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MONTHLY

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SIZING UP HIGH YIELD BONDS

Introduction

Equity returns usually grab the bulk of the headlines in times of extreme market stress or euphoria. This has certainly been the case lately, as events affecting the European common currency and fear of contagion beyond the region have driven down global equity prices. Although the broad equity market generally sets the tone for portfolio returns, varying performance from less visible asset classes like high yield bonds can materially impact investors' overall results.

High yield bonds, which are defined as the long-term debt of companies rated below investment grade by two or more major rating agencies, make up over 5% of the domestic US bond market. We include high yield bonds in policy benchmarks to enhance returns and to increase diversification. We also employ a disciplined valuation approach to actively manage their exposure within portfolios, allowing us to take advantage of temporary market dislocations. Last month, we reduced our exposure to high yield bonds, after declining yields produced very strong returns for our investors. As is the case with all bonds, a drop in high yield bond yields increases market prices but reduces the prospects for future returns.

In this *Monthly* we analyze the risk and return characteristics of high yield bonds, highlight how their performance compares to domestic equities and investment grade bonds, and examine current market conditions.

High Yield Returns

Over long time-periods, high yield bonds tend to produce returns that are higher than investment grade bonds, but lower than domestic equities. This was the case in the 25 years ending in December of 2011, where the annualized return for the high yield bond market was 8.5%, relative to US equities and investment grade bonds which produced annualized returns of 9.3% and 7.2%, respectively.

As is almost always the case, the additional returns of high yield bonds and equities were accompanied by additional risks. Over longer time periods, high yield bonds generally experience 60% to 80% of the return

(Continued on page 2)

CURRENT TOPIC

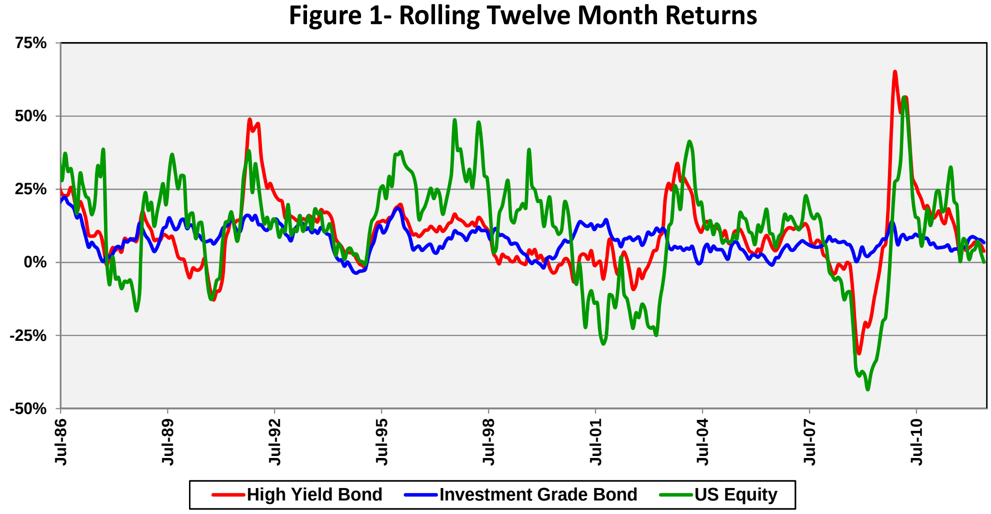
Sizing Up High Yield Bonds

- *Introduction*
- *High Yield Returns*
- *Diversification Benefits*
- *Drivers of Return and Risk*
- *Current Market Conditions*

Strategy

- *We eliminated our overweight to high yield bonds during the month of May.*
- *Portfolios remain modestly overweight global equity exposure and underweight investment grade bond exposure.*

Figure 1- Rolling Twelve Month Returns



Sources: Barclays, Russell, Stairway Partners

Sizing up High Yield Bonds - cont'd

volatility of domestic equities. Figure 1 illustrates the effects of this volatility by showing the periods of extreme or sustained negative returns that investors in high yield bonds had to endure, in order to reap the rewards of higher returns over the 25 year time period. The most obvious example of this volatility occurred around the most recent financial crisis, where high yield bonds produced a negative return of 31.2% in the twelve months ending in November 2008, only to rebound in the subsequent twelve months to produce a positive 65% return. These large swings in market pricing can provide an excellent opportunity for active investors to enhance portfolio returns, but require a disciplined process and constant monitoring.

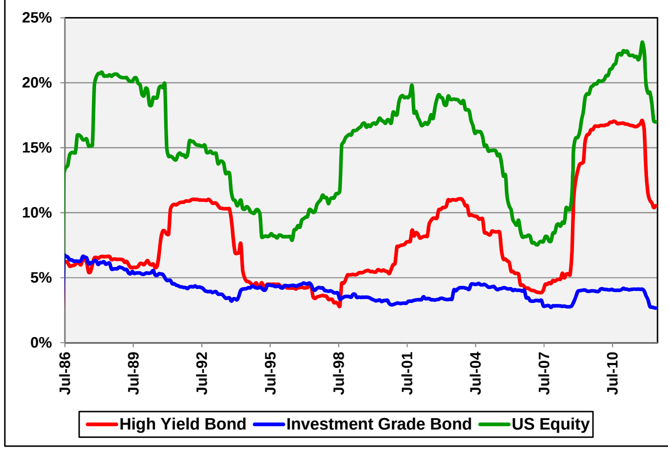
Diversification Benefits

The overall return of a portfolio is largely determined by the average of the returns of its individual assets. The overall riskiness of a portfolio is affected not only by the average return volatility of the individual assets, but also by the relationship between the returns of those assets.

This relationship, which is known as the correlation, can be expressed as a number between -1 and +1. A correlation of +1 between a pair of assets means that they move in locked-step, where positive returns for one asset are accompanied by positive returns in the other. A correlation of -1 means that the returns of two assets move in opposite directions, where positive returns for one asset are accompanied by negative returns for the other. A correlation of 0 means that the returns of two assets are completely independent from one another, where positive or negative returns for one asset have no impact on the returns of the other asset.

Much like returns, volatilities and correlations can experience significant changes over shorter time-horizons. Figure 2 illustrates how much the shorter-term volatilities for US equities and high yield bonds can change over time.

Figure 2 - Annualized Return Volatility (3 year)

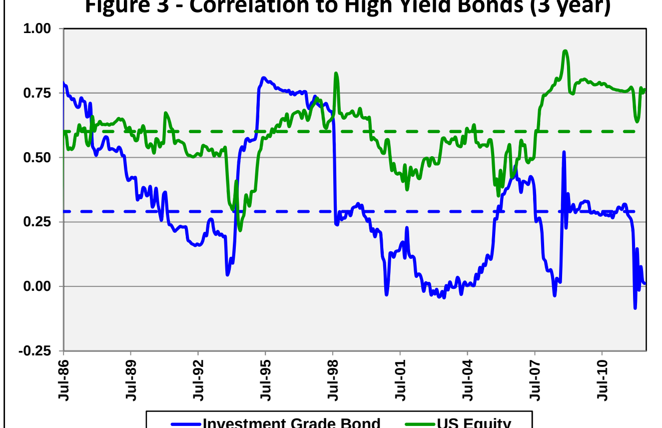


Although the short-term volatilities for high yield bonds and US equities tend to move in the same direction, the timing and magnitude of these changes can vary dramatically. During the 25 year time period shown in the figure, high yield bond volatility ranged from as low as 25% to as high as 85% of US equity volatility. By comparison, the volatility of investment grade bonds was relatively stable.

Figure 3 shows the correlation of high yield bonds to US equities and to investment grade bonds. On average and through time both correlations are positive, meaning that high yield bond returns share a positive relationship with both asset classes. In most time periods, the relationship with equities is stronger than the relationship with bonds, which is consistent with the relative returns shown in Figure 1.

> **"VOLATILITIES AND CORRELATIONS CAN EXPERIENCE SIGNIFICANT CHANGES OVER SHORTER TIME-HORIZONS"**

Figure 3 - Correlation to High Yield Bonds (3 year)



Sources: Barclays, Russell, Stairway Partners

Drivers of Return and Risk

Over time, the majority of high yield bond returns come from coupon income, adjusted for credit losses. A detailed discussion of the effects of credit losses is available in the August 2009 *Monthly* – High Yield Market Update. Shorter-term returns and return volatility are most heavily influenced by

(Continued on page 3)

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.

(Continued from page 2)

changes in market yields. Market yields change over time based on investors' changing views of the general level of interest rates, liquidity, and forward looking credit conditions.

The portion of high yield bond rates that are attributable to the general level of interest rates can be observed by looking at US Treasury yields for like maturity bonds. The difference between high yield bond yields and treasury yields is referred to as the credit spread.

Figure 4 shows the yield on high yield bonds through time, with the components of Treasury yields and credit spreads broken out. The fact that Treasury bonds represent a significant portion of the investment grade bond market and also factor into pricing of all domestic bonds helps to explain the positive correlation between the returns of high yield and investment grade bonds.

Credit spreads, on the other hand, are more closely tied to the equity market. A decline in equity prices is generally accompanied by an increase in credit spreads. This is the result of a link between the market's perception of a company's enterprise value and its ability to honor contractual debt obligations. Because credit spreads have historically experienced more dramatic movements than Treasury yields, high yield bond returns have had a higher correlation to equity returns than to investment grade bond returns.

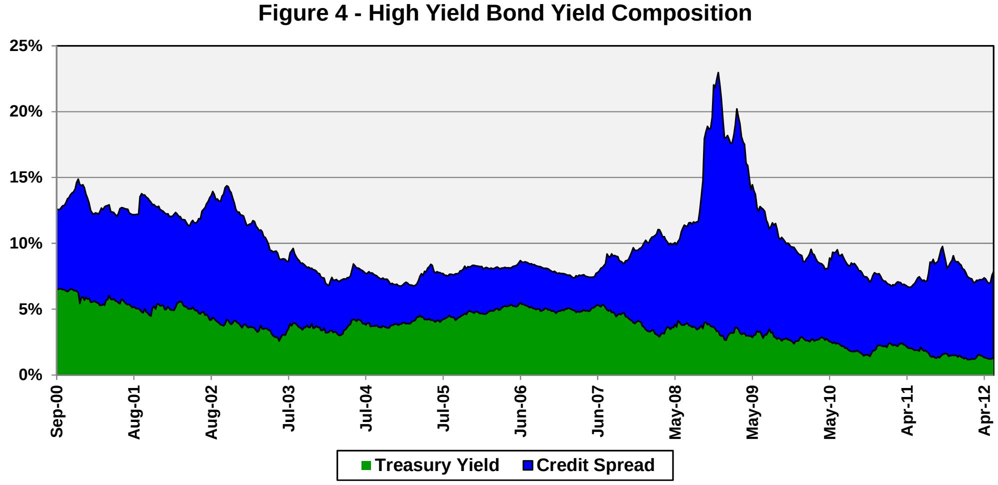
Current Market Conditions

The strong performance of the high yield bonds over recent months has brought our forward looking return estimates close to what we believe is fair value. As a result, we recently reduced our positions back to neutral across all of our accounts.

We believe that yields in the high yield bond market will increase modestly over a three year horizon, due to an increase in Treasury rates. The anticipated increase in rates should drive high yield bond prices lower, but not enough to offset the positive returns coming from income.

Default rates are currently modest, and should detract less than usual from performance over the next three years. We believe that credit spreads will remain relatively stable, as they are currently close to their historical average and our fair value estimates.

Figure 4 - High Yield Bond Yield Composition



Sources: Barclays, Stairway Partners

"A DECLINE IN EQUITY PRICES IS GENERALLY ACCOMPANIED BY AN INCREASE IN CREDIT SPREADS"

3 Year Annualized Return Estimates for Global Markets

6/1/2012	Total Returns			After-Tax Total Returns		
	Expected	Hurdle	Excess	Expected	Hurdle	Excess
Equities						
United States	**11.3%**	**4.1%**	**7.2%**	**9.6%**	**3.9%**	**5.7%**
Non-US Developed Markets	**22.8%**	**4.6%**	**18.1%**	**19.3%**	**4.4%**	**14.9%**
EMU	31.8%	5.0%	26.8%	27.0%	4.8%	22.2%
UK	28.0%	4.9%	23.1%	23.7%	4.7%	19.0%
Japan	13.7%	5.0%	8.7%	11.6%	4.8%	6.8%
Canada	-0.6%	4.4%	-5.0%	-0.5%	4.2%	-4.7%
Emerging Markets	**22.7%**	**5.9%**	**16.8%**	**18.5%**	**5.7%**	**12.9%**
Fixed Income						
US Aggregate	**-1.7%**	**2.2%**	**-3.9%**	**-2.0%**	**2.0%**	**-4.0%**
US Treasuries						
2 Year	-0.2%	0.9%	-1.1%	-0.5%	0.7%	-1.2%
5 Year	-3.3%	1.4%	-4.7%	-3.1%	1.2%	-4.4%
10 Year	-7.2%	2.0%	-9.2%	-6.5%	1.8%	-8.3%
30 Year	-10.9%	2.1%	-13.1%	-9.6%	1.9%	-11.5%
TIPS						
5 Year	-2.0%	1.5%	-3.5%	-2.2%	1.3%	-3.5%
10 Year	-6.7%	2.0%	-8.7%	-6.1%	1.8%	-7.9%
30 Year	-15.3%	2.4%	-17.7%	-13.0%	2.2%	-15.2%
Municipal	**-0.5%**	**1.5%**	**-2.0%**	**0.0%**	**1.3%**	**-1.3%**
2 Year	0.0%	0.8%	-0.8%	0.3%	0.6%	-0.4%
5 Year	-1.7%	1.2%	-2.8%	-1.1%	1.0%	-2.1%
10 Year	-2.2%	1.6%	-3.8%	-1.4%	1.4%	-2.8%
20 Year	0.7%	1.8%	-1.2%	1.2%	1.6%	-0.5%
High Yield	**3.7%**	**3.1%**	**0.6%**	**1.7%**	**2.9%**	**-1.2%**
High Quality High Yield	3.6%	2.2%	1.4%	1.8%	2.0%	-0.3%
Emerging Market ($ demonimnated)	**0.4%**	**3.3%**	**-2.9%**	**-0.8%**	**3.1%**	**-3.9%**
Foreign Aggregate	**-5.3%**	**3.5%**	**-8.9%**	**-4.9%**	**3.3%**	**-8.2%**
Foreign Aggregate (hedged)	-3.6%	1.9%	-5.5%	-3.8%	1.7%	-5.5%
Foreign Treasury	**-5.7%**	**3.1%**	**-8.7%**	**-5.1%**	**2.9%**	**-8.0%**
Foreign Treasury (hedged)	-4.1%	1.4%	-5.5%	-4.1%	1.2%	-5.3%
Cash	**0.6%**	**0.6%**	**0.0%**	**0.4%**	**0.4%**	**0.0%**
Currency						
Euro	-3.0%	2.3%	-5.3%			
British Pound	-0.2%	2.2%	-2.4%			
Japanese Yen	-1.0%	2.4%	-3.4%			
Canadian Dollar	-1.0%	1.4%	-2.5%			

Notes
1. Foreign market returns assume US dollar as the base currency and are unhedged unless otherwise indicated.
2. All hurdle returns are based on long-term asset volatility. Equity and fixed income hurdle rates include expected cash returns.
3. After-tax total returns assume that all gains and losses are long-term and can be realized within the investment horizon.
4. After-tax total returns only take into account Federal taxes based on the following tax rates:
   - 35.0% Ordinary Income, 15.0% Qualified Income, 0.0% Exempt Income, and 15.0% Capital Gains/(Losses)