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MONTHLY

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DIVERSIFICATION WITHIN MARKETS

Introduction

Investors have become acutely aware of the level of market risk, which has been elevated in recent years. In fact, looking back over the past 30 years, the worst quarterly, semiannual and annual returns for US and International equity markets all occurred in 2008 and the beginning of 2009. In stark contrast, those same markets also produced some of the best quarterly and semiannual returns for the last 30 years in the period that immediately followed.

As is always the case, the returns on many individual stocks within these markets were even more extreme. There were winners, like Apple whose value has more than tripled since the first quarter of 2009. Unfortunately, there were also companies like General Motors, AIG, Lehman Brothers, Fannie Mae & Freddie Mac whose equities lost virtually all of their value as the financial crisis drove them out of business or into government receivership.

Even though general business conditions and investor sentiment tend to move equity prices in in the same direction, the number of individual stocks or the type of mutual funds held by investors can have a profound impact on their portfolio's overall risk characteristics.

We have written extensively about diversification in the past as it relates to combining asset classes like stocks and bonds to reduce the overall risk of a balanced portfolio. In this *Monthly* we will discuss the benefits of diversification within an asset class by examining a portfolio of individual stocks. We will also discuss how the same principals of diversification apply to bonds and how funds and separately managed accounts (SMA) can be used to gain the benefits of diversification in a broad portfolio.

Individual Stocks

Individual stocks are all subject to the risk of the overall market. This broad market risk, known as systematic risk, can not be reduced through diversification.

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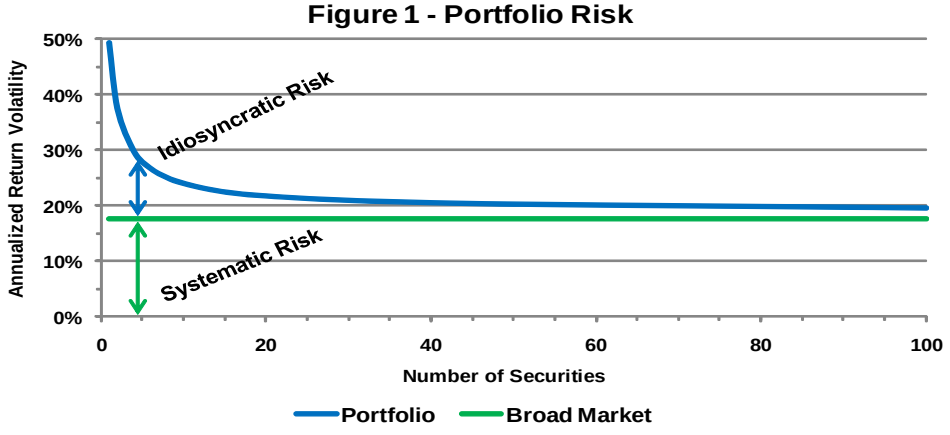
CURRENT TOPIC

Diversification Within Markets

STRATEGY

- *We made no strategy changes during the month of July.*
- *Portfolio strategies remain overweight developed equity markets*

Figure 1 - Portfolio Risk



Sources: Edwin J Elton and Martin J Gruber, Stairway Partners

"EMPIRICAL STUDIES HAVE SHOWN THAT INCREASING THE NUMBER OF SECURITIES IN A PORTFOLIO CAN DECREASE THE OVERALL RISK"

DIVERSIFICATION WITHIN MARKETS - CONT'D

Individual stocks are also impacted by factors which are unique to each company. These individual characteristics create what is known as idiosyncratic or stock specific risk. Investors can reduce their exposure to this type of risk through diversification.

Empirical studies have shown that increasing the number of securities in a portfolio can decrease overall risk by reducing the level of risk that comes from concentrated holdings in individual securities. One of the most famous studies on diversification was published by Edwin J. Elton and Martin J. Gruber in their book "Modern Portfolio Theory and Investment Analysis". Elton and Gruber took a universe of over 3,000 stocks and calculated the riskiness of portfolios containing randomly selected groups of holdings with equal weights. They used annualized return volatility as a measure of risk. The study concluded that as the number of securities in a portfolio increases, the overall riskiness of the portfolio decreases. They also concluded that the incremental diversification benefit from each additional security declines as the total number of securities goes up. Figure 1 shows that increasing the number of holdings from one to twenty dramatically decreases the return volatility, which falls from 49% down to 22%. The subsequent effect of increasing the number of holdings from twenty to one hundred only decreases the return volatility from 22% down to 20%. Eventually, as more and more securities are added the risk of the portfolio does not change materially and the investor is left with the systematic risk of the overall market.

Because Elton and Gruber's study used a random selection methodology, the equities in their portfolios did not have any sector or industry biases. An investor may experience less diversification benefit from the same number of securities, if they favor stocks with similar characteristics such as high dividend payouts or bias toward a particular industry.

Equity Diversification using Funds

We believe that the most efficient way for investors to gain exposure to a large number of securities is through passive mutual funds or exchange traded funds (ETF's). Passive funds are designed to replicate the returns of a given market by purchasing a representative amount of hundreds or even thousands of the securities that comprise that market's index. As a result, one fund can give a portfolio extremely well diversified exposure to the market which it covers. A good example of such a fund is IWV, the Russell 3000 ETF that we use for US Equities, which holds over 2,900 individual stocks.

Our March 2008 *Monthly* "Efficient Asset Class Exposure", which primarily focused on returns, provided a detailed explanation of why we believe that passive funds are the best way to gain exposure to markets. From a diversification standpoint, passive funds are valuable not only because they contain many securities, but also because their market exposure is well defined and targeted to a specific index. Because of this well defined exposure, multiple passive funds can be combined to cover different markets without the risk of unintended overlap.

Figure 2 shows how our current equity ETF line-up covers the grand majority of the global equity markets without overlap.

Some investors attempt to improve their portfolio's returns by using actively managed funds or separately managed accounts, where managers strive to outperform the market by concentrating exposure in certain sub-sectors of their market or

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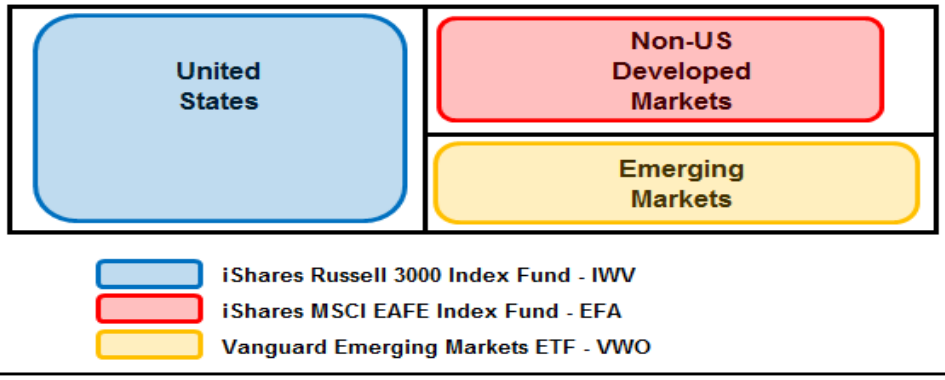
Figure 2 - Coverage of Global Equity Markets
(Passive Fund Strategy)



Source: Stairway Partners

"PASSIVE FUNDS CAN BE COMBINED TO COVER DIFFERENT MARKETS WITHOUT THE RISK OF UNINTENDED OVERLAP"

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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venturing into other markets.

This manager discretion results in actively managed funds having a lower level of transparency and less constant exposure to well defined markets over time. Figure 3 provides a hypothetical example of how broad diversification can be impacted by the use of actively managed funds. The figure illustrates that a well-intentioned investor seeking to build a diversified portfolio by purchasing multiple actively managed funds can end up with a portfolio that is overexposed to some sectors of the market and lacking in exposure to others. This is because active managers can independently migrate into same positions creating overlap and unwanted concentration.

Bond Diversification

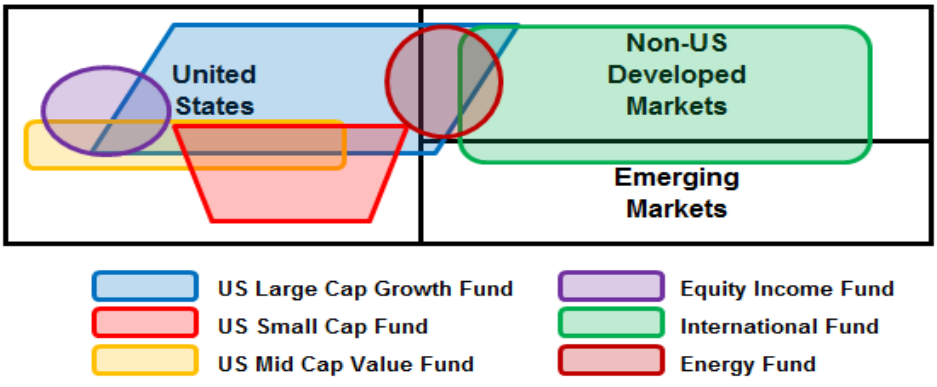
Although most of the research on diversification has focused on stocks, the same concepts apply to bonds. As is the case with stocks, increasing the number of bonds in a portfolio reduces the idiosyncratic risk, and passive funds can provide efficient exposure to well defined fixed income markets.

There is one important distinction to draw between the risks of holding concentrated positions in bonds versus stocks. Normal market volatility affects both stocks and bonds in much the same way. However, the distribution of potential returns over the life of an individual bond is very different from that of an individual stock. In the worst case, when a company goes out of business, both stock and bond investors share significant downside risk. There were many unfortunate examples of this seen in the recent financial crisis. On the other hand, bond investors seldom share equity investors potential for significant capital gains when a company's performance exceed market expectations. Unless bonds are purchased at deep discounts, the fact that they mature at a stated par amount limits potential gains. This asymmetry of potential returns makes a very strong case for diversifying bond portfolios.

Conclusion

Both academic research and recent experience support the practice of diversification within investment portfolios. By increasing the number of holdings and reducing concentrated exposure to individual securities, investors can dramatically reduce the overall risk of their portfolios. We believe that the most efficient way for investors to take advantage of the benefits of diversification is through the use of passive mutual funds, which follow well defined investment objectives and provide predictable market exposure.

Figure 3 - Coverage of Global Equity Markets
(Hypothetical Active Fund Strategy)



Source: Stairway Partners

"ACTIVELY MANAGED FUNDS HAVE A LOWER LEVEL OF TRANSPARENCY AND DO NOT PROVIDE CONSTANT EXPOSURE TO WELL DEFINED MARKETS OVER TIME"

Strategy

Asset Class	Expected Return	Hurdle Return	Strategy Exposure	Comment
Equities				
US	15.3%	5.2%	over	Exposure above benchmark weight due to attractive pricing
Non-US Developed			over	Exposure above benchmark weight due to attractive pricing
Eurozone	26.2%	5.6%		
Japan	3.8%	3.8%		
UK	30.4%	5.9%		
Emerging	5.4%	10.5%	neutral	Asset class close to fair value
Fixed Income				
US Treasury Bonds			under	Treasuries expensive
2-Year	0.4%	1.9%		
5-Year	0.5%	2.6%		
10-Year	1.3%	3.4%		
30-Year	3.3%	4.0%		
US Municipal Bonds			under	In most maturities, municipal bonds are overpriced
2-Year	0.5%	1.5%		
5-Year	0.9%	2.1%		
10-Year	2.6%	2.8%		
30-Year	9.0%	3.7%		
US High Yield	3.9%	3.7%	over	Sector is attractive relative to other fixed income sectors
Non-US Government Bonds			under	Yields remain below fair levels
Euro 10-Year	0.4%	3.6%		
Japan 10-Year	0.4%	1.2%		
UK 10-Year	1.1%	4.1%		
Emerging Markets Debt	2.4%	3.9%	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	-3.2%	23.0%	-2.8%	Euro is near fair value
Japanese yen	-1.2%	2.6%	-0.8%	Yen is near fair value
UK pound	-1.8%	28.5%	-0.7%	Pound is near fair value

Notes: **As of: July 31, 2010**

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.