2215 York Road, Suite 515 Oak Brook, IL 60523
www.stairwaypartners.com
630-371-2626 phone 630-371-2617 fax

MONTHLY

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MARKET AND STRATEGY MOVES

Introduction

As many of you are aware, stock markets worldwide have fallen substantially from their highs in the fall of last year. Government and high-quality bonds have been doing well as their prices have moved in the opposite direction of equities. This flight to safety which started in the financial sector has increasingly moved to the real side of the economy . Pundits have been more frequent and vociferous in their predictions of recession, with its detrimental effect on earnings. Some had gone so far as to say that a recession actually began in the fourth quarter of last year.

In this uncertain and negative environment, we bought high yield bonds and equities, two of the riskier asset classes. We will use this *Monthly* to explain these actions - why we were adding to assets that were experiencing falling prices and seemingly becoming more risky.

Market Developments

In stock markets globally, the first three weeks of January were a continuation, although more pronounced, of the weakness in the fourth quarter of last year. The US equity market declined 16.4% from its peak in early October to the close of trading on January 22 (see Figure 1). The same pressure was being felt in non-US equities and the high yield bond market.

What was behind these sharp drops? Coming into the new year, investors were becoming increasingly spooked by the possibility that the US economy would slip into recession. These fears were driven by problems in banks and the financial system, and worries that the downturn in housing would induce a pullback in consumer spending. The consumer had been a

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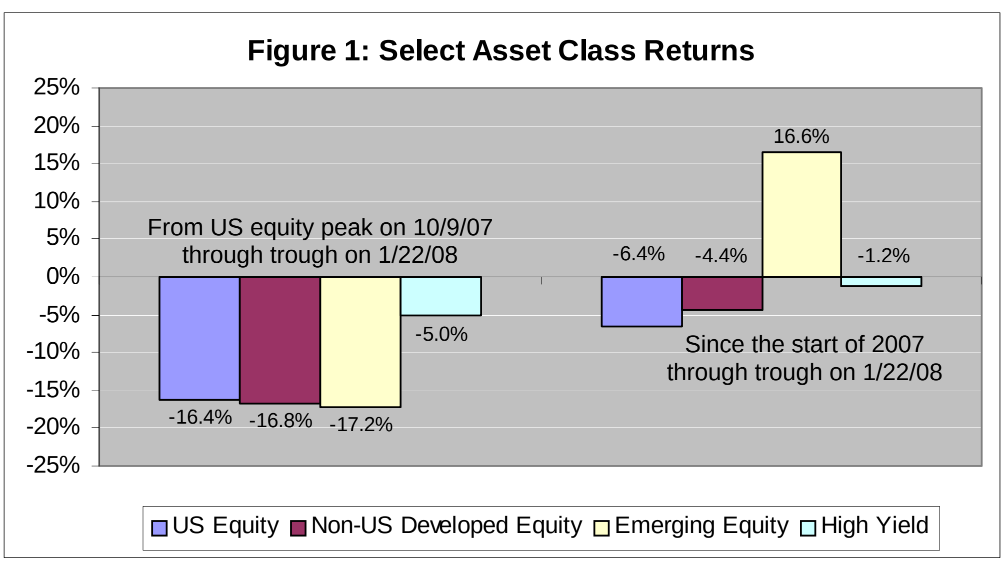
CURRENT TOPIC

STRATEGY

- *In January we made two strategy changes*
- *We added exposure to US equities and high yield bonds to bring both to neutral*
- *Portfolio strategy remains underweight non-US equities*

"THE US EQUITY MARKET DECLINED 16.4% FROM ITS PEAK IN EARLY OCTOBER TO THE CLOSE OF TRADING ON JANUARY 22"



Sources: Russell, MSCI, Lehman Brothers

Market and Strategy Moves - Cont'd

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significant support of global growth in the past few years. This led to downgrading of earnings and growth expectations. An integral part of this increased pessimism was also a rise in risk perceptions, which made the risk-return calculation of investors decidedly less attractive. Markets overseas followed much the same trajectory as the US markets, with equities and more credit-sensitive sectors taking hits while government bonds performed strongly. Despite the recent decline, emerging equities still have positive performance compared to losses across the developed equity markets since the start of 2007 (see Figure 1).

Strategy Background

We had been stating the case for some time that investors were too optimistic. This view was based on what we considered to be several "errors" that investors were making: an under-appreciation of the potential for risk to rise in the future, an assumption that the elevated earnings trend of the last five years would persist indefinitely, and the resulting conclusion that stock prices were cheap – or at least fair value.

As readers of past *Monthly* pieces know, we have taken issue with each of these points. Our belief has been that, while investors perceived risk to be permanently lower, it was only cyclically low and likely to rise. It is during these times, when risk is low, that prospective returns become skewed to the downside. We didn't know why or when risk would re-emerge, just that there are periods in which it is suppressed and others in which it is elevated. In addition, optimism about earnings was likely to be shattered, which could be a cause of the rise in risk perceptions. No economy or financial market is able to sustain high expectations forever.

So, our conclusion was that stock prices were *above* levels justified by their fundamentals, i.e. their normal levels of risk and earnings.

At the start of the summer 2007, we saw the US equity market as being moderately overpriced. Prices in excess of fundamental value meant that return expectations were below normal returns - less than fair compensation for risk. This was not a huge mis-pricing, but one that justified our small underweight.

Strategy Response

When the stock market's decline reached nearly 15% from its peak level, US equities reached what we considered to be fair value. The expected return had, as a result, risen to a level we considered to be fair compensation for risk. So, in mid-January in the midst of the market "meltdown", we brought US equity allocations up to neutral (benchmark) weights. Our strategy remains underweight non-US equities, as their return prospects were not improved sufficiently by the recent declines.

The high yield market was very much an analogous story to US equities. Yields early last year were too low, providing poor compensation for default risk or the possibility that yields might rise (causing prices and returns to drop). As the financial sector started running into trouble over the summer, the leveraged buyout (LBO) market seized up. Lending to highly leveraged companies and poorer credit

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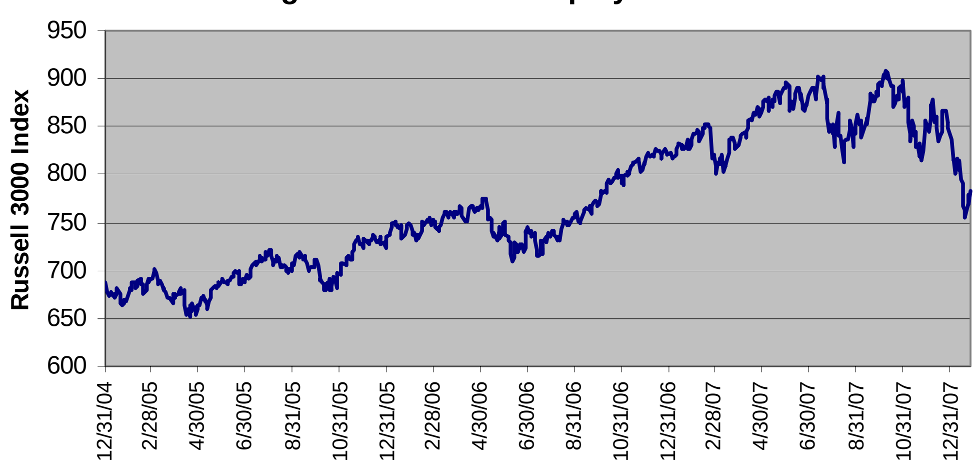
Figure 2: Broad US Equity Market



Source: Russell

"In mid-January in the midst of the market "meltdown", we brought US equity allocations up to neutral weights"

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. The dominant amount 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.

risks was essentially stopped dead in its tracks. Compounding the financial sector issues, heightened concerns about a slowing economy toward year-end boosted fears of rising default rates.

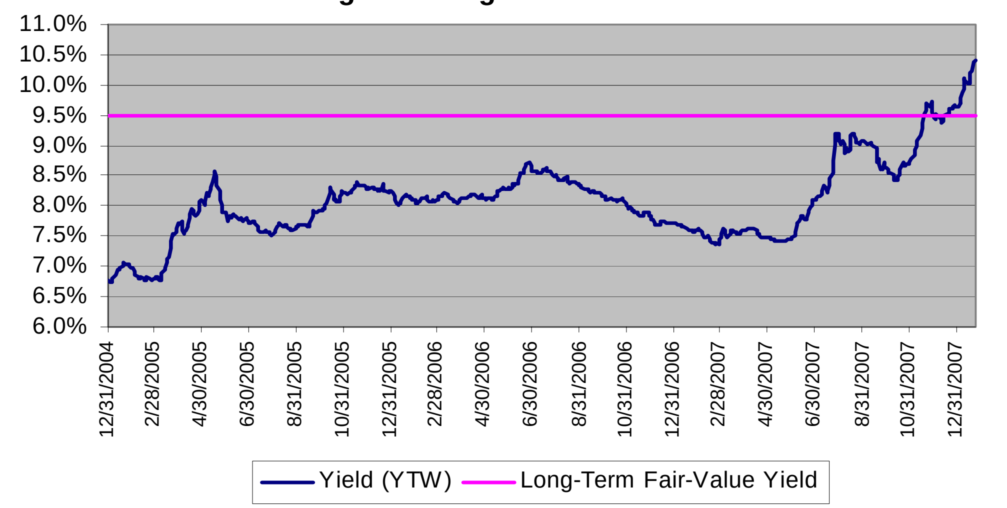
Although the yield in this sector increased to near fair value levels in September during the initial stages of the market turmoil, we felt that the re-pricing was only partially along in high yield. We made no strategy change at the time, based on our weighing of the prospective return, which was then close to "fair", against the prospective risks. There were two risks that entered our deliberations: first, the risk that yields would continue to rise and thus further hurt high yield bond prices and returns, and second, the risk of continuing to have no exposure to an asset class that had cheapened up considerably.

In January, after the high yield market experienced substantial further deterioration in November and December, yields had widened out significantly past their September levels (as we anticipated they might). In fact, yields had actually risen somewhat above fair levels. With this increased yield compensation, the prospective returns to high yield were good and would provide a cushion of income if the market were to deteriorate further. From being too expensive, the high yield bond market had moved to incorporate significant future risk into prices. In weighing this much-improved risk-return trade-off, we made the decision to move portfolios back into the asset class at neutral or benchmark allocations.

Summary

Our strategy-setting process essentially comes down to weighing the potential risks of exposure to an asset class against the returns we expect to earn by maintaining that exposure. Strategy changes come about largely in response to market price changes, rather than changes to assumptions about long-term fundamentals. As US equity and high yield bond prices fell in the second half of 2007 and early January, these asset classes became fairly priced. The cheaper pricing made for better prospective returns and less negatively skewed risks. As a result of the improved risk and return outlook, we added to US equities and reintroduced high yield across client portfolios. The process by which we arrived at these asset allocation changes is the same process we use for all the asset class decisions and for both underweighting and overweighting.

Figure 3: High Yield Market



Sources: Lehman Brothers, Stairway Partners

Note: YTW denotes Yield to Worst

"FROM BEING TOO EXPENSIVE, THE HIGH YIELD BOND MARKET HAD MOVED TO INCORPORATE SIGNIFICANT FUTURE RISK INTO PRICES"

Strategy

Asset Class	Expected Return	Hurdle Return	Strategy	Comment
Equities			under	
US	7.4%	7.3%	neutral	Exposure at benchmark weight
Non-US Developed			small under	Moderately unattractive relative to risk
Eurozone	8.1%	7.8%		
Japan	-0.3%	4.6%		
UK	10.7%	8.7%		
Emerging	-3.1%	11.6%	under	Asset class inadequately pricing risk
Fixed Income				
US Treasury Bonds			neutral	Sector has become expensive as interest rates have declined
2-Year	1.9%	3.3%		
5-Year	1.6%	3.8%		
10-Year	1.6%	4.4%		
30-Year	1.6%	4.9%		
US Municipal Bonds			neutral	Yields at most maturities near fair value levels
2-Year	2.4%	2.9%		
5-Year	2.5%	3.2%		
10-Year	3.0%	3.6%		
30-Year	5.9%	4.2%		
US High Yield	7.8%	5.8%	neutral	Sector has become more attractive as spreads have widened
Non-US Government Bonds			under	Yields in some markets too low, especially at longer maturities
Euro 10-Year	2.7%	4.5%		
Japan 10-Year	0.0%	1.9%		
UK 10-Year	3.2%	5.0%		
Emerging Markets Debt	2.4%	6.1%	under	Spreads over US Treasuries remain too tight
Cash	3.8%	---	over	Allocation comes from overpriced asset classes

Currencies	Expected FX Change	Equity Return with Currency	10-Year Bond Return with Currency	
Euro	-8.0%	0.0%	-5.3%	Euro is expensive
Japanese yen	2.2%	1.9%	2.2%	Yen is slightly attractive
UK pound	-6.1%	4.5%	-3.0%	Pound is expensive

Notes: **As of: January 31, 2008**

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 foreign equity markets.