Second-quarter gross domestic product grew at a 2.0% annual pace, and a similar number is forecast for the third quarter. The Federal Reserve Board (the Fed) cut interest rates twice during the quarter, bringing the federal funds target rate to a 1.75%–2.00% range. The market is currently pricing in at least one more cut before year-end. Despite the Fed’s easing, the U.S. dollar remained strong for a very friendly environment for the fixed income market, which continued its remarkable year in the third quarter.

Rate cuts, slow economic growth, and falling inflation made for a very friendly environment for the fixed income market, which continued its remarkable year in the third quarter. The Bloomberg Barclays U.S. Aggregate Bond Index was up 2.27% in the quarter, bringing its year-to-date return to 8.52%. The corporate bond sector was once again the biggest winner, with the corporate portion of the index up 3.05% for the quarter (gaining 13.20% for the year-to-date). Treasuries also had a strong quarter as rates fell across the yield curve, particularly at the long end. The 2-year Treasury declined 13 basis points (0.13%), compared with a 34 basis point (0.34%) fall in the 10-year yield. The Treasury portion of the index rose 2.40%, with the 20-plus year subcomponent up 8.15% during the quarter. The commercial mortgage-backed securities (CMBS) portion of the index lagged the overall index, returning 1.89%. Agency MBS continued their underperformance as interest rate volatility remained high. The MBS portion of the index was up 1.37%. Lacking much duration or credit risk, the asset-backed securities (ABS) portion of the index was again the laggard, returning just 0.92%.

How did the market’s fixed income sectors perform?

The Fund began the quarter with a modestly long duration position versus the Bloomberg Barclays U.S. Aggregate Bond Index, but as rates fell precipitously during the quarter, we reduced some longer positions and ended the quarter with a small underweight to duration versus the index.** The Fund continues to have a heavy weighting to non-agency mortgage-backed securities and asset-backed securities. Within the securitized sector, we continue to focus on very seasoned, pre-crisis securities, though we have added significant exposure to newer issues.**

The Fund has a large underweight to the corporate sector, but the corporates we do own in the Fund are long duration, which helped offset some of the headwinds from our sector underweight as corporate bonds posted another strong quarter. However, overall, the underweight was a large headwind for the Fund.**

We also maintained a high-quality bias in the third quarter. We do own junk bonds, but within that category we stayed at the high end of the spectrum. U.S. high-yield bonds underperformed in the third quarter, so any allocation to that asset class was a marginal headwind.**

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† Each Lipper Mutual Funds average is an equally weighted average of the mutual funds within their respective investment objectives, adjusted for reinvestment of capital gain distributions and income dividends.

Past performance does not guarantee future results. The performance data quoted represents past performance and current returns may be lower or higher. The investment return and principal value will fluctuate so that an investor’s shares, when redeemed, may be worth more or less than the original cost. To obtain performance information current to the most recent month end, call 800-762-7085 or visit us at www.cavanalhillfunds.com.

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Investment Risks
Short-term investment-grade bonds offer less risk and generally a lower rate of return than longer-term higher yielding bonds. Bond funds will tend to experience smaller fluctuations in value than stock funds. However, investors in any bond fund should anticipate fluctuations in price, especially for longer-term issues and in environments of changing interest rates. High-yield bonds, “commonly referred to as junk bonds,” have a higher risk of default or other adverse credit events, but have the potential to pay higher earnings over investment-grade bonds. The higher risk of default, or the inability of the creditor to repay its debt, is the primary reason for the higher interest rates on high-yield bonds. International investing involves increased risk and volatility.

How did your strategies influence performance?
The Fund outperformed its index by 21 basis points (0.21%) in the third quarter. The outperformance was primarily driven by the longer-than-benchmark duration position through most of the quarter, and was helped by large spread tightening in the few corporate positions in the Fund.**

How do you expect to position your Fund in the coming months?
Fixed income prices are at or near their highest levels in history. Because yields are the inverse of prices, the expected returns for fixed income are at or near their lowest levels in history. Given these valuations, it makes sense to exercise caution. The corporate bond market looks complacent, as it has thus far ignored what we believe to be a significant slowdown in economic growth expectations. The large underperformance of agency MBS so far this year, particularly relative to the returns in the corporate market, may provide a decent opportunity to move up in credit quality without giving up much yield. Outside of government-guaranteed bonds, we will continue to focus on securities that we believe can withstand significant slowdown scenarios.**

** Portfolio composition is subject to change.
Past performance is no guarantee of future results.