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Stairway Partners, LLC Monthly

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PROTECTING WEALTH AGAINST INFLATION

Introduction

Many investors have been concerned about the potential for increased inflation since the effects of the financial crisis began to abate in the first half of 2009. They fear that the accommodative policies put in place by the Fed to spur economic growth will be left in place too long, ultimately eroding the value of US Dollar based assets. The recent increase in gasoline prices has exacerbated the situation, as investors now see the price of a known commodity increase on what seems to be a daily basis.

Although equity markets have shown considerable strength lately, many investors who were mauled by the last bear market are still skeptical about equities ability to keep pace with inflation in the future. With cash rates effectively stuck at zero and bond yields near historic lows, these investors are now looking to alternative strategies to safeguard the value of their assets.

In this *Monthly*, we discuss the effect that inflation has on the value of investments and examine the return characteristics of several alternatives, often purchased by investors in an effort to protect themselves against inflation.

Losing Principal versus Losing Value

The aforementioned increase in gasoline prices has caught the attention of the media and has increased the anxiety level of many investors around the issue of inflation. Figure 1 shows the national average price for a gallon of unleaded gasoline, which has increased dramatically over the past several months. Many people use gasoline prices as a gauge for overall inflation, because it is something that they purchase regularly and observe as they drive past the corner gas station. Unfortunately, this visibility can lead to overreaction in times of rapidly rising gas prices and complacency when gas prices are stable or declining.

A more comprehensive gauge of inflation is the Consumer Price Index (CPI), which is far less volatile and includes a representative group of goods and services commonly purchased by consumers. Figure 2 shows the high-level breakdown for CPI, where gasoline represents less than one third of the Transportation component and only about 5% of the total index. We believe that short-term fluctuations in gas prices are less of a concern for long-term investors than the steadily increasing level of CPI, which erodes the value of their wealth. This negative effect compounds over time and can leave investors with significantly less purchasing power, even if the principal

(Continued on page 2)

Current topic

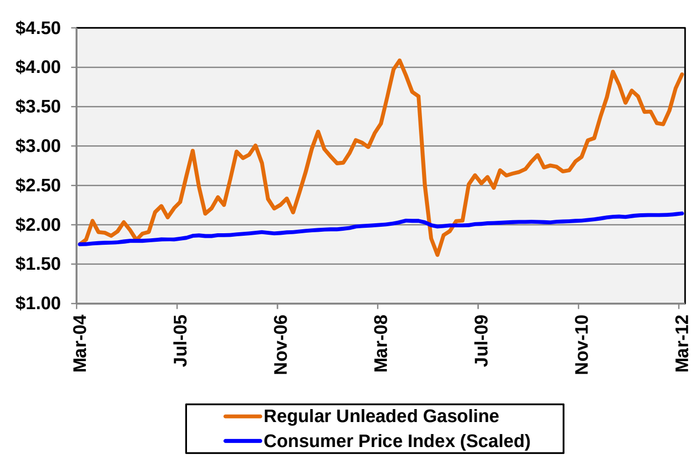
Protecting Wealth Against Inflation

- *Introduction*
- *Losing Principal versus losing Value*
- *Inflation Protected Bonds*
- *Gold*
- *Conclusion*

Strategy

- *We made no strategy changes during the month of March.*
- *Portfolios remain overweight global equity and high yield bond exposure and underweight investment-grade bond exposure.*

Figure 1 - Historical Prices



Sources: Bloomberg, AAA, Bureau of Labor Statistics, Stairway Partners

PROTECTING WEALTH AGAINST INFLATION - CONT'D

value of their portfolio does not change.

In general, investing in assets that produce returns that are higher than inflation will increase the value of a person's wealth over time. The return that an investment produces over and above inflation is known as the ***real return***. Over long time periods, traditional asset classes like stocks, bonds, and even cash will generally produce positive real returns. We showed the long-term effectiveness of these traditional strategies with regard to inflation in the November 2011 *Monthly* – "Is More Conservative Always Safer?"

Over shorter time-periods, where both inflation and the returns for risky assets like equities and are more difficult to predict, many investors turn to alternative strategies in an effort protect themselves from inflation.

Inflation Protected Bonds

Bonds generally do a poor job of protecting investors from unexpected increases in inflation. This is because higher inflation often drives up market yields and depresses bond prices, as investors require additional compensation for the anticipated loss of purchasing power or the potential for the Fed to raise interest rates. In 1997, the US Treasury began issuing a class of bonds that compensate investors for inflation based on changes in CPI. These bonds are known as Treasury Inflation Protected Securities (TIPS). TIPS are unique, in that they are a relatively conservative investment with the potential to act as an effective hedge against broad inflation.

TIPS yields can also be subtracted from nominal Treasury bond yields to derive a market based estimate of future inflation. This difference, which is known as the Break-Even Inflation (BEI), is shown at the bottom of Figure 3. Currently, the market is pricing future inflation between 2 % and 2½ % for the entire maturity spectrum, which is consistent with the Fed's long-term inflation target and our own estimates.

While it is true that TIPS will provide additional compensation to investors for unanticipated inflation, they will not always fully protect them from realized inflation. The top of Figure 3 shows that real yields in the TIPS market are currently negative for maturities of ten years or less. This means that a purchaser of short or intermediate TIPS, who hold the bonds to maturity, will earn a rate of return that is less than inflation, and thus lose purchasing power.

If TIPS are not held to maturity it is also important to remember that TIPS are indeed bonds, and that their market value will decline, if yields rise from today's extraordinarily low levels. As an example, **if the real yield on ten-year TIPS increases from today's -0.2% level to a more normal 2.6% level in three years, investors could expect to lose roughly 10% of their value.**

(Continued on page 3)

Figure 2 - Consumer Price Index Composition

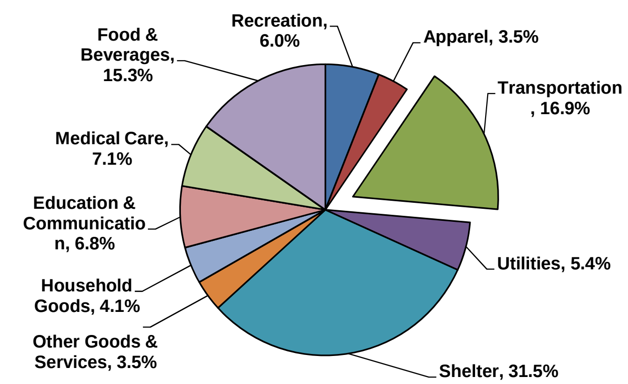
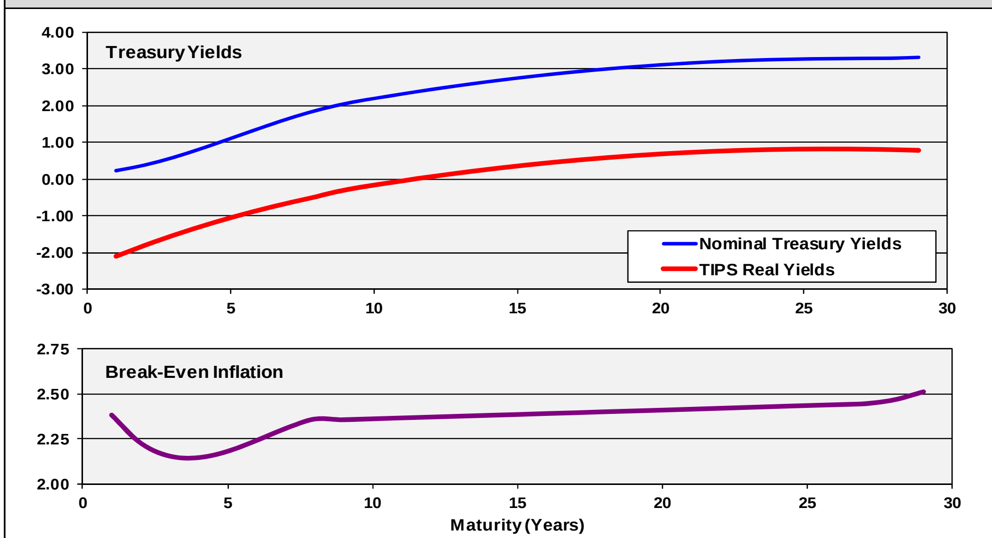


Figure 3 - Inflation Protected Bond Pricing



Sources: Bloomberg, Bureau of Labor Statistics, 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.

(Continued from page 2)

Gold

Another investment that is often thought of as a hedge against inflation is gold. Many investors who are fearful that the Fed will over-stimulate the economy through excessively low rates or other expansive policies also believe that the value of the dollar will fall relative to hard assets, such as gold. This theory has a great deal of intuitive appeal, since gold can be thought of as a currency that cannot be tainted by the politically motivated actions of a non-vigilant central bank.

Unfortunately for investors, the price movements of gold can be far more dramatic than the accumulation of inflation would imply. Figure 4 shows the price of gold relative to a value index that we created using historical inflation. The increase in our value index over time confirms that the price of gold indeed should have increased as inflation eroded the value of the dollar since the early 1970s. The figure also shows that the recent run-up in gold prices far exceeds what can be explained by observed inflation, and that there have been long periods of inflation that were accompanied by falling gold prices. **In fact, during the twenty year period between the end of 1980 and the end of 2000, gold prices fell by 54% while the general level of prices increased by over 50%.**

Some of gold's price volatility can be attributed to the fact that it is impossible to determine how much future inflation is priced into the price of gold. Unlike TIPS, gold lacks an explicit link to inflation and a cash-flow structure that can be compared to comparable securities. The result may be that investors chase gold prices higher when inflation fears rise and liquidate positions at lower prices, when those fears abate.

Conclusion

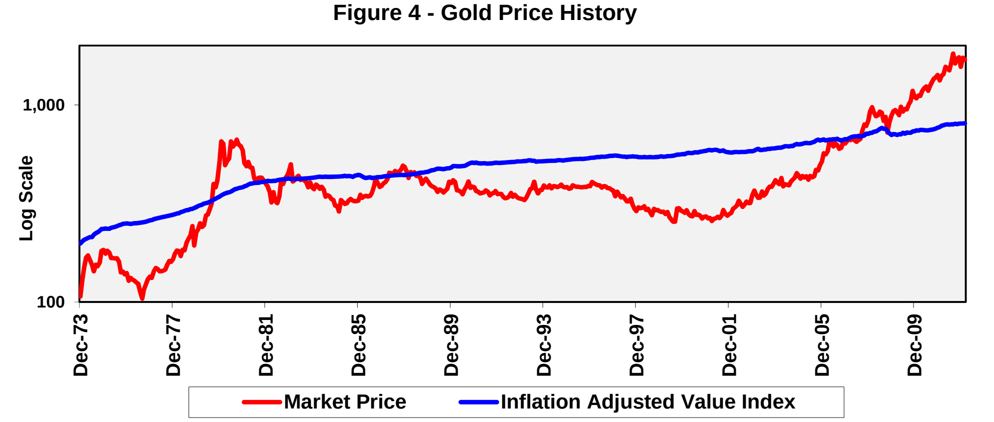
Over time, investors can protect their wealth from the corrosive effects of inflation by investing in assets that produce sufficiently high long-term returns.

TIPS can effectively protect investors from inflation, if real yields are positive and bonds are held until maturity. Unfortunately, much of the TIPS market currently trades with negative real yields, which effectively locks investors into a loss of purchasing power over the life of the bonds. Gold has intuitive appeal, but recent price movements have far exceeded past inflation, and uncertainty around market pricing can lead to results that deviate wildly from expectations.

We believe that the best way to protect one's wealth and to increase the real value of a portfolio over time is to follow a long-term investment strategy, which includes a diversified mix of assets, whose fundamental earnings characteristics compare favorably to long-term inflation.

"THE RECENT RUN-UP IN GOLD PRICES FAR EXCEEDS WHAT CAN BE EXPLAINED BY OBSERVED INFLATION"

Figure 4 - Gold Price History



Sources: Bloomberg, Bureau of Labor Statistics, Stairway Partners

3 Year Annualized Return Estimates for Global Markets

3/30/2012	Total Returns			After-Tax Total Returns		
	Expected	Hurdle	Excess	Expected	Hurdle	Excess
Equities						
United States	**8.0%**	**4.1%**	**3.9%**	**6.8%**	**3.9%**	**2.9%**
Non-US Developed Markets	**16.6%**	**4.6%**	**12.1%**	**14.1%**	**4.4%**	**9.8%**
EMU	23.6%	4.9%	18.6%	20.1%	4.7%	15.3%
UK	23.2%	4.9%	18.4%	19.7%	4.7%	15.0%
Japan	8.6%	5.0%	3.6%	7.3%	4.8%	2.5%
Canada	-4.2%	4.3%	-8.5%	-3.5%	4.2%	-7.7%
Emerging Markets	**16.3%**	**5.8%**	**10.5%**	**13.2%**	**5.6%**	**7.6%**
Fixed Income						
US Aggregate	**-1.1%**	**2.1%**	**-3.3%**	**-1.6%**	**1.9%**	**-3.5%**
US Treasuries						
2 Year	-0.2%	0.9%	-1.0%	-0.5%	0.7%	-1.2%
5 Year	-2.8%	1.4%	-4.1%	-2.8%	1.2%	-4.0%
10 Year	-4.9%	1.9%	-6.8%	-4.7%	1.7%	-6.4%
30 Year	-6.7%	2.0%	-8.7%	-6.2%	1.8%	-8.1%
TIPS						
5 Year	-2.4%	1.4%	-3.8%	-2.5%	1.2%	-3.7%
10 Year	-5.4%	2.0%	-7.3%	-5.1%	1.8%	-6.8%
30 Year	-12.0%	2.3%	-14.3%	-10.5%	2.1%	-12.6%
Municipal	**0.0%**	**1.4%**	**-1.4%**	**0.5%**	**1.3%**	**-0.8%**
2 Year	0.0%	0.8%	-0.7%	0.3%	0.6%	-0.3%
5 Year	-1.6%	1.1%	-2.8%	-1.0%	1.0%	-2.0%
10 Year	-1.7%	1.6%	-3.2%	-0.9%	1.4%	-2.3%
20 Year	1.5%	1.8%	-0.2%	1.9%	1.6%	0.3%
High Yield	**2.3%**	**3.0%**	**-0.7%**	**0.6%**	**2.8%**	**-2.2%**
High Quality High Yield	2.3%	2.2%	0.1%	0.7%	2.0%	-1.3%
Emerging Market ($ demonimnated)	**-0.6%**	**3.2%**	**-3.9%**	**-1.6%**	**3.0%**	**-4.6%**
Foreign Aggregate	**-4.4%**	**3.5%**	**-7.9%**	**-4.2%**	**3.3%**	**-7.5%**
Foreign Aggregate (hedged)	-2.8%	1.8%	-4.6%	-3.1%	1.6%	-4.7%
Foreign Treasury	**-4.4%**	**3.0%**	**-7.4%**	**-4.1%**	**2.9%**	**-6.9%**
Foreign Treasury (hedged)	-3.1%	1.4%	-4.5%	-3.2%	1.2%	-4.4%
Cash	**0.5%**	**0.5%**	**0.0%**	**0.4%**	**0.4%**	**0.0%**
Currency						
Euro	-4.0%	2.3%	-6.3%			
British Pound	-0.9%	2.2%	-3.1%			
Japanese Yen	0.7%	2.4%	-1.8%			
Canadian Dollar	-2.0%	1.4%	-3.5%			

Notes
1. Foreign market returns assume US dollar as the base currency and are unhedged unless otherwise indicated.
2. All hurdle returns are based on long-term asset volatility. Equity and fixed income hurdle rates include expected cash returns.
3. After-tax total returns assume that all gains and losses are long-term and can be realized within the investment horizon.
4. After-tax total returns only take into account Federal taxes based on the following tax rates:
    - 35.0% Ordinary Income, 15.0% Qualified Income, 0.0% Exempt Income, and 15.0% Capital Gains/(Losses)