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MONTHLY

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CASH AND LONG-TERM INVESTMENT RETURNS

Introduction

The Fed effectively reduced cash rates to zero at the end of 2008, where they have remained ever since. As a result, 2011 marked the end of the worst one, three, five, and ten year return periods for cash investments in over a century. Despite these persistently low returns, companies and individuals have continued to hold large amounts of cash on their collective balance sheets. This aversion to risk is most likely attributable to lingering anxiety over credit availability, or fear of deteriorating economic and market conditions.

Because cash is a short-term investment, many investors ignore the long-term implications of holding a large portion of their portfolio in cash over time. To increase the chances of meeting long-term financial objectives, we believe that it is important to view equity and bond market returns within the context of cash returns. As a result, we have always used forward-looking estimates of cash rates to evaluate long-term returns in equity and bond markets. The details of our process for estimating cash rates have been discussed in several *Monthlies*, most recently in April of 2011 – "The Consistent Fed".

Recent changes in the Fed's communication policies have brought greater media attention and clarity to the likely path of cash rates. In this *Monthly* we compare the Fed's newly disclosed rate forecasts to our own estimates, and discuss the implications of future cash rates on the returns of long-term investments.

The Fed and Cash Rates

The Fed has long used the overnight Fed Funds rate as its primary monetary policy tool. Prior to August of last year, when the Fed commit-

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CURRENT TOPIC

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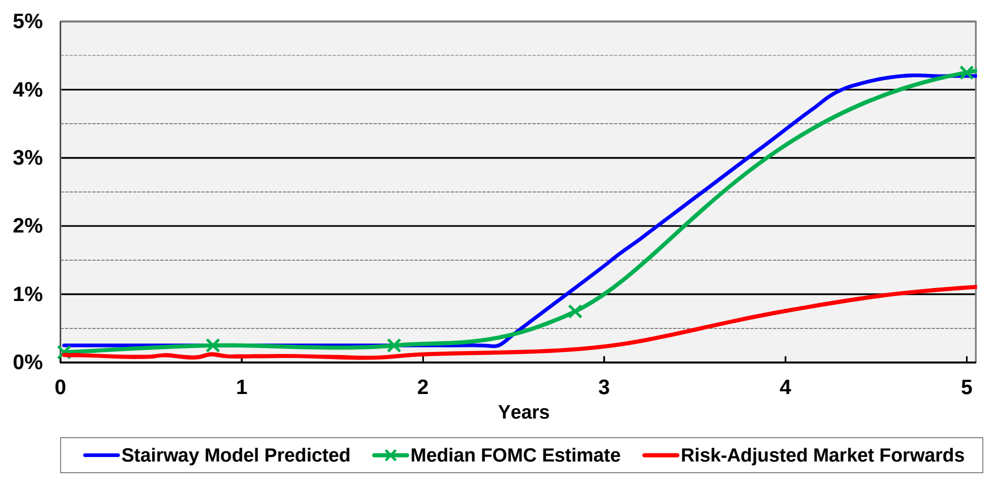
Strategy

- *We made no strategy changes during the month of February.*
- *Portfolios remain overweight global equity and high yield bond exposure and underweight investment-grade bond exposure.*

Figure 1 - Estimated Path of Fed Funds Rate



Sources: Bloomberg, Federal Open Market Committee, Stairway Partners

"THE MARKET PRICING OF THE FED FUNDS RATE BEYOND THREE YEARS IS MATERIALLY LOWER THAN THE FED'S LONGER-TERM ESTIMATES"

CASH AND LONG-TERM INVESTMENT RETURNS - CONT'D

ted to leaving rates "at exceptionally low levels" through mid-2013, future rate policies were left intentionally vague. On January 25th of this year, the Fed further increased their transparency by expanding their regular communications to include a three-year range of forecasts for the Fed Funds rate and for several key economic indicators. These forecasts, along with longer-term estimates came from the members of the Federal Open Market Committee's (FOMC) Board of Governors and from the twelve regional Federal Reserve Banks.

Figure 1 illustrates how the latest FOMC estimates compare to our own forecasts and the current market pricing of the Fed Funds rate through time. It is not surprising that the expected path of the Fed Funds rate from the FOMC closely matches our own estimates, since our model was constructed based on historical Fed behavior and uses economic forecasts which are consistent with the Fed's current projections. It is important to remember that the reported FOMC Fed Funds rate path is not a guarantee. If economic conditions deviate from the Fed's projections, then the appropriate monetary policy response should also change. Stronger growth or higher inflation would most likely result in an acceleration of the schedule for increasing the Fed Funds rate.

Figure 1 also reveals that the market pricing of the Fed Funds rate beyond three years is materially lower than the Feds longer-term estimates. This is somewhat perplexing since many have criticized the Fed's ongoing zero rate policy as being too accommodative. The gap between the current market pricing and the Fed's predicted path indicates that market participants are either forecasting much slower growth, lower inflation, or a dramatic change in the Fed's rate setting policies. We do not believe that the Fed has changed its long-term policy procedures and we are encouraged that their explicit forecast matches our long-held assumptions.

Figure 2 - Stairway Expected Cash Rates

Year 1	0.25%
Year 2	0.25%
Year 3	0.75%
Year 4	3.50%
Year 5	4.25%
Average	1.79%

Cash and Long-Term Discount Rates

At Stairway Partners, we estimate the current value of all equity and bond investments as the discounted value of their future cash flows. The discount rates that we construct are a combination

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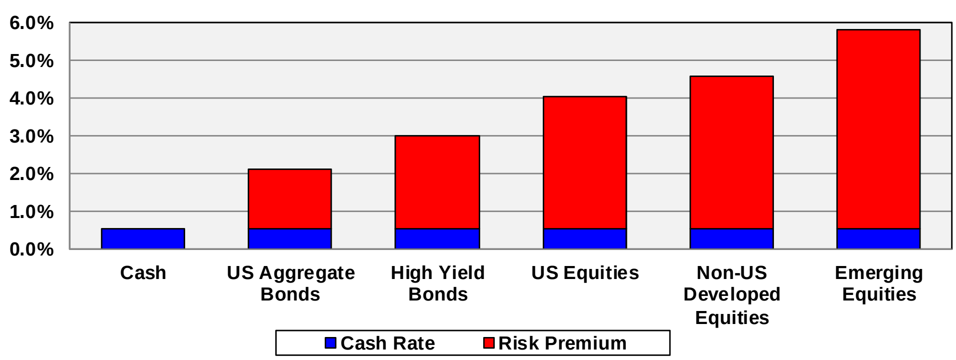
Figure 3 - Current Hurdle Returns over Three-Year Investment Horizon

	Cash Rate	Risk Premium	Hurdle Return
Cash	0.5%	0.0%	0.5%
US Aggregate Bonds	0.5%	1.6%	2.1%
High Yield Bonds	0.5%	2.5%	3.0%
US Equities	0.5%	3.5%	4.1%
Non-US Developed Equities	0.5%	4.0%	4.6%
Emerging Equities	0.5%	5.3%	5.8%



Source: Stairway Partners

"THE HURDLE RETURN IS THE RETURN THAT WE BELIEVE COMPENSATES INVESTORS FOR THE RISK-FREE CASH RATE OVER A THREE-YEAR INVESTMENT HORIZON PLUS COMPENSATION FOR 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. 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.

(Continued from page 2)

of the average cash rates between now and when each cash flow occurs, and a risk premium based on the characteristics of the specific asset.

We use the average of the expected future cash rates over a horizon to represent the risk-free rate that an investor would expect to earn over that time-period. Figure 2 shows the average cash rate that results from our estimates over the next five years.

Hurdle Returns for Long-Term Investments

The last page of this publication contains our expected return estimates for the broad asset classes that we monitor. These estimates are based on the discounted cash-flow methodology described above. The report also contains "hurdle returns" for each asset class. For a given asset class, the hurdle return is the return that we believe compensates investors for the risk-free cash rate over a three-year investment horizon plus compensation for risk. Hurdle returns are useful in that they provide a consistent benchmark for evaluating expected returns.

Figure 3 shows the hurdle returns for several major asset classes, broken down to illustrate the contribution from cash rates and risk premiums. The current hurdle rates are relatively low compared to historical returns and many investors' long-term assumptions. This is due to the unusually low cash rates that we believe will persist over the three-year investment horizon.

Unfortunately, many investors do not have an investment process that takes expected cash returns into account, when evaluating the attractiveness of long-term investments. As a result, they may miss out on the benefits of the relatively higher returns that riskier assets can produce in times of unusually low cash rates.

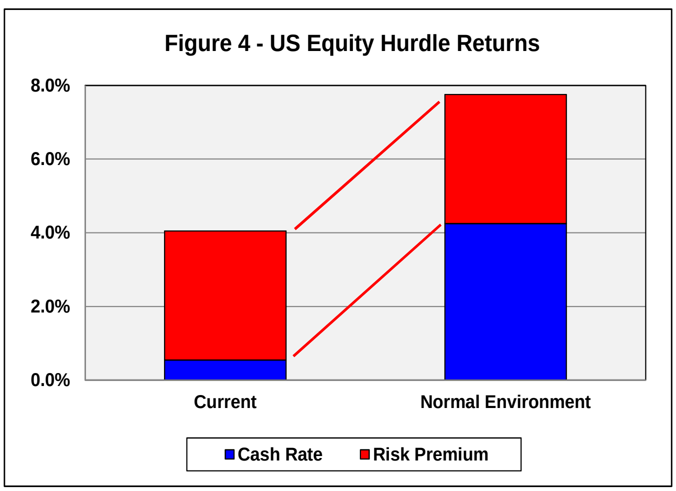
Figure 4 illustrates our belief that US equity investors should be just as happy to earn 4% when cash rates are close to zero, as they are to earn 8% in a more normal environment when cash rates are closer to 4%. Over time, these incremental returns should compound to benefit long-term investors.

Conclusion

Recent changes to the Fed's communication policies have given investors a clearer view of the future direction of monetary policy. Although today's exceptionally low level of cash rates is likely to persist for the next three years, not all investors account for this as they evaluate the attractiveness of long-term investments. As a result, many investors shy away from long-term investments that may benefit them by providing incremental returns over cash.

We believe that a disciplined process which incorporates expected cash rates can help to put near-term expected returns for riskier assets into perspective, allowing investors to make more informed investment decisions.

"US EQUITY INVESTORS SHOULD BE JUST AS HAPPY TO EARN 4% WHEN CASH RATES ARE CLOSE TO ZERO, AS THEY ARE TO EARN 8% IN A MORE NORMAL ENVIRONMENT WHEN CASH RATES ARE CLOSER TO 4%"



Source: Stairway Partners

3 Year Annualized Return Estimates for Global Markets

3/1/2012	Total Returns			After-Tax Total Returns		
	Expected	Hurdle	Excess	Expected	Hurdle	Excess
Equities						
United States	**8.5%**	**4.1%**	**4.5%**	**7.2%**	**3.9%**	**3.4%**
Non-US Developed Markets	**16.7%**	**4.6%**	**12.1%**	**14.1%**	**4.4%**	**9.8%**
EMU	24.0%	4.9%	19.0%	20.4%	4.7%	15.6%
UK	22.8%	4.9%	17.9%	19.3%	4.7%	14.6%
Japan	8.9%	5.0%	3.9%	7.5%	4.8%	2.7%
Canada	-5.1%	4.3%	-9.5%	-4.4%	4.1%	-8.5%
Emerging Markets	**15.0%**	**5.8%**	**9.2%**	**12.1%**	**5.6%**	**6.5%**
Fixed Income						
US Aggregate	**-1.4%**	**2.1%**	**-3.5%**	**-1.8%**	**1.9%**	**-3.7%**
US Treasuries						
2 Year	-0.2%	0.9%	-1.1%	-0.6%	0.7%	-1.2%
5 Year	-3.1%	1.4%	-4.4%	-3.1%	1.2%	-4.2%
10 Year	-5.7%	1.9%	-7.6%	-5.3%	1.7%	-7.0%
30 Year	-8.0%	2.0%	-10.0%	-7.3%	1.8%	-9.1%
TIPS						
5 Year	-2.6%	1.4%	-4.0%	-2.7%	1.2%	-3.9%
10 Year	-5.9%	2.0%	-7.9%	-5.5%	1.8%	-7.3%
30 Year	-13.3%	2.3%	-15.6%	-11.5%	2.1%	-13.6%
Municipal	**-0.6%**	**1.4%**	**-2.0%**	**0.0%**	**1.3%**	**-1.3%**
2 Year	0.0%	0.8%	-0.7%	0.3%	0.6%	-0.3%
5 Year	-1.8%	1.1%	-2.9%	-1.1%	0.9%	-2.1%
10 Year	-2.2%	1.6%	-3.8%	-1.4%	1.4%	-2.8%
20 Year	0.5%	1.8%	-1.3%	1.0%	1.6%	-0.6%
High Yield	**2.0%**	**3.0%**	**-1.0%**	**0.4%**	**2.8%**	**-2.4%**
High Quality High Yield	1.9%	2.2%	-0.3%	0.3%	2.0%	-1.7%
Emerging Market ($ demonimnated)	**-0.7%**	**3.2%**	**-3.9%**	**-1.6%**	**3.1%**	**-4.7%**
Foreign Aggregate	**-4.3%**	**3.5%**	**-7.8%**	**-4.0%**	**3.3%**	**-7.3%**
Foreign Aggregate (hedged)	-2.8%	1.8%	-4.6%	-3.1%	1.6%	-4.7%
Foreign Treasury	**-4.3%**	**3.0%**	**-7.3%**	**-4.0%**	**2.8%**	**-6.8%**
Foreign Treasury (hedged)	-3.1%	1.4%	-4.5%	-3.3%	1.2%	-4.4%
Cash	**0.5%**	**0.5%**	**0.0%**	**0.3%**	**0.3%**	**0.0%**
Currency						
Euro	-3.5%	2.3%	-5.8%			
British Pound	-0.8%	2.2%	-3.0%			
Japanese Yen	0.5%	2.4%	-1.9%			
Canadian Dollar	-2.2%	1.4%	-3.7%			

Notes

1. Foreign market returns assume US dollar as the base currency and are unhedged unless otherwise indicated.
2. All hurdle returns are based on long-term asset volatility. Equity and fixed income hurdle rates include expected cash returns.
3. After-tax total returns assume that all gains and losses are long-term and can be realized within the investment horizon.
4. After-tax total returns only take into account Federal taxes based on the following tax rates:
   - 35.0% Ordinary Income, 15.0% Qualified Income, 0.0% Exempt Income, and 15.0% Capital Gains/(Losses)