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HOW BAD IS THE BOND MARKET?

Introduction

In reading the financial press, one would think that the risk in the bond market is quite high and investors could lose a considerable amount of money.

Some have gone so far as to describe the bond market as a "bubble". A bubble is typically defined as a market that is priced by investors who have no regard for fundamentals. Given this backdrop, one might expect a dire outcome for those investors who have fixed income exposure.

2004 Review

About a year ago, there were similar predictions for bonds and interest rates. The consensus predicted the 10-year treasury yield would rise by approximately 1% or 100 basis points.

In Figure 1, we review the changes that occurred on select benchmark interest rates, treasury yields and Fed funds, for 2004. We also include our assessment of long-term fair value for these rates.

Stairway Partners fair value is our longer-term estimation of where rates are fairly priced to compensate the investor for the risk associated with investing in bonds. The movement from today's prices to fair value is the basis for our expected returns. (See page 4 Strategy table.)

Although investment grade bonds under-performed equities, they surprisingly produced positive returns for 2004. The Lehman Aggregate, which is a market-weighted index of investment grade bonds, produced a total return of 4.34% and the Lehman Municipal Index produced a total return of 4.48%

As you can see in Figure 1, we expect rates to rise, which is similar to consensus views. It is noteworthy that during 2004 the Federal Reserve raised short term interest rates (Fed funds) by 1.25% while longer-term treasury yields actually declined.

Why are rates below most experts' estimation of fair value?

There are many ideas on why rates are still below most market participants' estimates of fair value.

We believe that, over the longer-term, interest rates are determined by inflation, real cash rates (short-term rates minus inflation), and the risk of holding bonds.

Let's examine some key areas to see where the market is priced versus our assessment of fair value for each area.

Inflation expectations (Figure 2) have already moved higher and now sit above our estimation of

(Continued on page 2)

Figure 1	12/31/03	12/31/04	2004 Change	Stairway Fair Value	Difference*
Fed Funds	1.00	2.25	1.25	4.30	2.05
2-Yr Tsy	1.82	3.07	1.25	4.58	1.51
5-Yr Tsy	3.25	3.61	0.36	4.89	1.28
10-Yr Tsy	4.25	4.22	-0.03	5.22	1.00
30-Yr Tsy	5.07	4.83	-0.24	5.44	0.61

*Stairway Fair Value minus 12/31/04 market yields

CURRENT TOPICS

"ALTHOUGH INVESTMENT GRADE BONDS UNDER-PERFORMED EQUITIES, THEY SURPRISINGLY PRODUCED POSITIVE RETURNS FOR 2004"

Note: *Stairway Fair Value* is our long-term estimation of interest rates

HOW BAD IS THE BOND MARKET? - CONTINUED

(Continued from page 1)

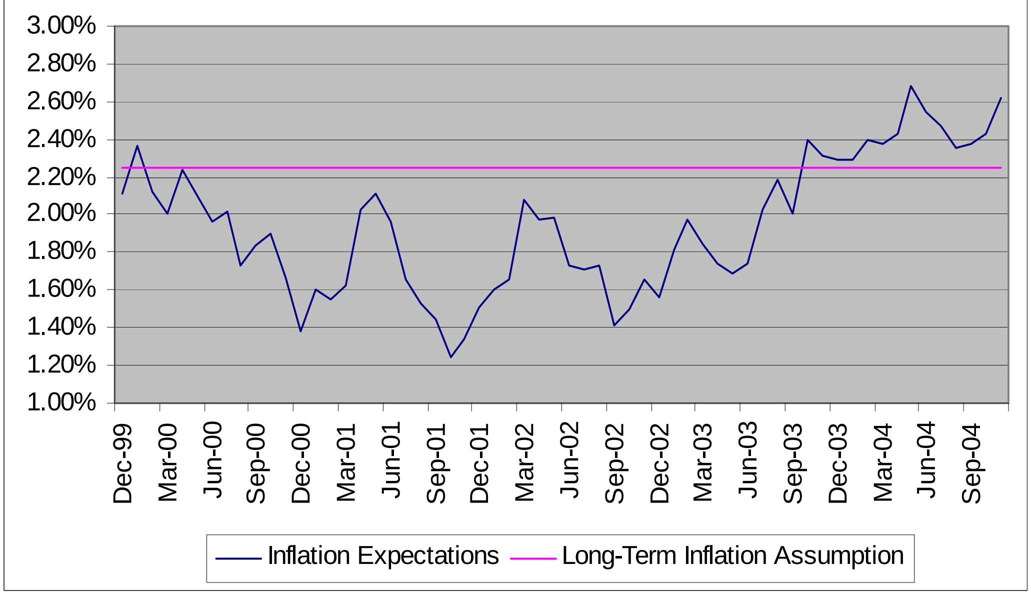
long-term inflation. We believe that inflation expectations priced in the market are appropriate and are not the reason that rates are too low. In our December 2004 *Monthly* we explored this topic in more detail.

Some suggest that massive buying by foreign central banks has driven the yields on treasury rates too low. Credit sensitive bonds, which foreign central banks do not buy, have outperformed treasury notes and spreads have tightened. (Figure 3) This should not be the case in an environment where central banks are irrationally purchasing treasury notes to defend their currencies. Therefore, we do not think that foreign central bank buying is a good explanation for current low rates.

So what is the reason for low rates?

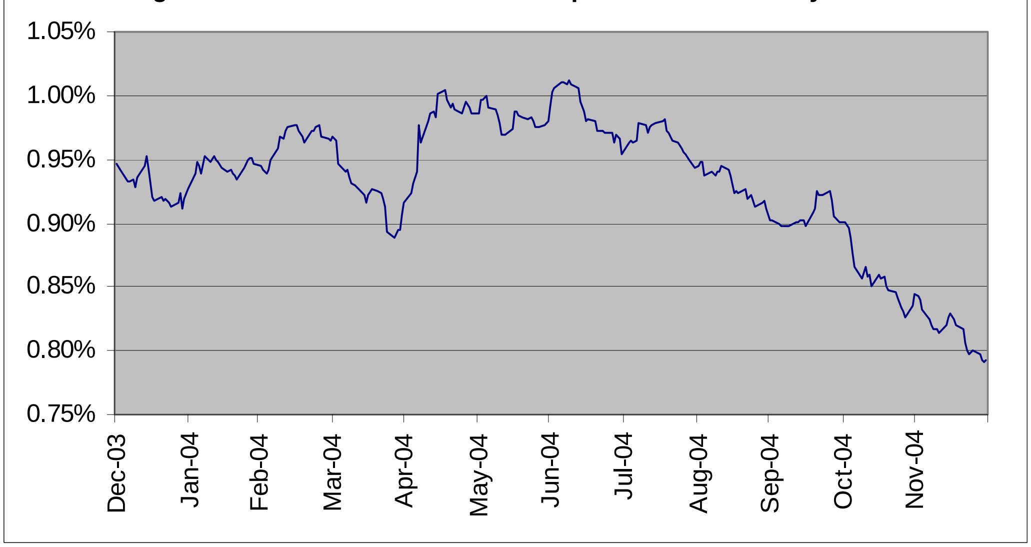
We believe the real cash rate, which is too low, is the main reason why interest rates are below fair value. Real cash rates, which are a function of the Fed funds rate adjusted for inflation, sit well below fair value. (Figure 4) The biggest risk to bonds is that the Federal Reserve would need to

Figure 2: Inflation Expectations



Note: Inflation expectations are measured as the difference in yield between 10-year Treasury Inflation Protected Securities and the current 10-year treasury note. Source: Bloomberg

Figure 3: Investment Grade Credit - Spreads over Treasury Yields



Source: Lehman Brothers

Quiz: Pick the best performing scenario for the Lehman Aggregate Bond Index if rates rise 1.00% in 2005	
Scenario 1:	entire rate rise occurs the first business day of 2005
Scenario 2:	entire rate rise occurs the last business day of 2005
Scenario 3:	rates move up by the same amount each month

Quiz Notes:

Assume parallel shift in rates and spreads unchanged

Answer on next page

About Stairway Partners, LLC

Stairway Partners was formed to provide our clients (starting with ourselves) with an effective and comprehensive solution for managing their wealth. Our disciplined and rigorous approach comes from our collective knowledge in serving large institutional clients over many years.

Our core investment belief is that asset allocation is the single most important determinant of success in any investment plan. 90% of risk and return comes not from your choice of individual investments but from your asset class mix. Stairway Partners focuses our resources on risk management and asset allocation. This includes building your custom blueprint (investment policy and benchmark) and aligning your portfolio with our investment strategy utilizing the global capital markets.

PAUL RAIDL, OUR CHIEF TECHNOLOGIST, HAS NOW IMPLEMENTED STAIRWAY PARTNERS' PROPRIETARY ANALYTICS FOR CLIENT USE ON OUR WEB SITE

THE BOND MARKET

(Continued from page 2)

tighten rates faster than is currently priced into the market. This might be in response to the Fed thinking that inflation is getting out of hand. We do not think that this is the most likely scenario.

In our view, the most likely scenario has the Federal Reserve raising short rates in small increments over time, thus producing a return of 3.5% for 10-year treasuries over the next 3 years.

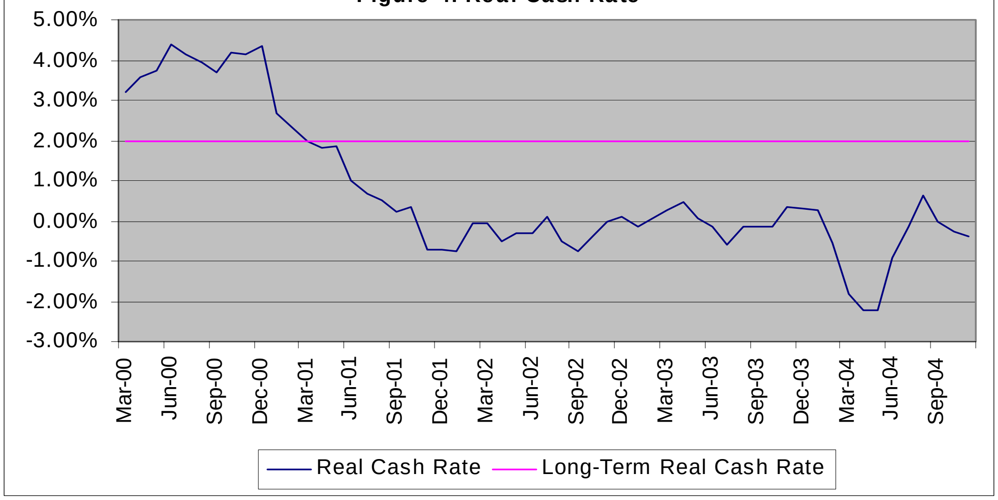


Figure 4: Real Cash Rate

Note: The real cash rate is the difference between the yield on cash adjusted for inflation

Investment implications

It is very important that market prognostications be put into context and measured. If I expect rates to rise by 1%, should I be completely out of fixed income?

The answer is no. Bonds do have a place in the portfolio as they help to balance out risk, and in certain scenarios would outperform equities.

Investors should not make decisions in isolation based on a single market view. Just as important, there are numerous market outcomes that could greatly penalize a non-diversified portfolio. As an example, if the global economy slows and earnings come under pressure, fixed income could outperform equities. A prudent investor should have diversified exposures.

Our current strategy has an underweight in taxable investment grade bonds for tax-exempt clients and a neutral weight in municipal bonds for clients that pay taxes at the highest rate. Although we have not discussed them specifically in this article, we maintain no exposure to High Yield and Emerging Market Debt.

> "BONDS DO HAVE A PLACE IN THE PORTFOLIO AS THEY HELP TO BALANCE OUT RISK AND IN CERTAIN SCENARIOS WOULD OUTPERFORM EQUITIES"

Answer: Scenario 1 is the best because the investor gets the benefit of higher yields for the entire year.		**Total Return**
Scenario 1:	entire rate rise occurs the first business day of 2005	0.76
Scenario 2:	entire rate rise occurs the last business day of 2005	-0.24
Scenario 3:	rates move up by the same amount each month	0.52

It is interesting to note that in 2 of the 3 scenarios the return is still positive.

Not exactly a bubble !

Strategy

Asset Class	Expected Return	Hurdle Return	Strategy	Comment
Equities				
US	4.8%	7.0%	neutral	Slightly overvalued but strategy still neutral
Non-US Developed				
Eurozone	7.7%	6.7%	neutral	Euro strength may undermine attractive price
Japan	0.6%	4.3%	under	Market has already priced in economic recovery
UK	10.1%	8.4%	neutral	Pound strength may undermine attractive price
Emerging	10.4%	12.4%	neutral	Recent strength has made slightly less attractive
Fixed Income				
US Treasury Bonds			under	Real rates are too low
2-Year	2.9%	3.8%		
5-Year	3.0%	4.3%		
10-Year	3.1%	4.7%		
25-Year	3.5%	5.2%		
US Municipal Bonds			neutral	Neutral for taxable accounts
2-Year	2.1%	2.7%		
5-Year	2.4%	3.1%		
10-Year	3.3%	3.7%		
25-Year	6.5%	4.3%		
US High Yield	2.9%	5.4%	under	Too much risk for the yield
Emerging Markets Debt	3.7%	5.7%	under	Too much risk for the yield
Cash	3.5%	---	over	Attractive versus taxable bonds

Currencies	Expected Return	Equity Return with Currency
Euro	-4.7%	3.0%
Japanese yen	0.9%	1.5%
UK pound	-4.8%	5.3%

Notes: **As of: 12/31/2004**

The expected return is our estimate of the annualized return likely to be generated over a 3-year horizon.

The expected returns are expressed in local currencies (e.g., Japanese equity return is stated in yen terms).

The hurdle rate represents the annualized return that an asset needs to generate in order to cover its risk.

Equity Return with Currency (in Currencies section) is the annual return we would expect a US dollar investor to earn from holding the foreign equity market.