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RISK DOESN'T ALWAYS LEAD TO RETURN

Introduction

Financial theory and conventional wisdom suggest that higher risk should be expected to be rewarded with higher return. This generally does hold true over long periods of time. For example, in the long run, equities have had higher returns than bonds, and bonds in turn have had higher returns than cash. This ordering of returns is consistent with the ordering of risk: equities are riskier than bonds, and bonds are riskier cash.

However, this consistency of return with risk does not always hold true over shorter time frames. Financial markets tend to deliver their worst performance when risk, defined as market volatility, is rising.

Is there a typical relationship between shorter-term risk and return? And, what might that tell us about investors' behavior and future returns?

Background

As mentioned, there has been a reasonably good relationship between risk and return over time (see Figure 1). Stocks have had better returns than bonds, while bonds clearly had lower risk. The lowest returning asset class has been cash, which is accompanied by its near-zero level of risk.

The regression or best-fit line shows that the relationship is, as expected, upward sloping. It's also clear that the fit is not perfect, even over the ***13-year*** span shown. Some asset classes have generated more return than was warranted by their risk – for example, emerging markets bonds – and some have generated less –

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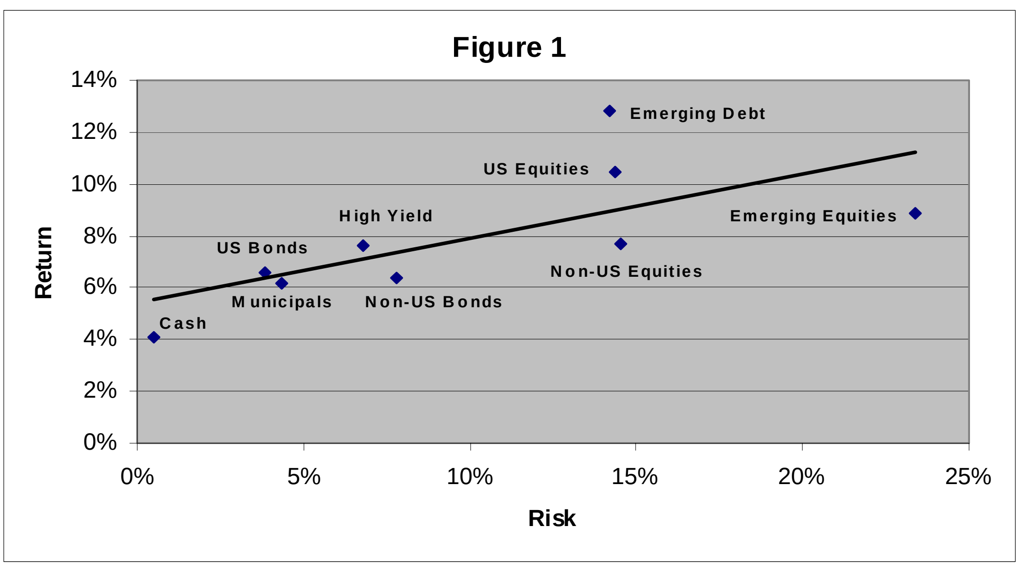
CURRENT TOPICS

Risk and Return - Depending on the time frame, this classic relationship can move considerably

- *Introduction*
- *Background*
- *Timeframe is Everything*
- *A Negative Relationship*
- *Investor Behavior*
- *Investment Implications*

STRATEGY

We had no strategy changes during the month of March.



RISK AND RETURN ARE POSITIVELY RELATED OVER THE LONG RUN

Sources: Bloomberg, MSCI, Russell, Lehman, Stairway Partners. Notes: Period covers 12/31/1992 through 12/31/2005; returns are annualized; risk is calculated as the annualized standard deviation of monthly returns.

Risk Doesn't Always Lead to Return - Cont'd

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for example, emerging equities. Any analysis of this sort should be taken with a grain of salt, due to the sensitivity to the time period chosen, i.e. the start and end dates.

Also, the historical risk and return experience will not always offer a good guide to the future. A good example is emerging markets debt, which started the period with very high yields: the index's yield exceeded 12% and its spread (or additional yield over Treasury bonds) was nearly 7%. Emerging debt yields fell by more than 6%, as both the underlying Treasury curve declined and the spreads narrowed, producing extraordinarily good returns. Given the current environment, low yields and narrow spreads, a repeat of the great emerging markets bond performance is highly unlikely.

Timeframe is Everything

Although higher risk asset classes produce higher returns over the long run, one cannot conclude that this relationship holds over shorter time periods. When risk is increasing, returns turn "perversely" negative instead of increasing in line with the increase in risk.

Risk & Return: A Negative Relationship

This inverse relationship between risk and return over time is shown for the US equity market in Figure 2. Here, we have used daily observations to show that the long-run positive association of risk with return cuts the opposite way over shorter time frames.

Over the last 10 years, any time that risk has spiked upward the market has fallen, often quite sharply. For example, from mid-July to early October 1998, the stock market declined approximately 20% at the same time that risk quadrupled. Likewise, from 2000 through late 2002, a series of risk spikes coincided with sharp drops in the equity market, which was already trending downward in line with the elevated level of risk. This culminated in a peak in risk at the stock market's bottom. A last example is during the October 2005 market weakness, when risk rose from about 10% to 15%.

The story is the same in non-US equity markets (Figures 3 & 4), where upward jumps in risk also have occurred simultaneously with market weakness. Many of the episodes of heightened risk in these asset classes coincide with trouble in the US market.

Near the end of 2002, risk had started falling as the markets bottomed. The decline in equity market risk to the low levels prevalent since the middle of 2004 has been associated with very strong stock market performance.

Investor Behavior

This shorter-term "perverse" relationship between risk and returns makes perfect sense when considered in the context of investor behavior. As market risk starts rising, investors begin to experience significant losses. This causes them to become fearful and view prospective returns negatively. This often culminates in selling at market bottoms, coinciding with the greatest level of market volatility.

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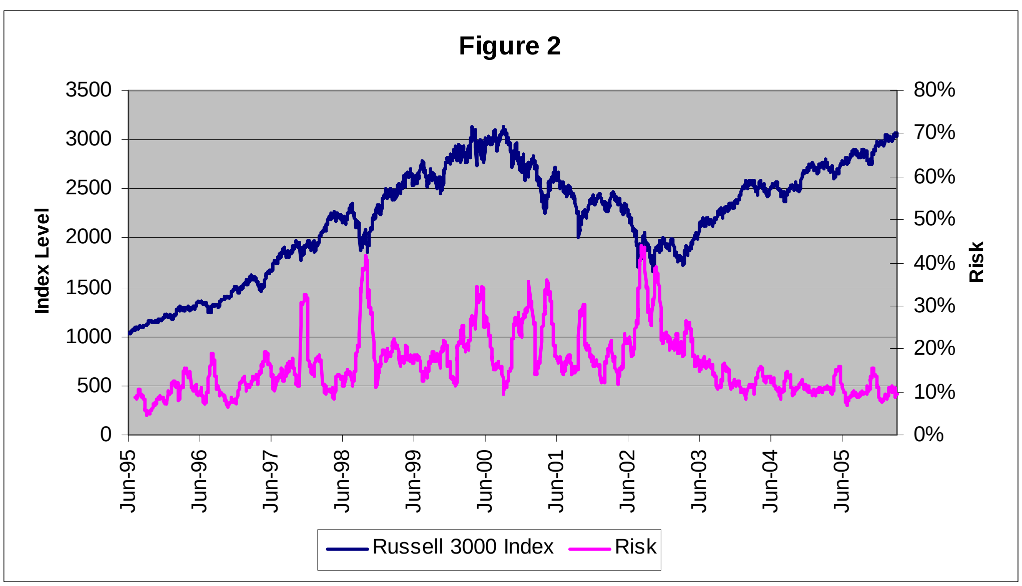


SHORTER TERM, THE RELATIONSHIP BETWEEN RISK & RETURN IS NEGATIVE

Sources: Russell, Stairway Partners

Notes: Risk is calculated as the annualized standard deviation of daily returns on a rolling 25-day basis. Russell 3000 is the total return index.

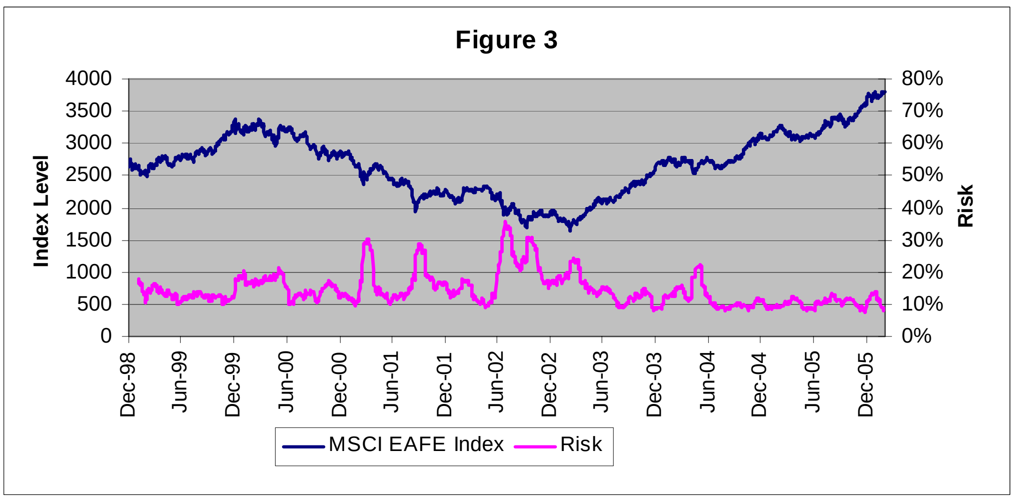
About Stairway Partners, LLC

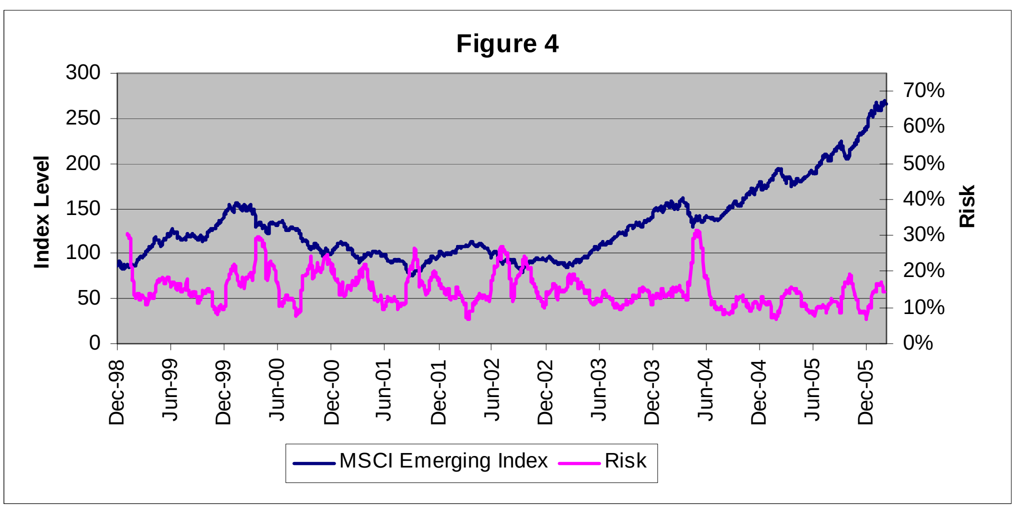
Stairway Partners was formed to provide our clients (starting with ourselves) with an effective and comprehensive solution for managing their wealth. Our disciplined and rigorous approach comes from our collective knowledge in serving large institutional clients over many years.

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.

The converse also happens: when risk has been low, investors tend to be complacent and extrapolate this low risk environment into the future. Sentiment is often of the "it's different this time" type. The good returns that are associated with declining levels of risk reinforce investors' positive views. The end result is typically that money flows into the "high return/ low risk" asset class at the top.

We highlighted this relationship between flows and returns in our research piece titled, "The Case for Disciplined Investing" August 2004.





Source: MSCI, Stairway Partners

Notes: Risk is calculated as the annualized standard deviation of the daily returns on a rolling 25-day basis. EAFE and MSCI EM are total return indices.

Investment Implications

The cyclicality of risk and the behavior of investors at its peaks and troughs provide strong lessons for asset allocation strategy. When risk is high and investors are concerned about an asset class, they usually drive prices below levels justified by long-term fundamentals. In this environment, we would view the prospects for that investment as good: our expectations would be that risk would decline toward its long-term level, resulting in attractive returns.

With risk currently running at quite low levels, and a number of markets (emerging equity and debt especially) pricing for sustained tranquility, the *forward-looking* risks as we see them are actually *higher* than average.

Unless risk continues to be restrained, it would seem that surprises, when they occur, will tend to raise investors' perceptions of risk and damage returns. When this happens, the herd behavior - record amounts of money flowing into Non-US equities, emerging and developed markets - is likely to reverse.

Strategy

Asset Class	Expected Return	Hurdle Return	Strategy	Comment
Equities			small under	
US	4.4%	8.2%	neutral	Exposure equal to normal portfolio weighting
Non-US Developed			small under	Remains unattractive relative to US market
Eurozone	-0.4%	7.0%		
Japan	-11.3%	4.3%		
UK	4.0%	8.2%		
Emerging	-0.3%	11.6%	under	Asset class inadequately pricing risk
Fixed Income				
US Treasury Bonds			under	Shorter maturities offer best relative value
2-Year	4.8%	4.7%		
5-Year	4.9%	4.9%		
10-Year	4.6%	5.1%		
30-Year	3.7%	5.2%		
US Municipal Bonds			neutral	Sector is fairly priced
2-Year	3.5%	3.4%		
5-Year	3.8%	3.6%		
10-Year	4.3%	3.9%		
30-Year	7.4%	4.4%		
US High Yield	4.7%	6.7%	under	Spreads over US Treasuries remain too tight
Non-US Government Bonds			under	Yields generally insufficient compensation for risk
Euro 10-Year	2.4%	4.4%		
Japan 10-Year	0.7%	2.1%		
UK 10-Year	3.1%	4.9%		
Emerging Markets Debt	3.9%	6.9%	under	Spreads over US Treasuries remain too tight
Cash	4.5%	---	over	Allocation comes from overpriced asset classes

Currencies	Expected Return	Equity Return with Currency	10-Year Bond Return with Currency	
Euro	-1.5%	-1.9%	0.9%	Close to fair value
Japanese yen	5.1%	-6.2%	5.8%	Yen is slightly attractive
UK pound	-2.2%	1.8%	0.9%	Close to fair value

Notes: **As of: 3/31/2006**

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.