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SPREADS AND YIELDS

Introduction

The financial press has widely reported that bond yields are very low and spreads are abnormally wide. It is our view that, within the broader bond market, it is the yields on US Treasury bonds that are abnormally low and the non-Treasury sectors offer yields much closer to what we perceive as fair value.

Background

For bond investors, yield usually refers to the interest rate they would expect to earn over the term of the bond. This yield should compensate the investors for the risks inherent in bonds.

Bond investors are exposed to an array of risks. One risk that almost all of them face is *interest rate* risk - the risk of bond prices changing due to interest rate changes after the investment is made. Longer-maturity bonds have more interest rate risk than bonds with shorter maturities because, for a given interest rate change, price fluctuates more the longer a bond's maturity.

When comparing bond investments outside of the Treasury market, an investor needs to consider risks in addition to interest rate risk. Examples include: *credit risk* - the uncertainty of the timely repayment of principal and interest due to changing credit worthiness; *prepayment risk* - the uncertainty, in residential mortgage securities, of the timing of receipt of principal due to homeowners' rights to prepay their mortgages. Many homeowners prepay their higher-rate mortgages as interest rates decline. These prepayments typically flow through to mortgage bond investors, forcing them to reinvest their principal at lower yields. *Liquidity risk* arises when investors prefer highly liquid securities in times of distress such as the last nine months. We believe that investors' current preference for liquidity is a primary reason that Treasury yields are so low.

As compensation for these

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CURRENT TOPIC

Spreads and Yields

- *Introduction*
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STRATEGY

- *We added significantly in March to developed equities both in US and non-US markets*
- *Portfolio strategy remains underweight emerging markets - both equities and bonds*

Figure 1: Composition of Taxable Bond Indices

Index	Market Value (Billions $)	% of Total	Yield	Spread	Maturity (years)	Rating
Lehman Investment Grade Index	10,495.77		4.55%	1.98%	7.05	AA1/AA2
US Treasuries	2,364.54	22.5%	2.66%	-	7.04	AAA/AAA
Agency Mortgage Backed Securities	4,087.50	38.9%	5.09%	2.60%	5.86	AAA/AAA
Corporate Bonds	2,016.60	19.2%	5.89%	3.04%	10.45	A2/A3
Agency Debt	1,153.05	11.0%	3.18%	1.01%	5.55	AAA/AA1
Commercial Mortgage Securities	547.05	5.2%	6.15%	3.55%	6.06	AAA/AA1
Asset Backed Securities	82.22	0.8%	6.32%	4.23%	4.47	AAA/AA1
Lehman High Yield Index	590.97		10.90%	8.29%	7.24	B1/B2

Source: Lehman Brothers

SPREADS AND YIELDS - CONT'D

(Continued from page 1)

other risks, investors require more yield than found in Treasury bonds. The difference in yield between non-Treasury bonds and Treasury bonds, for a given maturity, is called the spread. The greater the perceived risk relative to Treasuries, the wider the spread needed for compensation.

Composition

Figure 1 shows the composition of the major sectors of the US market as determined by Lehman Brothers. The Lehman Brothers Aggregate Bond Index is the most commonly used benchmark for US investment grade bonds – that is, bonds rated BBB or higher. Also, in Figure 1, we have included for comparison the Lehman Brothers High Yield Index, bonds rated below BBB.

It is interesting to note that Treasuries account for only 22.5% of the US investment grade index. It is also interesting to note that the non-Treasury components of the index – agency debt, corporate bonds, agency mortgage bonds, etc. – have considerably higher yields than Treasuries. As a result, the spreads over Treasuries shown in Figure 1 are near historically wide levels.

Valuation

As mentioned earlier, Treasury yields are at very low levels. Figure 2 shows the current market yields of Treasury benchmark maturities versus Stairway Partners' assessment of long-term fair value yields. As you can see, we believe that current market yields in Treasuries are substantially below yields that we would consider appropriate compensation for risk.

The most obvious reasons for low yields are the slowing

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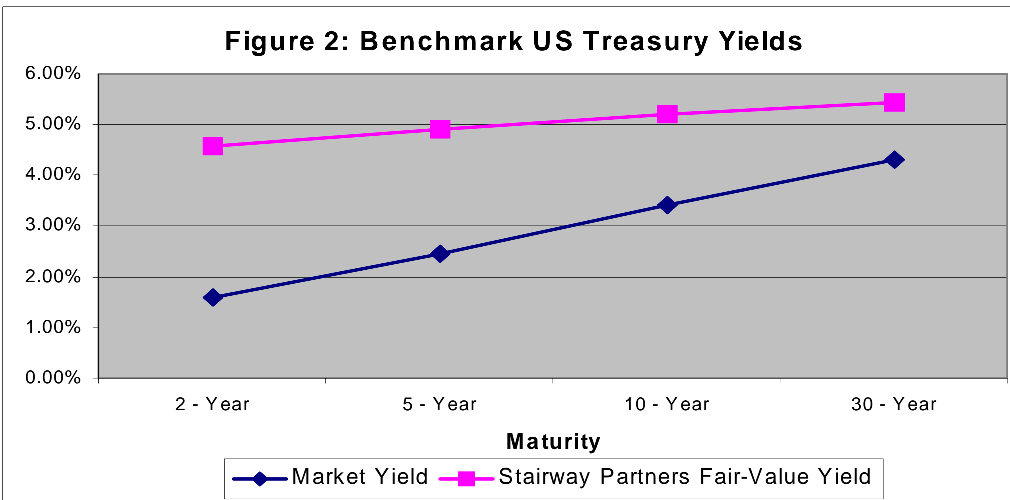
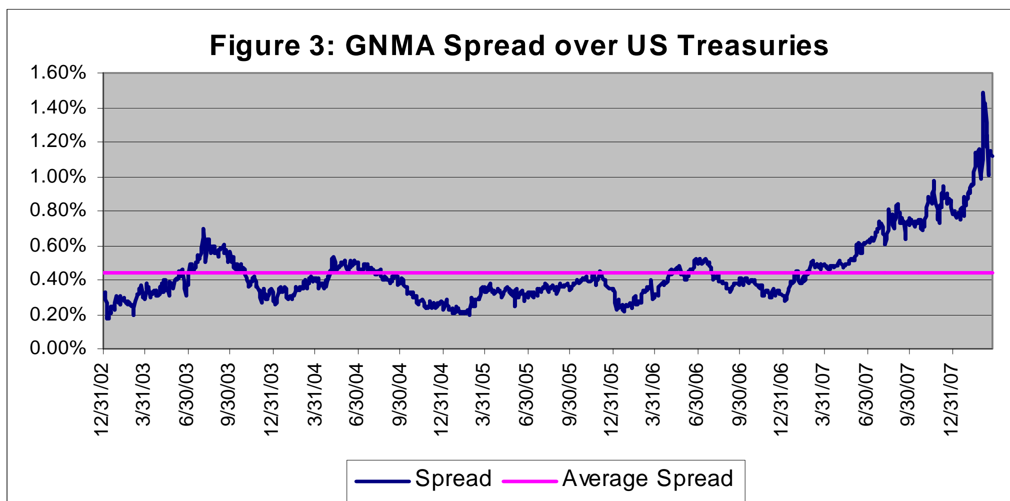


Sources: Bloomberg, Stairway Partners



Sources: Lehman Brothers, Stairway Partners

Note: GNMA spread is option adjusted

"CURRENT MARKET YIELDS IN TREASURIES ARE SUBSTANTIALLY BELOW YIELDS THAT WE WOULD CONSIDER APPROPRIATE COMPENSATION FOR RISK"

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"EVEN GNMA MORTGAGE BACKED SECURITIES, WHICH ARE GOVERNMENT GUARANTEED, ARE CURRENTLY COMMANDING ABNORMALLY WIDE SPREADS"

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.

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economy and the Federal Reserve's aggressive lowering of short-term interest rates. The reason for *abnormally* low yields, we believe, is a liquidity preference being expressed by investors who are pouring money into a perceived safe haven from more-risky investments.

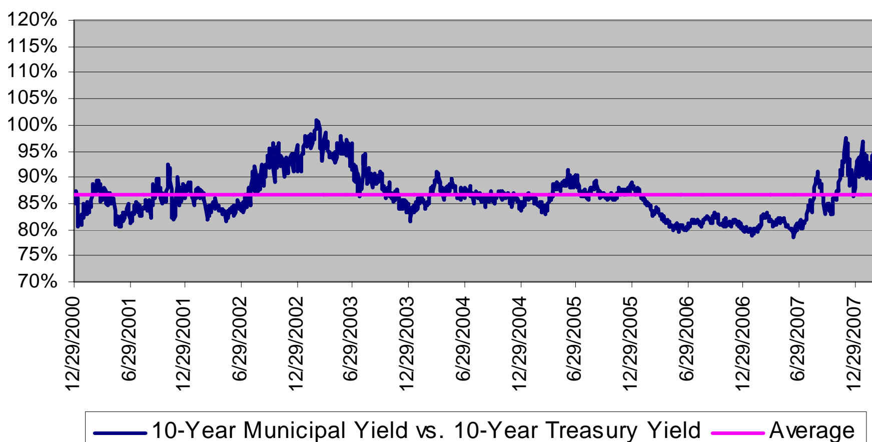
As noted, there are currently big differences between the yields in the Treasury market and non-Treasury markets. These wide spreads result in elevated yields which offer investors reasonable compensation for the various risks associated with these markets. Even GNMA mortgage-backed securities, which are government guaranteed (backed by the full faith and credit of the US government), are currently commanding abnormally wide spreads (see Figure 3).

Another example of a high-quality market that is currently very attractive relative to Treasuries is the municipal bond market. Figure 4 shows a popular measure used to track the relationship between the municipal bond market and Treasury market. This is the ratio, expressed in percent terms, of the AAA rated 10-year general-obligation municipal bond yield relative to the 10-year Treasury bond yield. In recent years, high-quality municipal bonds have yielded less than Treasuries - historically around 85% - due to their federally tax-exempt status. This ratio is now at 112%, meaning that investors in AAA municipal bonds actually receive a *higher* yield than available in the Treasury market.

Investment Implications

As mentioned earlier, Treasury yields are very low and do not represent good long-term value. As we move through the current crisis, there is a high probability that yields on Treasuries will move substantially higher. When this happens, we expect spreads between Treasuries and other sectors to narrow significantly as yields on the non-Treasury sectors rise less than Treasury yields. As a result, we expect returns in the non-Treasury sectors will be considerably better than Treasury returns.

Even if rates do not rise, the non-Treasury sectors should provide better returns, given their higher current yields. Of course it is possible for the economy to deteriorate further and the preference for safe liquid Treasuries to become even stronger. But given where bond markets are currently priced, we believe much of this scenario is already priced in. As a result of the relatively small share of Treasuries in the overall bond market and the better value to be found in the non-Treasury sectors, we remain close to neutral in bond exposure across portfolios.



Sources: Bloomberg, Stairway Partners

"ANOTHER EXAMPLE OF A HIGH-QUALITY MARKET THAT IS ATTRACTIVE RELATIVE TO TREASURIES IS THE MUNICIPAL BOND MARKET"

Strategy

Asset Class	Expected Return	Hurdle Return	Strategy Exposure	Comment
Equities			small under	
US	9.3%	7.1%	small over	Exposure slightly above benchmark weight
Non-US Developed			small under	Asset class fairly priced as markets have fallen
Eurozone	10.0%	7.8%		
Japan	3.8%	4.7%		
UK	12.0%	8.8%		
Emerging	-3.2%	11.5%	under	Asset class remains expensive
Fixed Income				
US Treasury Bonds			neutral	Non-Treasury sectors more attractively priced
2-Year	1.4%	3.1%		
5-Year	1.0%	3.7%		
10-Year	1.2%	4.3%		
30-Year	1.5%	4.9%		
US Municipal Bonds			neutral	Sector overall is near fair value
2-Year	2.4%	2.9%		
5-Year	2.8%	3.3%		
10-Year	3.9%	3.8%		
30-Year	8.1%	4.4%		
US High Yield	9.2%	5.6%	neutral	Sector is pricing for deteriorating fundamentals
Non-US Government Bonds			under	Yields too low, especially at longer maturities
Euro 10-Year	2.8%	4.5%		
Japan 10-Year	-0.4%	1.9%		
UK 10-Year	2.9%	4.9%		
Emerging Markets Debt	2.7%	5.8%	under	Spreads over US Treasuries remain too tight
Cash	3.6%	---	over	Allocation comes from overpriced asset classes

Currencies	Expected FX Change	Equity Return with Currency	10-Year Bond Return with Currency	
Euro	-9.9%	0.1%	-7.1%	Euro is expensive
Japanese yen	0.2%	4.0%	-0.2%	Yen is close to fair value
UK pound	-5.3%	6.7%	-2.4%	Pound is expensive

Notes: **As of: March 31, 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.

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