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MONTHLY

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BORING IS GOOD

Introduction

In our last *Monthly,* we revisited the topic of herd behavior, exploring how some investors chase returns by purchasing what has done well and selling what has done poorly. In this *Monthly*, we will contrast how a portfolio with steady returns can outperform a portfolio with more volatile returns. Steady returns are often the result of proper diversification and disciplined investing.

Background

Investors who run in herds tend to be the same people who like "stories". These stories may be emotionally appealing but emotions can lead to buying high and selling low. This type of performance chasing often leads to portfolios with significant performance differences from year to year. Many times these excessive return fluctuations are uncompensated, and can be destructive to wealth. We illustrate this point using a simple example and then apply this concept to hypothetical portfolios with different levels of risk to see how the values fluctuate over time.

Case Studies

Figure 1 is the simple illustration of two portfolios. Each portfolio has a starting value of $100, but one has equal upward and downward swings of 30%, while the other moves up and down by 8%. It is interesting to note that in both cases, the "average" return is 0%. In the first case, however, the 30% swings either way led to a 9% loss when compared with the starting value. In the second case, the 8% swings resulted in less than a 1% loss.

We can further expand on this concept by creating two hypothetical portfolios with differing levels of volatility, and explore how the two portfolios fare after 12 years. The first portfolio represents a more volatile and to some a "sexier" series

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CURRENT TOPICS

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.

Figure 1: Portfolio Examples

	Starting Balance	Year 1 Return	Year 1 Ending Balance	Year 2 Return	Year 2 Ending Balance	$ Change in Portfolio Value	% Change in Portfolio Value
Portfolio A	100.00	30%	130.00	-30%	91.00	(9.00)	-9.0%
Portfolio B	100.00	8%	108.00	-8%	99.36	(0.64)	-0.6%

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IN THE SECOND CASE, THE 8% SWINGS RESULTED IN LESS THAN A 1% LOSS."

BORING IS GOOD - CONT'D

of returns which results in large fluctuations in performance. It may be fun to talk about the +20% return years but as most seasoned investors know, highly volatile performance typically cuts both ways. The second portfolio represents a more disciplined approach producing returns that some may view as "boring".

Some of the statistics seen in Figure 2 show that, on the surface, the sexy portfolio looks pretty good. The highs achieved are certainly very attractive and both the sum and average of the yearly returns are greater than they are for than the boring portfolio. Nevertheless, the ending balances for both portfolios are different, and these differences in value, along with the risk taken to achieve these returns, are what really matter.

What may be counterintuitive to many is that the boring portfolio wins. It finished with an ending balance of just over $1.7 million while the sexy portfolio finished with a value of just over $1.5 million. Figure 3 highlights the cumulative growth of both portfolios and the subsequent higher ending value of the boring portfolio.

On an annualized return basis (which is the actual growth rate of the portfolio's value), the boring portfolio produced a return that was 1 percentage point higher than the sexy portfolio over the 12 year period. Lastly, in addition to having superior returns, the boring portfolio took substantially less risk - about 60% less.

Figure 2: Sexy Portfolio vs. Boring Portfolio

Starting Balance	$1,000,000			
	Sexy		**Boring**	
	Rate of Return	Market Value	Rate of Return	Market Value
Year 1	32%	1,320,000	12%	1,120,000
Year 2	-25%	990,000	-6%	1,052,800
Year 3	10%	1,089,000	4%	1,094,912
Year 4	18%	1,285,020	11%	1,215,352
Year 5	-21%	1,015,166	-4%	1,166,738
Year 6	2%	1,035,469	3%	1,201,740
Year 7	-17%	859,439	-5%	1,141,653
Year 8	31%	1,125,866	17%	1,335,734
Year 9	12%	1,260,969	8%	1,442,593
Year 10	-12%	1,109,653	-2%	1,413,741
Year 11	9%	1,209,522	5%	1,484,428
Year 12	27%	1,536,093	16%	1,721,937
	66.0%	Sum of Returns	59.0%	
	5.5%	Average Return	4.9%	
Total Portfolio Value After 3 Years		**$1,536,093**		**$1,721,937**
Cummulative 3 Year Return		53.6%		72.2%
Annualized Return		3.6%		4.6%
Annualized Risk		20.2%		8.1%

Just for the sexy portfolio to catch up, it must increase....12.1%

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.

Portfolio risk is market driven and influenced by the mix of assets held within the portfolio. Investors should only take risks for which they expect to be compensated. Uncompensated risk may not be noticed in a hot market, but eventually it is likely to lead to poor results.

Consistency

As part of our investment process there are three elements that we feel lead to less volatile returns. We have written about these specific topics in previous *Monthly* research pieces. Summarized, these three points are:

- Diversification

Portfolios that take advantage of the less-than-perfect correlations among asset classes can have smoother returns and improved overall risk characteristics. Even the best investors are sometimes wrong, but when properly diversified their wrong decisions do not cost them too much.

- Disciplined investing

Successful investors use a consistent and objective investment process. This helps them identify when markets do not compensate investors for their inherent risk. This analysis also tends to lean against the herd, preventing the investor from chasing returns of "hot" markets.

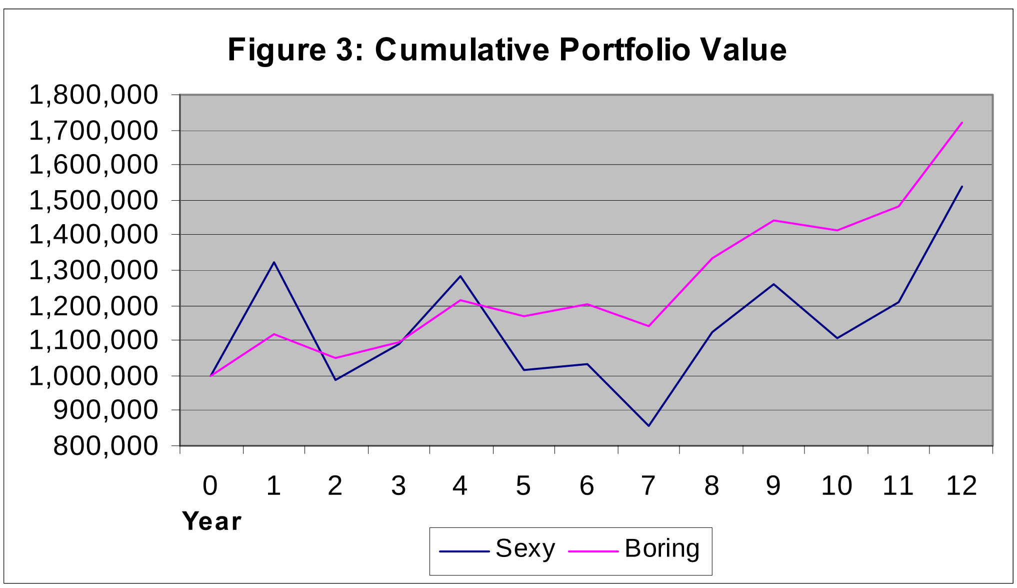
- Separation of long-term objectives and short-term considerations

Long-term is expressed by a benchmark - the portfolio allocation that will generate the risk and return characteristics desired by the investor. Our client portfolios have benchmarks that are customized and consist of a globally diversified blend of assets.

Short-term strategy involves assessments of risks and opportunities relative to current market conditions. The portfolio manager should increase allocation to the asset classes that represent the best opportunities as identified by the investment process. This short-term strategy should always have certain parameters or governors to ensure that the portfolio in aggregate does not have an unnecessary concentration of risk.

Conclusion

Portfolios that have volatile returns may be exciting in good times, but over the long haul that same risk can have wealth eroding effects. By being diversified and disciplined, and having a clear separation of long-term goals and short-term strategies, investors have a better chance of growing wealth at a consistent rate over time.



"UNCOMPENSATED RISK MAY NOT BE NOTICED IN A HOT MARKET, BUT EVENTUALLY IT IS LIKELY TO LEAD TO POOR RESULTS"

Strategy

Asset Class	Expected Return	Hurdle Return	Strategy	Comment
Equities			small under	
US	3.4%	8.5%	small under	Exposure slightly below normal
Non-US Developed			small under	Moderately unattractive relative to risk
Eurozone	-2.0%	7.6%		
Japan	-10.4%	4.6%		
UK	3.6%	8.7%		
Emerging	-2.7%	10.8%	under	Asset class inadequately pricing risk
Fixed Income				
US Treasury Bonds			neutral	Shorter-term maturities are fairly priced
2-Year	4.6%	4.6%		
5-Year	4.4%	4.7%		
10-Year	4.1%	5.0%		
30-Year	3.5%	5.2%		
US Municipal Bonds			neutral	Sector is fairly priced
2-Year	3.6%	3.4%		
5-Year	3.7%	3.6%		
10-Year	3.9%	3.8%		
30-Year	6.2%	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	3.0%	4.5%		
Japan 10-Year	0.4%	2.0%		
UK 10-Year	4.4%	5.2%		
Emerging Markets Debt	3.3%	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	-4.9%	-6.9%	-1.9%	Euro is somewhat expensive
Japanese yen	5.5%	-4.9%	5.9%	Yen is slightly attractive
UK pound	-6.0%	-2.3%	-1.5%	Pound is somewhat expensive

Notes: **As of: 3/31/2007**

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.