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AGAINST THE GRAIN

Introduction

Our investment process is based on assessing the long-term fundamentals that drive each asset class. However, fundamentals are much slower-moving than prices are, so assets can become over-priced or under-priced as investors and traders turn overly optimistic or pessimistic relative to these underlying drivers.

This month, we look at our fundamental assessment of the US equity market since the start of last year and discuss how that, combined with changing stock prices, led us to move portfolios from under-exposed to an overweight allocation earlier this year. We also note that equity strategy in Stairway portfolios ended up moving in the opposite direction from the allocation changes made by the typical investor who once again bought high and sold low.

Observations

We have, in the past, shown charts like Figure 1 which compares the level of the stock market to the VIX volatility index. The VIX is a measure of how much risk investors perceive to be in the stock market. Essentially, Figure 1 shows that this is an inverse relationship - the stock market advances when investors perceive risk to be low. Conversely, the market tends to drop sharply concurrent with increases in the VIX. As an example, the period from September 2007 to March of this year was one in which the VIX was elevated and trending higher. Consistent with past behavior, stocks fell over this higher risk period.

Why does this pattern occur? Investors tend to "pay up" when the financial and economic environment looks good – risk is low, growth prospects appear bright, and returns have been good. Conversely, they become unwilling to invest when the environment appears darker and risk seems high, despite lower prices. People tend to extrapolate the current situa-

(Continued on page 2)

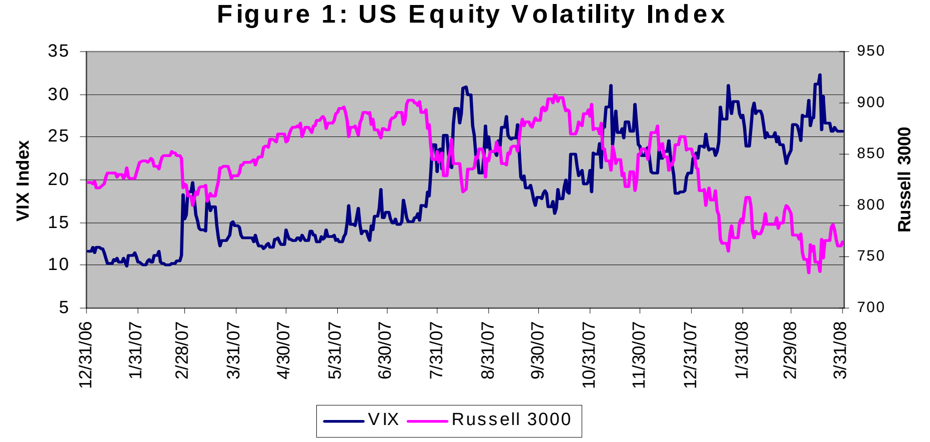
CURRENT TOPIC

Against the Grain

STRATEGY

- *We made no strategy changes in the month of April*
- *Equity and high-yield bond markets have improved dramatically since we increased exposure*

Figure 1: US Equity Volatility Index



Sources: Russell, Bloomberg

"PEOPLE TEND TO EXTRAPOLATE THE CURRENT SITUATION WITHOUT FULLY ACCOUNTING FOR THE FACT THAT TRENDS DON'T LAST FOREVER"

AGAINST THE GRAIN - CONT'D

(Continued from page 1)

tion without fully accounting for the fact that trends don't last forever.

Follow the Leader

This observation on behavior can be verified by looking at how people actually allocate their money. Using data from the Investment Company Institute (ICI), which is a mutual fund trade group, Figure 2 shows net purchases and sales of equity mutual funds. During the early part of 2007, while equity markets were doing well, investors were adding to their stock holdings. Then, in August, as the equity market started to decline, investors began pulling money out of equity funds. As the equity market recovered in September and made a new high in October, investors bought back into stocks.

More recently, when stocks took a beating in January, large amounts of equity mutual funds were liquidated. This occurred in the month when the stock market's performance was the worst and prices were at their lowest level in quite a while.

Examining stock market pricing and investor purchases and sales, we clearly see investors' tendency to buy high and sell low repeated once again.

This behavior was highlighted in recent articles in the Financial Times (April 28, 2008), discussing the substantial amounts of money that investors pulled out of equity mutual funds in the first quarter of this year.

Against the Flow

We approach investment decision-making from a different angle than the typical investor who chases returns. Instead, we base our assessments on long-term funda-

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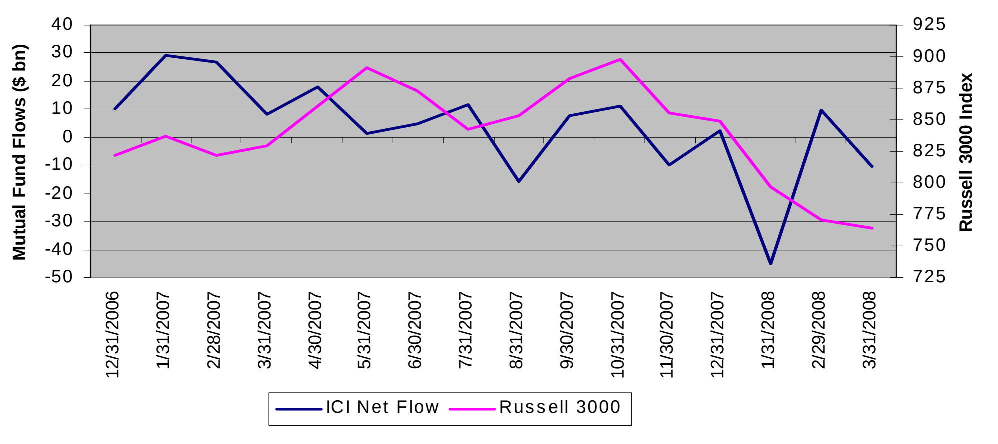
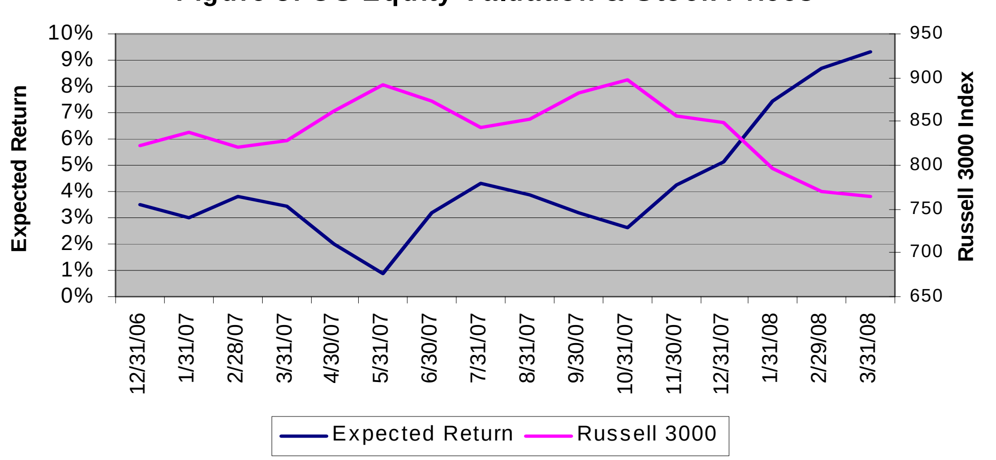
Figure 2: Equity Fund Net Flows & Stock Prices



Sources: Investment Company Institute, Russell, Stairway Partners

Figure 3: US Equity Valuation & Stock Prices



Sources: Russell, Stairway Partners

"EXAMINING STOCK MARKET PRICING AND INVESTOR PURCHASES AND SALES, WE CLEARLY SEE INVESTORS' TENDENCY TO BUY HIGH AND SELL LOW REPEATED ONCE AGAIN"

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"AS PRICES ROSE OUR RETURN EXPECTATIONS WORSENED, AND AS PRICES DECLINED OUR RETURN EXPECTATIONS IMPROVED"

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.

mentals. For instance, the fair value we derive for the US equity market is based in part on our evaluation of the long-term trend in earnings. However, market prices are much more volatile, changing as investor sentiment and psychology change. So, with prices more volatile than fundamentals and fair value, the attractiveness of the stock market will change over time.

If prices drop, we find equities more attractive – buying at a lower price implies a higher return, since the long-run cash flows to the investor haven't necessarily changed. If prices rise sharply, we find the stock market less attractive, since investors are paying more for something that's "worth" the same. Figure 3 shows a history of our expectations for US equity market returns compared to the Russell 3000 index. It is clear that as prices rose our return expectations worsened, and as prices declined our return expectations improved.

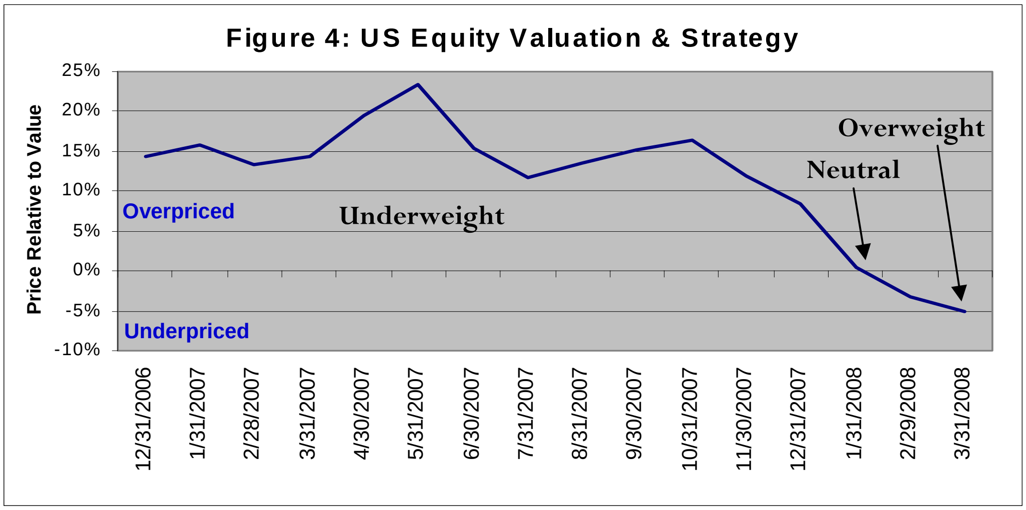
Translating to strategy

This kind of long-term anchoring leads us to strategy changes that are the opposite of typical behavior. Instead of buying high and selling low, we tend to reduce exposure as prices move up and increase exposure as prices fall. Some have referred to this type of behavior as "contrarian".

Figure 4 shows the evolution of our valuation model output from the start of 2007. Rather than showing return expectations, here we show a comparison of market price against our assessment of fair value. When price was greater than fair value, the equity market was unattractive (overpriced) and investors were paying too much. When price was below fair value, the opposite is true – equities were attractive (underpriced). As the figure shows, we maintained an underweight position in US equities while the market was overpriced, moved portfolios to neutral allocation (benchmark weight) as prices reached fair value in January of this year, and then moved to a small overweight as the equity market moved into an underpriced situation.

Conclusion

Market prices are considerably more volatile than fundamentals are. Many investors lack a solid foundation with which to make investment decisions, so are left buying or selling as their fears are allayed or stoked. The foundation of our process is built on using long-term fundamentals to set a fair value anchor. This ultimately leads us to buy as prices fall and sell as prices rise. While this may be uncomfortable to some, we believe that this approach produces strategy changes and portfolios that will perform well over the long term.



Source: Stairway Partners

"We maintained an underweight position in US equities while the market was overpriced"

Strategy

Asset Class	Expected Return	Hurdle Return	Strategy Exposure	Comment
Equities				
US	7.6%	7.2%	small over	Exposure slightly above benchmark weight
Non-US Developed			small under	Asset class fairly priced as markets have fallen
Eurozone	8.0%	7.9%		
Japan	-0.3%	4.6%		
UK	9.6%	8.7%		
Emerging	-5.7%	11.5%	under	Asset class remains expensive
Fixed Income				
US Treasury Bonds			neutral	Non-Treasury sectors more attractively priced
2-Year	2.0%	3.4%		
5-Year	1.9%	4.0%		
10-Year	2.0%	4.5%		
30-Year	2.1%	5.0%		
US Municipal Bonds			neutral	Sector overall is near fair value
2-Year	2.5%	2.9%		
5-Year	2.9%	3.3%		
10-Year	3.9%	3.8%		
30-Year	7.9%	4.4%		
US High Yield	8.0%	5.6%	neutral	Sector is pricing for deteriorating fundamentals
Non-US Government Bonds			under	Yields too low, especially at longer maturities
Euro 10-Year	3.3%	4.6%		
Japan 10-Year	0.5%	2.0%		
UK 10-Year	3.7%	5.1%		
Emerging Markets Debt	2.6%	5.9%	under	Spreads over US Treasuries remain too tight
Cash	3.7%	---	over	Allocation comes from overpriced asset classes

Currencies	Expected FX Change	Equity Return with Currency	10-Year Bond Return with Currency	
Euro	-9.5%	-1.4%	-6.1%	Euro is expensive
Japanese yen	1.7%	1.4%	2.2%	Yen is close to fair value
UK pound	-5.3%	4.3%	-1.6%	Pound is expensive

Notes: **As of: April 30, 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.