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HIGH YIELD - LOW RETURN?

Background

High yield bonds are fixed rate securities that are rated below investment grade. The credit rule for inclusion in the Lehman Brothers US High Yield Index states that each bond must be rated Ba1 or lower by the credit rating agencies – Moody's and/or Standard & Poor's. Other requirements are that the bonds have a fixed rate, have a maturity of at least one year, and be denominated in US dollars.

As of March 31st, the Lehman Brothers Index has a market value of approximately $600 billion. This value represents about 0.6% of the global capital market and 1.1% of the global bond market.

The current yield on the high yield market, according to Lehman's yield to worst calculation, is 7.72%. In purchasing high yield bonds, an investor is effectively lending money (at less than 8%) to a group of companies that have credit ratings below investment grade. The average credit quality in high yield bonds is B1/B2, which is significantly below the AA1/AA2 average credit quality of the Lehman Aggregate Investment Grade Bond Index.

One measure of value in high yield is the spread or yield over US Treasury bonds. Figure 1 illustrates that this relationship has moved considerably lower over the last three years. The lower the spread, the less the compensation for the difference in credit risk between US treasuries and high yield bonds.

Performance

Over the last three years, returns in the high yield market have been quite good versus more conventional asset classes such as US equities and US investment grade bonds (see Figure 2).

This performance is primarily due to high ingoing yields at the start of this time period and the subsequent spread tightening that has since occurred. Investors willingness to accept lower spreads was partially due to the economic recovery and its ensuing effect on improving credit fundamentals in the companies that constitute the high yield market. As spreads tightened, investors not only earned the additional yield over treasuries but also participated in the price appreciation from the underlying bonds.

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CURRENT TOPICS

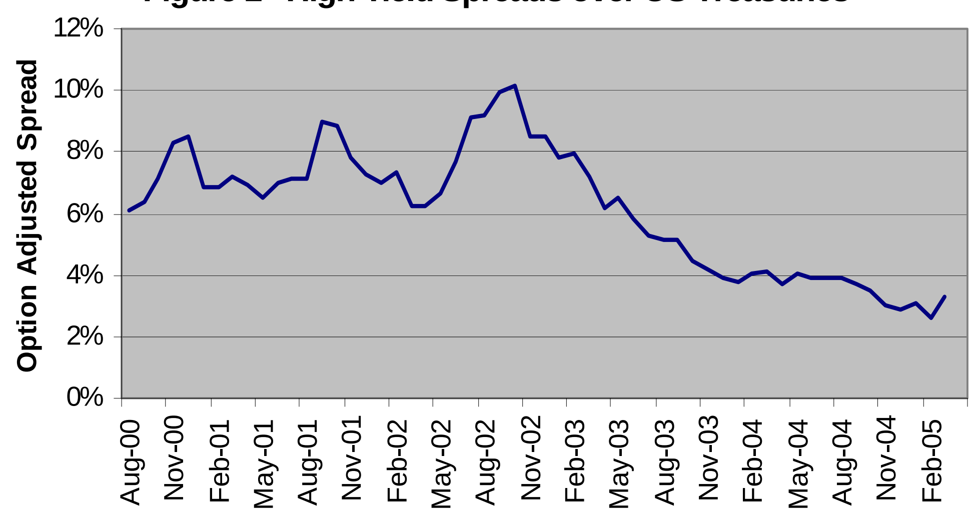
High Yield

- *Background*
- *Performance*
- *Fundamentals*
- *Investment Implications*

Expected Returns & Strategies

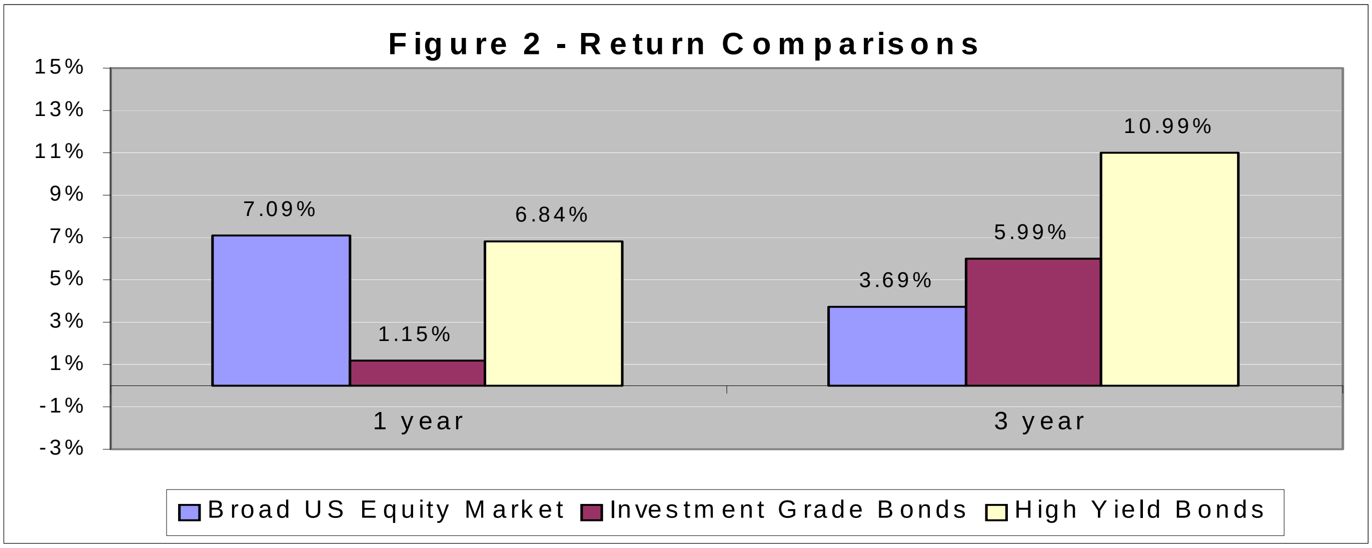
- *High Yield & Emerging Debt less overpriced as yields have risen*
- *Investment Grade Bonds also less overpriced*
- *Emerging Equity Markets closer to fair value due to price declines*

Figure 1 - High Yield Spreads over US Treasuries



Source: Lehman Brothers

High Yield - continued



Sources: Russell, Lehman Brothers, Stairway Partners

Notes: 3-year returns are annualized; data through 3/31/2005

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Fundamentals

Long-term returns from the high yield market are driven by several fundamental factors. The yield received by investors consists of the interest rate exposure that is inherent in all fixed rate bonds as well as the incremental spread earned from taking on credit risk.

Interest rate risk can vary over time but over the long term will explain less than a third of the total risk and return in the high yield market. The credit component of high yield represents the majority of the risk and return that the investor is underwriting.

As discussed earlier, the ingoing yield is a starting point for investors while other factors, such as credit and changes in interest rates, will drive the ultimate return.

As with all bond markets, interest rates moving up or down affects returns. Rising rates are a near term negative as they reduce prices of bonds and the opposite is true when rates are falling.

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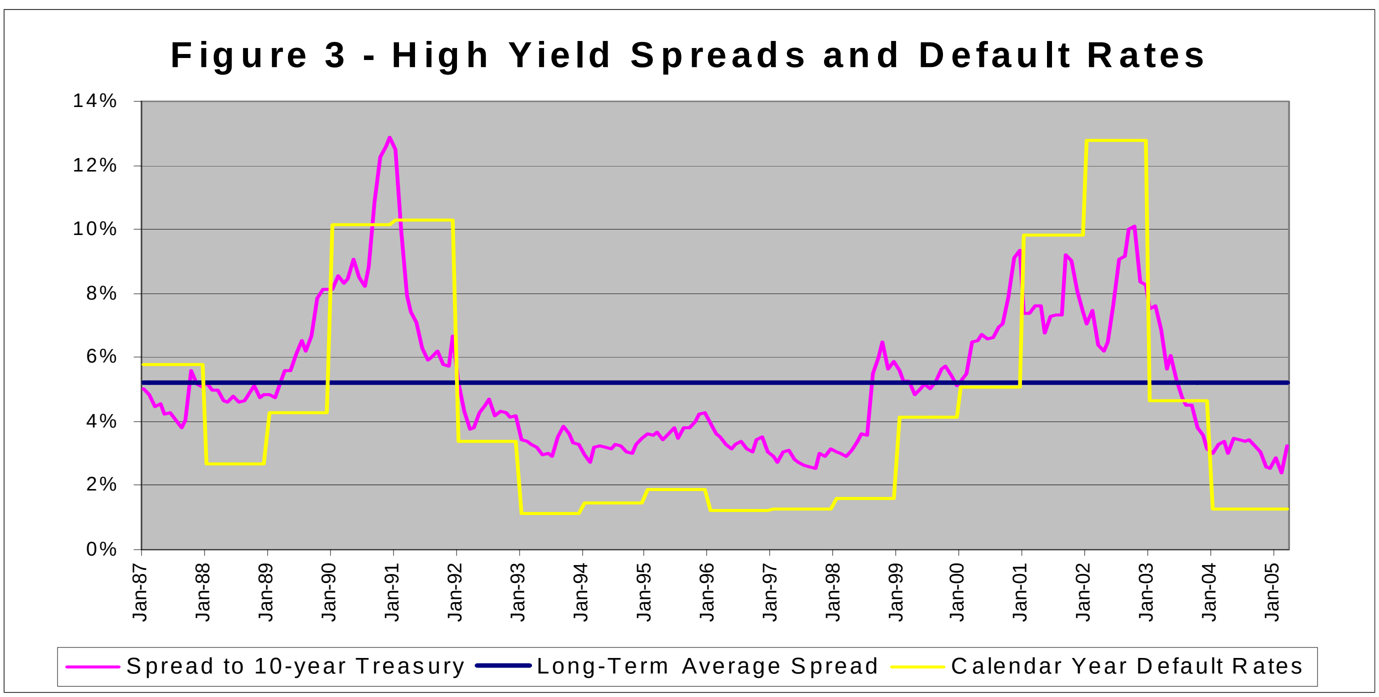

Sources: Lehman Brothers, Dr. Edward Altman - NYU Stern School of Business

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

STRATEGY CHANGES: WHEN YIELDS ON TAXABLE INVESTMENT-GRADE BONDS ROSE LAST MONTH, WE REDUCED UNDERWEIGHT POSITIONS BY HALF. WE ALSO CUT IN HALF THE MAXIMUM UNDERWEIGHT IN EMERGING MARKETS DEBT, GIVEN THE RISE IN TREASURY RATES AND A SIGNIFICANT WIDENING OF SPREADS.

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Another factor that drives returns is the change in spreads that results from investors' beliefs about future fundamentals. If the amount of credit compensation that investors require goes up over time, spreads in high yield will widen. This spread widening is a negative to current investors, who have held the asset class when spreads were narrower, by reducing the value of the bonds they currently hold.

Default and recovery rates are other factors that affect returns. The default rate is usually expressed as the amount of bonds that default as a percentage of the total index. The range for defaults has been as high as 12.79% in 2002 and has fallen as low as 1.11% in 1993 (yellow line in Figure 3). In 2004, the high yield market had a very low default rate of 1.25% compared to the long-term average of 4.5%.

Actual default rates are driven by multiple factors, such as the economic cycle and the credit quality of the outstanding issues that represent the high yield market at any given time.

Along with defaults, another factor affecting returns is the amount of money recovered (*the recovery rate*) by the investor through the bankruptcy process. The recovery rate is driven by the residual value of the company and how long the settlement or "workout" takes for the investor to receive the proceeds. In summary, the default rate detracts from returns and the recovery rate adds a portion of that loss back.

After a company defaults, their bonds are removed from the high yield index. The return from the defaulted portion of the index is derived from the outgoing price of the bonds. This price is derived from market information, residual value of the company, and the time it takes to receive the proceeds.

Investment Implications

As seen in Figure 3, high yield spreads represented by the red line remain tight, despite the recent widening. This narrow spread is well below its long-term average (blue line) and has coincided with default rates (yellow line) at very low levels.

With spreads already tight and defaults already low, what can we expect from this asset class going forward?

Our expected return from high yield over the next 3 years is 4.4% on an annualized basis. This expected return is derived from the ingoing yield of 7.72% with adjustments for interest rates moving modestly higher, spreads widening further, and default rates also moving higher from 1.25% to 5%, a more normal long-term level. In Figure 4, we assess the prospects for high yield by decomposing the components of return.

Summary

Due to the underlying risk in the asset class, Stairway Partners has a hurdle return for the high yield market of 5.7%. Given today's prices, tight spreads, and the probability of increased defaults over time, we have an expected return for high yield of 4.4%. Quite simply, the return we expect from high yield is not fair compensation for the amount of risk imposed by the asset class. As a result, we have a maximum underweight in high yield across all of our portfolios.

Figure 4 - Prospects for High Yield

Return Factors	Question	Answer
Interest Rates	Is now a good time for the underlying rate exposure?	No - Rates should move modestly higher.
Spreads	Is the incremental spread for credit risk attractive?	No - High Yield spreads are tight.
Default Rates	Are default and recovery rates poised to improve?	No - Default rates are already very low.
Total Return	Is there enough yield to compensate for the risk?	No - Yields remain too low.

Strategy

Asset Class	Expected Return	Hurdle Return	Strategy	Comment
Equities				
US	5.7%	7.2%	neutral	Slightly overvalued but strategy still neutral
Non-US Developed				
Eurozone	6.1%	6.7%	neutral	Close to fair value
Japan	0.2%	4.3%	neutral	Volatile fundamentals
UK	9.4%	8.4%	neutral	Pound strength offsets slightly attractive market
Emerging	9.9%	12.4%	neutral	Poor recent performance has decreased overpricing
Fixed Income				
US Treasury Bonds			under	Real rates are too low, but pricing has improved
2-Year	3.7%	4.2%		
5-Year	3.8%	4.6%		
10-Year	3.7%	4.9%		
25-Year	3.4%	5.1%		
US Municipal Bonds			neutral	Attractive pricing in longer maturities
2-Year	2.7%	3.0%		
5-Year	3.1%	3.4%		
10-Year	3.9%	3.8%		
25-Year	6.7%	4.3%		
US High Yield	4.4%	5.7%	under	Pricing improved with increased spreads and Treasury rates
Emerging Markets Debt	4.9%	5.9%	under	Pricing improved with increased spreads and Treasury rates
Cash	3.7%	---	over	Allocation comes from overpriced asset classes

Currencies	Expected Return	Equity Return with Currency
Euro	-3.3%	2.8%
Japanese yen	2.4%	2.5%
UK pound	-4.5%	5.0%

Notes: **As of: 3/31/2005**

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.