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MONTHLY

VOLUME 6, ISSUE 8 AUGUST 2009

HIGH YIELD BOND MARKET UPDATE

Introduction

High yield bonds, also known as junk bonds, are debt securities that are rated below investment grade. On a year-to-date basis, the high yield bond index has produced a total return of 38.4%, which is the second highest of the major asset classes we follow. Like other risky asset classes, the excellent performance comes after a terrible 2008.

We last wrote about high yield bonds in our November of 2006 *Monthly,* titled "Risk and Return in High Yield". At that time, general investor confidence was high and yields in this asset class were low by historical standards. We then argued that investors were not being adequately compensated for the risks associated with the high yield bond market. As a result, we had no high yield exposure in client portfolios. As market prices declined, we reintroduced high yield bonds to portfolios during 2008, moving to an overweight position in October. Since that time, high yield bonds have enjoyed excellent performance. In this *Monthly* we revisit our discussion of the high yield bond market by reviewing recent performance, examining return components, and addressing how current credit composition affects our investment outlook for the sector.

Perspective

Figure 1 illustrates the annual performance history of high yield bonds going back to 1983 - the inception of the Barclays US High Yield Index. With a negative return of 26.2%, 2008 stands out as the worst year for the high yield market. The magnitude of the loss was the result of low ingoing yields (see Figure 2), the seizing up of credit markets and the precipitous decline in economic conditions. High yield issuers are dependent

(Continued on page 2)

CURRENT TOPIC

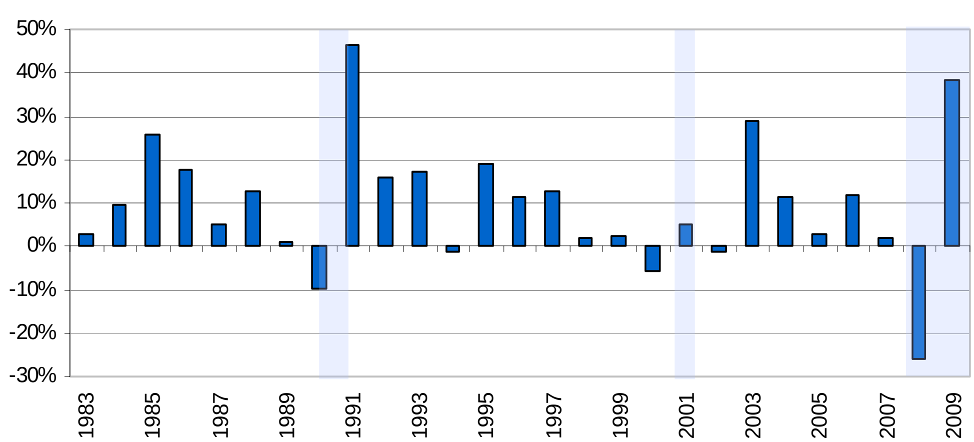
High Yield Bond Market Update

- *Introduction*
- *Perspective*
- *Components of Return*
- *Current Credit Quality*
- *Investment Implications*

Strategy

- *There were no strategy changes in client portfolios during the month of July*
- *Portfolio strategies remain overweight developed equity markets and high yield bonds*

Figure 1: High Yield Index Yearly Total Returns



Source: Barclays, NBER Notes: Shaded areas show recession, 2009 is YTD through July

"ON A YEAR-TO-DATE BASIS, THE HIGH YIELD BOND INDEX HAS PRODUCED A TOTAL RETURN OF 38.4%"

High Yield Bond Market Update - Cont'd

on a healthy economy to produce cash flow needed to service their debt so it should not be surprising that the worst return years occurred around economic recessions.

Components of Return

Returns on high yield bonds are a function of income, changes in market yields and credit losses. Income, perhaps the most intuitive of the three, accrues to investors through the payment of coupons. Changes to market yields are a bit more complex, as they reflect forward looking estimates of underlying interest rates, liquidity and credit conditions. As the yields of existing bonds adjust to meet new expectations, market prices change and affect the value of the outstanding debt. An increase in yields lowers the value of the bonds contained in a portfolio. The reverse is true when yields decline. Figure 2 shows the yield of the Barclays High Yield Bond Index reaching nearly 23% in December of 2008. This extraordinary move to higher yields was the primary reason that high yield investors suffered dramatic losses in 2008.

The third and final factor affecting high yield bond returns is credit losses. Credit losses occur when companies are unable to meet their contractual obligations and default on payments that are owed to bond holders. If it were not for defaults, the long-term returns on high yield bonds would look very similar to their long-term average yields. In fact, historical returns have been lower than market yields through time, because some level of defaults have existed in the high yield bond market. According to Moody's, the long-term default rate for high yield bonds has been 4.5%. In our valuation process, our forward-looking estimate of long-term default rates is a more conservative 5%.

It is also important to assess default rates than can occur over shorter periods of time, as they can deviate substantially from the long-term average. We monitor two factors which have been closely linked to defaults - general economic conditions and the aggregate credit quality of the outstanding bonds in the high yield market. As

(Continued on page 3)

"The yield of the Barclays High Yield Bond Index reached nearly 23% in December of 2008... This extraordinary move to higher yields was the primary reason that high yield investors suffered losses in 2008."

Figure 2: High Yield Index - Yield

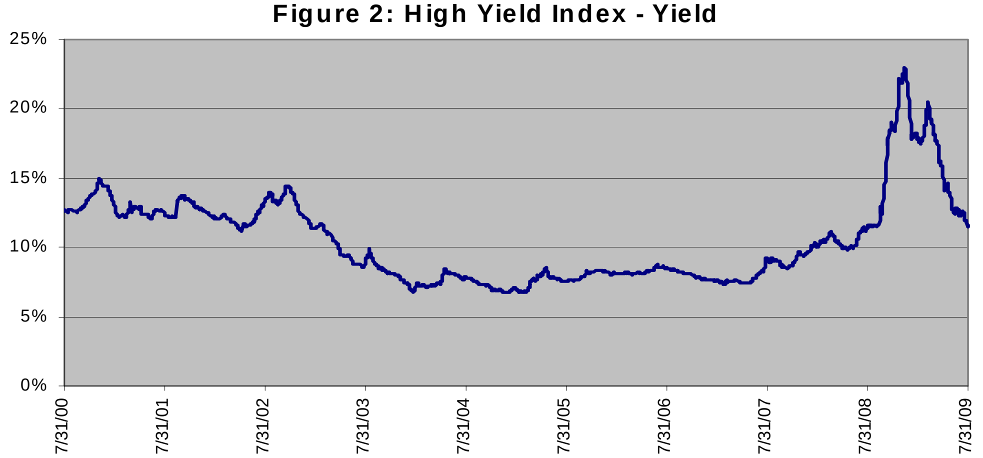
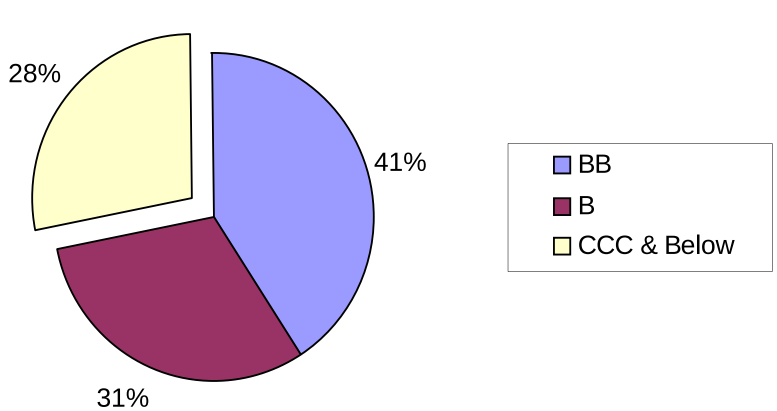


Figure 3: Credit Composition of High Yield Index



Sources: Barclays, Stairway Partners Note: Credit composition is expressed as market value %

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.

mentioned earlier, the level of economic activity is an important determinant of defaults. The aggregate credit quality of the high yield market also affects corporate defaults. Rating agencies, like Moody's and S&P, assign individual credit ratings to companies by examining their financial condition and their ability to meet future financial obligations. These ratings, despite recent criticisms, provide a reasonable measure of how much economic stress companies can weather.

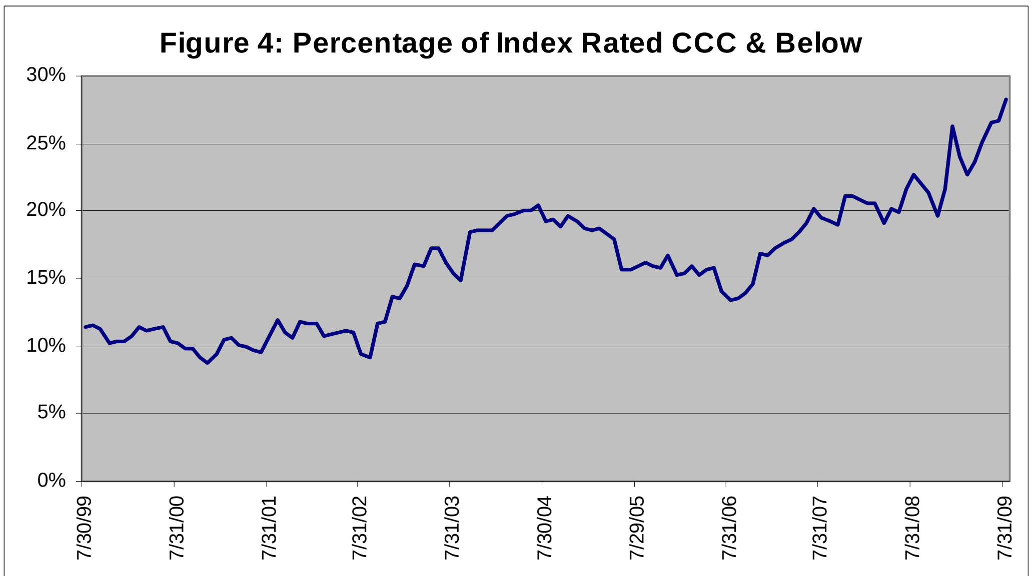
When companies default on their debt, bond investors have a claim on the assets of the failed issuers. As assets are liquidated or companies restructure, bond holders receive compensation against their original claims. The amount of compensation ultimately received by the bondholder is known as the recovery rate, and has averaged 40% over the past 25 years. Recovery rates are greatly influenced by defaults. In periods of low default rates, recovery rates have been as high as 60% and in periods when default rates are high, recovery rates have been below 25%.

Current Credit Quality

Figure 3 shows the composition of the high yield index by credit quality. Currently, 28% of the high yield market resides in the lowest quality categories. As you can see in figure 4, the current percentage of the High Yield Bond Index rated CCC and below is elevated by historical standards. For this reason, we assume that a much higher than normal level of defaults will occur in the near term given the recent economic contraction. Based on our expectations of higher near-term defaults, we also assume that recovery rates will be lower than normal. Our near-term estimates of default and recovery rates are 12% and 25% respectively, worse than past recessions, and significantly more penal than our long-term assumptions.

Investment Implications

Within our fundamental valuation framework, high yield bonds still offer attractive prospective returns, even after this year's strong performance. However, the recent improvements in high yield bond prices have brought this asset class much closer to fair value. Continued improvement in high yield bond prices would justify a reduction in allocation from current strategy.



Sources: Barclays, Stairway Partners

"The current level of the High Yield Bond Index rated CCC and below is elevated by historical standards …

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Strategy

Asset Class	Expected Return	Hurdle Return	Strategy Exposure	Comment
Equities				
US	20.5%	5.9%	over	Exposure above benchmark weight due to attractive pricing
Non-US Developed			over	Asset class remains attractive despite recent rally
Eurozone	24.5%	5.8%		
Japan	13.8%	4.4%		
UK	21.1%	6.2%		
Emerging	9.0%	10.3%	neutral	Asset class is close to fair value
Fixed Income				
US Treasury Bonds			under	Treasuries expensive, but non-Treasury sectors are more attractive
2-Year	0.9%	2.9%		
5-Year	1.0%	3.6%		
10-Year	1.5%	4.4%		
30-Year	1.2%	4.8%		
US Municipal Bonds			under	In most maturities, municipal bonds are modestly overpriced
2-Year	1.0%	2.2%		
5-Year	1.1%	2.8%		
10-Year	2.5%	3.5%		
30-Year	8.9%	4.5%		
US High Yield	4.9%	4.3%	over	Pricing has improved considerably but asset class is still attractive
Non-US Government Bonds			under	Yields remain below fair levels
Euro 10-Year	1.4%	4.2%		
Japan 10-Year	-0.1%	1.9%		
UK 10-Year	2.0%	4.7%		
Emerging Markets Debt	4.0%	4.6%	under	Other asset classes offer better value
Cash	2.6%	---	minimal	

Currencies	Expected FX Change	Equity Return with Currency	10-Year Bond Return with Currency	
Euro	-8.1%	16.5%	-6.7%	Euro is moderately overpriced
Japanese yen	-2.2%	11.6%	-2.3%	Yen is near fair value
UK pound	-1.4%	19.6%	0.5%	Pound is near fair value

Notes: **As of: July 31, 2009**

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.