

# MONTHLY

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## MARKET VALUATION AND STRATEGY

### Introduction

A fundamental aspect of investment decision-making involves weighing the potential risk against the potential for return. Different firms have different approaches to thinking about the relationship between risk and return. Some are very ad hoc, relying more on intuition. Others employ highly quantitative investment models. At Stairway Partners, our approach is to develop return expectations based on long-term fundamentals. In this *Monthly*, we will discuss how we develop our return expectations and how those are translated into strategy decisions.

### Our Process

It is difficult to consistently forecast where markets are going in the near term. Rather than trying to forecast direction, our investment process involves estimating a fair value for each market or asset class. We then use this fair value to determine what the market's "tendency" will be over time. If the market is overpriced, it may continue getting more expensive – but in the end, we would expect its price to revert back towards the level supported by its overall fundamentals. This reversion is what makes the expected return on an overpriced asset unattractive or

an underpriced asset attractive.

Many readers are already familiar with the process we use: discounted cash flow analysis (Figure 1). This approach is widely used in valuing various types of assets across a number of disciplines – project evaluation, corporate finance, and portfolio management. The discounted cash flow approach entails evaluating the future stream of cash flows accruing to the investor, and discounting it back to the present using an appropriate discount rate. The discount rate is commensurate with the level of risk for the asset

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### CURRENT TOPICS

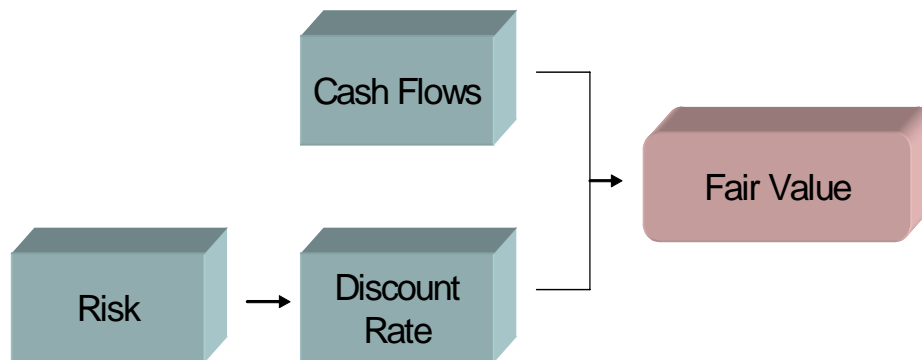
#### Market Valuation & Strategy

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#### STRATEGY

Strategy was unchanged in May. Portfolios remain underweight riskier asset classes: a small underweight in US equities, larger underweights to non-US equities, and no exposure to high yield and emerging debt.

Figure 1: Estimating Fair Value



“THE DISCOUNT RATE IS COMMENSURATE WITH THE LEVEL OF RISK FOR THE ASSET CLASS; THE HIGHER THE RISK, THE GREATER THE DISCOUNT RATE”

## MARKET VALUATION AND STRATEGY - CONT'D

class; the higher the risk, the greater the discount rate. We can then compare this present value with the current market price to make an assessment as to the asset's attractiveness—whether it is overpriced or underpriced. Because we can use this approach consistently across all asset classes, it provides us with a means to view the attractiveness of asset classes, not only on an absolute basis, but relative to each other as well.

We find that other approaches, such as the “Fed model” or the commonly-used Price/Earnings model (P/E), may provide some information on relative pricing, but do not help us think about whether all assets might be expensive or cheap. For example, the P/E model can provide poor signals when earnings are very high or low relative to their trend. At the end of 2001 and in early 2002, the P/E on the S&P 500 Index was high, meaning that investors were “paying a lot” for stocks. However, it was high because earnings had

taken a big hit, not because prices were elevated. So, instead of being expensive as you would assume from the high P/E, the US equity market was instead fairly cheap and was about to take off on its current 5-year bull run. Conversely, using P/E as a valuation metric has a tendency to make the stock market look “cheap” when earnings are at a peak.

### Hypothetical Example

Translating our market expectations to specific strategy positions is not a mechanical process, but instead allows for flexibility. Strategy involves weighing risk and return, with an understanding of the uncertainty or variability of those risk and return assumptions.

Figure 2 shows a hypothetical example of the variability of equity returns using reasonable risk and return assumptions. In this example, we use three starting points. The first starts from an equity market that is fairly priced. The second is 5% overpriced and the last is 5% underpriced. From those

starting points, we calculate a range of potential outcomes: the expected return, the top decile return and the bottom decile return. It is interesting to note that even if a market is 5% above fair value (overpriced), it can certainly go substantially higher. However, the return distribution has shifted unfavorably for the investor. The reverse is true of a market that is 5% underpriced. In this instance, returns can still be negative but more of the distribution lies in positive territory.

### The Real World

Our investment process entails making judgments as to the potential for prices to continue advancing versus the potential for corrections. We make incremental shifts in our strategy as prices change, altering the potential for gains and losses.

As with any asset allocation decision, overpriced markets can continue advancing and markets that look attractive can decline further. A risk with our gradual approach, where we would be selling a

market as it rose beyond fundamentals, is that we could end up selling equities too aggressively when they have considerable gains remaining. This is only a relative risk—portfolios would not perform as well as their benchmarks, although their performance might be quite good in absolute terms. Relative risk can also arise by not being aggressive enough in reducing exposure before a significant or lengthy market downturn. We can illustrate these relative risks by exploring how much further the S&P had to go in two different environments: 1998, when our return expectations were poor; and 2002, when return expectations were much higher.

Figure 3 shows a real-world illustration of our hypothetical example. At the end of December 1998, the S&P 500 had already delivered several years of strong appreciation. As history unfolded, the 5-year annualized return from December 1998 to December 2003 was negative 0.6%. However, the fact that the top of this bull market was not until August 2000 is important to note. From December 1998 until December 1999, the S&P return was 21.0%. Furthermore, in the 20 months between December 1998 and August 2000 the total return was 26.0%. This shows how much more the S&P Index continued to advance despite deteriorating earnings.

**Figure 2: Illustration of Return Expectations**

Market Price	1 Yr. Expected Return		
	Expected	Top Decile	Bottom Decile
Fair	8.0%	27.2%	-11.3%
5% Overpriced	2.8%	21.1%	-15.5%
5% Underpriced	13.6%	33.9%	-6.6%

Assumptions: 15% risk and any market mispricing corrects in one year

## 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 blue-print (investment policy and benchmark) and aligning your portfolio with our investment strategy utilizing the global capital markets.

By April 2002, stocks had sustained a significant correction. For the 5 years from that point, to April 2007, the annualized return was 8.5%. However, in the short 5-month period between April 2002 and September 2002, the S&P Index had a return of -23.7%. Despite the healthy longer-

term return, the first 5 months produced a loss of nearly a quarter of the value. This is how much the market continued to decline despite the improving fundamentals.

### Another Example

In contrast to equities, with low return expectations but where we maintain signifi-

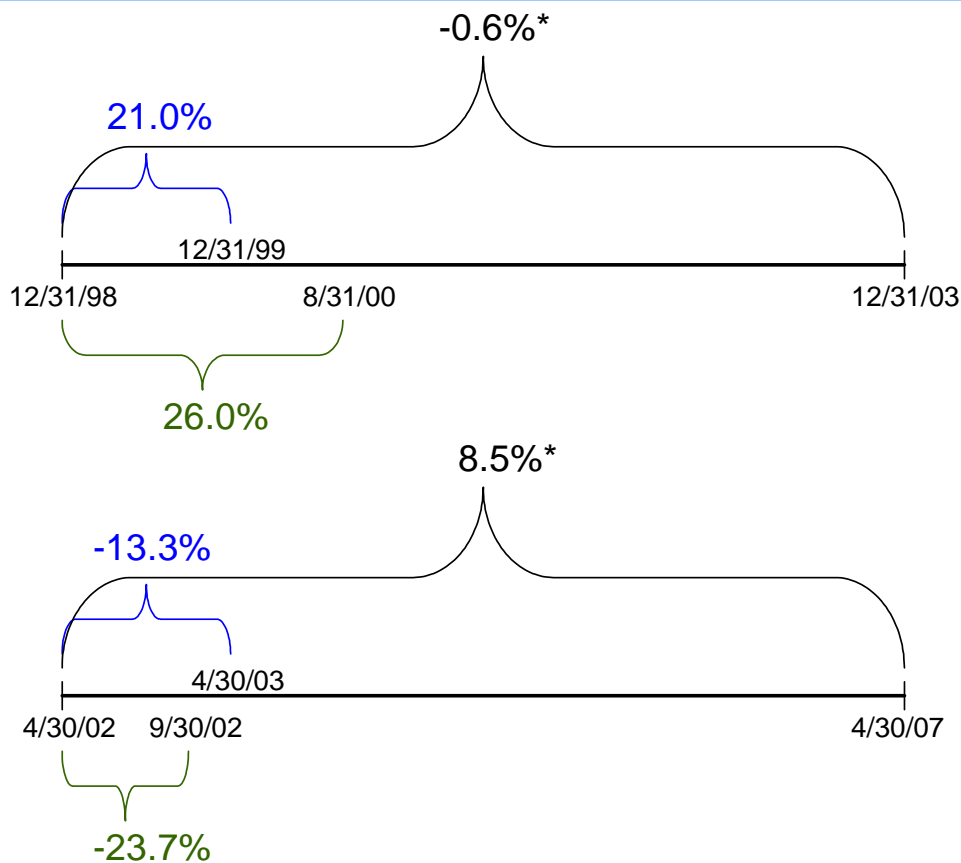
cant exposure, high yield bonds have decent return expectations but portfolios have no exposure. The high yield bond market typically experiences dramatic shifts in actual returns around "normal" expectations. For this specific asset class, our expected return is not unreasonable. However, this

expectation inherently assumes a smooth path from the current conditions—high prices, tight spreads over Treasuries, and few defaults—to a more "normal" condition. The problem here is that when the high yield market runs into trouble, conditions are rarely smooth. Credit spreads tend to widen dramatically, while at the same time defaults increase and prices drop precipitously. What happens is that the high yield market goes well past where it would be priced assuming "normal" levels of risk, spreads, and defaults. Returns could very well turn out to be much lower than our expectations and would clearly be insufficient for the risk brought to portfolios with this exposure.

### Summary

At Stairway Partners, our investment strategy setting involves thinking about how assets are being priced and how that might develop over time. By actively evaluating the potential for price movements and making incremental adjustments as dictated by fundamentals, our process ultimately aims to provide good market returns while dampening volatility.

**Figure 3: S&P Index Returns**



Sources: Standard & Poor's, Stairway Partners

\* Annualized returns

## Strategy

Asset Class	Expected Return	Hurdle Return	Strategy	Comment
<b>Equities</b>				
US	0.9%	8.5%	small under	Exposure slightly below normal
Non-US Developed			small under	Moderately unattractive relative to risk
Eurozone	-4.3%	7.7%		
Japan	-11.2%	4.6%		
UK	2.0%	8.8%		
Emerging	-5.6%	10.8%	under	Asset class inadequately pricing risk
<b>Fixed Income</b>				
US Treasury Bonds			neutral	Shorter-term maturities are fairly priced
2-Year	4.9%	4.7%		
5-Year	5.0%	4.9%		
10-Year	4.6%	5.1%		
30-Year	4.2%	5.3%		
US Municipal Bonds			neutral	Sector is fairly priced
2-Year	3.7%	3.5%		
5-Year	3.9%	3.6%		
10-Year	4.2%	3.9%		
30-Year	6.6%	4.3%		
US High Yield	3.8%	6.9%	under	Spreads over US Treasuries remain too tight
Non-US Government Bonds			under	Yields generally insufficient compensation for risk
Euro 10-Year	3.9%	4.7%		
Japan 10-Year	0.7%	2.1%		
UK 10-Year	5.1%	5.4%		
Emerging Markets Debt	3.6%	7.2%	under	Spreads over US Treasuries remain too tight
Cash	4.7%	---	over	Allocation comes from overpriced asset classes
10-Year				
	Expected	Equity	Bond	
	FX Change	Return with	Return	
		Currency	with	
			Currency	
<b>Currencies</b>				
Euro	-5.1%	-9.4%	-1.2%	Euro is somewhat expensive
Japanese yen	6.7%	-4.5%	7.5%	Yen is slightly attractive
UK pound	-6.1%	-4.1%	-1.0%	Pound is somewhat expensive

**Notes:**
**As of: May 31, 2007**

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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