STAIRWAY PARTNERS, LLC

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

# MONTHLY

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## CURRENT TOPICS

*Market Mania*

- *2005 Consensus Forecast*
- *Pricing vs. Fundamentals*
- *Equities: A case in point*
- *Investment Implications*

*Expected Returns & Strategies*

- *Dollar strength moved currencies towards fair value*
- *High Yield added to portfolios after spreads widened*
- *Equities rally - sector slightly overvalued*

*Web site Update*

- *Overview on page 3*

# MARKET MANIA VERSUS FUNDAMENTALS

### Introduction

2005 has proved to be an interesting year for market participants. At the beginning of the year, consensus called for stocks to outperform bonds, foreign currencies to appreciate further versus the US dollar, and inflation expectations to increase.

Figure 1 shows the changes that have occurred since January 1st. As you can see, in all cases the opposite has occurred relative to consensus expectations. Bonds have soundly beaten stocks, foreign currencies weakened considerably versus the dollar, and inflation expectations (the difference between 10-year Treasury bonds and Treasury Inflation Protected Securities) have actually fallen, despite the run-up in oil and other commodities. Markets seem to consistently test the consensus view and punish the herd.

It is interesting to note that the consensus view at the start of 2005 looked like the best performers from the fourth quarter of 2004 (Figure 2). This type of behavior, extrapolating what has done well, is quite common. In August 2004, we wrote a research piece, titled "The Case for Disciplined Investing—Don't run with the herd", that observes momentum behavior and illustrates the punishing effects of consensus investing.

### Background

Financial markets tend to move around quite a bit. Some of this volatility can be attributed to normal economic cyclicality, such as changes in growth or inflation. But a well known maxim in investing is "prices are more volatile than fundamentals".

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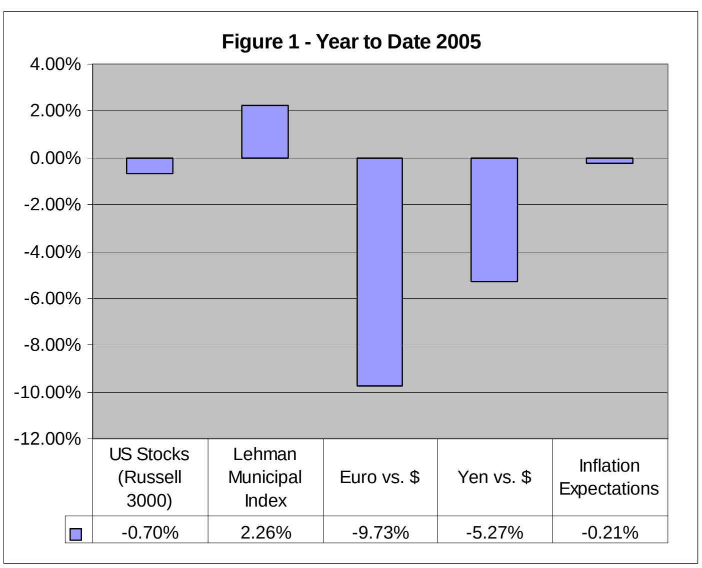
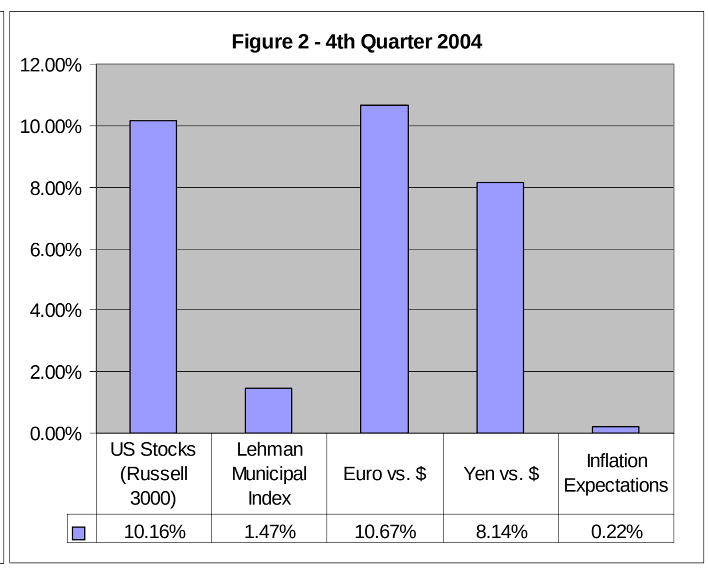
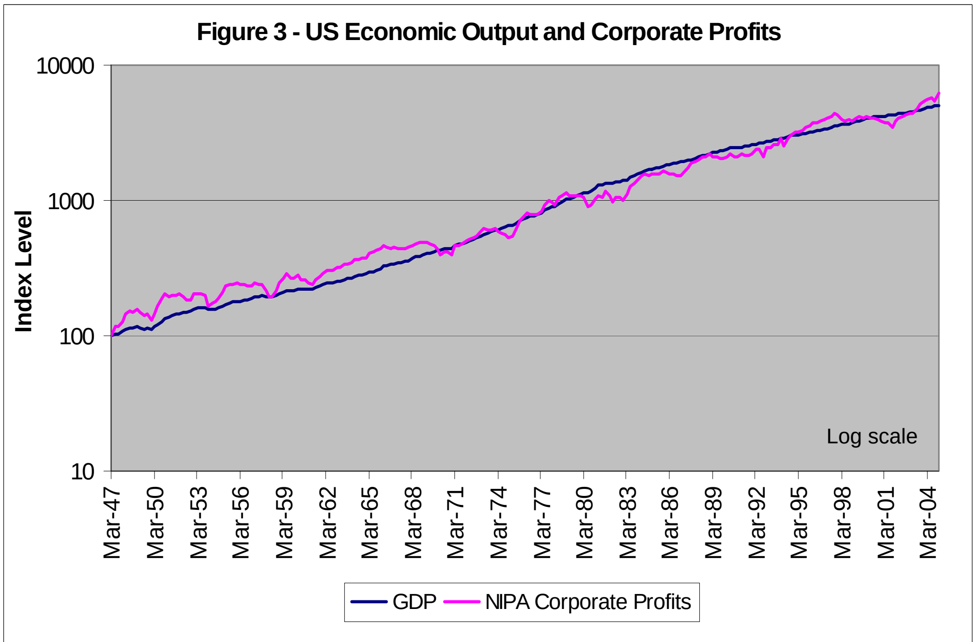


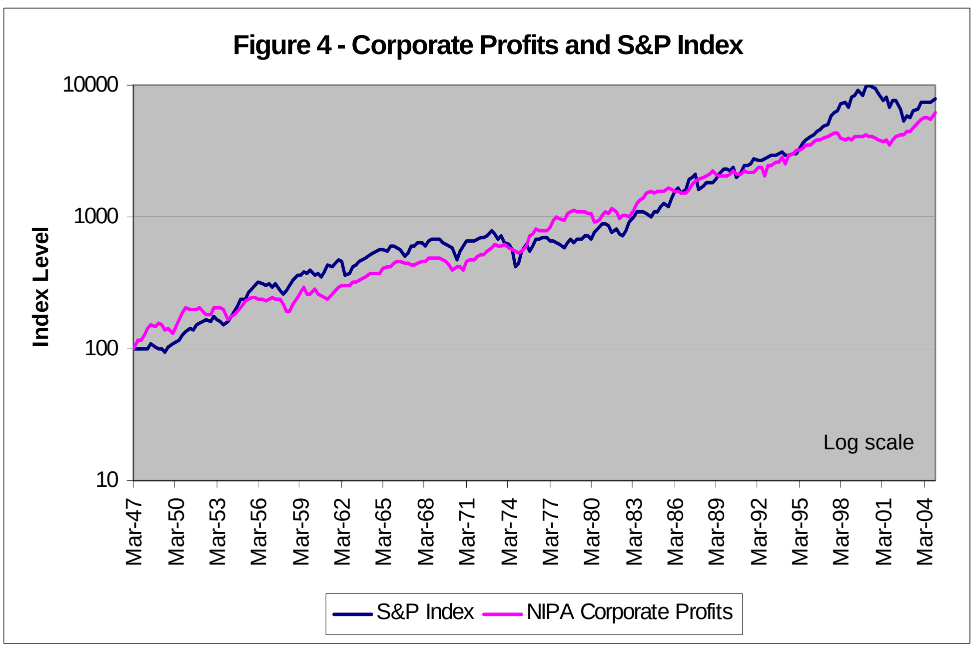

Sources: Russell, Lehman Brothers, Bloomberg, Stairway Partners Note: Figure 1 data through 5/31/2005

# MARKET MANIA VERSUS FUNDAMENTALS - CONT'D.




<u>Observations</u>

- US economic growth has been stable over time
- Corporate profits have grown at the same rate as GDP
- However, corporate profits are more volatile




- S&P Index is the most volatile of the three series
- But over the long run, the S&P Index has grown at the same rate as corporate profits (note how close the ending index values are)
- Largest divergence between prices and fundamentals occurred during the stock market bubble of the late 90s

Sources: Bureau of Economic Analysis, Standard & Poor's, Haver Analytics, Stairway Partners

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To illustrate this point, we look at three series: US economic output, corporate profits and the S&P 500 Index dating back to 1947. Each of these data series is indexed to 100 at the start of the time period to facilitate comparisons over the full term. Figure 3 shows that US nominal GDP growth has been stable over time. Corporate profits (NIPA), which have grown at the same rate, are slightly more volatile. Figure 4 shows that equity prices, as evidenced by the S&P Index, are the most volatile series of the three but still match the growth in economic output and earnings. It is interesting to note that the largest divergence between prices and fundamentals (profits) occurred during the equity bubble in the late 1990s.

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## 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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STRATEGY CHANGE: IN EARLY MAY, AFTER SPREADS WIDENED OUT SIGNIFICANTLY IN THE HIGH YIELD SECTOR, WE REDUCED OUR UNDERWEIGHT BY HALF. THIS INTRODUCED HIGH YIELD EXPOSURE ACROSS OUR CLIENT PORTFOLIOS.

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**Why Does This Happen?**

We believe the reason for such behavior is that investors disproportionately weight near-term news and are not sufficiently grounded in longer-term fundamentals.

A good example is the equity market, which at the start of 2005 was a favored asset class and was an overweight in most strategist models.

As commodity prices surged and economic releases suggested slower growth than consensus, economists lowered their near-term economic forecasts causing the stock market to question near-term earnings prospects. This led to a decline in equity prices, leaving the Russell 3000 down 5.7% through April 20th (low for year).

Recently, commodity prices have declined and economic data reverted back to show trend growth, resulting in economists flipping their near-term forecasts, and equity prices moving substantially higher.

Had long-term fundamentals really changed? Or was the decline in equities simply an over-reaction that made their prices more attractive?

**Investment Implications**

Prices should be properly viewed against the long-term fundamentals for any asset class. Our earlier illustration showed how corporate profits trend over time at the same rate as economic growth. The phenomenon of prices moving around more than fundamentals provides opportunity to the disciplined investor. A successful investment process requires that decisions not be influenced by consensus views or near-term market events. Furthermore, a disciplined long-term fundamental approach keeps investors from being swayed by the herd mentality.

### *Client Web Site Updates*

*Research Library has 2 new tabs*

- *Strategy Changes*
    - *Listed chronologically*
    - *Complete rationale*
- *Performance Summaries*
    - *General review each month of market and portfolio performance*

*Market Information*

- *Non-US government 10-year bonds have been added to Strategy page*
    - *Expected Returns*
    - *Hurdle Returns*

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## Strategy

| Asset Class | Expected Return | Hurdle Return | Strategy | Comment |
|---|---|---|---|---|
| **Equities** | | | | |
| US | 5.4% | 7.3% | neutral | Slightly overvalued but strategy still neutral |
| Non-US Developed | | | | Some markets slightly attractive, but offset by unattractive currency |
| Eurozone | 5.9% | 6.7% | neutral | |
| Japan | 1.1% | 4.3% | neutral | |
| UK | 9.0% | 8.4% | neutral | |
| Emerging | 10.0% | 12.4% | neutral | Emerging equity close to fair value |
| **Fixed Income** | | | | |
| US Treasury Bonds | | | under | Real rates remain too low |
| 2-Year | 3.4% | 4.0% | | |
| 5-Year | 3.1% | 4.3% | | |
| 10-Year | 2.5% | 4.6% | | |
| 25-Year | 1.9% | 4.9% | | |
| US Municipal Bonds | | | neutral | Sector has moved to slightly overpriced |
| 2-Year | 2.7% | 3.0% | | |
| 5-Year | 2.8% | 3.3% | | |
| 10-Year | 3.3% | 3.7% | | |
| 25-Year | 5.6% | 4.2% | | |
| US High Yield | 4.6% | 5.8% | under | Market stabilized after GM & Ford downgrades |
| Non-US Goverment Bonds | | | under | Yields generally insufficient compensation for risk |
| Euro 10-Year | 1.0% | 4.1% | | |
| Japan 10-Year | -0.8% | 1.8% | | |
| UK 10-Year | 2.9% | 4.9% | | |
| Emerging Markets Debt | 3.9% | 6.0% | under | Spreads over US Treasuries remain too tight |
| Cash | 3.8% | --- | over | Allocation comes from overpriced asset classes |

| Currencies | Expected Return | Equity Return with Currency | 10-Year Bond Return with Currency | US dollar strength has moved currencies closer to fair value |
|---|---|---|---|---|
| Euro | -1.7% | 4.2% | -0.6% | |
| Japanese yen | 2.7% | 3.8% | 1.9% | |
| UK pound | -3.2% | 5.8% | -0.3% | |

**Notes:** **As of: 5/31/2005**

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.