STAIRWAY PARTNERS, LLC

2215 York Road, Suite 515 Oak Brook, IL 60523
www.stairwaypartners.com
630-371-2626 phone 630-371-2617 fax

MONTHLY

VOLUME 6, ISSUE 4 APRIL 2009

INVESTOR BEHAVIOR REVISITED

Introduction

We have written many times in the past about the striking herd behavior of investors. Examining mutual fund purchase and sales data, it is clear that many people hurt themselves, investing when prices are high and selling when asset prices have fallen. This month, we update information we have provided previously in order to see whether this behavior has remained the same during the market crisis of the last year and a half.

Equity Fund Flows

One of the first things to note is that investor behavior towards equity investment follows a similar pattern, regardless of which markets are involved. Figure 1 shows the net purchases (+) and sales (-) of US, non-US developed, and emerging equity mutual funds. A mutual fund flow is a net purchase if investors put more money into funds through new purchases than they take out through fund redemptions. Net sales occur when the opposite happens – a greater amount of redemptions than purchases.

From Figure 1, it is clear that money flowed into stocks – into all three broad equity asset classes – at the end of the 1990s, just as the tech bubble was reaching its apex. The belief at the time was that the global economy and financial markets were in a golden period, in which low risk, strong earnings growth, and unlimited potential were extrapolated far into the future. Then, there were periods of outflows during 2001 and 2002, although the US market experienced a much larger wave of selling than did the non-US developed and emerging equity markets. These redemptions were then followed by inflows across the board in early 2006/early-2007, particularly outside the US (some sales in US?), as investors

(Continued on page 2)

CURRENT TOPIC

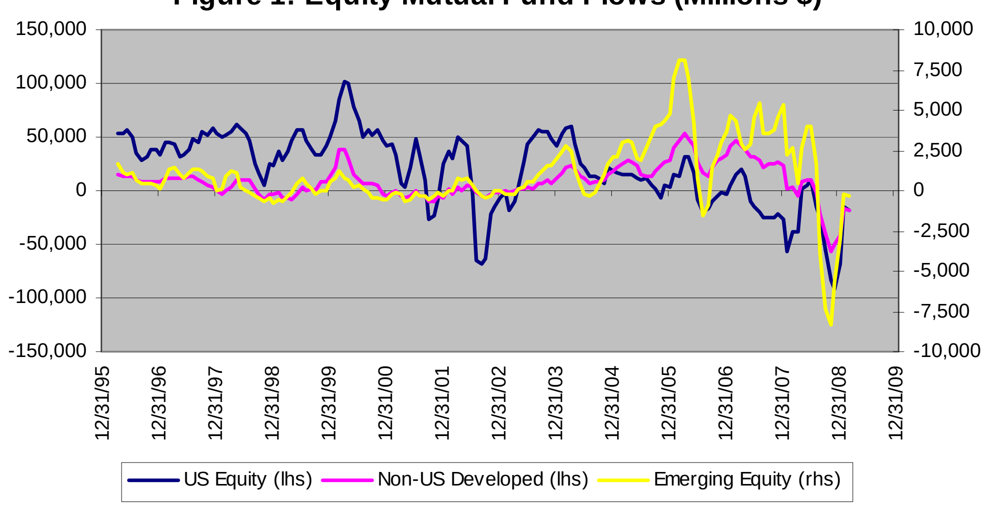
Investor Behavior Revisited

- *Introduction*
- *Equity Fund Flows*
- *US Equities*
- *Emerging Equities*
- *Summary*

Strategy

- *We added equity exposure across accounts in early March*
- *Portfolio strategies remain overweight equity markets and high yield bonds*

Figure 1: Equity Mutual Fund Flows (Millions $)



Sources: Investment Company Institute, Stairway Partners Note: Flows are 3-month sums

"EXAMINING MUTUAL FUND PURCHASE & SALE DATA, IT IS CLEAR THAT MANY INVEST WHEN PRICES ARE HIGH AND SELL WHEN ASSET PRICES HAVE FALLEN"

Investor Behavior Revisited - Cont'd

came to believe that non-US markets had decoupled from the US and would be immune to any slowdown experienced here. When this turned out not to be the case, the inflows were reversed by massive selling in 2008 across developed and emerging equity markets.

This buying and selling behavior is not indiscriminate. Instead, it follows investors' comfort with buying when times have been good and selling when times have been bad. In other words, the flows have coincided with or followed periods of exceptionally good and bad returns in the equity markets.

US Equities

Figure 2 shows that US equity mutual fund flows have been strongly correlated to stock market performance. Purchases (i.e., net inflows into funds) peaked near the start of 2000, just when the stock market was reaching its tech bubble peak. So, many investors committed new money to the stock market at its high point. The post-bubble outflows likewise coincided almost perfectly with the trough in the market in 2002.

What has been the picture more recently? Equity fund purchases were very strong in early 2006 and again in late '06-early '07, just before the stock market started its steep decline of 2008-09. When was the maximum selling pressure? Figure 2 shows us that it happened very near the end of 2008.

So, recent history reinforces the idea that investors in aggregate purchase near the peaks in stock market prices then sell at significantly lower prices – buy high/sell low.

Emerging Equities

A similar story is found in investor behavior with respect to non-US equities. Figure 3 shows that the same buy high/sell low herd men-

(Continued on page 3)

"Purchases and sales of US mutual funds have been strongly correlated to stock market performance"

*

" The same buy high/sell low herd mentality seen in US equities happens in emerging equity funds also"

Figure 2: US Equity Market & Mutual Fund Flows

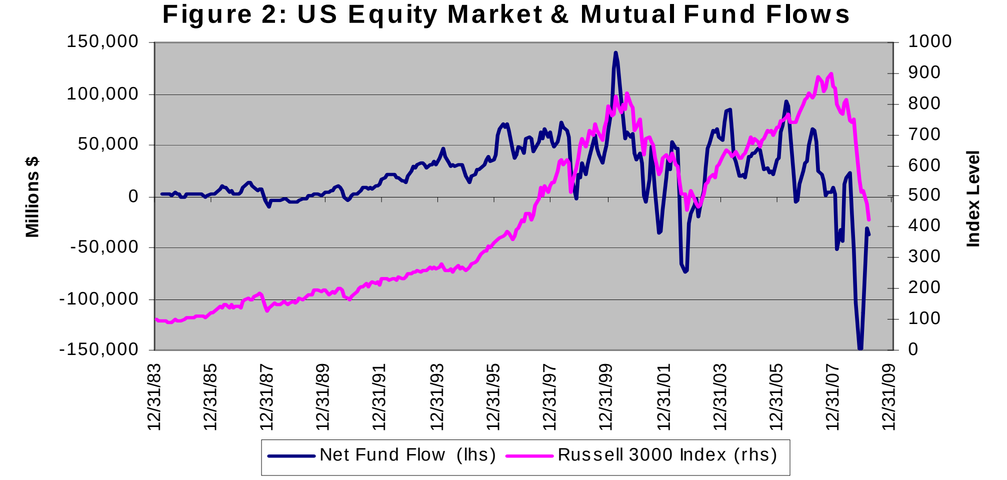
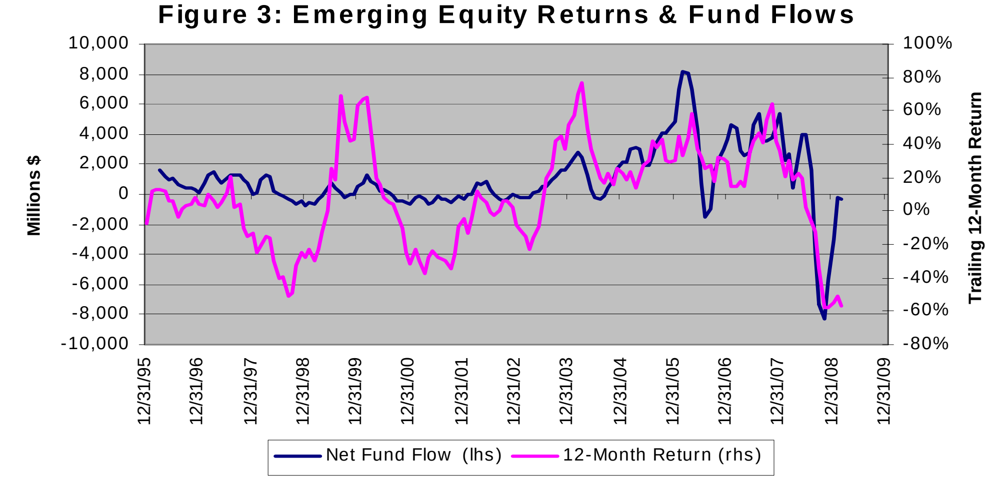


Figure 3: Emerging Equity Returns & Fund Flows



Sources: Investment Company Institute, Russell, MSCI, Stairway Partners

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.

tality seen in US equities happens in emerging market equity funds also. Inflows were positive, and large relative to prior history, just before the 1998 Asian crisis and Russian default. The poor returns in late '98 caused investors to get rid of emerging equity exposure in late '98 and early '99 – after they had lost money and just before the asset class was about to deliver positive performance on the order of 75%. Great returns in 2003 and the beginning of 2004 drew in another wave of investor funds. Most recently, the sustained inflows in 2007 and early 2008 occurred just in time for investors to be exposed to the 60% collapse of emerging equities – which induced them to pull out record amounts of money.

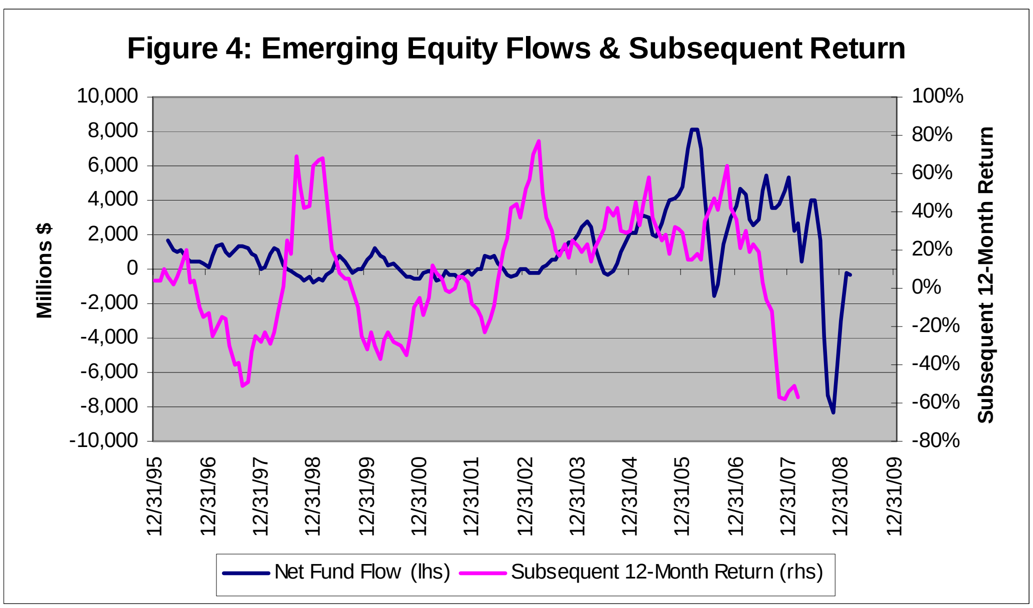
In Figure 4, we have shifted the magenta return line back by 12 months in order to show at each point in time the results of investor behavior, how they fared in the year subsequent to their buy/sell investment decision. So for example, the small peak in inflows/purchases at the start of 2000 correspond to a subsequent 12-month loss of about 40%. The liquidation of emerging equity exposure in 2006 came just in time for investors to miss gains of around 50% over the following 12 months. And recently, the investors committing significant money to emerging equities in late 2006 have been "rewarded" with one-year losses of nearly 60%. If this pattern continues in its historical fashion, the massive outflows in 2008 should presage excellent returns in late 2009.

Although space constraints prevent us showing the data, fund flows show that herd behavior – buying high and selling low happens in non-US developed equities also.

Summary

Investors have an extremely strong bias toward buying investments when returns have been good – and prices are high – then selling them when returns are poor – at very low prices. This buy-high/sell-low behavior is widespread, cropping up in US equities, non-US & emerging equities, and even bonds. Anecdotally, the herd has moved into (and out of) private equity and hedge funds in the same manner.

As we all know, the objective of an investment program should be to buy low and sell high, rather than the reverse. From the evidence, it appears that investors have been their own worst enemies.



Sources: Investment Company Institute, MSCI, Stairway Partners

"If this pattern continues in historical fashion, the massive outflows in 2008 should presage excellent returns in late 2009"

Strategy

Asset Class	Expected Return	Hurdle Return	Strategy Exposure	Comment
Equities				
US	30.1%	6.0%	over	Exposure above benchmark weight due to improved pricing
Non-US Developed			over	Asset class has become more attractive as markets have fallen
Eurozone	35.9%	6.2%		
Japan	22.8%	4.5%		
UK	28.5%	6.4%		
Emerging	24.2%	10.8%	neutral	Price declines have made asset class attractive
Fixed Income				
US Treasury Bonds			under	Treasuries expensive, but non-Treasury sectors priced better
2-Year	0.5%	2.7%		
5-Year	0.0%	3.3%		
10-Year	-0.3%	4.0%		
30-Year	-1.1%	4.5%		
US Municipal Bonds			under	Long-term maturities priced better than short-term maturities
2-Year	1.3%	2.3%		
5-Year	1.7%	2.9%		
10-Year	3.2%	3.7%		
30-Year	9.5%	4.6%		
US High Yield	22.1%	4.4%	over	Sector offers good return prospects relative to its risk
Non-US Government Bonds			under	Yields remain below fair levels
Euro 10-Year	1.0%	4.1%		
Japan 10-Year	-0.2%	1.9%		
UK 10-Year	0.6%	4.4%		
Emerging Markets Debt	6.9%	4.7%	under	Although sector is priced attractively, other asset classes offer better value
Cash	2.7%	---	minimal	

Currencies	Expected FX Change	Equity Return with Currency	10-Year Bond Return with Currency	
Euro	-5.6%	30.2%	-4.6%	Euro is moderately overpriced
Japanese yen	-0.3%	22.4%	-0.6%	Yen is slightly expensive
UK pound	3.5%	32.1%	4.1%	Pound is slightly underpriced

Notes: **As of: March 31, 2009**

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.