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THE HERD REVISITED

Introduction

One of our earliest research pieces looked at when investors moved money into and out of the stock and bond markets. Its conclusion was that investors are often their own worst enemies. They tend to chase performance and extrapolate the recent past, buying after returns have been good and selling after returns have been disappointing. The problem is that in financial markets a period of good returns is often followed by a stretch of poor returns, and vice versa. So, investors end up buying high when the environment has been benign, then selling low when they view the markets as most dangerous.

Our earlier research illustrated this herd behavior, but only in terms of the US equity and bond markets. This *Monthly* will update some of that analysis and extend it to non-US equity markets.

Background on the US

In Figure 1, we have plotted rolling 3-month periods of net purchases and sales (i.e., net money flows in or out) of US equity mutual funds in blue and the trailing 12-month return on the stock market in pink. It is clear from the figure that investors move money into the stock market when returns are good and sell stocks when returns are bad.

For example, in late 1998 three crises – the LTCM hedge fund implosion, the Thai baht collapse, and the Russian default – hit confidence and the financial markets. Returns were dragged down and investors halted what had been a run of relatively strong equity purchases. These equity market inflows occurred prior to the drop-off in returns, so behavior was typically trend-following. Notice that equity purchases approached zero just as the equity market was about to deliver

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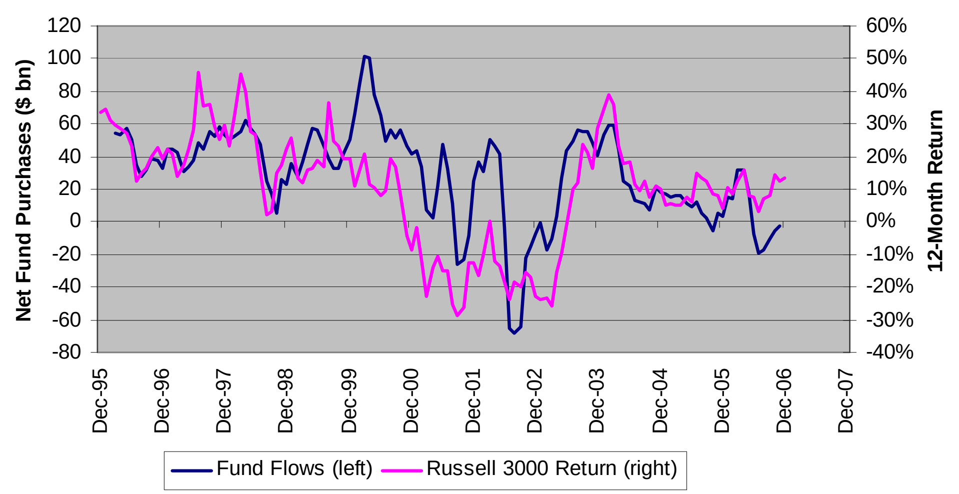
Figure 1: US Equity Fund Flows vs. Russell 3000



Sources: Russell, Investment Company Institute, Haver Analytics, Stairway Partners

CURRENT TOPICS

The Herd Revisited

- *Introduction*
- *Background on the US*
- *Non-US Fund Flows*
- *Conclusion*

STRATEGY

We remain underweight risk by maintaining lower than normal exposure to equities, primarily in the non-US developed and emerging markets. We also have minimum exposure to high yield bonds and emerging market debt.

"INVESTORS MOVE MONEY INTO THE STOCK MARKET WHEN RETURNS ARE GOOD AND SELL STOCKS WHEN RETURNS ARE BAD"

THE HERD REVISITED - CONT'D

some very strong returns.

Purchases were again very strong in 2000, after the sizeable returns of 1999 but more importantly *after* the market had already peaked. Following this, investors pulled money out of equities in 2002, *after* the stock market return had been negative for a couple of years.

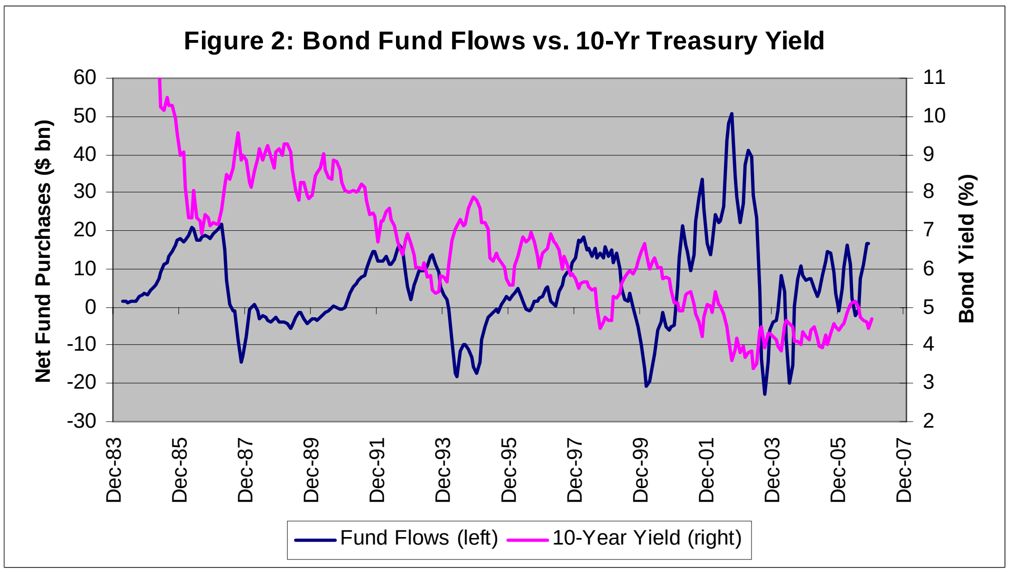
Figure 2 shows the corresponding relationship of money flows and the bond market. The blue line is net purchases and sales of taxable investment-grade bond funds and the pink line shows the yield on the 10-year Treasury bond. Just as investors often put money into the stock market when returns are or have been good, they buy bonds when yields have been falling and returns *have been* good. When yields are rising and returns are poor, investors tend to move the opposite direction, pulling money out of bonds.

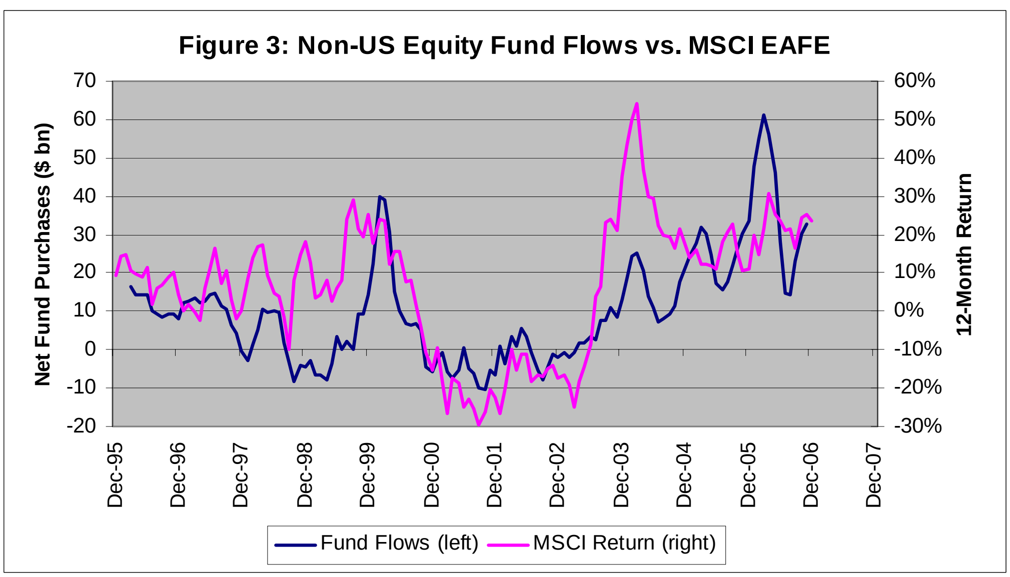
In mid-1980s for instance, interest rates declined and investors plowed substantial amounts into bond funds at the trough in yields. Then, when rates rose (returns were poor), they pulled back out, even though the higher yields were indicative of better returns to be had in the years to come. The same thing happened in 1994 and again in 2000.

Another illustration of this "wealth destructive" behavior occurred when the stock market plummeted after the tech bubble. Investors shifted large amounts of assets from stocks into bonds during the period from 2001 through much of 2003. But, these bond fund purchases happened just as interest rates were hitting their lows and were about to begin a 3-year climb.

Non-US Fund Flows

We can see that investors fall into the same performance-chasing trap and exhibit very similar behavior when putting money into and pulling it out of non-US equities. Flows into international stock funds are closely related to the returns experienced in the developed non-US equity market.





"INVESTORS FALL INTO THE SAME PERFORMANCE CHASING TRAP IN . . . NON-US EQUITIES"

Sources: MSCI, Investment Company Institute, Haver Analytics, Bloomberg, Stairway Partners

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.

In Figure 3, the pink line shows the trailing 12-month return to a US investor on the MSCI EAFE Index. There was a sharp spike in new money being funneled into non-US stocks in early 2000, just when the foreign markets (mirroring the US) had peaked and were about to experience substantial declines. When the EAFE index was performing poorly – their investments were losing money – investors reversed course and pulled some money back out, primarily in 2001.

The great performance in late 2003 and early 2004 brought investors back into this asset class. Investors continued to pour in record amounts of money during the early part of 2006, as returns exceeded those in US equities, while the dollar weakened and economies in Europe and Japan improved.

The picture in emerging markets is also interesting (Figure 4). Despite returns that were only mediocre in the mid 1990s, the amount of money flowing into emerging equity mutual funds was reasonably strong. But, when the Thai baht & Russian default crises hit in 1998, investors pulled out of emerging equities – but *after* the bad returns had already hit them. Great returns in the late 1990s elicited only a small response; investors re-entered the asset class, but not in a big way (in spite of the huge gains) probably because they were still smarting from the '98 losses.

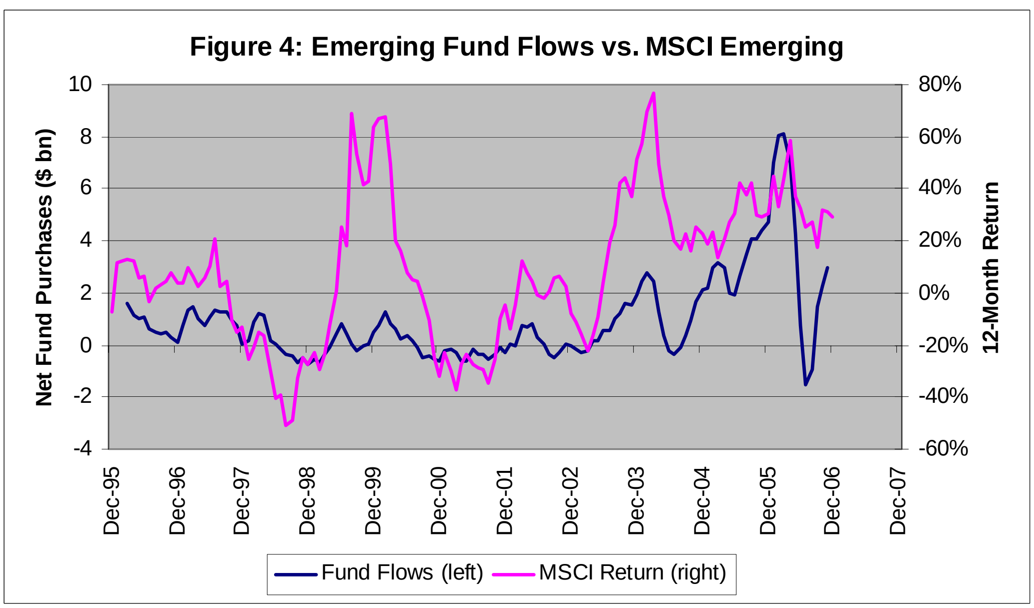
More recently, the pattern of returns and flows has been similar to what we saw in developed markets: excellent returns in late 2003-early 2004 caused a sizeable flow into emerging equities.

Both 2005 and 2006 continued the record streak of inflows despite the hiccup that occurred in May-June 2006 when emerging markets lost about a quarter of their value in a 5 week period. It is interesting to note that even in this short time period, one can observe herd behavior when investors in this mini-cycle sold at the bottom after having just invested near the top.

Conclusion

Over time, investors tend to flock into the areas that have experienced good returns. They often become enamored of what's "hot", extrapolating the recent past into the future. On the other side, they flee those areas that have had poor performance, thinking that these disappointing returns bode ill for the future. Many times, the good returns and the cash flows that chase them are subsequently followed by poor returns – the classic buy high-sell low behavior.

The recent record flows into non-US stock investments, both developed and emerging, have been driven by strong returns over the last 3 years. Investors remain largely backward looking, focused on the recent past rather than considering the potential risks of increasing exposure to assets that have already had substantial gains.



Sources: MSCI, Investment Company Institute, Haver Analytics, Stairway Partners

Strategy

Asset Class	Expected Return	Hurdle Return	Strategy	Comment
Equities			small under	
US	3.8%	8.5%	small under	Exposure slightly below normal
Non-US Developed			small under	Moderately unattractive relative to risk
Eurozone	-1.1%	7.5%		
Japan	-11.1%	4.6%		
UK	4.5%	8.7%		
Emerging	-1.3%	11.3%	under	Asset class inadequately pricing risk
Fixed Income				
US Treasury Bonds			neutral	Shorter-term maturities are fairly priced
2-Year	4.7%	4.6%		
5-Year	4.4%	4.7%		
10-Year	3.9%	4.9%		
30-Year	2.9%	5.1%		
US Municipal Bonds			neutral	Sector is fairly priced
2-Year	3.6%	3.4%		
5-Year	3.7%	3.6%		
10-Year	3.8%	3.8%		
30-Year	5.9%	4.2%		
US High Yield	3.8%	6.9%	under	Spreads over US Treasuries remain too tight
Non-US Government Bonds			under	Yields generally insufficient compensation for risk
Euro 10-Year	2.8%	4.5%		
Japan 10-Year	0.4%	2.0%		
UK 10-Year	4.1%	5.2%		
Emerging Markets Debt	3.5%	7.2%	under	Spreads over US Treasuries remain too tight
Cash	4.7%	---	over	Allocation comes from overpriced asset classes

Currencies	Expected FX Change	Equity Return with Currency	10-Year Bond Return with Currency	
Euro	-4.6%	-5.6%	-1.8%	Euro is somewhat expensive
Japanese yen	5.7%	-5.4%	6.1%	Yen is slightly attractive
UK pound	-5.8%	-1.4%	-1.8%	Pound is somewhat expensive

Notes: **As of: 2/28/2007**

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.