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EFFICIENT ASSET CLASS EXPOSURE

Introduction

At Stairway Partners, we typically use low-cost, passive vehicles to obtain exposure to asset classes. We are sometimes asked why we do not construct portfolios using individual stocks and laddered bonds, or use actively managed mutual funds. There are several reasons why passive investment vehicles are our answer to this question:

• Active management is a zero-sum game before accounting for costs.

• Increased costs incurred from transactions, management fees, and taxes have a significant negative impact on returns over time.

• As the number of securities in a portfolio is reduced, the benefits of diversification can be lost.

Zero-Sum Game

Active management, in aggregate, is a zero-sum game, meaning the gains achieved by one participant come at the expense of another. The logic behind this is as follows: the weight of ExxonMobil (XOM) in the US stock market (as represented by a broadly-inclusive index like the Russell 3000) is approximately 3.25% (see Figure 1). In other words, when all investors' holdings of XOM stock are added together, it comes to 3.25% of the total value of the stock market. Some investors (whether they be individuals or money managers) may think that XOM's prospects are particularly strong. As a result, they might allocate more of their portfolios to XOM, thus increasing their percentage ownership in XOM relative to its overall market share (i.e., they are overweight). By definition then, other investors *must* hold less than 3.25% of their US equity exposure in XOM stock. Thus, they are holding a smaller percentage ownership relative to the overall market and are underweight. These differences in ownership percentage counterbalance each other, resulting in the 3.25% average weighting.

What happens when XOM stock goes up 10% while the rest of the market returns only 2%? Those who were

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CURRENT TOPIC

Efficient Asset Class Exposure

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STRATEGY

- *We made no strategy changes in the month of February*
- *Portfolio strategy remains underweight non-US equities and overweight cash*

Figure 1: Zero-Sum Game

Illustrative Returns	
ExxonMobil	Rest of Market
10.00%	2.00%

Investor	% of Active Investors	Portfolio Weight: ExxonMobil	Portfolio Weight: Rest of Market	Portfolio Return
Underweight	75%	1.00%	99.00%	**2.08%**
Market Weight		3.25%	96.75%	**2.26%**
Overweight	25%	10.00%	90.00%	**2.80%**

Source: Stairway Partners

"ACTIVE MANAGEMENT, IN AGGREGATE, IS A ZERO-SUM GAME, MEANING THE GAINS ACHIEVED BY ONE PARTICIPANT COME AT THE EXPENSE OF ANOTHER."

EFFICIENT ASSET CLASS EXPOSURE - CONT'D

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overweight XOM will outperform because they have more of the stock that did better than the overall market. Conversely, investors who held less than the 3.25% weight will do worse. In aggregate, the "gains" achieved by those who overweighted XOM and outperformed must be equivalent to the "losses" experienced by those who underweighted the stock and underperformed. Hence, across all investors in the asset class, active management – decisions to hold other than the market weight – is a zero-sum game.

This concept has been addressed frequently in the past, with probably the best exposition being William Sharpe's article, *The Arithmetic of Active Management* (Financial Analysts Journal 1991). It is important to note that this zero sum game is true *only before costs*.

Costs

To the extent that active managers experience higher trading costs and charge high management fees, in aggregate they will underperform the broad market index, in effect making it a negative sum game. Costs include management fees, transactions costs, and (often overlooked) tax effects. We demonstrated the impact costs can have on portfolio returns in our May 2007 *Monthly*.

According to a Morningstar analysis, the average annual expense ratio for actively-managed equity mutual funds is 1.44%, or 144 basis points, while the average passive equity fund has a total expense ratio of 0.73%, or 73 basis points, about half that of the actively managed funds. Expenses for wrap accounts are often even higher than for active managers. In comparison, the iShares Russell 3000 exchange traded fund that we use in client portfolios to gain exposure to the US equity market has an annual expense ratio of only 0.2%, or 20 basis points.

In addition to these differences in fees, studies published by Jeffrey & Arnott show that active stock-picking strategies often result in large tax costs (*Is Your Alpha Big Enough to Cover Its Taxes?* Journal of Portfolio Management 1993). Their studies conclude that very few managers can outperform a passive investment fund in a taxable account.

This difference in all-in costs (fees, expenses, and taxes) between active and passive management strategies within an asset class is a substantial hurdle for an active manager to overcome. Figure 2 shows a hypothetical distribution of actively managed portfolios. Since the aggregate market is a zero-sum game, we know that the market return is the weighted average of all the market participant returns and is thus designated by the line in the middle of the distribution. Once we account for costs, the number of managers who outperform the market is reduced. In Figure 3, the distribution is shifted to the left by the amount of the incremental active management costs, reducing the shaded area that represents the managers who outperform the market.

Reduced Diversification

A traditional rule of thumb is that investors need only 15 to 20 stocks in a portfolio to gain sufficient diversification

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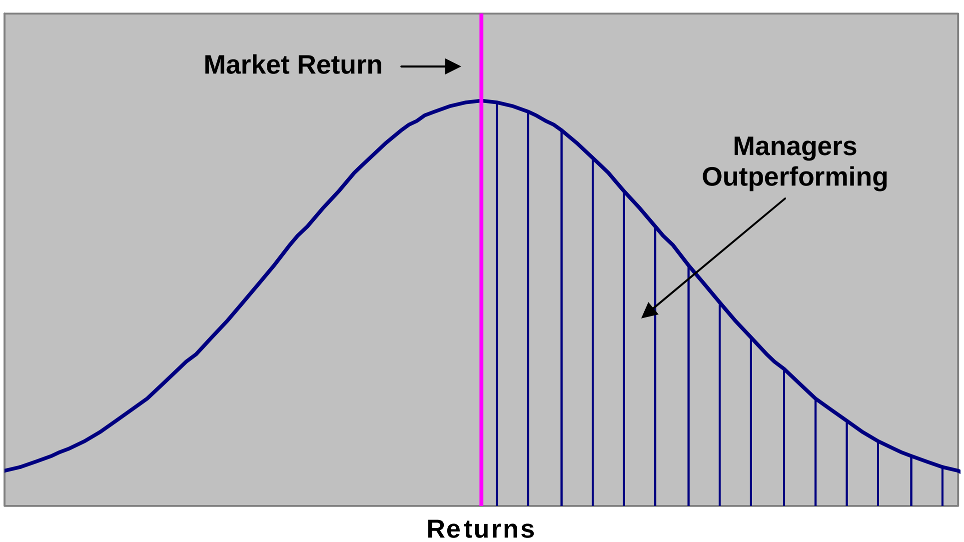
Figure 2: Hypothetical Distribution of Active Managers



"SINCE THE AGGREGATE MARKET IS A ZERO-SUM GAME, WE KNOW THAT THE MARKET RETURN IS THE WEIGHTED AVERAGE OF ALL THE MARKET PARTICIPANT RETURNS"

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.

to reduce their portfolio's risk level to the market's risk. However, this rule has a couple of caveats that need to be considered.

First, the assumption with this rule is that the securities have been selected so as to diffuse the unique risks inherent in each security. If, in fact, these securities are too similar to one another, then the portfolio will not gain the full benefit of diversification. Only a reduced portion of the stocks' individual risks will be diversified away.

Second, this is only the *expectation* of diversification. Even with 20 stocks in a portfolio, should the investor experience significant problems in one or two of the holdings, the actual risk of the portfolio will be much higher than what was expected and, more importantly, much higher than the market's risk. With a limited number of securities, each individual security has a much bigger impact on the portfolio.

In summary, a broadly diversified exposure eliminates the risk of concentrated positions.

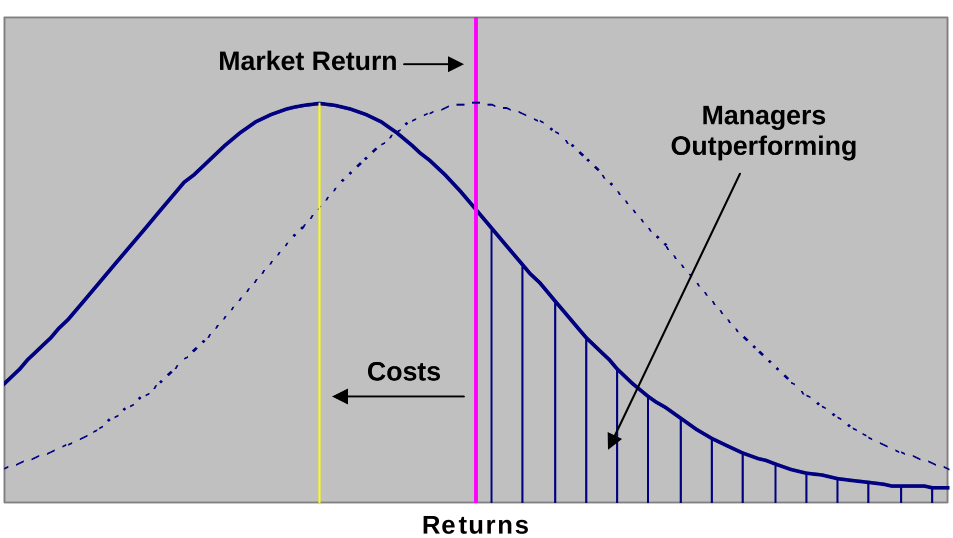
Active Management

This is not to say that active management within an asset class does not ever make sense. Investors should consider whether they can gain access to managers who can consistently produce superior returns over time to cover the higher costs, tax consequences and potential illiquidity. These skills are likely to be found in hedge funds and private equity investments, and the best managers are often not available to the general public. In addition to the higher expenses, the "costs" of being wrong in selecting a poor manager or fund tend to be much greater due to the large dispersion of results in hedge funds and private equity.

Conclusion

There are many reasons to consider broad exposures to asset classes, including the benefits of diversification, lower fees and tax advantages. Active management can certainly have a place in an investor's portfolio, if the important conditions mentioned above are met. For traditional stock and bond investments, we believe that passive index-like investments provide the most attractive means of gaining exposure to asset classes.

Figure 3: Distribution of Active Managers with Costs



"THIS DIFFERENCE IN ALL-IN COSTS IS A SUBSTANTIAL HURDLE FOR AN ACTIVE MANAGER TO OVERCOME"

Strategy

Asset Class	Expected Return	Hurdle Return	Strategy	Comment
Equities			under	
US	8.7%	7.3%	neutral	Exposure at benchmark weight
Non-US Developed			small under	Asset class near fair value as prices have fallen
Eurozone	8.5%	7.8%		
Japan	0.2%	4.7%		
UK	10.7%	8.7%		
Emerging	-5.3%	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	1.5%	3.1%		
5-Year	1.1%	3.7%		
10-Year	1.4%	4.4%		
30-Year	1.8%	4.9%		
US Municipal Bonds			neutral	Market has become more attractive over last month as yields have risen
2-Year	2.7%	3.0%		
5-Year	3.2%	3.4%		
10-Year	4.3%	3.9%		
30-Year	8.3%	4.5%		
US High Yield	8.5%	5.8%	neutral	Sector is pricing for deteriorating fundamentals
Non-US Government Bonds			under	Yields too low, especially at longer maturities
Euro 10-Year	2.6%	4.4%		
Japan 10-Year	-0.2%	1.9%		
UK 10-Year	3.1%	4.9%		
Emerging Markets Debt	2.5%	6.0%	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	-8.7%	-0.2%	-6.1%	Euro is expensive
Japanese yen	1.5%	1.7%	1.2%	Yen is close to fair value
UK pound	-6.1%	4.6%	-3.0%	Pound is expensive

Notes: **As of: February 29, 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.