determine how long rates remain this low. As portfolio bonds with attractive coupons mature those proceeds must be reinvested at lower rates, lowering the overall pool’s acquisition yield. Given that we expect interest rates will eventually move upward, we want to position the portfolio to fully take advantage of interest rates moving upward whenever that occurs. We realize a material change in rates may not occur until late 2014. Nevertheless, our bias is to defensively structure the portfolio so that it is less sensitive to interest rate shifts and its market value is shielded from significant declines. We continue to look selectively at callable securities. They are typically bought as surrogates for securities with short maturities but also may offer an attractive yield pick-up relative to those non-callable bonds with a comparable maturity. We also find some floating rate securities attractive. These securities have coupons that change quarterly, are pegged to LIBOR, a commonly used rate to define interest costs, and therefore have the ability to reset in concert with higher rates. Certain high quality sectors such as asset backed securities (ABS) and taxable municipals are attractive on a risk adjusted basis. And lastly, during those periods when we find the yield curve steep, slightly longer securities that are advantaged by the curve, add value to the portfolio.

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