

MONTHLY

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INVESTING IN A VOLATILE ENVIRONMENT

CURRENT TOPICS

Introduction

Whether it is the perceived safety in numbers or some other aspect of human nature, most investors become bullish when the market goes up and bearish when the market goes down. This tendency to follow the trend can lead to poor outcomes when investing. As markets become more volatile, they will harm investors who hold too much risk at the top and then subsequently may force them out after prices decline. How should an investor handle the trade-off between risk and reward in this environment?

Case in Point

The recent dramatic moves, both up and down, in emerging equity markets provide an excellent example. As the market moved significantly higher in 2005 and the first 4 months of 2006 (Figure 1), investors became even more optimistic about the prospects for this asset class. In essence the great news, which had already caused investors to drive the market higher, was extrapolated even further into the future.

In addition, many now believe that risk, in this historically volatile sector, will be

different this time - that is it will be much lower than the past. Some have even argued that emerging markets have less risk than the US market - a claim that we have a significant issue with. (We mentioned this in our May 2006 *Monthly*.) A commonality in most of these emerging equity investment theses was an absence of discussion of price or value relative to the risk inherent in the sector. As a result, market strategists were either recommending high portfolio allocations or were

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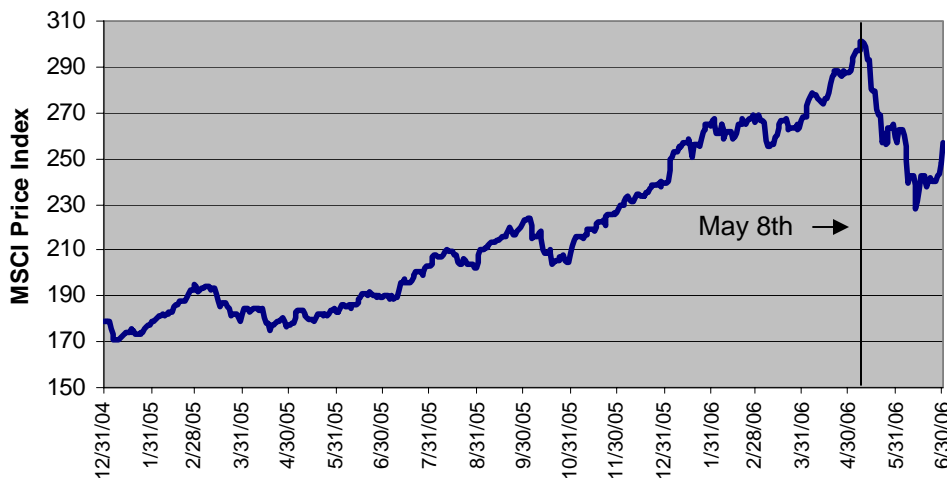
Investing in a Volatile Environment

- Introduction
- Case in Point
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- Conclusion

STRATEGY CHANGE

AFTER THE DRAMATIC DECLINE IN EMERGING EQUITY MARKETS, WE INCREASED EXPOSURE ON JUNE 13TH, MOVING FROM A MAXIMUM UNDERWEIGHT TO A 50% UNDERWEIGHT.

Figure 1: Emerging Equity Price Index



“AS THE MARKET MOVED SIGNIFICANTLY HIGHER, INVESTORS BECAME EVEN MORE OPTIMISTIC ”

INVESTING IN A VOLATILE ENVIRONMENT - CONT'D

(Continued from page 1)

getting investors into this sector for the first time.

A recent *Wall Street Journal* article cited a widely quoted market strategist who recommended a 10% allocation very close to the top of the market. In our view, a 10% allocation to emerging equities, in the context of a typical balanced portfolio, is very aggressive and should be made only when the market is extremely attractive. Often this occurs when investors are fearful and have panicked, getting out "at all cost".

The result of the optimism earlier this year was record amounts of money flowing into emerging equities, chasing returns and exposing investors to significant risk. The herd rides on.

Stairway Difference

There are several elements in our investment process that help to guide us through volatile markets. Our investment process has two clear and distinct steps.

The first is to construct a blueprint or investment policy that focuses on the long-term risk and return characteristics that are appropriate for each client portfolio.

Residing in this blueprint is the normal allocation to each asset class as well as a pre-defined range in which to adjust exposure as prices move away from fair value. Because the blueprint is only focused on long-term objectives, it does not shift as markets move. As many of you are aware, each of the portfolios that we manage has its own customized blueprint.

The second distinct element is the strategy setting process

which guides us through markets as they move away from fair value. Fundamental to our process is the belief that investors have to be compensated for the risk of each asset class. This means that riskier asset classes have to provide higher expected returns than asset classes with less risk. The hurdle return is our estimate of the return needed for each asset class to compensate for its risk.

Just because markets run up and everyone is optimistic does not mean that risk goes away. It is usually at this time when prospective risk is much higher than most market participants perceive.

We believe this was clearly the case in emerging markets. As emerging equities ran up, we did not change our long-term assumptions for risk or growth. As a result, this asset class became too expensive given the potential for disap-

pointment. Naturally we began to reduce exposure to emerging equities, relative to each portfolio's benchmark, at the time that others were getting in. Figure 2 shows a summary of our strategy moves out of emerging equities as the market ran up and subsequent reentry after the market sold off.

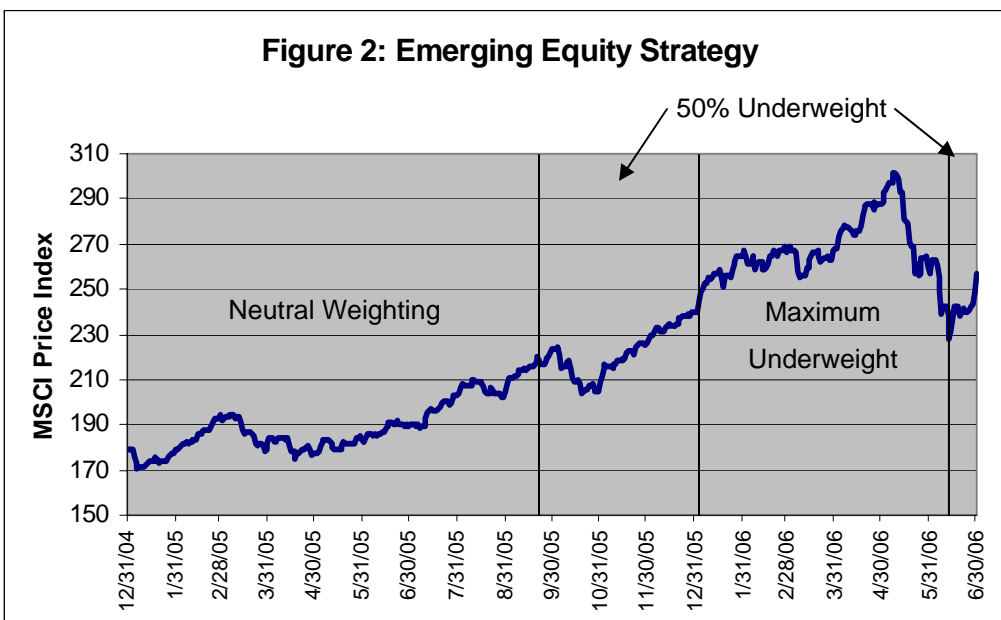
Even though our disciplined and objective process resulted in portfolios missing the last portion of the up move, being out during the even greater sell-off ultimately resulted in better performance. This is true on both an absolute and risk-adjusted basis.

Maintaining Discipline

After the recent sell-off, equity markets have moved closer to fair value. Figure 3 includes the output from our

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Figure 2: Emerging Equity Strategy



EMERGING EQUITY STRATEGY

12/31/04 - 9/22/05
Neutral weight

9/22/05
Reduced exposure to
50% underweight

1/3/06
Reduced exposure
further to maximum
underweight

6/13/06
Increased exposure to
50% Underweight

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.

May 5th weekly valuation update (close to the recent top for equity markets) and our updated output for those same markets. This shows, in our framework, how much the recent price declines have improved our expected returns in the equity asset classes.

As noted earlier, this dramatic sell-off provided us the opportunity to increase exposure to emerging equities after the index had dropped by 24.5%, from May 8th to June 13th.

Please note that our expected returns are still below our hurdle returns, which means that equity

markets are not yet to the point where we would be increasing allocations above client benchmarks. Looking across asset classes, it is much the same in other areas, with only Treasury and municipal bonds offering expected returns that fully compensate investors for their risk. As a result, our portfolios remain underexposed to risk in general.

Conclusion

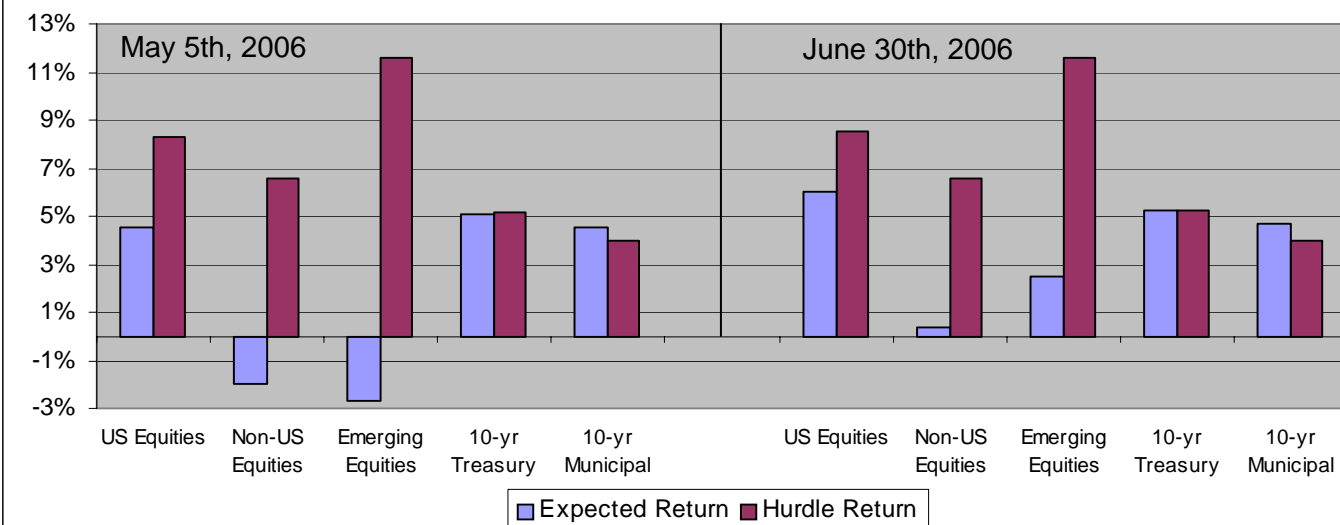
Market volatility has picked up dramatically. Many investors have reversed their earlier manic behavior and have started selling after prices have gone down.

Our valuation shows it is still time to be patient by being close to benchmark or blueprint weights. We still maintain an underweight to non-US equity markets, both emerging and developed.

We cannot predict how markets will behave in the near-term, we can only take the prices others set in the market. If equity markets move substantially higher, ahead of fundamentals, we would once again reduce exposure. If equity markets move substantially lower, we would increase allocation as risk becomes more attractively priced.

“THE RECENT PRICE DECLINES HAVE IMPROVED OUR EXPECTED RETURNS IN THE EQUITY ASSET CLASSES”

Figure 3: Valuation Changes in Equity Markets



Source: Stairway Partners

Strategy

| Asset Class | Expected Return | Hurdle Return | Strategy | Comment |
|-------------------------|-----------------|---------------|-------------|---|
| Equities | | | | |
| | | | small under | |
| US | 6.0% | 8.5% | neutral | Exposure equal to normal portfolio weighting |
| Non-US Developed | | | small under | Remains unattractive relative to US market |
| Eurozone | 2.6% | 7.1% | | |
| Japan | -8.1% | 4.4% | | |
| UK | 5.9% | 8.3% | | |
| Emerging | 2.5% | 11.6% | under | Asset class inadequately pricing risk |
| Fixed Income | | | | |
| US Treasury Bonds | | | neutral | Sector is fairly priced |
| 2-Year | 5.2% | 4.9% | | |
| 5-Year | 5.3% | 5.0% | | |
| 10-Year | 5.2% | 5.2% | | |
| 30-Year | 4.8% | 5.3% | | |
| US Municipal Bonds | | | neutral | Sector is fairly priced |
| 2-Year | 3.8% | 3.5% | | |
| 5-Year | 4.1% | 3.7% | | |
| 10-Year | 4.7% | 4.0% | | |
| 30-Year | 7.6% | 4.4% | | |
| US High Yield | 5.5% | 6.9% | under | Spreads over US Treasuries remain too tight |
| Non-US Government Bonds | | | under | Yields generally insufficient compensation for risk |
| Euro 10-Year | 3.0% | 4.5% | | |
| Japan 10-Year | 1.2% | 2.2% | | |
| UK 10-Year | 3.8% | 5.1% | | |
| Emerging Markets Debt | 5.0% | 7.2% | under | Spreads over US Treasuries remain too tight |
| Cash | 4.7% | --- | over | Allocation comes from overpriced asset classes |
| | | | 10-Year | |
| | | Equity | Bond Return | |
| | Expected | Return with | with | |
| Currencies | FX Change | Currency | Currency | |
| Euro | -3.2% | -0.6% | -0.2% | Close to fair value |
| Japanese yen | 4.2% | -4.0% | 5.3% | Yen is slightly attractive |
| UK pound | -4.1% | 1.7% | -0.3% | Close to fair value |

Notes:
As of: 6/30/2006

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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