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CURRENCY RISK AND GLOBAL INVESTING

Introduction

With the depreciation of the dollar over the last several years, non-US investments have performed extremely well in comparison to US markets.

As you can see in Figure 1, this out-performance of foreign equity markets relative to the US is primarily due to currency movement (differential between purple and blue bar). The actual underlying equity markets have performed similarly in their respective currencies.

As a result of this out-performance, many investors are just now raising their awareness of investing outside of the US. An important issue is how to effectively utilize non-US investments within a well structured plan to achieve financial objectives.

This becomes increasingly important as financial market product pushers are now (after the dollar decline) offering a plethora of non-US investment ideas.

There is a clear distinction between chasing returns by investing in what has done well and having a plan to utilize non-US markets.

Global Investing

Whether or not the dollar is expected to go up or down, we believe in globally diverse portfolios. Investors who do not consider investments outside of their countries are exhibiting *home bias*.

By utilizing the liquid global capital markets, an investor increases the opportunity set, while adding diversification benefits. US stocks and bonds account for less than half of the global capital markets.

Currency Strategy

Investing in currency-only strategies as an isolated investment decision may provide for a poor risk/reward trade-off. We think about currency risk and return when evaluating non-US asset classes *in the context of the overall portfolio.*

The way we measure risk from currency is by measuring its volatility. Mathematically speaking, this is the standard deviation of periodic returns. This measure of risk is expressed on an annualized basis, meaning that a risk of 10% would put returns at plus or minus that

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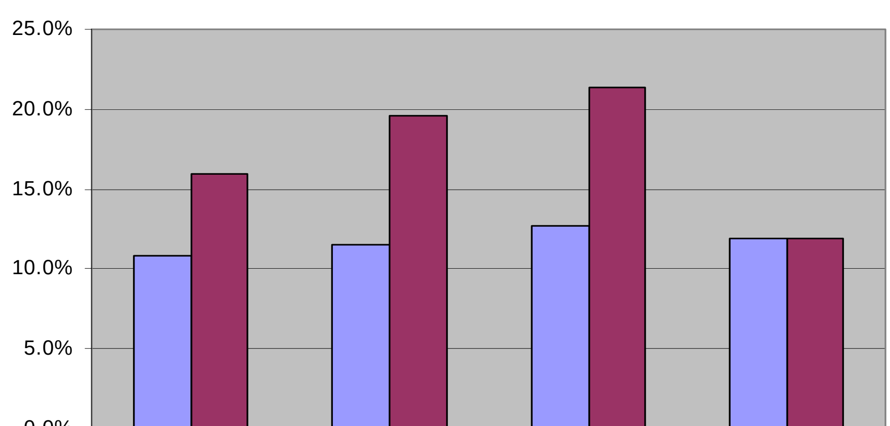
Figure 1 - Equity Index Total Returns for 2004



	MSCI Japan	MSCI UK	MSCI Eurozone	Russell 3000 US
In local currency	10.8%	11.5%	12.7%	11.9%
In USD	15.9%	19.6%	21.4%	11.9%

Source: MSCI, Russell

CURRENT TOPICS

Stairway Update: Performance reporting will be available on our client web site in February

CURRENCY RISK AND GLOBAL INVESTING - CONTINUED

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amount two-thirds of the time.

Since the returns of currencies and investments are uncorrelated, the total risk of investing in non-US markets is not the sum of the two risk components.

As an example, the contribution to overall risk from currency is much smaller when associated with an asset class that has greater investment risk than the currency. The reverse is true when an asset class has lower investment risk than the risk of the currency.

Figure 2 portrays the relationship between currency risk and a range of investment risks (Examples A through E).

Limitations

Although explicit historical measurement of risk and correlation is important in managing portfolios, it provides an incomplete picture of what needs to be considered in a strategy. Any historical measure will not capture structural changes and, by definition, is not forward-looking. In addition, there is a return distribution implicit in the risk calculation which may not accurately reflect the behavior of currencies. In

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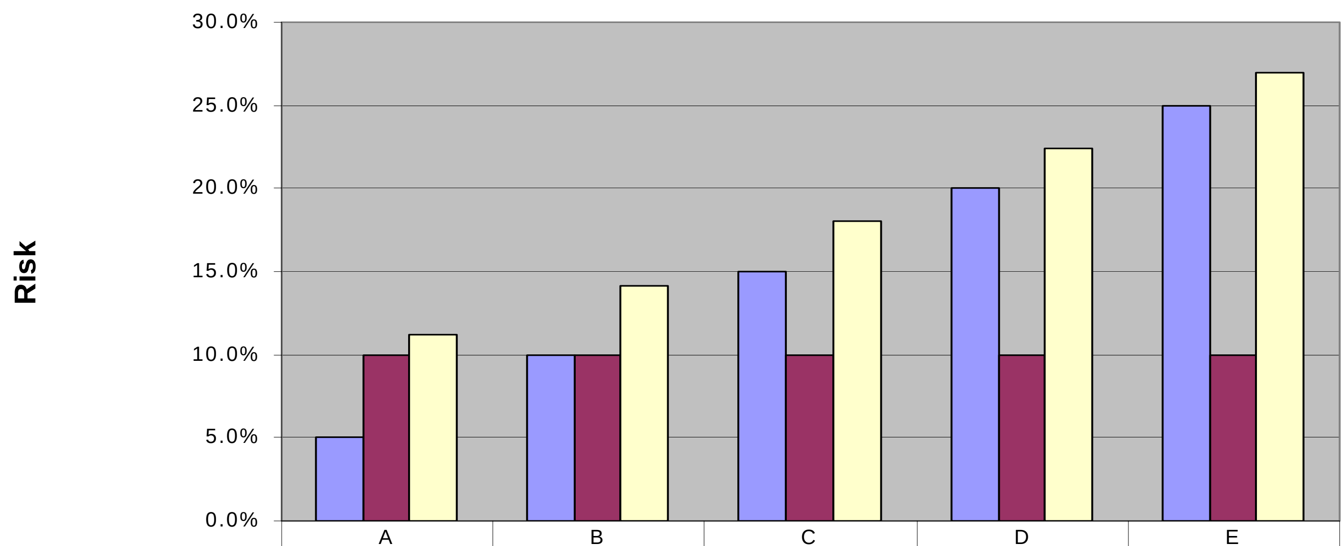
Figure 2 - Investment Risk versus Currency Risk



	A	B	C	D	E
Investment Risk:	5.0%	10.0%	15.0%	20.0%	25.0%
Currency Risk:	10.0%	10.0%	10.0%	10.0%	10.0%
Total Risk:	11.2%	14.1%	18.0%	22.4%	26.9%

As the investment risk of the underlying asset class goes up, the additional risk due to currency diminishes.

As illustrated above:

- Example A has an investment risk of 5% and a currency risk of 10%. The currency “adds” risk of 6.2% (total risk of 11.2% less the investment risk of 5%). The currency contribution to risk is considerable.
- Example C has an investment risk of 15% and currency risk of 10%. The currency “adds” risk of 3% (total risk of 18% less the investment risk of 15%). The currency contribution to risk is more muted.

Conclusion: Non-US equities have much less contribution to risk from currencies than non-US bonds.

Source: Stairway Partners, LLC

Assumes zero correlation between currency and investment risk

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.

PERFORMANCE REPORTING ON OUR CLIENT WEB SITE WILL BE AVAILABLE IN FEBRUARY

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fact, sudden, large dislocations are more likely than the distribution would forecast.

Investment Implications

Over the long run, currency moves and the subsequent impact on investment returns tend to be a wash. However, it is particularly important to "worry" about currency when the exchange rate is far from its fundamental value.

Currencies, like asset classes, require a high degree of fundamental analysis. (We will discuss this particular topic in a later piece.)

Entry points for markets that have currency risk can be critical. If a currency is close to its fundamental value, then active currency strategies designed to capture smaller near-term moves are, in most cases, costly and a needless drag on performance.

The US dollar has already moved considerably versus other major currencies - Japanese yen, euro and British pound (Figure 3). As reported in our strategy (see page 4), and discussed in more detail in our December 2004 *Monthly*, we now have the US dollar slightly attractive versus the euro and pound, and slightly undervalued versus the yen.

More specifically, we recommend investors avoid non-US bonds. The underlying asset class is not attractive and this is not the time to add foreign currency exposure to chase past performance.

Non-US equities on the other hand, look fairly valued and an investor should have them at a normal allocation (neutral or equal to the benchmark weight). This includes emerging markets as well as the developed non-US markets.

Summary

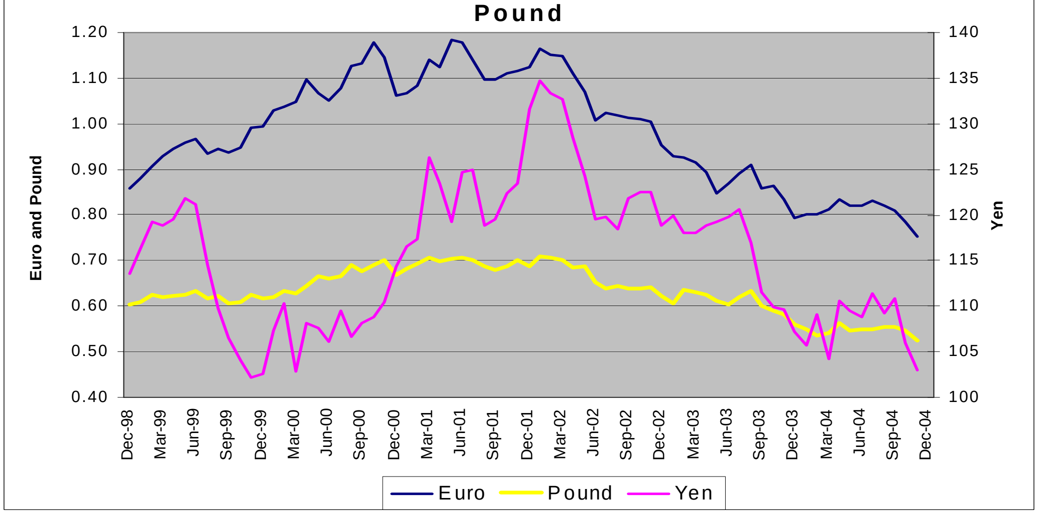
Investment strategies that incorporate the global markets are an important part of a sound investment plan.

One should not be invested in non-US markets on an ad-hoc basis - chasing returns and reacting to headlines about the US current account deficit.

Foreign asset classes should be included as part of a broader plan. This includes building a blueprint that utilizes the diversification benefits and expanded opportunity set that global asset classes provide investors.

"OVER THE LONG RUN, CURRENCY MOVES AND THE SUBSEQUENT IMPACT ON INVESTMENT RETURNS TEND TO BE A WASH"

Figure 3 - Exchange Rates US dollar verus Euro, Yen and Pound



Source: Bloomberg

Strategy

Asset Class	Expected Return	Hurdle Return	Strategy	Comment
Equities				
US	5.7%	7.1%	neutral	Slightly overvalued but strategy still neutral
Non-US Developed				
Eurozone	7.3%	6.7%	neutral	Close to fair value
Japan	1.2%	4.3%	neutral	Volatile fundamentals are still improving
UK	9.9%	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	3.1%	3.9%		
5-Year	3.1%	4.3%		
10-Year	2.9%	4.7%		
25-Year	2.7%	5.0%		
US Municipal Bonds			neutral	Attractiveness is in longer maturities
2-Year	2.2%	2.8%		
5-Year	2.5%	3.2%		
10-Year	3.2%	3.7%		
25-Year	6.0%	4.2%		
US High Yield	3.2%	5.5%	under	Too much risk for the yield
Emerging Markets Debt	3.7%	5.8%	under	Too much risk for the yield
Cash	3.6%	---	over	Attractive versus taxable bonds

Currencies	Expected Return	Equity Return with Currency
Euro	-3.5%	3.8%
Japanese yen	1.3%	2.5%
UK pound	-4.3%	5.6%

Notes: **As of: 1/31/2005**

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.