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WHERE'S THE DIVERSIFICATION?

Introduction

One of the fundamental principles of investing is the benefit of diversification. Assets that have low correlation to "the market" – that is, they don't move closely in tandem with other assets – are desirable because they can help improve the risk and return characteristics of a portfolio. A well-diversified portfolio should produce a smoother, less volatile pattern of returns than a concentrated portfolio.

Diversification also allows investors to add small amounts of "risky" investments to their portfolios without a noticeable increase in overall risk. In their search for returns over the last few years, many investors have taken the diversification argument as justification to pour money into many different areas: emerging markets, private equity, commodities and hedge funds.

Recently, however, this flow of capital has produced some unintended consequences: many of these "diversifying" investments have been moving more closely together. Diversification has been reduced, resulting in investors potentially having portfolios that are riskier than anticipated.

Historical Observations

As Figure 1 shows, the non-US equity asset classes have been behaving more like the US market than they had prior to the mid to late 1990s. Diversifying an equity portfolio outside the US provided a greater risk-reduction benefit in the 1970s and 1980s. But, with the globalization of investors' portfolios, it appears as though equity market movements have become more

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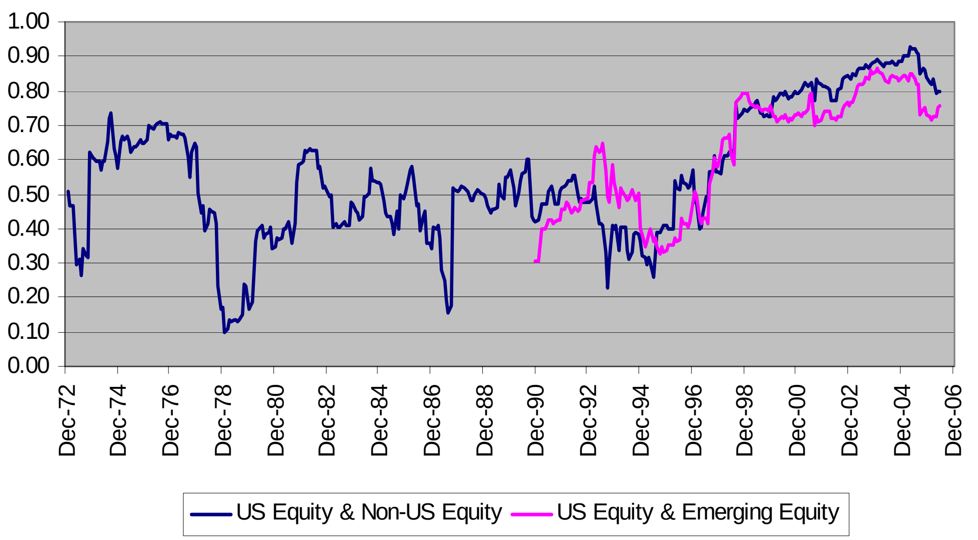
CURRENT TOPICS

STRATEGY

There were no strategy changes in the month of July. Portfolios remain underweight non-US equities, high yield and emerging debt.

Figure 1: Rolling 36-Month Correlation Among Global Equity Markets



Sources: MSCI, S&P, Stairway Partners

"NON-US EQUITY ASSET CLASSES HAVE BEEN BEHAVING MORE LIKE THE US MARKET THAN THEY HAD PRIOR TO THE MID TO LATE 1990s"

Where's the diversification? - cont'd

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similar.

Although many investors consider commodities to be an acceptable asset class, we do not view them as such. This is simply because commodities, such as futures contracts or gold bullion, are not income-producing assets like stocks or bonds. Nevertheless, we can look at the relationship between the US equity market and commodities to see whether investors are receiving their anticipated diversification. Figure 2 shows that, over the long run, the correlation between the stock market and the Goldman Sachs Commodity Index (which is heavily weighted toward energy) has fluctuated around zero – i.e., good diversification.

Another interesting observation is the relationship between a different alternative investment – in this case, hedge funds – and the stock market. Figure 3 illustrates the close relationship between returns in emerging equities and emerging markets hedge funds. This high level of correlation, also seen in a number of other hedge fund categories, not only implies that hedge funds may be falling short of their expected diversification, but also that they contain a lot of market risk.

Recent Developments

How does this picture of higher correlation and lower diversification look over the more recent past? Observing financial markets since the start of this year, it has seemed that moves in the US stock market have been closely mirrored by other equity markets *and* by other financial markets more generally. In fact, the correlations across global equity markets remain elevated, in keeping with the last few years. What is interesting is that the behavior of commodities has recently moved much more closely in line with equities. This phenomenon has been attributed to investors' herd-like movements of capital into (and out of) all types of risky investments at the same time. Figure 4 shows the correlation between commodities and emerging equity markets since the beginning of 2006. Clearly, the relationship between these "alternative" investments has been much stronger recently than in the more distant past.

Investment Implications

If correlations have moved to higher levels than was the case historically, and more importantly, if they are higher than investors have

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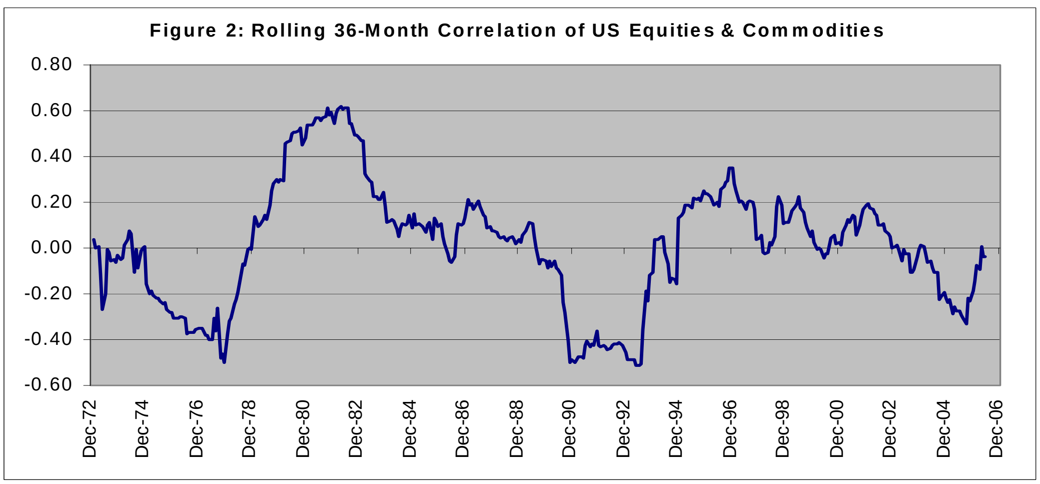
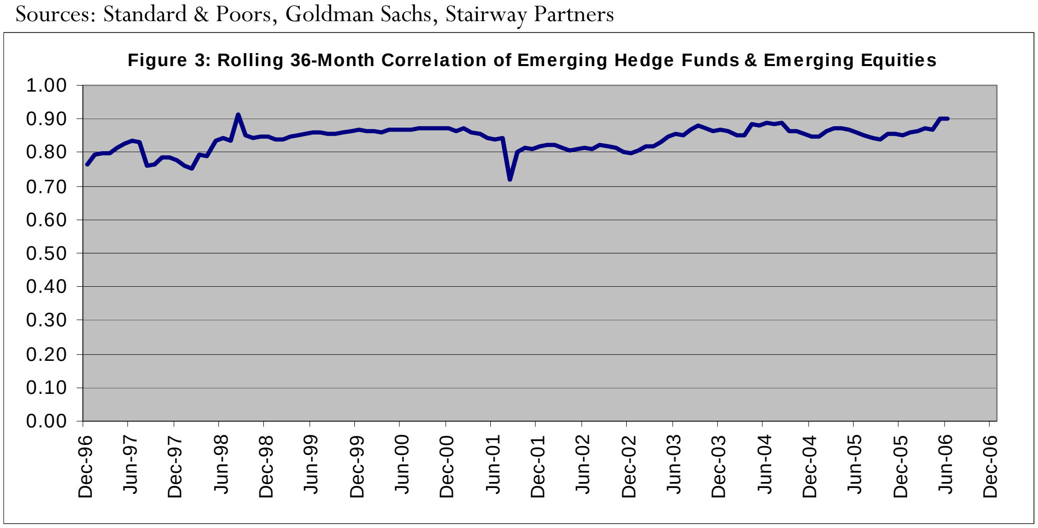


Sources: Standard & Poors, Goldman Sachs, Stairway Partners



Sources: Bloomberg, CS/Tremont, MSCI, Stairway Partners

"HEDGE FUNDS MAY BE FALLING SHORT OF THE LEVEL OF DIVERSIFICATION THAT IS EXPECTED FROM THEM"

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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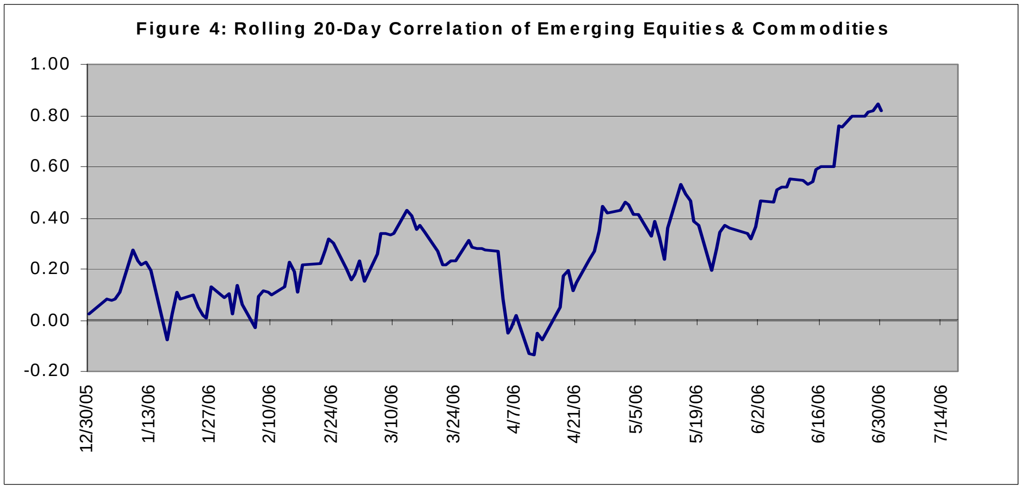
assumed in their portfolio risk estimates, there is considerably less diversification to mitigate risk. Investors may be "falsely secure" in thinking that, since they have a number of investments in their portfolio, a significant downturn in financial markets would have only a small impact on their wealth.

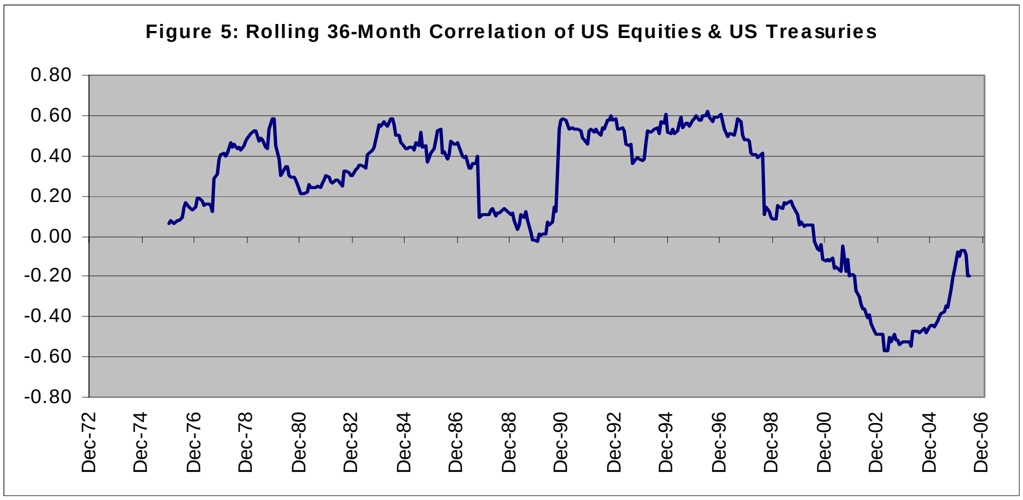
It also seems that many investors view high-quality bonds as poor-returning and irrelevant. Because bond returns have been moving independently of stocks and other financial markets, bonds provide one of the few diversification opportunities in this market environment. As Figure 5 illustrates, the US equity market and Treasury bond market have diverged dramatically since the late 1990s, with bond returns being most dissimilar to stock returns during the bursting of the tech bubble after 1999.

Conclusion

We feel that the implications for investors are pretty clear: investment-grade bonds remain one of the best diversifying assets in a portfolio. Investors are not getting the level of diversification in other riskier investments that they would have in the past. So, having exposure to high quality fixed income is extremely important. If (when) investors again flee from risky assets, the attraction of low-correlation bonds will become obvious.



Sources: MSCI, Goldman Sachs, Stairway Partners



Sources: Standard & Poors, Lehman Brothers, Stairway Partners

"HIGH-QUALITY BONDS PROVIDE ONE OF THE FEW DIVERSIFICATION OPPORTUNITIES IN THIS MARKET ENVIRONMENT"

Strategy

Asset Class	Expected Return	Hurdle Return	Strategy	Comment
Equities			small under	
US	5.8%	8.5%	neutral	Exposure equal to normal portfolio weighting
Non-US Developed			small under	Remains unattractive relative to US market
Eurozone	2.3%	7.2%		
Japan	-8.0%	4.5%		
UK	5.4%	8.3%		
Emerging	2.1%	11.6%	under	Asset class inadequately pricing risk
Fixed Income				
US Treasury Bonds			neutral	Sector is fairly priced except at longest maturities
2-Year	5.0%	4.8%		
5-Year	5.0%	4.9%		
10-Year	4.8%	5.1%		
30-Year	4.3%	5.3%		
US Municipal Bonds			neutral	Sector is fairly priced
2-Year	3.7%	3.4%		
5-Year	4.0%	3.6%		
10-Year	4.4%	3.9%		
30-Year	7.0%	4.3%		
US High Yield	5.3%	6.9%	under	Spreads over US Treasuries remain too tight
Non-US Government Bonds			under	Yields generally insufficient compensation for risk
Euro 10-Year	2.7%	4.5%		
Japan 10-Year	1.2%	2.2%		
UK 10-Year	3.6%	5.0%		
Emerging Markets Debt	4.3%	7.2%	under	Spreads over US Treasuries remain too tight
Cash	4.8%	---	over	Allocation comes from overpriced asset classes

Currencies	Expected FX Change	Equity Return with Currency	10-Year Bond Return with Currency	
Euro	-3.1%	-0.8%	-0.5%	Close to fair value
Japanese yen	4.2%	-3.8%	5.4%	Yen is slightly attractive
UK pound	-4.5%	0.9%	-0.9%	Close to fair value

Notes: **As of: 7/31/2006**

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.