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MONTHLY

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RETURNS, EARNINGS AND RISK

Introduction

Those who follow our research know we are currently underweight certain risky asset classes in what, to many, is a very healthy market environment. This *Monthly* will help to articulate our views by reviewing historical returns across asset classes, examining the state of the earnings cycle, and observing the level of risk priced in today's market.

Returns

Figure 1 shows the one- and three-year returns across a broad array of asset classes. To provide context, we rank these asset classes using our estimation of their long-term risk, with the less risky asset classes on the left side of the figure and the most risky on the right. Some of our readers may be surprised at just how well the riskiest asset classes have performed over the last several years.

Consistent with past behavior, there are now significant money flows into the asset classes that *have* performed well. One might ask: Where was the insight three years ago before these markets took off? Is it different this time? Or, are investors once again chasing performance?

The Earnings Cycle

As shown, we are now in an environment in which equity markets have generated double digit returns on an annualized basis over the last 3 years. The returns in international equity markets have been the highest, with annualized gains in non-US developed and emerging in excess of 29% and 45%, respectively. This has come about as earnings have improved considerably off the trough

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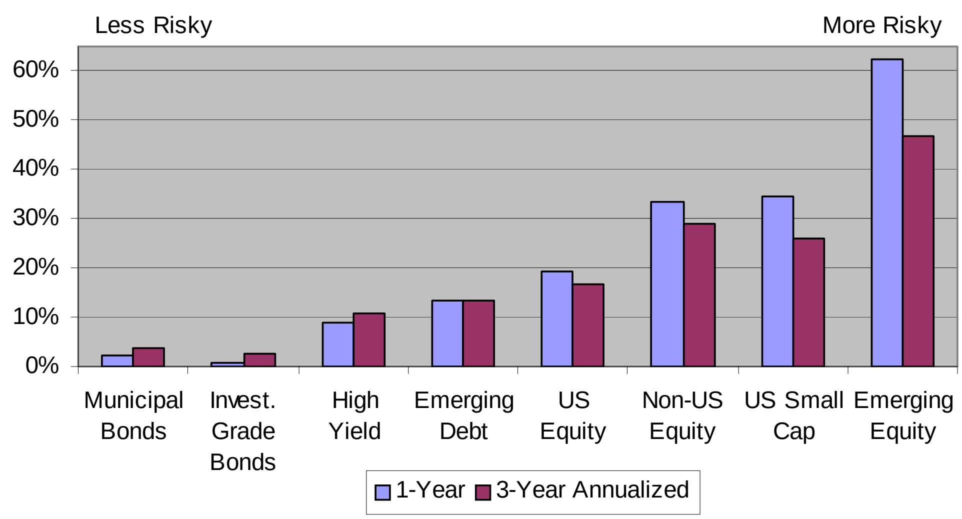
Figure 1: Total Returns



Sources: MSCI, Russell, Lehman, Stairway Partners.
Notes: Periods end 4/30/2006. Non-US and Emerging Equity returns are in US dollars.

CURRENT TOPICS

Returns, Earnings and Risk - A look at some of the factors underpinning our portfolio strategy

- *Introduction*
- *Historical Returns*
- *The Earnings Cycle*
- *Risk*
- *Investment Implications*

STRATEGY CHANGE

In April, we moved interest rate exposure to neutral by adding investment grade bonds in tax-exempt accounts.

"SOME OF OUR READERS MAY BE SURPRISED AT JUST HOW WELL THE RISKIEST ASSET CLASSES HAVE ALREADY PERFORMED"

Returns, Earnings and Risk - cont'd

(Continued from page 1)

earlier in the decade.

Earnings, which are sensitive to the economic cycle, tend to post large increases when an economy is growing above potential. When economic performance is below trend, the opposite is true - earnings become depressed. Over the long run however, earnings growth must parallel economic growth. We discussed this fundamental relationship in our June 2005 *Monthly,* "Market Mania Versus Fundamentals".

As most investors know, the long-term growth and accrual of earnings, and payout of cash to shareholders, are extremely important underpinnings of equity prices. The long-term cash flows associated with earnings and dividends are important inputs in our valuation process.

It is often the case that investors extrapolate good or bad performance based on recent trends in earnings or market prices. Some recent examples: In 1999, earnings growth was very strong but had reached a peak. Investors did not anticipate that earnings and market prices would soon decline. This was followed by a period in 2002 when investors were too pessimistic about earnings and prospects for equity prices. In hindsight, 2002 was a great time to invest into the equity market. The balance of risk and reward was in the investor's favor – earnings were weak but were about to turn around and equity prices were "cheap" relative to their long-term fundamentals.

In Figure 2, we show year-over-year earnings growth for the global equity markets. As mentioned before, earnings growth has been strong since the trough of 2001 - 2002. Other important considerations: 1) the actual peak in earnings growth occurred over a year ago in all of these markets, 2) earnings are still growing at a healthy level, and 3) the actual growth rates are all now very similar.

The data clearly show that earnings outside the US are not growing significantly faster than in the US. In addition, the money flows to non-US markets have occurred largely *after* the peak in growth rates. Lastly, earnings growth may come in slower than expected, disappointing the sanguine forecasts for the non-US markets.

Risk

As you can see in Figure 3, risk - as measured by return volatility - has come down quite a bit in riskier asset classes. This decline in volatility for the riskier assets has been associated with good returns. Bonds, which have had modest returns (less than cash), have seen volatility mostly unchanged.

Over this time frame, the decline in risk has come not only from stable and improving fundamentals but also as a result of other factors. For example, the high yield bond market has not only benefited from historically low default rates, but also from strong demand from derivative structures - collateralized loan (CLO) and debt (CDO) markets. Similarly, investors have poured capital into emerging equities at an unprecedented rate. The highest inflows occurred after the emerging total return index more than tripled from its level of three years ago. Analysts continue to extrapolate

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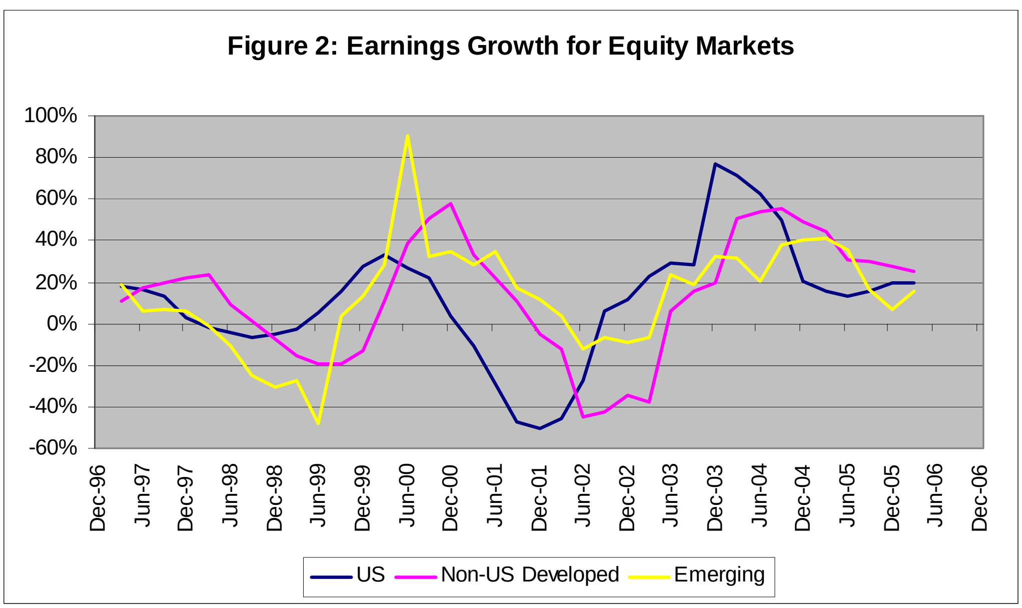


Sources: S&P, MSCI, Stairway Partners
Note: Growth rates are calculated on a year-over-year basis

"THE DATA CLEARLY SHOW THAT EARNINGS OUTSIDE THE US ARE NOT GROWING SIGNIFICANTLY FASTER THAN IN THE US"

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.

very high growth rates in emerging countries. Some even suggest that emerging markets are less risky than the US and other developed markets, justifying even higher valuations.

One other notion illustrated in Figure 3 is that risk has compressed across asset classes. In other words, investors in the riskiest classes have experienced declining risk relative to investment grade bonds.

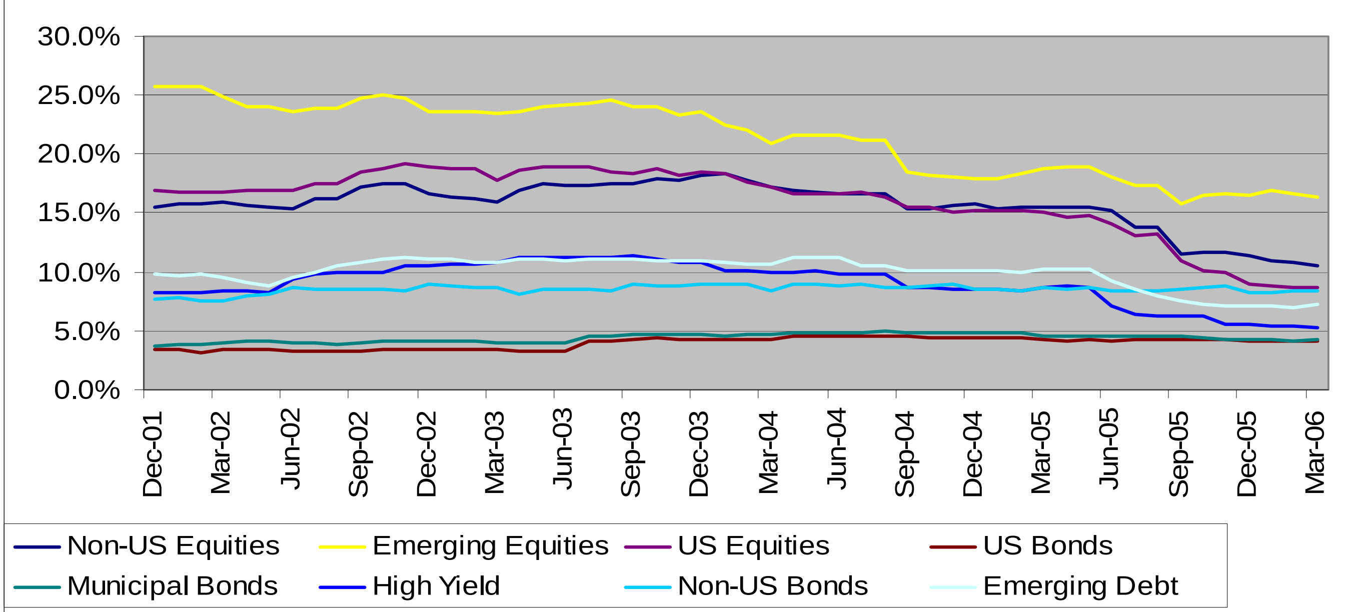
This comes at a time when interest rates have backed up and the prospective return on bonds has improved considerably. In our view, this argues for a strategy that favors bonds, a lower-risk asset, over the riskier asset classes that are priced much higher than they were three years ago.

Investment Implications

As a result of the outsized recent performance and prices already discounting great fundamentals, we believe that the risk reward tradeoff is now asymmetrically skewed to the downside for many of the riskier asset classes.

It is often the case that the causes of markets performing well make them less likely to do well in the future. This is because many positive aspects are already priced in and upside surprises become less probable. The same investors who are extrapolating low risk and great earnings, and are already overweight these asset classes, may be disappointed when things are not going their way. Any heightened awareness of risk or disappointment in the fundamental prospects could have many heading for the door at the same time. It is for this reason that, across portfolios, we are somewhat underweighted the riskier asset classes and have moved allocations into bonds.

Figure 3: Rolling 36-Month Volatility



Sources: MSCI, Russell, Lehman, Stairway Partners
Note: Volatility is calculated as the annualized standard deviation of the monthly returns on a rolling 36-month basis.

Strategy

Asset Class	Expected Return	Hurdle Return	Strategy	Comment
Equities			small under	
US	4.9%	8.3%	neutral	Exposure equal to normal portfolio weighting
Non-US Developed			small under	Remains unattractive relative to US market
Eurozone	0.6%	7.0%		
Japan	-10.5%	4.3%		
UK	4.6%	8.2%		
Emerging	-1.6%	11.6%	under	Asset class inadequately pricing risk
Fixed Income				
US Treasury Bonds			under	Sector is fairly priced except at the longest maturities
2-Year	4.9%	4.7%		
5-Year	5.0%	4.9%		
10-Year	5.0%	5.2%		
30-Year	4.7%	5.3%		
US Municipal Bonds			neutral	Sector is fairly priced
2-Year	3.6%	3.4%		
5-Year	3.9%	3.6%		
10-Year	4.5%	3.9%		
30-Year	7.7%	4.4%		
US High Yield	4.7%	6.8%	under	Spreads over US Treasuries remain too tight
Non-US Government Bonds			under	Yields generally insufficient compensation for risk
Euro 10-Year	2.8%	4.5%		
Japan 10-Year	1.1%	2.2%		
UK 10-Year	3.6%	5.1%		
Emerging Markets Debt	3.8%	7.0%	under	Spreads over US Treasuries remain too tight
Cash	4.6%	---	over	Allocation comes from overpriced asset classes

Currencies	Expected FX Change	Equity Return with Currency	10-Year Bond Return with Currency	
Euro	-2.8%	-2.2%	0.0%	Close to fair value
Japanese yen	4.0%	-6.5%	5.1%	Yen is slightly attractive
UK pound	-3.7%	0.9%	-0.1%	Close to fair value

Notes: **As of: 4/30/2006**

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.

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