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Monthly

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A Perspective on Market Risk

Introduction

The recent volatility in the equity market has caused discomfort to many investors. The significant downward move in stocks from last fall through March of this year (Figure 1) was driven by fears that our economy and financial system were at considerable risk. This market environment has caused some to ask: is the risk that I experience in financial markets worth the potential return?

We believe, for longer-term investors, the answer is yes. This *Monthly* will show that risk taking in financial markets has been rewarded over the long term. However, there have been many environments in which the opposite has occurred - risk taking has been punished.

Perspective

History shows that investing in stocks and bonds has provided investors, over time, with better-than-cash returns. Also, history shows that there has been a positive relationship between risk and return. This means that, over longer time periods, investing in higher-risk assets has produced higher returns and lower-risk assets have produced lower returns. Figure 2 is a familiar picture that illustrates the risks and returns produced by various asset classes over time.

It is important to note that financial markets may not deliver the same level of risk and return in the future as they have in the past. Consider the example of emerging debt. Emerging economies have substantially improved their fiscal and economic performance over the last ten years. As a result, yields on emerging countries' debt (the amount of income required as risk compensation) have declined substantially. To be specific, the yield on the Lehman

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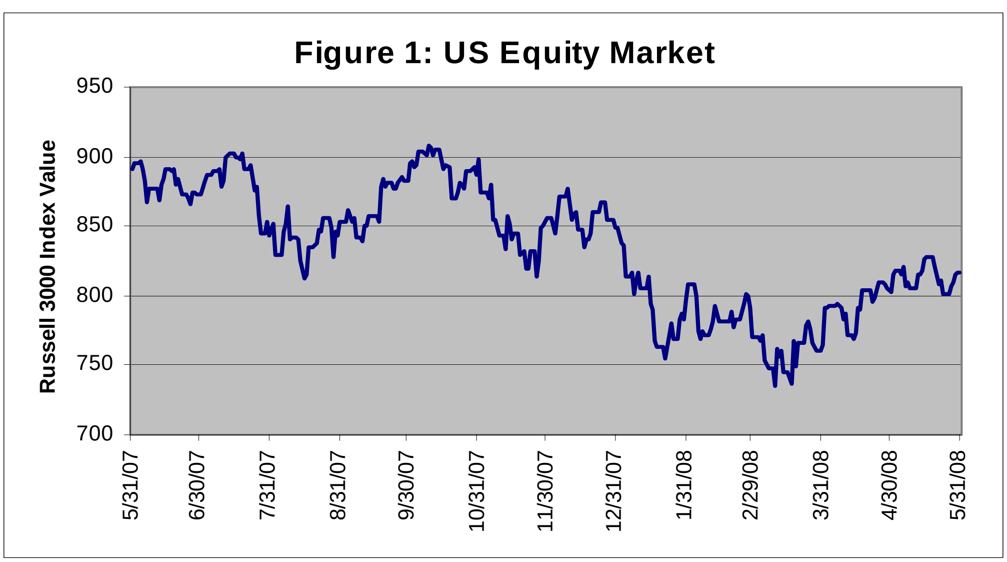

Source: Russell

Current topic

A Perspective on Market Risk

- *Introduction*
- *Perspective*
- *Caution*
- *Conclusion*

Strategy

- *We made no strategy changes in the month of May*
- *Portfolio strategy remains overweight the US equity market*
- *Non-US equities, both developed and emerging, remain below benchmark weightings*

"THE RECENT VOLATILITY IN THE EQUITY MARKET HAS CAUSED DISCOMFORT TO MANY INVESTORS"

A Perspective on Market Risk - Cont'd

(Continued from page 1)

emerging debt index was 12.23% when the index was created in January of 1993. As of May 30th 2008, that yield is down to 6.66%. This lower yield, which results from investors believing that the asset class has less risk than in the past, will translate into prospective returns below their historical average.

One problem with Figure 2 is that that the risk measure is not at all intuitive. That is because risk is measured here as the annualized standard deviation of the monthly returns. Technically that is fine, but may not mean much to many of our readers. We provide an alternative view of risk in Figure 3. Using the same underlying data as Figure 2, we show the range of returns around the average return for each asset class. This range is calculated as the best and worst 12-month periods for each asset class. A greater range means you would have gained or lost a lot more money in riskier asset classes (equities) than in lower-risk asset classes (bonds). Note that the asset classes with the wider ranges, i.e. greater risk, tend to have higher average returns. Consistent with Figure 2, there is a positive relationship between risk and return.

Caution

It is true that taking risk has

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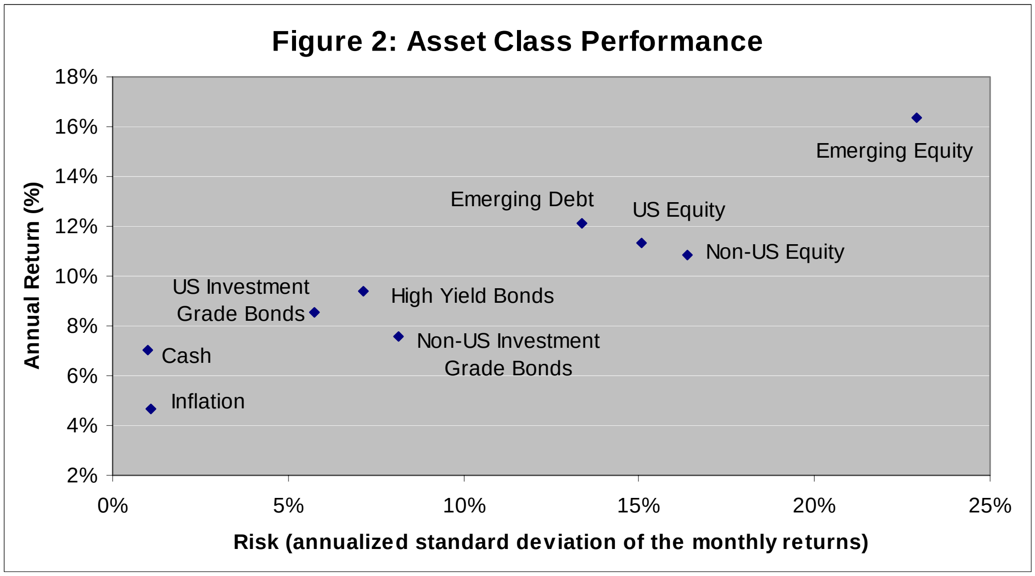

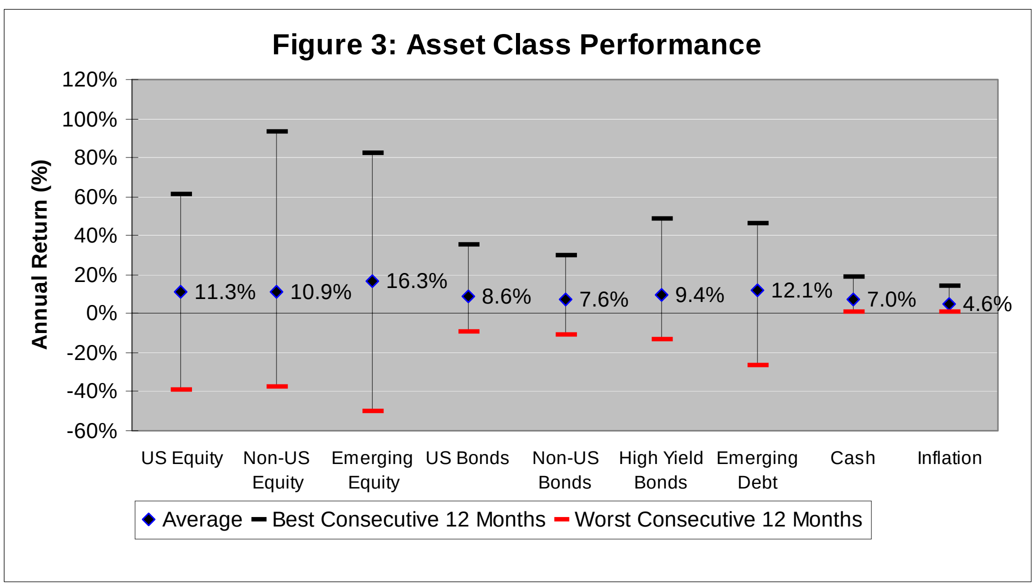

"FIGURE 2 IS A FAMILIAR PICTURE THAT ILLUSTRATES THE RISKS AND RETURNS PRODUCED BY VARIOUS ASSET CLASSES OVER TIME"

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"WE SHOW THE SAME AVERAGE RETURN (AS IN FIGURE 2), WHILE PORTRAYING RISK AS THE BEST AND WORST 12-MONTH PERIODS"

Sources: S&P, MSCI, Haver, Bloomberg, Lehman, Stairway Partners

Note: Figures 2 & 3 use index data for each asset class that were available and as a result incorporate different time periods

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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been rewarded over the long term. Investors need to understand, however, that there are extended periods of time when returns have been poor - risk taking led to losses. Figure 3 clearly shows that the amount lost in a 12-month period has been substantial in the higher risk asset classes.

In addition, there are periods of time much greater than 12 months when returns were poor. Figures 4 and 5 show two such five-year periods. Figure 4 shows the five years ending on 12/31/1977. The returns across all asset classes suffered greatly due to the high inflation rate that was experienced during this time. You can see from the right-hand axis just how poor the inflation-adjusted returns were. Figure 5 shows the first five years of this decade, which included the popping of the internet bubble. Higher-risk equities performed poorly, while lower-risk bonds did well.

Figure 4: 5-Yr Average Returns Ending 12/31/1977

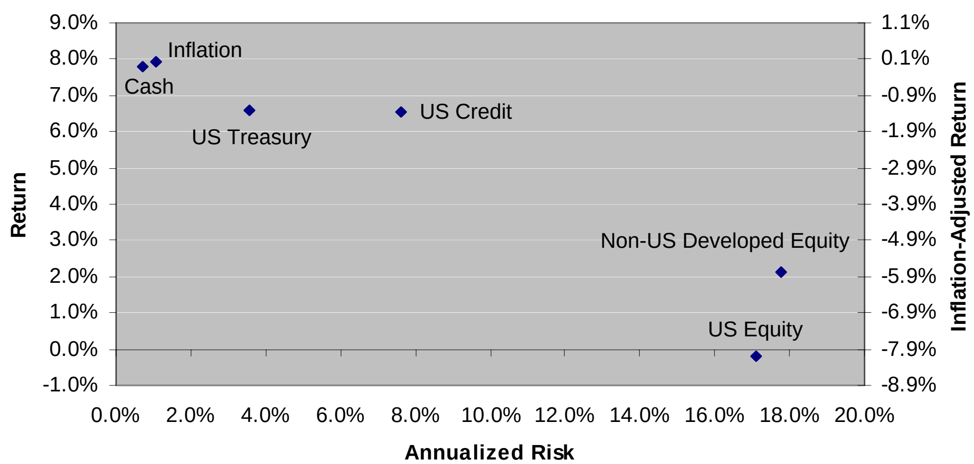
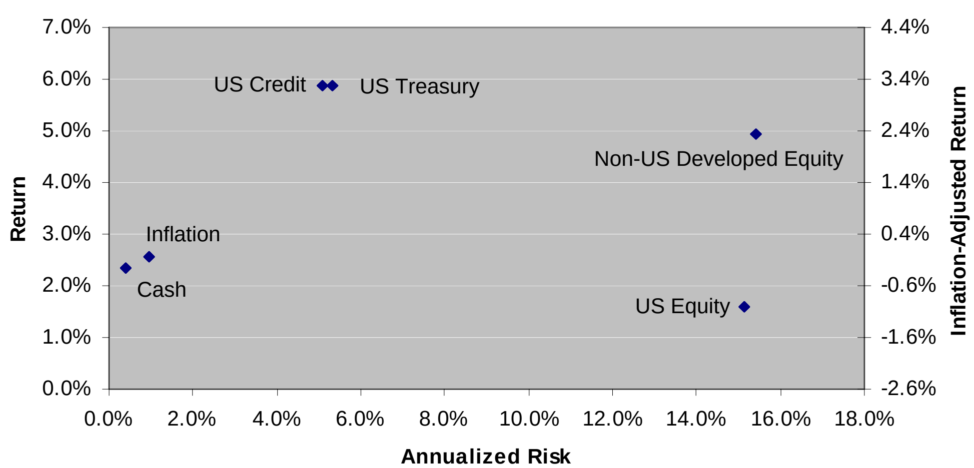


Figure 5: 5-Yr Average Returns Ending 12/31/2005



Sources: S&P, Russell, MSCI, Lehman Brothers, Haver, Bloomberg, Stairway Partners
Note: Risk is computed as the annualized standard deviation of the monthly returns

Conclusion

Market risk - exposure to stocks and bonds - has paid over time. However, there are periods when returns have been poor and the longer-term trend of being rewarded for risk taking did not hold true.

We believe that, over the long run, financial assets will provide compensation for their risk. However, our investment process leads us to reduce portfolios' risk exposures when we believe that market prices will not adequately compensate for anticipated risk.

Strategy

Asset Class	Expected Return	Hurdle Return	Strategy Exposure	Comment
Equities				
US	7.2%	7.0%	small over	Exposure slightly above benchmark weight
Non-US Developed			small under	Asset class fairly priced as markets have fallen
Eurozone	8.2%	7.9%		
Japan	-1.5%	4.6%		
UK	9.9%	8.7%		
Emerging	-6.2%	11.5%	under	Asset class remains expensive
Fixed Income				
US Treasury Bonds			neutral	Non-Treasury sectors more attractively priced
2-Year	2.4%	3.6%		
5-Year	2.5%	4.1%		
10-Year	2.9%	4.7%		
30-Year	2.9%	5.1%		
US Municipal Bonds			neutral	Sector overall is near fair value
2-Year	2.4%	2.9%		
5-Year	2.8%	3.3%		
10-Year	3.9%	3.8%		
30-Year	7.8%	4.4%		
US High Yield	8.1%	5.4%	neutral	Sector is pricing for deteriorating fundamentals
Non-US Government Bonds			under	Yields too low, especially at longer maturities
Euro 10-Year	4.0%	4.8%		
Japan 10-Year	0.9%	2.1%		
UK 10-Year	4.4%	5.2%		
Emerging Markets Debt	3.0%	5.7%	under	Spreads over US Treasuries remain too tight
Cash	3.5%	---	over	Allocation comes from overpriced asset classes

Currencies	Expected FX Change	Equity Return with Currency	10-Year Bond Return with Currency	
Euro	-9.4%	-1.2%	-5.4%	Euro is expensive
Japanese yen	2.0%	0.6%	3.0%	Yen is close to fair value
UK pound	-5.2%	4.7%	-0.8%	Pound is expensive

Notes: **As of: May 31, 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.