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MONTHLY

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UPDATE - BONDS AREN'T THAT BAD

Introduction

We last gave a comprehensive view of the bond markets in our January 2005 *Monthly* titled, "How Bad is the Bond Market?". It was in this piece that we warned investors that bonds, although somewhat overvalued, were not the disaster that many analysts were predicting at the time.

In our assessment, we expected short rates to rise significantly, inflation expectations to remain about the same, and the high yield and emerging debt sectors to underperform. In addition, we reviewed the role of bonds in a balanced portfolio.

Perspective

Figure 1 shows that, since the end of 2004, short-term interest rates (Fed funds and 2-year Treasury notes) have risen considerably. The intermediate part of the Treasury yield curve has also seen rates rise, but not nearly as much as in shorter maturities. At the longest maturities, Treasury bond yields actually declined. This leaves the term structure of Treasury rates modestly inverted, meaning that short rates are higher than long rates. Normally the yield curve is upwardly sloping, with short rates lower than longer-term rates. Although short rates rose as the Fed tightened, the returns on investment grade bonds in 2005 were in line with our forecasts (Lehman Aggregate Bond Index +2.43% and Lehman Municipal Index +3.52%).

The current inversion has led many to speculate about the yield curve's usefulness as an economic indicator. Some believe that, following historical patterns, it portends a recession. Others (including Fed Chairman Bernanke) believe it is the result of significant demand from non-US investors arising from a "*global savings glut*". Additional foreign demand comes from central banks who purchase US treasuries to keep their currencies from strengthening. We believe these factors are not mutually exclusive and all contribute to the inverted yield curve.

Figure 1 also shows Stairway Partners' assessment of fair-

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Figure 1: Yield Curve in Perspective

	12/31/04	2/28/06	Change	Stairway Fair Value	Difference*
Fed Funds	2.25	4.50	2.25	4.30	0.20
2-Yr Tsy	3.07	4.68	1.61	4.58	0.10
5-Yr Tsy	3.61	4.60	0.99	4.89	-0.29
10-Yr Tsy	4.22	4.55	0.33	5.22	-0.67
30-Yr Tsy	4.83	4.51	-0.32	5.44	-0.93

*Stairway Fair Value minus 2/28/2006 market yields

Source: Bloomberg, Stairway Partners

CURRENT TOPICS

Bond market update– it still isn't that bad

- *Perspective*
- *Valuation*
- *Risk and Returns*
- *Investment Implications*

CURRENT STRATEGY

- *We currently view several asset classes as being overpriced relative to their risk (see page 4)*
- *Municipal bonds and short-term Treasuries offer the best prospective returns versus their risk*
- *We believe US equities offer better value than overseas markets, particularly emerging market equities*

SHORT RATES HAVE BACKED UP CONSIDERABLY, LEAVING THEM ATTRACTIVE AT CURRENT MARKET LEVELS

BONDS AREN'T THAT BAD - CONT'D

(Continued from page 1)

value for interest rates. As you can see by the difference between our fair value and current rates (2/28/06), we believe that the front end of the Treasury yield curve provides investors with adequate compensation but yields at longer-term maturities are still too low.

Valuation

As described in the January 2005 *Monthly*, interest rates are a combination of the real short-term interest rate (Fed funds less inflation), inflation expectations and a risk premium (compensation for the risk of holding bonds). Two of the components, the real cash rate and inflation expectations, can be derived from market yields and compared with our long-term assumptions.

Figure 2 illustrates the real cash rate over time. As the Fed has raised rates, this component has moved close to our long-term assumption. This is in sharp contrast to 2004 when the real cash rate was negative and too low. Inflation expectations have remained reasonably well contained and are similar to their level of a year ago (see Figure 3). The market's inflation expectations remain very close to ours.

The last component of bond valuation, which is not as easily observed, is the amount of compensation investors require for risk. This compensation, the risk premium, is normally greater for longer-dated maturities because their returns are more volatile due to their greater sensitivity to changes in interest rates. As mentioned earlier, in a normal rate environment long rates are higher than short rates and the yield curve is positively sloped. With the 2-year Treasury note yielding 4.68% and the 30-year Treasury bond yielding 4.51%, the yield curve is clearly inverted hence not normal.

Risk and Returns

Figure 4 shows the relationship between our assessment of risk and return across various sectors of the fixed in-

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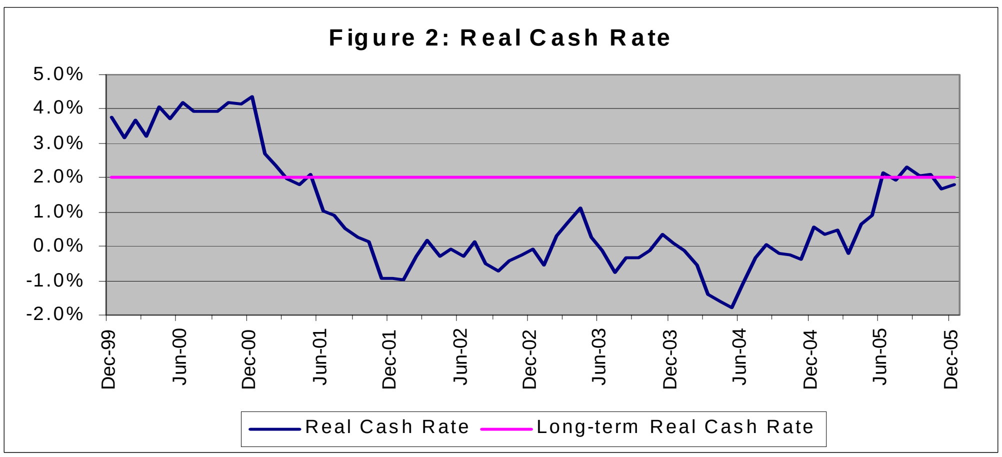

THE REAL CASH RATE HAS MOVED SIGNIFICANTLY HIGHER, LEAVING IT CLOSE TO OUR LONG-TERM ESTIMATE

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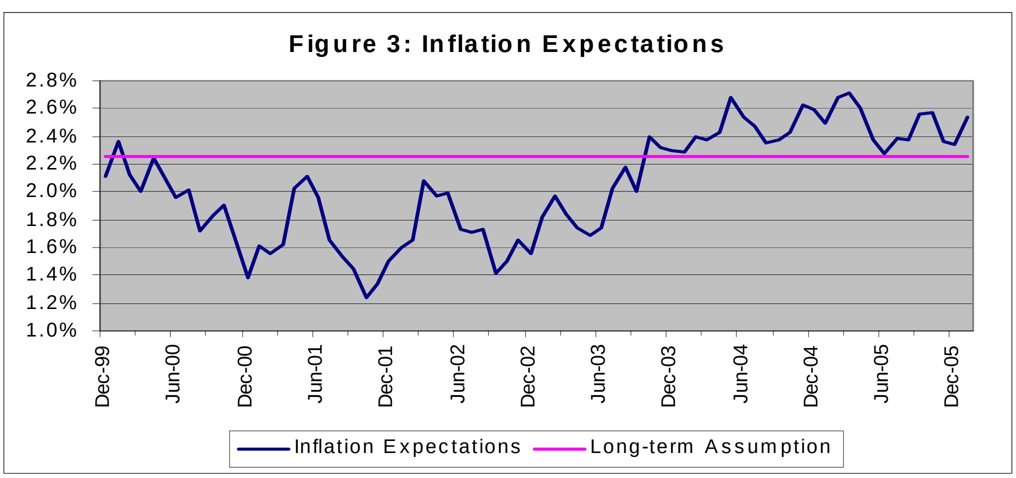
INFLATION EXPECTATIONS REMAIN AT A REASONABLE LEVEL



Sources: Bloomberg, Bureau of Labor Statistics, Stairway Partners

Notes: The real cash rate = 1-month Libor minus annualized 3-month change in Core CPI; Inflation Expectations = 10-Year Treasury Notes minus 10-Year TIPS

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.

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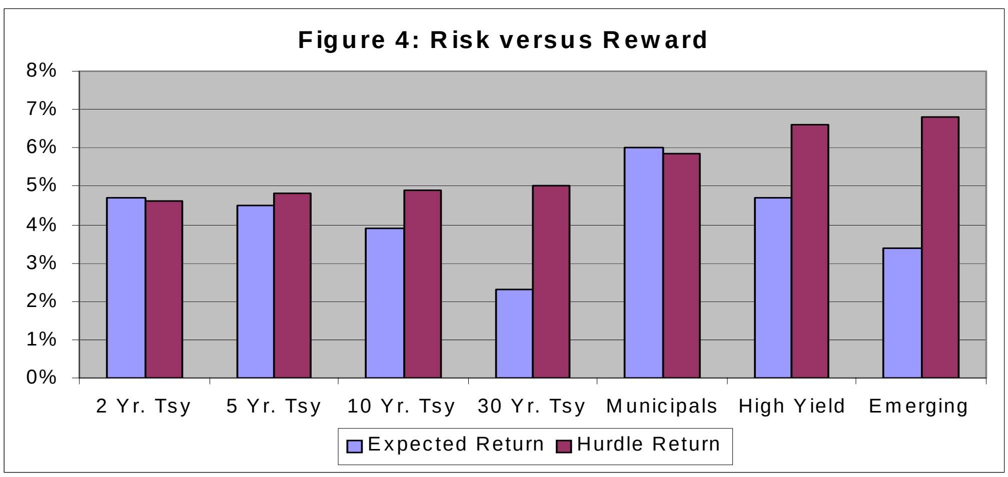
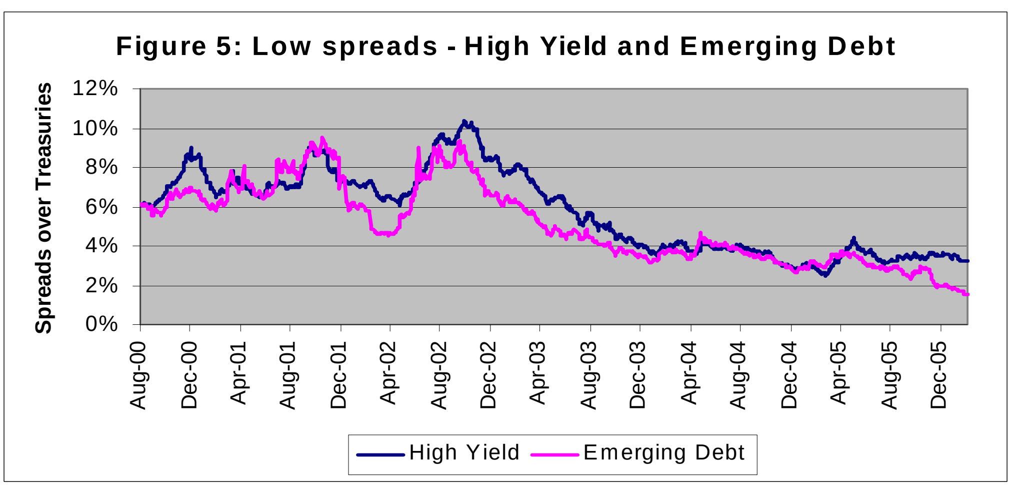
come market. The blue bars reveal our return expectations (given current pricing), while the purple bars depict the hurdle return that represents what we consider to be fair compensation for risk. The expected returns only match or exceed the hurdle returns in two sectors: short Treasuries and municipal bonds.

Note: For taxable investors, we have grossed-up the municipal bond returns to account for their status as exempt from Federal income tax.

High yield and emerging bonds are also included in this analysis. As our regular readers know, we view these sectors as overpriced compared to their risk. Spreads, the incremental yield over less-risky Treasury bonds, are too narrow, leaving little compensation for either credit or spread widening risk (Figure 5).





Sources: Lehman Brothers, Stairway Partners

Investment Implications

It is important to remember that bonds serve an important risk diversification role in a portfolio. As a result, we have kept some core exposure to taxable investment grade bonds despite longer-term rates not being attractive. In addition, we view prospective returns on investment grade bonds as higher than some of the riskiest asset classes.

For all of our accounts, as part of cash, we have an overweight in short Treasuries. With short rates having risen significantly over the past year, this sector has competitive prospective returns. We also maintain high yield and emerging bond exposures at their minimums.

For non-taxable accounts (retirement accounts and foundations), we are underweight interest rate risk in general by having a smaller allocation to the investment grade sector as represented by the Lehman Aggregate Bond Index.

For taxable accounts, in higher tax brackets, we are neutral interest rate risk by having a small overweight in municipal bonds.

Strategy

Asset Class	Expected Return	Hurdle Return	Strategy	Comment
Equities			small under	
US	4.8%	8.1%	neutral	Exposure equal to normal portfolio weighting
Non-US Developed			small under	Remains unattractive relative to US market
Eurozone	0.5%	6.9%		
Japan	-10.2%	4.3%		
UK	5.1%	8.2%		
Emerging	-0.1%	11.6%	under	Asset class inadequately pricing risk
Fixed Income				
US Treasury Bonds			under	Shorter maturities offer best relative value
2-Year	4.7%	4.6%		
5-Year	4.5%	4.8%		
10-Year	3.9%	4.9%		
30-Year	2.3%	5.0%		
US Municipal Bonds			neutral	Sector is fairly priced
2-Year	3.3%	3.3%		
5-Year	3.5%	3.5%		
10-Year	3.9%	3.8%		
30-Year	6.7%	4.3%		
US High Yield	4.7%	6.6%	under	Spreads over US Treasuries remain too tight
Non-US Government Bonds			under	Yields generally insufficient compensation for risk
Euro 10-Year	1.7%	4.2%		
Japan 10-Year	0.3%	2.0%		
UK 10-Year	2.7%	4.8%		
Emerging Markets Debt	3.4%	6.8%	under	Spreads over US Treasuries remain too tight
Cash	4.4%	---	over	Allocation comes from overpriced asset classes

Currencies	Expected Return	Equity Return with Currency	10-Year Bond Return with Currency	
Euro	-0.9%	-0.4%	0.8%	Close to fair value
Japanese yen	4.6%	-5.6%	4.9%	Yen is slightly attractive
UK pound	-2.5%	2.7%	0.2%	Close to fair value

Notes: **As of: 2/28/2006**

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.