STAIRWAY PARTNERS, LLC

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

MONTHLY

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FUNDING LONG-TERM PORTFOLIOS

Introduction

Most individuals with money to invest understand that long-term asset markets provide the returns needed to keep pace with inflation and increase their wealth over time. These individuals are also keenly aware that market returns come with risks, which can make their decision of how and when to invest difficult.

With the faith that their long-term objectives will best be met by the long-term returns of the market, many investors simply put money to work as soon as it is available. Others may choose to invest incrementally over some period of time, to avoid the potential shock of a near-term market decline. There are also those who choose to remain on the sidelines, because they feel that markets will provide them a better opportunity to invest at some point in the future.

In this *Monthly* we discuss the implications of these three funding strategies, and show how each would have impacted the long-term performance of a balanced portfolio through a variety of actual market environments.

Measuring Total Returns

To understand the impact that an investor's funding behavior has on performance, it is important to look objectively at the returns generated by their total pool of investable assets. This involves keeping track of the returns of the assets that have been invested in the market, and also the returns of the assets that have been held back in cash.

Unfortunately, many investors focus solely on their invested assets when markets appreciate, thus ignoring the dilutive effect that cash may have on the returns of their overall portfolio. It is also possible for investors to benefit from holding back cash, if markets deteriorate

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CURRENT TOPIC

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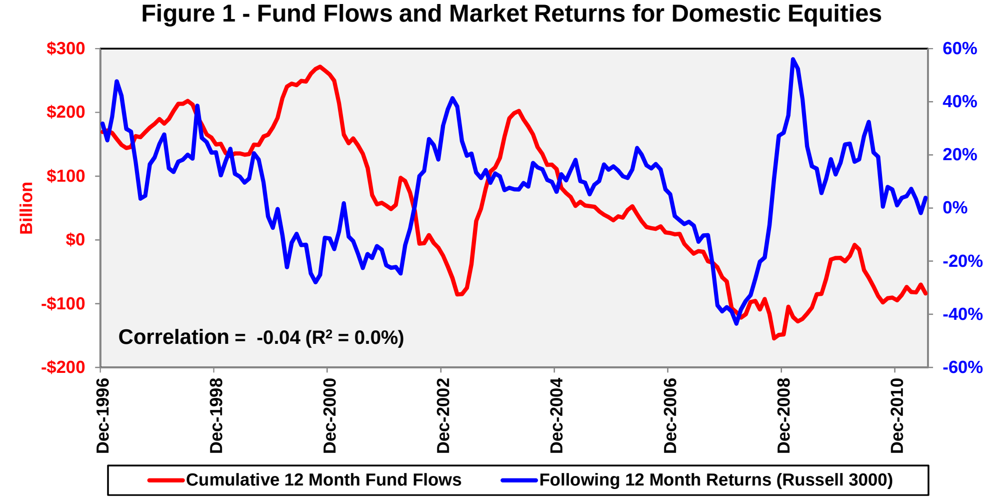
Strategy

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

Figure 1 - Fund Flows and Market Returns for Domestic Equities



Sources: Investment Company Institute, Russell

"INVESTORS WHO WAIT TO INVEST ARE NOT PREDISPOSED TO ACHIEVE ANY BETTER RESULTS THAN WOULD BE EXPECTED BY RANDOM CHANCE"

Funding Long-Term Portfolios - Cont'd

in the near-term. Here too it is important to measure overall results through time, to insure that cash is not held back for too long.

To illustrate how funding strategies impact long-term performance, we looked back at the historical performance of a balanced portfolio with 60% invested in global equities and 40% invested in domestic bonds. For our analysis we used monthly returns for the thirty six year period between 1976 and 2011. The returns and risks during this period are reasonably close to our long-term assumptions and contain a variety of different market environments, including the rise and fall of tech stocks around the turn of the millennium, double digit inflation in the early 80s and the most recent financial crisis and accompanying market crash. Over the entire period, the balanced portfolio produced an annualized return of 10.0%, while cash produced an annualized return of 6.2%.

Since each investor only experiences a slice of the market's long-term history, it is useful to go beyond the averages and look at the performance of a large number of finite time periods. This provides a more complete picture of an individual investor's actual chance of success. For our study, we used the 313 overlapping ten-year periods contained within our 36 year history.

Based on the average returns for these periods, an individual who invested $4 million at the outset could expect to have earned a 10.9% annualized return and ended up with a portfolio worth $12.0 million at the end of ten years. For the 313 periods studied, the balanced portfolio always produced a positive return and it beat cash 96% of the time.

Even in the worst case, where the balanced portfolio was liquidated at the bottom of the market in the first quarter of 2009, a $4 million investment produced a positive 1.5% annualized return and grew to $4.6 million.

Waiting for Safer Times

Making the decision to invest in volatile markets is a source of anxiety in almost any environment. When markets have been performing well, many investors fear that they have missed the best returns and that their investments will suffer in the future. When markets are strained, investors are bombarded with negative news and often fear that things will get worse before they get better. The result is that cautious investors may decide to keep their money in cash and wait until the markets appear to be more hospitable.

Unfortunately, the bulk of the evidence provided by academic research indicates that investors do a poor job of identifying when markets are going to be hospitable. A study quoted by Jack Bogle, the founder of Vanguard Group, in his book *Enough*, showed that investors missed out on as much as 40% of the equity market's return due to poor market timing and fund selection.

Investors' aggregate success in market timing can also be examined by comparing mutual fund flows to market performance. If investors were effective market timers, then we would expect to see periods of inflows followed by strong market returns, and periods of outflows followed by weak market returns. Figure 1 shows that for domestic equities there is no such relationship between twelve month net mutual fund purchases and the subsequent twelve months of market performance. Based on this evidence, we believe that investors who wait to invest are not predisposed to achieve any better results than would be expected by random chance.

To estimate the returns that a reticent investor would have experienced by delaying their investment, we assumed that they held their money in cash for the first three years, and then invested the entire $4

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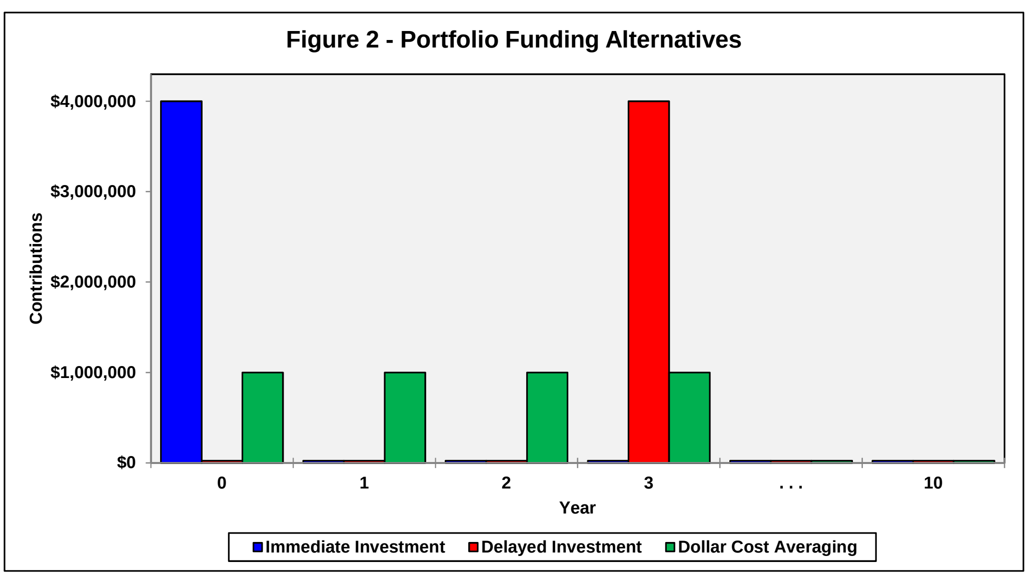

Source: Stairway Partners

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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million plus interest in the balanced portfolio for the remaining seven years. Looking back through time, the result was that on average, an investor who waited to invest ended up with an annualized return of 9.8% and $11.0 million at the end of 10 years. This is materially worse than the $12.0 million average ending value realized by an investor who did not hold back in the first three years.

Dollar Cost Averaging

The third and final funding strategy that we analyzed was that of an investor who invested their $4 million in the balanced portfolio through four roughly equal contributions, made over the first three years. This funding strategy is commonly known as dollar cost averaging. Specifically, we assume $1 million contributions were made at the beginning of the ten-year period, and at the end of years one, two, and three. The interest earned on the un-invested cash was combined with the final contribution made at the end of year three. Figure 2 illustrates the contribution profiles of dollar cost averaging and the other two funding strategies, which were discussed earlier.

The average return for the investor who used dollar cost averaging over the first three years was 10.4%, which resulted in an ending portfolio value of $11.5 million. As expected, this result is between the average returns achieved by investing the entire $4 million at the beginning of the ten-year period, or at the end of year three.

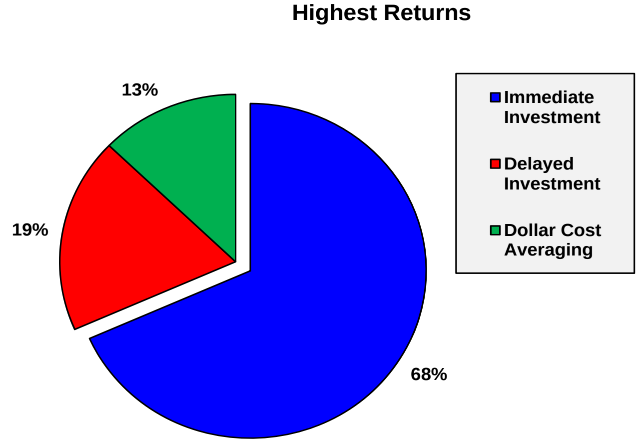
Figure 3 sums up the results of our study by showing the success rate for all three funding strategies in terms of the percentage of time that each provided the highest ten-year return. Although the portfolio funded using dollar cost averaging was in the middle in terms of average returns, it was actually the least likely to be the best alternative in a given ten-year period. In over two thirds of the ten-year periods, the best results were realized by the investor who did not delay the funding of the balanced portfolio.

Conclusion

Although market fluctuations generally wash out over time, long-term investors are not immune to the psychological and economic damage that can occur over shorter time periods. We believe that investors sometimes focus too much attention on short-term risks, as they contemplate committing to a long-term investment strategy. This can result in delayed funding, which historically has reduced returns, more often than not.

There is no guarantee of which funding strategy will yield the best results in the future for an individual at one point in time. However, an objective study of how investors would have fared through many market environments shows that those who invested their money sooner were more likely to achieve better results.

Figure 3 - Chance of Achieving Highest Returns



"IN OVER TWO THIRDS OF THE TEN-YEAR PERIODS, THE BEST RESULTS WERE REALIZED BY INVESTORS WHO DID NOT DELAY THE FUNDING OF THEIR BALANCED PORTFOLIO"

Sources: Barclays, Russell, MSCI, Bloomberg, Stairway Partners

3 Year Annualized Return Estimates for Global Markets

8/1/2012	Total Returns			After-Tax Total Returns		
	Expected	Hurdle	Excess	Expected	Hurdle	Excess
Equities						
United States	**9.6%**	**4.0%**	**5.6%**	**8.1%**	**3.8%**	**4.3%**
Non-US Developed Markets	**21.1%**	**4.5%**	**16.6%**	**17.8%**	**4.3%**	**13.5%**
EMU	30.2%	4.9%	25.3%	25.6%	4.7%	20.9%
UK	25.8%	4.8%	21.0%	21.8%	4.6%	17.2%
Japan	11.7%	4.9%	6.8%	9.9%	4.8%	5.2%
Canada	-0.9%	4.3%	-5.2%	-0.8%	4.1%	-4.9%
Emerging Markets	**21.6%**	**5.7%**	**15.8%**	**17.6%**	**5.6%**	**12.0%**
Fixed Income						
US Aggregate	**-1.7%**	**2.0%**	**-3.7%**	**-1.9%**	**1.9%**	**-3.8%**
US Treasuries						
2 Year	-0.1%	0.8%	-0.9%	-0.4%	0.6%	-1.0%
5 Year	-2.7%	1.3%	-4.0%	-2.6%	1.1%	-3.7%
10 Year	-6.2%	1.8%	-8.1%	-5.7%	1.7%	-7.4%
30 Year	-10.4%	2.0%	-12.4%	-9.2%	1.8%	-11.0%
TIPS						
5 Year	-1.7%	1.3%	-3.0%	-1.8%	1.2%	-3.0%
10 Year	-6.1%	1.9%	-8.0%	-5.6%	1.7%	-7.3%
30 Year	-15.3%	2.3%	-17.6%	-13.0%	2.1%	-15.2%
Municipal	**-0.7%**	**1.4%**	**-2.1%**	**-0.2%**	**1.2%**	**-1.4%**
2 Year	0.1%	0.7%	-0.6%	0.3%	0.5%	-0.3%
5 Year	-1.4%	1.1%	-2.5%	-0.9%	0.9%	-1.8%
10 Year	-2.2%	1.5%	-3.7%	-1.4%	1.3%	-2.8%
20 Year	-0.1%	1.7%	-1.8%	0.5%	1.6%	-1.1%
High Yield	**2.7%**	**2.9%**	**-0.3%**	**0.9%**	**2.8%**	**-1.8%**
High Quality High Yield	2.5%	2.1%	0.4%	0.9%	2.0%	-1.0%
Emerging Market ($ demonimnated)	**-0.5%**	**3.2%**	**-3.7%**	**-1.4%**	**3.0%**	**-4.5%**
Foreign Aggregate	**-4.4%**	**3.4%**	**-7.8%**	**-4.1%**	**3.3%**	**-7.3%**
Foreign Aggregate (hedged)	-3.5%	1.7%	-5.2%	-3.5%	1.6%	-5.1%
Foreign Treasury	**-4.6%**	**3.0%**	**-7.6%**	**-4.2%**	**2.8%**	**-7.0%**
Foreign Treasury (hedged)	-3.8%	1.3%	-5.1%	-3.7%	1.1%	-4.9%
Cash	**0.5%**	**0.5%**	**0.0%**	**0.3%**	**0.3%**	**0.0%**
Foreign Currency (versus US$)						
Euro	-1.8%	2.3%	-4.1%			
British Pound	-0.1%	2.2%	-2.3%			
Japanese Yen	0.0%	2.4%	-2.5%			
Canadian Dollar	-1.3%	1.4%	-2.8%			

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)