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CURRENCIES: OUR INVESTMENT APPROACH

Introduction

At the beginning of this year, it seemed as though everyone was calling for the US dollar to continue falling. The massive trade deficit and the accompanying current account deficit, coupled with the low savings rate of individual Americans, were all elements of the argument against the dollar. In contrast, we had stated in our December 2004 *Monthly*, "it is time to move against the herd and reduce exposure to foreign currencies." At that time, our research showed the dollar was attractive versus the euro and betting on further depreciation would not be our strategy. Conversely, and as stated earlier, the herd was counting on weak dollar momentum persisting.

Year-to-date, the dollar has risen substantially against other major currencies (see Figure 1). This reversal of momentum has caused a number of the dollar bears of seven months ago to reverse their positions recently. An article in *The Wall Street Journal* ("The Dollar Strikes Back", July 12, 2005) opens with the sentence: "With the U.S. dollar hitting a 52-week high against the euro last week, some professional investors who've been betting on foreign currencies *are starting to reverse course*" (our emphasis). The article goes on to say that "Investment firms…are telling clients to cut back exposure to investments in foreign currencies or are reducing their own positions in international equities." One firm is said to have begun "the year bearish on the dollar but is *now reducing* international stock exposure."

There are two disturbing trends at play here:

• First, it seems evident to us that much of impetus behind these recommendations is based on what the market has done over the last few months. Pundits who jump on the bandwagon typically are describing the reasons that currency markets have already moved and offer little insight as to expectations of future movements. Why should investors sell their foreign assets now that their value has (already) been significantly reduced by declines in the foreign currencies?

• Second is the apparent failure of these investment "experts" to separate the currency decision from the asset decision. Non-US equity markets actually performed very well while their currencies were weakening. If the dollar were to continue strengthening, it should provide a boost to non-US exporters, thus helping foreign equity markets. Wouldn't you want to own these foreign markets while hedging the currencies back to US dollars?

Regardless of the problem, all of this discussion skirts the central question for us: what constitutes a fair level for an exchange rate?

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Figure 1: US Dollar Strength

Currency	YTD 2005
Euro	13.0%
Japanese Yen	9.6%
British Pound	9.9%

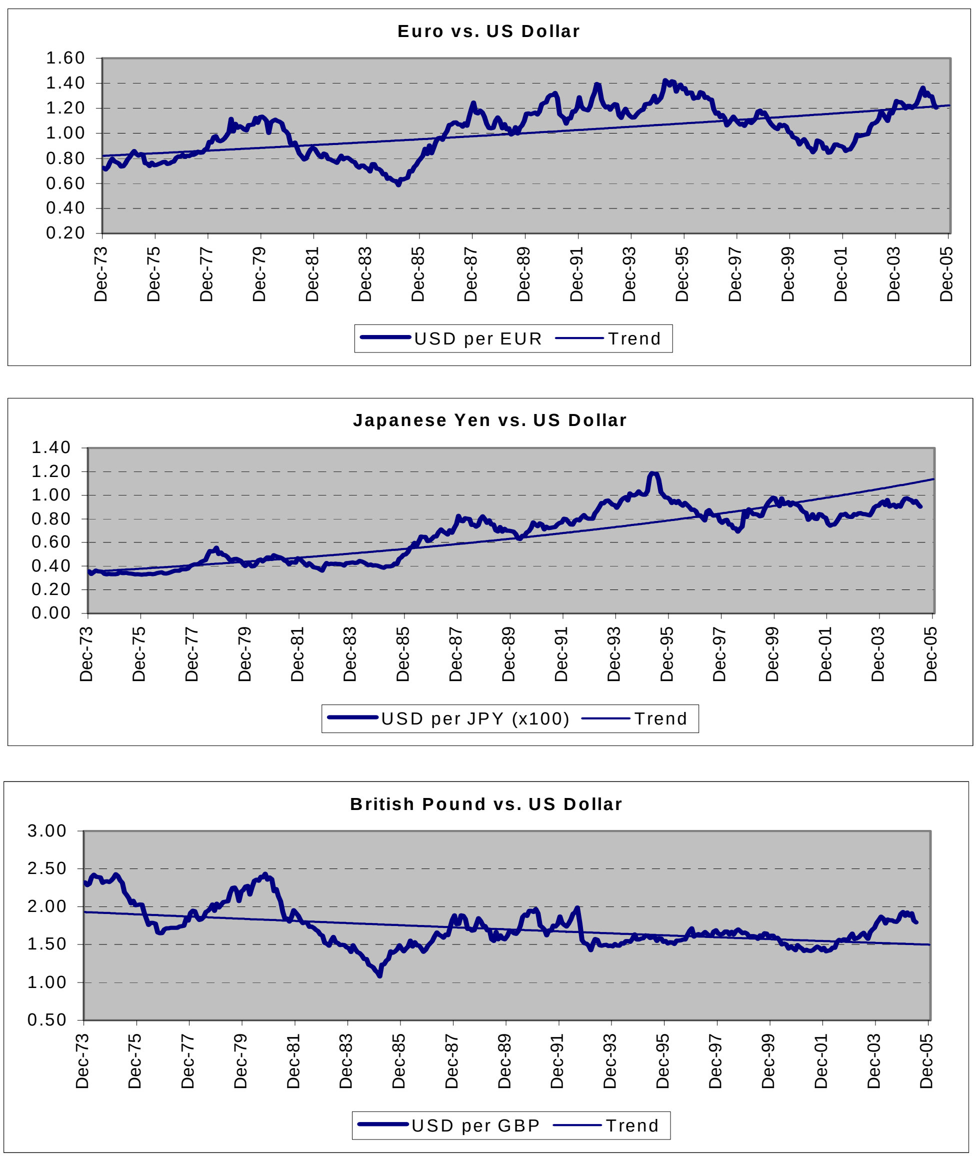
Sources: Bloomberg, Stairway Partners

CURRENT TOPICS

"This reversal of momentum has caused a number of the dollar bears of seven months ago to reverse their positions recently"

CURRENCIES: OUR INVESTMENT APPROACH - CONT'D

Figure 2



Sources: Bloomberg, Haver Analytics, Stairway Partners

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Background

Portfolios that are globally diversified naturally have currency exposures in them. Our investment process separates the currency decision from the asset class decision. Portfolios are constructed by selecting the best combination of asset classes and currency exposures that are consistent with each client's blueprint. We specifically avoid the noise and hype often associated with the currency market to avoid any "trading mentality" in what most describe as a notoriously difficult market.

Currencies, like stocks and bonds, move around a lot – they are much noisier than the underlying fundamentals. What are the fundamentals we consider to be important in the determination of a currency's fair value?

Fundamentals

Many factors are offered to explain exchange rate movements: current account balances, interest rate differentials, differences in economic growth rates, tax rates, etc. These can drive currencies over shorter time frames – or at least used to explain movements after the fact – but what is important to us is the long-run anchor.

Figure 2 shows long-term charts of the euro (deutschemark prior to 1999), Japanese yen, and British pound against the dollar. Clearly, the trends in the yen and euro have been to appreciate, while the pound has trended lower. In addition to the trend movements, there is considerable volatility over shorter time periods. What drives these long-term trends, and can it be employed as the anchor for a currency's fair value?

It helps to think of an exchange rate as simply the rate at which one currency can be converted into another. Identical goods should be priced similarly in different countries and currencies, so that there is no arbitrage profit to be made by buying in the cheaper country/currency, shipping to the

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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.

THERE WERE NO STRATEGY CHANGES FOR THE MONTH OF JULY. EVEN THOUGH EQUITIES PERFORMED WELL AND BONDS PERFORMED POORLY, WE REMAIN UNDERWEIGHT BONDS AND NEUTRAL ON EQUITIES.

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more expensive country, and re-selling. This is the fundamental notion of purchasing power parity (PPP) and is the basis for the well-known Big Mac currency comparison that is published occasionally by *The Economist* magazine. Differences in pricing of the Big Mac hamburger, which is presumably identical across markets, are taken to signify currency over- or under-valuation. (Of course, it would be impossibly messy to try to arbitrage burgers around the world, but you get the idea.)

While PPP may not explain movements from a speculator's point of view, it does provide us, as a long-term investor, with an important implication – if prices in one country are rising faster than in another, the higher inflation country should see its currency decline. This currency depreciation keeps the "real" price of goods the same in both markets.

Implications

The table in Figure 3 shows the average annual change in the three major currencies relative to the US dollar since 1973, the year that marked the beginning of the floating exchange rate era. The strength shown by the euro and the yen – annual appreciation of 1.6% and 3.0%, respectively – is reflected in the trend lines discussed earlier (Figure 2). As expected from the notion of PPP, this currency strength corresponds to higher inflation in the US than in those markets. With respect to the pound, the story is exactly the opposite: higher British inflation has driven that currency down against the dollar.

This long-run link between inflation differentials and exchange rate movements provides the foundation for our fair value levels of exchange rates.

In the near term, our return expectations are based on how far a currency has moved away from its fair level. In the long term, our expectations are a function of inflation differentials and their impact on the trend. When short-term trading moves a currency far enough from its long-term fundamental value, we will adjust exposures across portfolios to either reduce risk or capture return.

Summary

Given the dollar's rise in the first half of this year, we now see the major currencies as being close to fair value. Currency strategy, as a result, is neutral – currency exposures in portfolios are currently close to benchmark weights. As emphasized earlier, our investment process does not speculate on near-term price movements but ensures that currency risk within a globally diversified portfolio is appropriate given each client's blueprint.

Figure 3

Annualized Changes vs. US (12/73 to 6/05)

	Currency Change	Inflation Differential**
Euro*	1.6%	0.9%
Japanese Yen	3.0%	3.0%
British Pound	-0.8%	-2.1%

* Euro data are for Germany and the deutschemark prior to 12/99
** Inflation rates are based on producer price indices
Differential is US inflation minus foreign inflation

Sources: Bloomberg, Haver Analytics, Stairway Partners

Strategy

Asset Class	Expected Return	Hurdle Return	Strategy	Comment
Equities				
US	5.1%	7.5%	neutral	Slightly overvalued but strategy still neutral
Non-US Developed				Some markets close to fair value, currencies also close to neutral
Eurozone	4.1%	6.7%	neutral	
Japan	0.1%	4.3%	neutral	
UK	7.5%	8.3%	neutral	
Emerging	7.5%	11.6%	neutral	Slightly overvalued but strategy still neutral
Fixed Income				
US Treasury Bonds			under	Shorter maturities offer best relative value
2-Year	3.9%	4.3%		
5-Year	3.8%	4.5%		
10-Year	3.2%	4.8%		
25-Year	2.4%	5.0%		
US Municipal Bonds			small under	Sector has been moving closer to fair value
2-Year	2.8%	3.0%		
5-Year	3.0%	3.4%		
10-Year	3.6%	3.7%		
25-Year	5.9%	4.2%		
US High Yield	3.9%	6.0%	under	Spreads over US Treasuries remain too tight
Non-US Government Bonds			under	Yields generally insufficient compensation for risk
Euro 10-Year	1.0%	4.1%		
Japan 10-Year	-0.6%	1.8%		
UK 10-Year	2.9%	4.9%		
Emerging Markets Debt	4.0%	6.2%	under	Spreads over US Treasuries remain too tight
Cash	4.0%	---	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	-1.4%	2.7%	-0.4%	
Japanese yen	3.5%	3.6%	2.9%	
UK pound	-2.5%	5.0%	0.4%	

Notes: **As of: 7/31/2005**

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.