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DIVERSIFICATION HASN'T FAILED

Introduction

Many people have been taught that diversification – broadening their mix of assets to reduce concentration and risk – is a fundamental principle of investing. However, the past two years have put this to the test, so much so that the received wisdom is that diversification has failed. Many cite the "fact" that everything dropped last year. The declines in prices have led to the further belief that all assets become perfectly correlated in a down market. Even hedge funds and private equity didn't live up to expectations.

So diversification's protection against losses evaporated when it was most needed. But is this really the case?

Background

Figure 1 shows the performance of major asset classes in 2008. Clearly, the experience last year was *almost* uniformly negative, with equity asset classes sustaining losses of 35-55%. Emerging market debt and high yield bonds also showed very heavy losses (15-25%) for the year. Even municipal bonds lost money. However, taxable investment-grade bonds turned in a good positive return in 2008, due in large part to the substantial positive performance of Treasury bonds.

In response to these developments, many investors have fled to cash and Treasury bonds. In doing so, they have made an explicit trade-off: they are reducing their exposure to riskier assets – typically *after* sustaining big losses – but this means that they are giving up the possible benefits of diversification, plus any gains that might be produced in the future by the eliminated assets. For example, in moving out of equities and into Treasury bonds, investors gave up the opportunity

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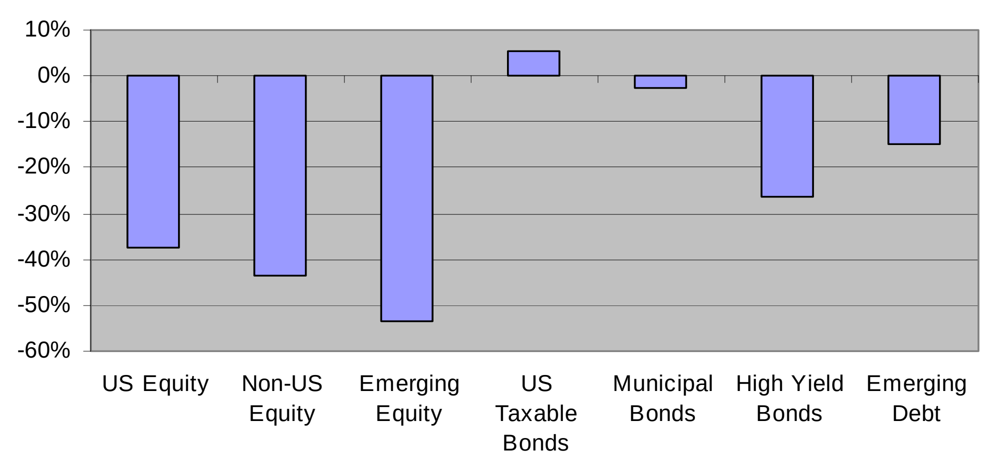
Figure 1: Asset Class Returns - 2008



Sources: Russell, MSCI, Barclays, Stairway Partners

CURRENT TOPIC

Strategy

- *We made no strategy changes during the month of April*
- *Portfolio strategies remain overweight equity markets and high yield bonds*

"CLEARLY, THE EXPERIENCE LAST YEAR WAS ALMOST UNIFORMLY NEGATIVE, WITH EQUITY ASSET CLASSES SUSTAINING LOSSES OF 35-55%"

DIVERSIFICATION HASN'T FAILED - CONT'D

to participate in the equity market recovery of the last two months. In addition, they are more exposed to the risk of rising bond yields in the future.

So, does the poor performance across most asset classes mean that the advice to diversify is wrong or that the model is "broken"? We would answer "no" but with some qualifications.

Diversification does not mean that different assets will necessarily move opposite to one another, although they may do so at times. Instead, it is the notion that different assets will not always move *in lockstep* with one another. In other words, the correlation between the assets is not perfect; it is less than 1.0. If two assets don't move together perfectly, the risk of a portfolio is less than the weighted average of the constituent assets' risks.

2008 Analyzed

If we examine some of the monthly returns, it is apparent that there were in fact diversifying effects last year. Figure 2 shows returns in the broad asset classes each month last year. It is apparent that performance in September and October was negative across the board. The resulting concern with diversification's effectiveness is understandable, as many people tend to focus on these short time frames when making judgments about the success of their investment programs. However, Figure 2 also shows that, immediately prior to this, August was a *positive* return month for US equities and bond asset classes while other equities were negative. Also, in March and July, for instance, bonds were positive while equities sustained losses.

By computing the correlation of the returns in each asset class last year, we produce the standard correlation matrix shown in Figure 3. Note that the correlations between investment-grade bonds and stocks remained low - the small, positive numbers highlighted in yellow.

Diversification Worked

The reason we and many others advocate diversified, multi-asset portfolios is to improve portfolio risk-return characteristics and minimize the problems of being wrong with concentrated or single-asset portfolios.

The following example will illustrate the benefits of diversification. Consider a simple balanced portfolio: 60% US equities and 40% municipal bonds. The risks

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Figure 2: Monthly Asset Class Returns - 2008

	Jan	Feb	Mar	Apr	May	Jun	Jul	Aug	Sep	Oct	Nov	Dec
US Equity	-6.1%	-3.1%	-0.6%	5.0%	2.0%	-8.3%	-0.8%	1.6%	-9.4%	-17.7%	-7.9%	1.9%
Non-US Equity	-9.2%	1.4%	-1.1%	5.4%	1.0%	-8.2%	-3.2%	-4.1%	-14.5%	-20.2%	-5.4%	6.0%
Emerging Equity	-12.5%	7.4%	-5.3%	8.1%	1.9%	-10.0%	-3.8%	-8.0%	-17.5%	-27.4%	-7.5%	7.8%
US Taxable Bonds	1.7%	0.1%	0.3%	-0.2%	-0.7%	-0.1%	-0.1%	0.9%	-1.3%	-2.4%	3.3%	3.7%
Municipal Bonds	1.3%	-4.6%	2.9%	1.2%	0.6%	-1.1%	0.4%	1.2%	-4.7%	-1.0%	0.3%	1.5%
High Yield Bonds	-1.3%	-1.4%	-0.3%	4.3%	0.4%	-2.8%	-1.3%	0.4%	-8.0%	-15.9%	-9.3%	7.7%
Emerging Debt	0.6%	-0.2%	-0.2%	1.2%	0.4%	-2.0%	0.7%	0.5%	-6.9%	-19.5%	3.6%	8.7%

"THE CORRELATIONS BETWEEN INVESTMENT-GRADE BONDS AND STOCKS REMAINED LOW - THE SMALL, POSITIVE NUMBERS HIGHLIGHTED IN YELLOW"

Figure 3: Asset Class Correlations - 2008

	US Equity	Non-US Equity	Emerging Equity	US Taxable Bonds	Municipal Bonds	High Yield Bonds	Emerging Debt
US Equity	1.00	0.91	0.85	0.35	0.47	0.91	0.77
Non-US Equity	0.91	1.00	0.98	0.49	0.37	0.88	0.83
Emerging Equity	0.85	0.98	1.00	0.43	0.19	0.84	0.79
US Taxable Bonds	0.35	0.49	0.43	1.00	0.42	0.46	0.81
Municipal Bonds	0.47	0.37	0.19	0.42	1.00	0.43	0.40
High Yield Bonds	0.91	0.88	0.84	0.46	0.43	1.00	0.81
Emerging Debt	0.77	0.83	0.79	0.81	0.40	0.81	1.00

Sources: Russell, MSCI, Barclays, Stairway Partners

Note: Correlations based on monthly returns

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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experienced in various asset classes during 2008 are shown in Figure 4. US equities (Russell 3000) and municipal bonds (Barclays municipal index) had risks of 22.4% and 8.1%, respectively. Taking a 60/40 weighted average of the two asset class risks gives a portfolio risk of 16.7%. But, because bonds and stocks didn't move perfectly together, the actual risk of the balanced portfolio was around 1.5 percentage points lower – a small, but effective reduction in risk. (Note that our July 2008 *Monthly* described how diversification can never work in the opposite direction: risk cannot be increased beyond the weighted average of the assets' risks.)

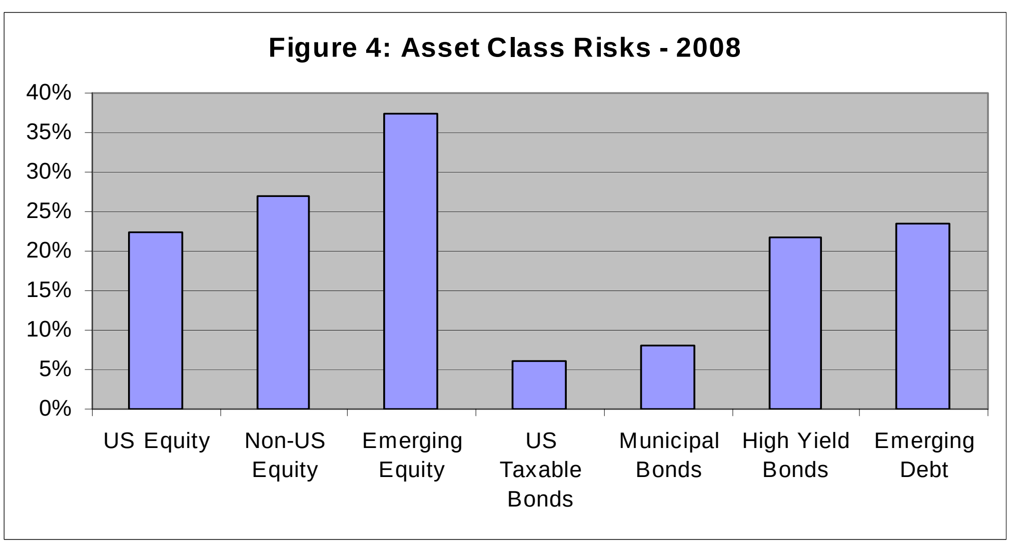
There is, in addition, an even bigger issue: we are firm believers in the usefulness of bonds in portfolios because they act as diversifying assets and provide downside protection. An all-stock portfolio would have produced enormous pain last year, easily losing 40% or more of its value in just 12 months (depending on the exposure to non-US, emerging markets, financials, etc.). Although municipal bonds were hurt by the financial markets crisis, they did provide portfolios with protection from the full brunt of the equity market problems. Rather than losing nearly 40% in US equities, a 60/40 mix would have been down less than 25%.

Of course, the opposite is also true: in a rising equity market, bonds will create a "drag" on performance, since there won't be full participation in the stock gains. But, taking both kinds of market environments into account, the diversified portfolio enhances the risk-return characteristics.

Summary

Many investors took their experiences in last year's financial market environment to mean that diversification is a failure, that this principle of investing is broken and should be discarded. We disagree: even with most asset classes showing losses, diversification still worked. It continued to provide risk-reducing benefits to portfolios.

Diversification did not keep portfolios from experiencing losses. But, elimination of risk is not possible by diversifying. It is likely the case that many investors misunderstood how diversification works and the magnitude of its benefits.



"EVEN WITH MOST ASSET CLASSES SHOWING LOSSES, DIVERSIFICATION STILL WORKED. IT CONTINUED TO PROVIDE RISK-REDUCING BENEFITS TO PORTFOLIOS"

Sources: Russell, MSCI, Barclays, Stairway Partners

Note: Risk is annualized standard deviation of monthly returns

Strategy

Asset Class	Expected Return	Hurdle Return	Strategy Exposure	Comment
Equities				
US	26.1%	5.9%	over	Exposure above benchmark weight due to attractive pricing
Non-US Developed			over	Asset class remains attractive despite recent rally
Eurozone	29.5%	6.1%		
Japan	19.1%	4.4%		
UK	25.0%	6.3%		
Emerging	17.9%	10.8%	neutral	Asset class is attractive but developed equities price better
Fixed Income				
US Treasury Bonds			under	Treasuries expensive, but non-Treasury are more attractive
2-Year	0.6%	2.8%		
5-Year	0.5%	3.5%		
10-Year	0.8%	4.2%		
30-Year	0.5%	4.7%		
US Municipal Bonds			under	In most maturities municipal bonds are modestly overpriced
2-Year	1.1%	2.3%		
5-Year	1.4%	2.9%		
10-Year	2.8%	3.6%		
30-Year	8.7%	4.5%		
US High Yield	17.0%	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	1.3%	4.1%		
Japan 10-Year	-0.1%	1.9%		
UK 10-Year	1.1%	4.5%		
Emerging Markets Debt	5.8%	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%	23.9%	-4.3%	Euro is moderately overpriced
Japanese yen	-0.5%	18.6%	-0.6%	Yen is close to fair value
UK pound	2.4%	27.4%	3.5%	Pound is slightly underpriced

Notes: **As of: April 30, 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.