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THE REAL CASH RATE

Introduction

Until the beginning of June, most investors believed that interest rates across the yield curve were too low. Since that time, there has been much rationalization about the current low-rate environment, with some notable investors now pronouncing that rates should, even after the significant rally, move lower.

What is driving this low-rate environment and what are the effects that investors need to consider?

We believe that current and prospective low real cash rates account for much of the modest over valuation in the investment grade bond market.

Definitions

The real cash rate is the nominal rate of interest on cash less the inflation rate. In Figure 1, on a rolling 12-month basis, we subtract inflation, as measured by the Consumer Price Index, from the return of 1-month Libor - a popular cash benchmark. The real cash rate is important because it is one of the basic components of return for all assets. Together with the inflation rate, it determines the nominal cash rate or the risk-free return. How much investors pay for riskier assets is comprised of the risk-free return plus an additional risk premium. Example: If the real cash rate is 5% instead of 0%, investors should demand more compensation for investing in stocks and bonds.

Historical Perspective

As shown in Figure 1, the return on cash usually ex-

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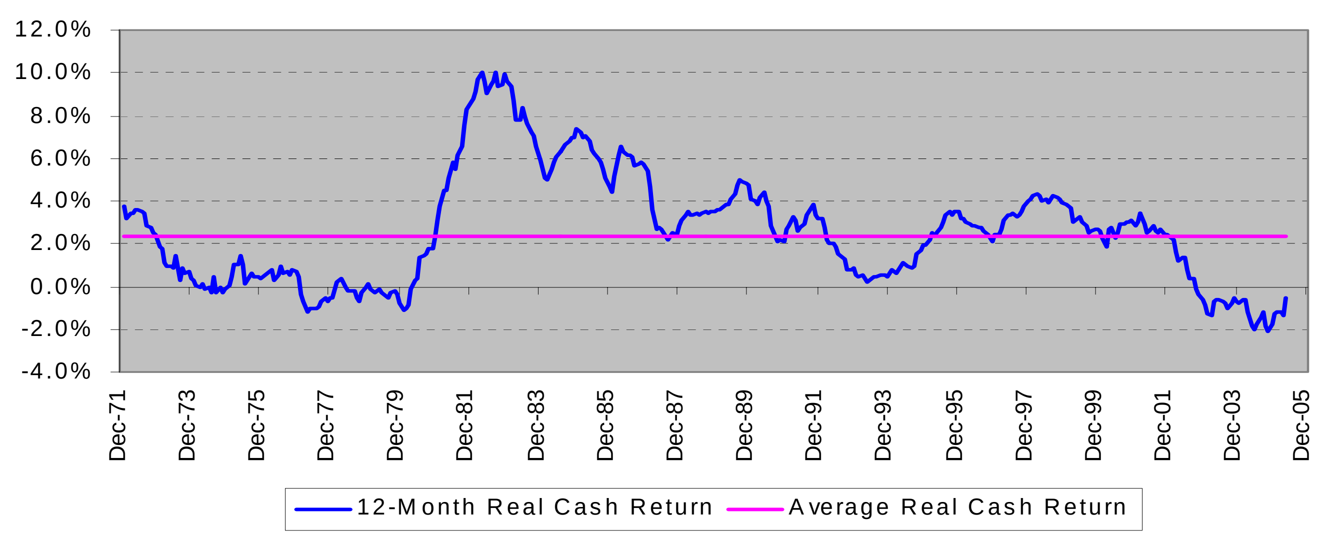
CURRENT TOPICS

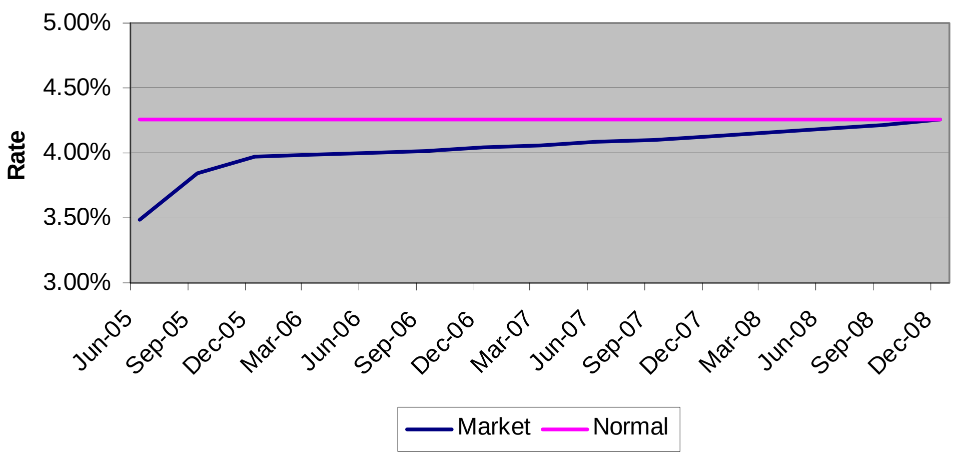
Figure 1: 12-Month Real Cash Return



Sources: Bureau of Labor Statistics, Federal Reserve, Stairway Partners

THE REAL CASH RATE - CONT'D

Figure 2: The Short Rate
Market Pricing versus Stairway Long-Term Assumption



Sources: Bloomberg, Stairway Partners

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ceeds inflation, as evidenced by the amount of time the real cash rate has been above zero. In addition, the actual level of the real cash rate has moved around considerably over time but its long-term average is in excess of 2%. Quite simply, investors have received, on average, in excess of 2% above inflation for holding cash.

As a result of low to negative real cash rates over the last several years, many market participants have now adopted a new paradigm for the real cash rate saying that this condition will persist for a protracted period of time. This shift in thinking has helped many to rationalize the low level of returns priced into financial markets, particularly investment grade bonds.

Rationale

Some of the reasons cited for low rates are:

• The Federal Reserve will come to the realization that the US economy is fragile. Thus the Fed will need to keep the short rate at a very low level.

• Global savings are high - meaning there is ample supply of money from a pool of international savers with little demand to put that money to work. This supply versus demand imbalance is keeping rates abnormally low.

• Asian central banks, in support of their trade surpluses and to keep their currencies from appreciating, are recycling dollars back into the US bond market.

While some of these reasons have merit, we would view them as temporal and argue the following points:

• The Federal Reserve believes the US economy is in decent shape. Despite imbalances reported in the financial press, most of the Federal Reserve's own releases, such as the Beige Book and the Z.1 Flow of Funds report, reveal an economic environment that is in need of higher rates. In addition, Fed officials have consistently repeated that current policy is accommodative, suggesting that the Fed will raise rates at "a measured pace". A more neutral Fed policy should move the cash rate closer to 4.25%.

• Foreign countries that currently have high savings rates and are flush with cash will eventually need to redirect their economies towards domestic consumption. This will alter the global savings pool and shift capital away from the US, helping the real cash rate to normalize and moving rates higher.

• Asian countries cannot export their way to healthy and balanced economies. Over time, their currencies need to appreciate which should reduce trade surpluses and, as a result, slow the pace of dollar assets being added to foreign exchange reserves.

Outlook

Cash rates should move towards more normal levels over time. This will be driven by the real cash rate moving from its current low level to a neutral level of around 2%. Combined with a long-term inflation assumption of 2.25%, we feel the appropriate level for short rates, such as 1 month Libor, will be centered around 4.25%. Figure 2 shows current market pricing and the future path of short rates as implied by forward contracts on 3-month Eurodollar futures, versus Stairway Partners' long-term assumption. Please note that market expectations converge on our long-term assumption in just over 3 years.

The issue for investors is timing. If the path to a more normal level takes longer than is currently priced in the market, it will pay to hold longer-term securities because the negative price effect of rates moving higher would be offset by the incremental yield on the longer securities.

For example, Figure 3 repeats the market expectations for 3-month cash rates from

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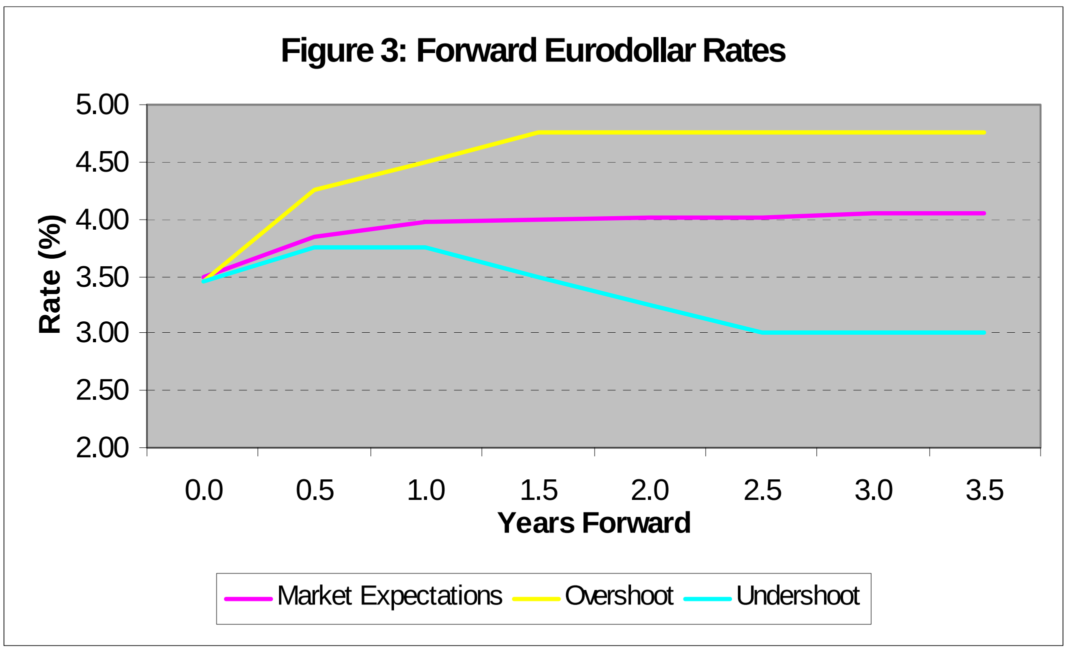
About Stairway Partners, LLC

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.

STRATEGY CHANGE: IN EARLY JUNE, AFTER YIELDS DROPPED SIGNIFICANTLY ACROSS THE YIELD CURVE, WE REDUCED INTEREST RATE EXPOSURE ACROSS OUR CLIENT PORTFOLIOS.



Sources: Bloomberg, Stairway Partners

The current 10-year bond yield of just under 4.0% is even lower than the fair yield consistent with the "undershoot" path

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Figure 2 and compares them to overshoot and undershoot scenarios. Given current market expectations, a fair yield on the 10-year Treasury bond should be about 5.0%. The current 10-year bond yield of just under 4.0% is even lower than the fair yield consistent with the undershoot path. This undershoot path has the Fed raising rates only one more time and then starting to ease again next year. A third scenario—an overshoot in which rates rise even more rapidly than expected—is also mapped out. Here, the yield on the 10-year bond needs to be 5.5% or more in order to compensate investors fairly for rising rates.

We currently feel sentiment is overly biased towards this new paradigm of persistent low real rates. We believe this has skewed the risks towards higher real rates than the bond market currently has priced in. Consequently, we have an underweight in interest rate exposure for both taxable and tax-exempt portfolios.

Investment Implications

The current low real cash rate environment has produced a low expected return environment across asset classes - but it is not a disaster. As you can see in our expected return outlook on page 4, asset classes are somewhat overpriced across the board. As a result, we have an overweight to cash at the expense of fixed income. As the cash rate moves higher, the expected returns of bonds should improve. When that happens we will be reallocating our portfolios from cash to where the market is most attractive.

Strategy

Asset Class	Expected Return	Hurdle Return	Strategy	Comment
Equities				
US	5.4%	7.5%	neutral	Slightly overvalued but strategy still neutral
Non-US Developed				Some markets close to fair value, currencies also close to neutral
Eurozone	4.7%	6.7%	neutral	
Japan	0.2%	4.3%	neutral	
UK	7.9%	8.3%	neutral	
Emerging	8.8%	12.4%	neutral	Emerging equity slightly overpriced
Fixed Income				
US Treasury Bonds			under	Real rates remain too low
2-Year	3.5%	4.1%		
5-Year	3.1%	4.3%		
10-Year	2.4%	4.6%		
25-Year	1.5%	4.9%		
US Municipal Bonds			neutral	Sector has moved to slightly overpriced
2-Year	2.6%	3.0%		
5-Year	2.7%	3.3%		
10-Year	3.2%	3.7%		
25-Year	5.5%	4.2%		
US High Yield	4.1%	5.9%	under	Spreads over US Treasuries remain too tight
Non-US Goverment Bonds			under	Yields generally insufficient compensation for risk
Euro 10-Year	0.7%	4.0%		
Japan 10-Year	-0.9%	1.7%		
UK 10-Year	2.6%	4.8%		
Emerging Markets Debt	3.8%	6.2%	under	Spreads over US Treasuries remain too tight
Cash	3.9%	---	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	-0.9%	3.7%	-0.3%	
Japanese yen	3.5%	3.7%	2.5%	
UK pound	-2.8%	5.2%	-0.2%	

Notes: **As of: 6/30/2005**

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.