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MONTHLY

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WAITING FOR THE "FAT PITCH"

Introduction

The financial media seem obsessed with reporting small moves in currency, stock and bond markets. The alleged best and brightest are always able to explain in hindsight even the smallest market changes over short time periods. It seems that impatient investors crave activity, as though they are bored with anything less. This *Monthly* will explore why it's important to remain disciplined by waiting for the "fat pitch".

Patience

It shouldn't be the case that investors always have great ideas, as sometimes markets are priced close to fair value. There can be periods in which returns, both actual and expected, are somewhat boring and the last thing an investor should do is be impatient by "forcing the issue".

It is during these times that a "normal" position across asset classes is the most appropriate strategy. A normal position should comprise a diversified global portfolio that best reflects an investor's long-term objectives. We refer to this normal position as the *blueprint* or benchmark. By maintaining a normal position when there are no great ideas, you force diversification and balance when it is needed most.

To use a baseball analogy, if there are no "fat pitches" to hit, why should investors swing for the fences? For those of you not familiar with this analogy, a fat pitch is one that is very easy to hit, implying that the batter should swing aggressively since there is a high probability of a great outcome.

This analogy holds true for investors evaluating opportunities in currency, stock or bond markets. Investors who swing at bad pitches, by forcing bets that produce unwarranted and overly aggressive strategies, will have a higher probability of striking out.

Risk & Return

Another way to approach this issue is from a risk compensation point of view. Risk can be thought of on an absolute basis (whether I make or lose money) or on a relative basis (how I perform against my long-term objectives). Some investors who focus on absolute risk tend to react to short-term fluctuations. In this analysis, we focus on a relative basis because that provides better alignment with longer-term financial blueprints and objectives.

If asset classes are not significantly over-priced or under-priced, a patient investor should simply align their market exposures with their long-term goals. Conversely, when asset classes are priced at extreme levels, either too expensive or too cheap, an investor should take advantage of these mispricings by moving away from their long-term normal position.

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Stairway Partners will be relocating on October 1st

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CURRENT TOPICS

"By maintaining a normal position when there are no great ideas, you force diversification and balance when it is needed most"

WAITING FOR THE "FAT PITCH" - CONT'D

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This would be accomplished by reducing exposure to asset classes that are too expensive and/or increasing exposure to asset classes that are out-of-favor. As an investor shifts away from their normal allocations, they typically raise the amount of relative risk in the portfolio. This strategy is okay as long as the size of the opportunity justifies the incremental risk. Referring back to the baseball analogy, you are swinging at "fat pitches" more aggressively because you have a good chance at a favorable outcome.

Examples

Suppose a mix of 50% US equities and 50% bonds is appropriate given an investor's long-term objectives. Note, we typically incorporate a much broader mix of global asset classes, but we want to keep this example straightforward and easy to understand.

Figure 1 shows that the risk of this normal mix is 8.4%. Recall that this risk measure is the expected annualized level of return volatility. To provide some context, our assumption is that equities have annualized return volatility of about 15% and bonds about 5%.

Figure 1 also shows that, as you change strategy to move either more into equities or more into bonds, the risk of the portfolio deviates significantly from your long-term normal position. This is reflected in the deviation column which shows the amount of risk the strategy has relative to the long-term allocation of 50% stocks and 50% bonds.

Why would an investor deviate from their long-term allocation?

The answer is that there might be an opportunity, when market prices move sufficiently away from fundamentals, to put in place a strategy different from the long-term portfolio objectives. In essence, the investor gets to swing at a fat pitch.

In reality, fat pitches don't come "down the pipe" too often. And when they do, many batters may not recognize them and, even worse, may strike out with bases loaded.

One fat pitch, still in investors' memories, occurred during the first three years of this decade when the equity bubble burst. Figure 2 shows the 1, 2 and 3 year annualized performance, starting from 12/31/99, for

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Figure 1: Expected risk relative to long-term objectives

	Asset Mix	Annualized Risk	Deviation
Normal Mix	50/50 Equities/Bonds	8.4%	0.0%
Strategy A	80/20 Equities/Bonds	12.2%	4.4%
Strategy B	20/80 Equities/Bonds	5.5%	4.4%

Deviation = annualized risk relative to long-term objectives (the normal mix)

Figure 2: The bursting of the equity bubble

		Annual Performance from 12/31/99		
Strategy	Asset Mix	1 -Year	2 -Year	3 -Year
Not swinging	50/50 Equities/Bonds	2.0%	0.3%	-2.0%
Striking out	80/20 Equities/Bonds	-3.7%	-5.6%	-9.1%
Hitting the fat pitch	20/80 Equities/Bonds	7.7%	6.1%	5.2%

Figure 3: Buying equities when they were attractive

		Annual Performance from 12/31/02		
Strategy	Asset Mix	1 -Year	2 -Year	2 Yr. 8 Mo.
Not swinging	50/50 Equities/Bonds	17.1%	12.5%	10.5%
Hitting the fat pitch	80/20 Equities/Bonds	25.3%	17.7%	14.3%
Striking out	20/80 Equities/Bonds	9.2%	7.5%	6.8%

Figures 2 and 3 assume monthly rebalancing

Sources: Russell, Lehman, 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.

AFTER INTEREST RATES MOVED CONSIDERABLY HIGHER IN THE BEGINNING OF AUGUST, WE REVERSED OUR STRATEGY CHANGE OF JUNE 1ST BY PURCHASING INVESTMENT GRADE BONDS FOR BOTH TAXABLE AND TAX-EXEMPT ACCOUNTS.

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three different scenarios: not swinging (staying with the long-term objectives), striking out (being overweight equities at the wrong time) and hitting the fat pitch (being underweight equities at the right time).

Another good example would be when equities became attractively priced during 2003. Figure 3 shows the 1, 2 and 3 year annualized performance, starting from 12/31 2002, for the same three examples: not swinging, hitting the fat pitch and striking out.

It should be noted that in both these examples, most investors struck out with bases loaded. This was demonstrated in our research piece "The Case for Disciplined Investing" (August 2004).

Investment Implications

This year has produced little in terms of fat pitches. In our estimation, most asset classes have not strayed significantly away from their fair values. We have remained disciplined by not swinging at pitches outside the strike zone. Instead, our strategy decisions have resulted in a number of singles and walks.

These include reducing exposure to investment grade bonds when rates moved considerably lower (almost a fat pitch), and then adding back the same exposure when interest rates moved up. We also have, to varying degrees, maintained underweights in the emerging debt and high yield markets because their expected returns are insufficient for the amount of risk they impose.

Conclusion

Currently, most markets are close to fair value. As a result, we remain disciplined by being as diversified as possible and not swinging at pitches out of the strike zone.

Stairway Partners, LLC is moving

On October 1st, 2005

Stairway Partners, LLC

will relocate to:

2215 York Road

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Oak Brook, IL 60523

Our new phone numbers will be:

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Strategy

Asset Class	Expected Return	Hurdle Return	Strategy	Comment
Equities				
US	5.5%	7.6%	neutral	Slightly overvalued but strategy still neutral
Non-US Developed				Some markets close to fair value, currencies also close to neutral
Eurozone	4.5%	6.7%	neutral	
Japan	-1.9%	4.3%	neutral	
UK	7.4%	8.2%	neutral	
Emerging	7.2%	11.6%	neutral	Slightly overvalued but strategy still neutral
Fixed Income				
US Treasury Bonds			under	Shorter maturities offer best relative value
2-Year	3.7%	4.2%		
5-Year	3.4%	4.4%		
10-Year	2.6%	4.6%		
25-Year	1.7%	4.9%		
US Municipal Bonds			small under	A drop in rates has moved sector to slightly overpriced
2-Year	2.8%	3.0%		
5-Year	2.9%	3.3%		
10-Year	3.3%	3.7%		
25-Year	5.3%	4.1%		
US High Yield	4.1%	6.1%	under	Spreads over US Treasuries remain too tight
Non-US Government Bonds			under	Yields generally insufficient compensation for risk
Euro 10-Year	0.6%	4.0%		
Japan 10-Year	-0.5%	1.8%		
UK 10-Year	2.6%	4.8%		
Emerging Markets Debt	3.7%	6.3%	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	Currencies close to fair value
Euro	-1.6%	2.8%	-1.0%	
Japanese yen	3.4%	1.5%	2.8%	
UK pound	-3.0%	4.4%	-0.5%	

Notes: **As of: 8/31/2005**

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.