STAIRWAY PARTNERS, LLC

2215 York Road, Suite 515 Oak Brook, IL 60523
www.stairwaypartners.com
630-371-2626 phone 630-371-2617 fax

MONTHLY

VOLUME 9, ISSUE 7 JULY 2012

CASH, A NICE PLACE TO VISIT

Introduction

Many investors, who are looking for refuge against today's volatile markets, are finding the current environment very challenging. This is because cash rates are close to zero, and are likely to remain there for the foreseeable future. Unfortunately, the natural aversion to extremely low cash rates can drive some investors into markets which offer higher yields, but considerably more risk in the current environment.

In the March *Monthly* – "Cash and Long-Term Investment Returns", we explained how we use cash rate projections to evaluate the prospective returns of long-term assets. In this *Monthly*, we show how the use of cash can influence the risk and return characteristics of portfolios, both in the long-term and over shorter time horizons. We also discuss some reporting issues involving cash, which may distort investors' perception of their overall performance.

Investment Policies

We believe that it is very important for individuals to understand the potential risks and returns of markets and to have an explicit plan, before they become investors. This explicit plan can best be expressed through an investment policy, which includes a benchmark defining the investor's long-term exposure to markets, and ranges defining how much discretion their investment manager has to add value through active strategies. Figure 1 shows a very basic example of an investment policy for a moderate balanced portfolio, which will have 60% exposure to equity markets over time. The discretionary ranges for this policy allow the equity exposure to be increased to as much as 80% in times where equities are expected to produce above average returns, and as low as 40% in times where equities are expected to produce below average or negative returns.

The discipline imbedded in this type of investment policy helps to control risk and to insure that investors maintain a level of market exposure which is consistent with their long-term financial objectives. The benchmark also provides an objective framework for measuring the value provided

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Figure 1 - Example of Basic Investment Policy

	Benchmark	Policy Ranges Minimum	Policy Ranges Maximum
Equities	60.0%	40%	80%
Bonds	40.0%	10%	60%
Cash	0.0%	0%	20%
	100.0%		

Source: Stairway Partners

CURRENT TOPIC

Cash, a Nice Place to Visit

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Strategy

- *We made no strategy changes during the month of June.*
- *Portfolios remain overweight global equity exposure and underweight investment grade bond exposure.*

CASH, A NICE PLACE TO VISIT - CONT'D

through active management. We believe that each of these attributes plays an important role within a disciplined investment process, which is tailored to meet an individual's financial needs.

Cash and Long-Term Returns

A long-term investor with the sole objective of maximizing their wealth over time could choose to invest all of their assets in the market which is expected to produce the highest long-term returns. This would be reasonable, if it were not for the fact that investments with higher expected returns also tend to come with more risk. Looking back over time, this can be observed in the history for several well-known market indices. In the 36 year period ending in December of 2011, the S&P 500 equity index produced an average annual return of 10.9%. The more conservative Barclay's US Aggregate bond and LIBOR cash indices produced lower returns of 8.3% and 6.2%, respectively. As expected, the higher equity returns over this period were accompanied by higher risk. The standard deviation of returns, which is the statistical measure of volatility most often used to describe risk, was 5.6% for bonds and 1.1% for cash. Equity volatility was considerably higher at 15.5%. The higher risk for equities could also be observed by looking at the worst 12-month return period, which was an unfortunate -43.3%.

Because few have the stomach to subject all of their wealth to this level of risk, most prudent investors follow a diversified strategy and keep a portion of their assets in safer investments like bonds or cash. To apply this simple concept within the context of the aforementioned investment policy, investors must determine which safe assets provide the best protection from risk without sacrificing too much return, and then allocate an appropriate portion of that asset in their benchmark.

Figure 2 illustrates the tradeoff between risk and return for individual assets and a continuum of hypothetical portfolios which combine those assets. The colored lines in the figure represent two spectrums of balanced portfolios which could be created by combining either stocks and bonds, or stocks and cash. Both upwardly sloping lines indicate that reducing the allocation to equities and increasing the allocation to either bonds or cash will lower both the expected return and the overall level of risk. The relative position of the lines shows that portfolios using bonds as their safe asset are expected to produce better returns given the same level of risk. As an example, we show the returns that could be expected from constructing two different balanced portfolios with the same moderate level of risk, equivalent to the portfolio described in Figure 1. The additional expected return provided by the balanced portfolio containing bonds explains why we do not advocate the inclusion of cash in the benchmark of a long-term portfolio.

Strategic Use of Cash

Although we believe that persistently holding cash in a long-term portfolio detracts from performance, there are many times when an opportunistic allocation to cash can greatly improve results. Cash is the least volatile of all

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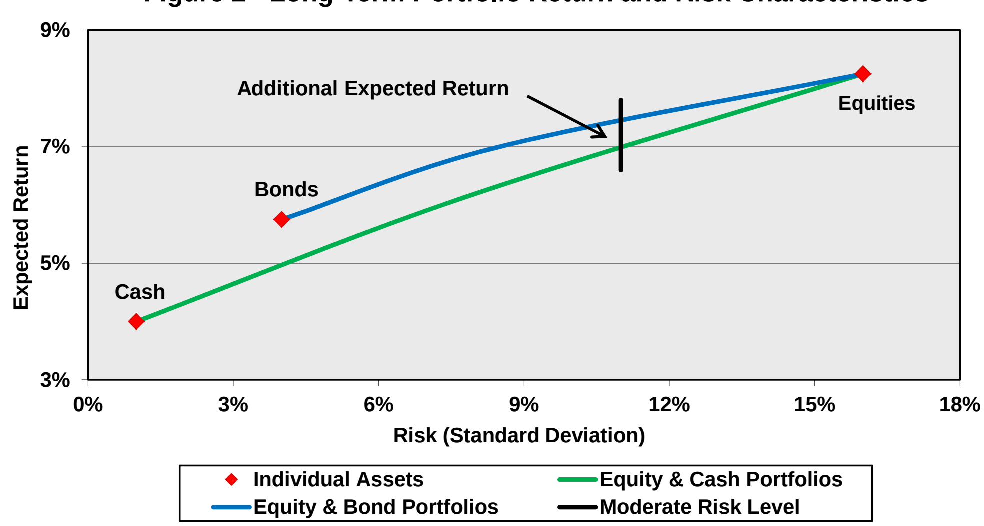
"PORTFOLIOS USING BONDS AS THEIR SAFE ASSET ARE EXPECTED TO PRODUCE BETTER RETURNS GIVEN THE SAME LEVEL OF RISK"

Figure 2 - Long-Term Portfolio Return and Risk Characteristics



Source: Stairway Partners

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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assets, which means that its expected returns do not vary dramatically over time. As a result, cash allocations are almost always the result of negative expected returns for another asset class.

Figure 3 shows the historical excess return of cash relative to both US equity and bond returns over the 36 calendar years through 2011. Even though cash underperformed both of the other asset classes over the 36 year period, there were 12 years where cash outperformed bonds, and 11 years where cash outperformed equities. The fact that cash frequently outperforms these other assets with better long-term performance shows that having the discretion to opportunistically use cash can reduce risk and improve portfolio results.

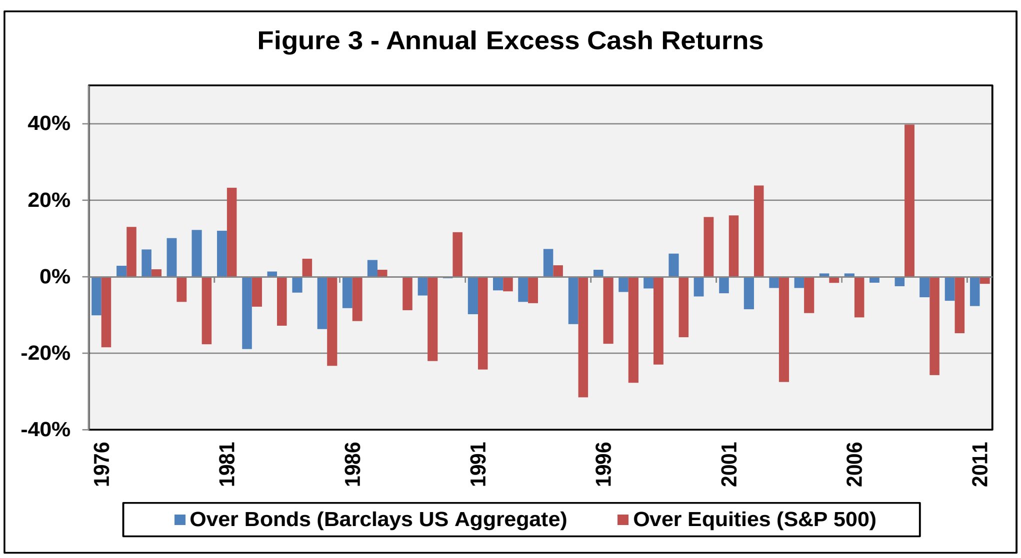
Since cash is generally expected to underperform equity and bond investments over time, it is important to monitor the relative attractiveness of these assets to insure that cash balances do not outlive their usefulness.

Currently, we are maintaining higher than normal cash positions within our portfolios. This is because we believe that bond markets are poised to produce relatively poor returns over a three-year investment horizon, which can be seen on the expected return table on the last page of this publication. Even though cash rates are near zero and are likely to stay there for quite some time, we believe that reducing cash and increasing bond allocations would detract from performance and actually increase the overall level of portfolio risk.

We also held relatively large cash balances in our portfolios in the latter half of 2007. At that time, cash provided a good alternative to equities, which we believed to be overvalued. Subsequently, as equity markets declined and expected returns increased, we reduced cash to purchase equities.

Conclusion

As is the case with any active decision with the potential to materially affect returns, it is important to measure the impact of holding cash on the overall performance of a portfolio. Because money held in cash outside of long-term portfolios is often thought of as "uninvested", some investors lose track of the effect that cash can have on their overall returns.



Sources: Barclays, Standard &Poor's, Bloomberg, Stairway Partners

"OVER THE 36 YEAR PERIOD, THERE WERE 12 YEARS WHERE CASH OUTPERFORMED BONDS AND 11 YEARS WHERE CASH OUTPERFORMED EQUITIES"

3 Year Annualized Return Estimates for Global Markets

7/2/2012	Total Returns			After-Tax Total Returns		
	Expected	Hurdle	Excess	Expected	Hurdle	Excess
Equities						
United States	**11.1%**	**4.0%**	**7.1%**	**9.4%**	**3.8%**	**5.6%**
Non-US Developed Markets	**21.4%**	**4.5%**	**16.9%**	**18.1%**	**4.3%**	**13.8%**
EMU	30.7%	4.9%	25.9%	26.1%	4.7%	21.4%
UK	26.4%	4.8%	21.6%	22.3%	4.6%	17.7%
Japan	11.5%	4.9%	6.5%	9.7%	4.8%	5.0%
Canada	-0.5%	4.3%	-4.7%	-0.4%	4.1%	-4.5%
Emerging Markets	**21.4%**	**5.7%**	**15.7%**	**17.5%**	**5.6%**	**11.9%**
Fixed Income						
US Aggregate	**-1.2%**	**2.0%**	**-3.2%**	**-1.5%**	**1.9%**	**-3.4%**
US Treasuries						
2 Year	0.0%	0.8%	-0.8%	-0.3%	0.6%	-0.9%
5 Year	-2.4%	1.3%	-3.7%	-2.4%	1.1%	-3.5%
10 Year	-5.7%	1.8%	-7.5%	-5.3%	1.7%	-6.9%
30 Year	-9.6%	2.0%	-11.6%	-8.5%	1.8%	-10.4%
TIPS						
5 Year	-1.1%	1.3%	-2.4%	-1.4%	1.2%	-2.6%
10 Year	-5.3%	1.9%	-7.2%	-5.0%	1.7%	-6.7%
30 Year	-13.7%	2.3%	-16.0%	-11.8%	2.1%	-13.9%
Municipal	**0.1%**	**1.4%**	**-1.3%**	**0.5%**	**1.2%**	**-0.7%**
2 Year	0.2%	0.7%	-0.5%	0.3%	0.5%	-0.2%
5 Year	-1.1%	1.1%	-2.2%	-0.7%	0.9%	-1.6%
10 Year	-1.5%	1.5%	-3.0%	-0.8%	1.3%	-2.1%
20 Year	1.5%	1.7%	-0.3%	1.8%	1.5%	0.3%
High Yield	**3.3%**	**2.9%**	**0.4%**	**1.5%**	**2.8%**	**-1.3%**
High Quality High Yield	3.3%	2.1%	1.2%	1.6%	1.9%	-0.4%
Emerging Market ($ demonimnated)	**0.5%**	**3.2%**	**-2.7%**	**-0.7%**	**3.0%**	**-3.7%**
Foreign Aggregate	**-4.3%**	**3.4%**	**-7.7%**	**-4.0%**	**3.3%**	**-7.3%**
Foreign Aggregate (hedged)	-3.2%	1.7%	-4.9%	-3.3%	1.6%	-4.9%
Foreign Treasury	**-4.6%**	**3.0%**	**-7.6%**	**-4.3%**	**2.8%**	**-7.1%**
Foreign Treasury (hedged)	-3.6%	1.3%	-4.9%	-3.6%	1.1%	-4.7%
Cash	**0.5%**	**0.5%**	**0.0%**	**0.3%**	**0.3%**	**0.0%**
Currency						
Euro	-2.0%	2.3%	-4.3%			
British Pound	-0.4%	2.2%	-2.6%			
Japanese Yen	-0.6%	2.4%	-3.0%			
Canadian Dollar	-0.7%	1.4%	-2.1%			

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)