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MONTHLY

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CURRENCY UPDATE

Introduction

In this *Monthly*, we update our view of the currency markets and review the fundamental process that drives our decisions.

In contrast to most, we are not dollar bears and view the major currencies - euro, pound sterling and yen - as reasonably close to fair value versus the US dollar. The yen looks slightly attractive relative to the dollar, while the euro and pound sterling look slightly overpriced (Figure 1). These views remain similar to what we wrote in our past *Monthly* research pieces - December 2004 and August 2005.

Consensus

Judging from the financial press and the various research pieces we review, the consensus is still firmly bearish on the US dollar. The major arguments against the US dollar remain the same: the current account deficit (which is dominated by the trade deficit) and low US savings rate have created global imbalances that need to be rectified by the US dollar declining significantly. Because the current account is mirrored by the capital account, there is also a fear that foreign investors, tired of financing US consumption of imported goods, will stop buying and might even start selling US assets.

While we do agree that the US needs to improve its savings rate and reduce its dependence on foreign capital, depreciating the currency may not be the answer. This route could seriously damage global growth as export-oriented economies such as Japan, China and the Euro-zone may suffer greatly in this scenario.

Another argument that has gained recent attention is the less favorable interest rate differential. If the Federal Reserve is close to the end of its tightening cycle and other central banks continue to raise interest rates, this narrowing gap between US and foreign rates will cause investors to favor other currencies. This argument overlooks, in our

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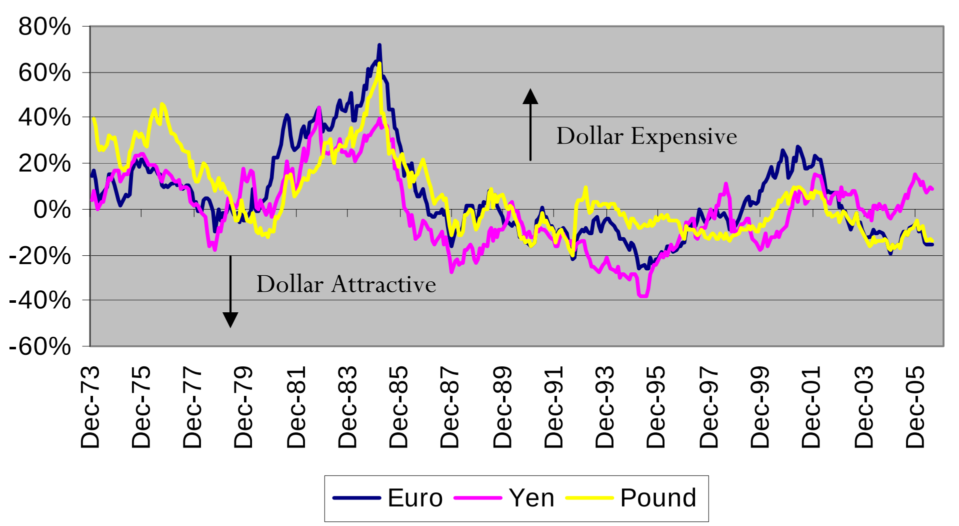
STRATEGY

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

Figure 1: US Dollar Relative Value



Source: Stairway Partners

> "THE YEN LOOKS SLIGHTLY ATTRACTIVE RELATIVE TO THE DOLLAR, WHILE THE EURO AND POUND STERLING LOOK SLIGHTLY OVERPRICED"

CURRENCY UPDATE - CONT'D

Figure 2: Euro and Yen versus US Dollar

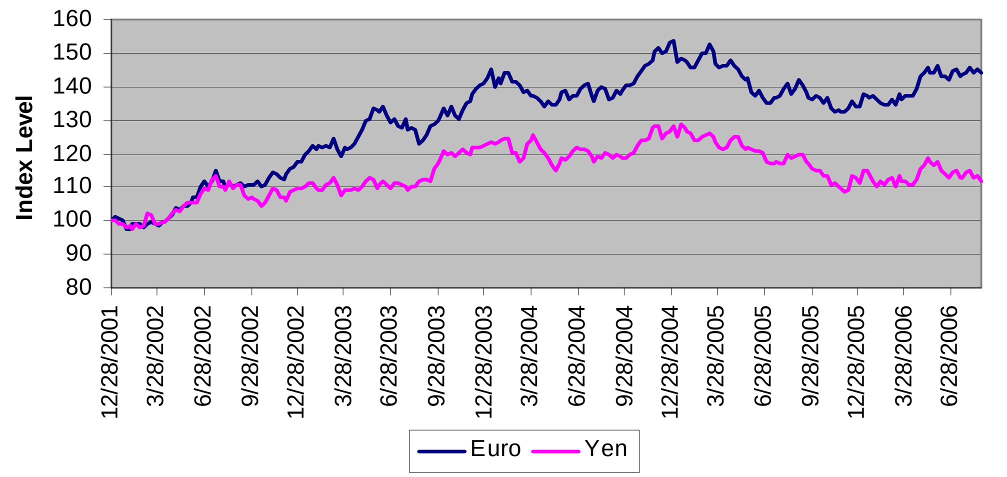


Figure 3: US Trade Balance ($ Billions)

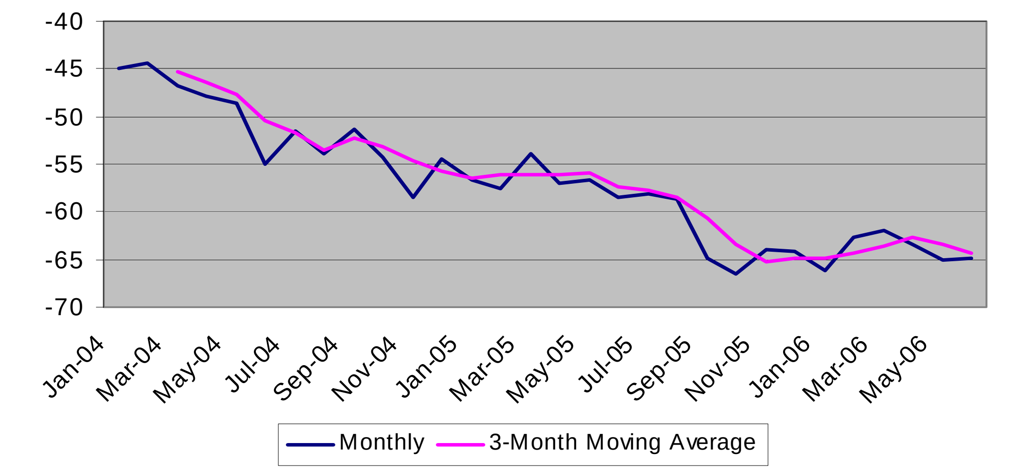
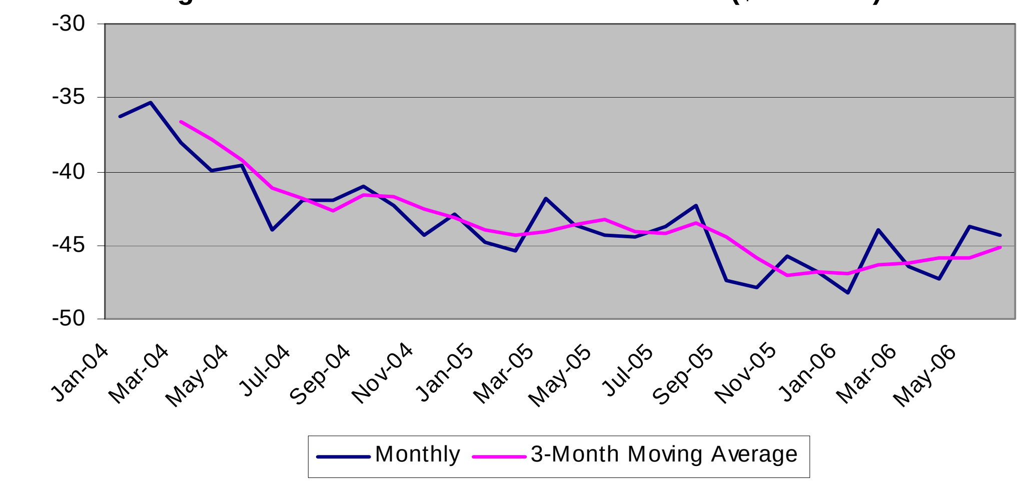


Figure 4: Non-Petroleum Trade Balance ($ Billions)



Sources: Bureau of Economic Analysis, Bloomberg, Haver Analytics, Stairway Partners

view, the fact that the economies of Japan, Europe and China have relied on the US consumer and exports for much of their growth. We do not believe, as some do, that other economies are immune to a US slowdown. This immunity argument hinges on the belief that domestic consumption in these other economies will pick up sufficiently to offset the drop in exports.

Evidence

As Figure 2 shows, the dollar has weakened significantly over the past five years. It is important to note that currency revaluation takes time to work its way into trade numbers (sometimes referred to as the "J curve" effect). We believe that the significant dollar weakness since February 2002 has in fact been showing up in the trade data.

Figure 3 shows that, since last October, the trade deficit has actually flattened out. This is despite a significant increase in the price of oil. Figure 4 shows that the non-petroleum trade deficit had stopped widening in

"THE DOLLAR HAS WEAKENED CONSIDERABLY OVER THE LAST FIVE YEARS"

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"SINCE OCTOBER THE TRADE DEFICIT HAS ACTUALLY FLATTENED OUT"

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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early 2004. In fact, as a percent of GDP, the trade balance has actually troughed and has shown a small improvement (Figure 5).

Process Revisited

In managing globally diversified portfolios that naturally have currency exposures outside the US, we separate the currency decision from the asset class decision. This is different from many other money managers who combine the asset and currency decisions - for example, recommending non-US equities as a way to play dollar weakness.

This does not make sense to us because foreign equity markets, as mentioned earlier, can be sensitive to the competitiveness of their exports. A significantly weaker dollar will adversely impact the sales and earnings of foreign companies that rely on exports to the US. In a recent WSJ article ("German Outlook Worsens in Latest Economic Survey" 8/23/2006), the ZEW economic research institute states that the appreciation of the euro against the dollar will curtail the growth in exports, thus reducing growth in the European economies.

Fundamentals

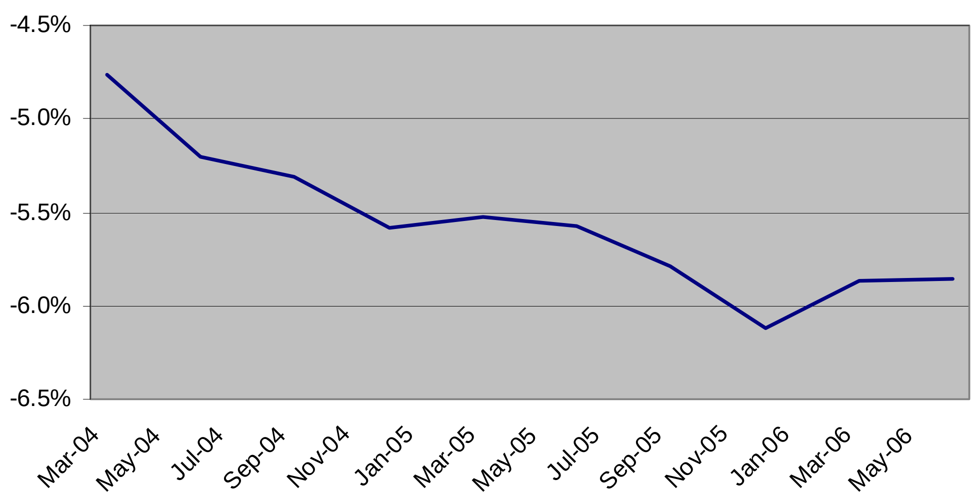
Consistent with our firm's overall philosophy, we also view currencies in terms of long-term fundamentals, not with a short-term trading mentality. This is especially helpful in currency markets which are often fickle and volatile. Even the best investors find it difficult to get the timing of currency strategies correct – witness Warren Buffet who had a significant and widely known short position in the US dollar at the beginning of 2005 right when it was about to strengthen significantly. He then went on to reduce his short dollar exposure just before the dollar started to weaken again.

As reported in the past, we construct a fair value for currencies that starts with the fundamental notion of purchasing power parity (PPP). Essentially, PPP exists when identical goods are priced "the same" in different currencies, so that there is no arbitrage profit to be made by buying in the cheaper country/currency, shipping to the more expensive country and re-selling. PPP may not help a trader or speculator, but it does provide the investor with an anchor to assess long-term fair value in the currency markets.

Investment Implications

With the exception of the Chinese yuan, most currencies are reasonably close to fair value. For the long-term investor, it is not appropriate to have a significant position either in favor of or against the dollar. As a result, the currency exposures in our client portfolios are a consequence of our market views on the individual asset classes.

Figure 5: Trade Deficit as a Percent of GDP



Sources: Department of Commerce, Bureau of Economic Analysis, Stairway Partners

"AS A PERCENT OF GDP, THE TRADE BALANCE HAS ACTUALLY TROUGHED AND HAS STARTED TO IMPROVE"

Strategy

Asset Class	Expected Return	Hurdle Return	Strategy	Comment
Equities			small under	
US	5.1%	8.5%	neutral	Exposure equal to normal portfolio weighting
Non-US Developed			small under	Remains unattractive relative to US market
Eurozone	1.1%	7.2%		
Japan	-9.2%	4.5%		
UK	5.5%	8.4%		
Emerging	1.3%	11.6%	under	Asset class inadequately pricing risk
Fixed Income				
US Treasury Bonds			neutral	Sector is fairly priced except at longer maturities
2-Year	4.8%	4.7%		
5-Year	4.7%	4.8%		
10-Year	4.3%	5.0%		
30-Year	3.6%	5.2%		
US Municipal Bonds			neutral	Sector is fairly priced
2-Year	3.5%	3.4%		
5-Year	3.7%	3.6%		
10-Year	4.1%	3.8%		
30-Year	6.4%	4.2%		
US High Yield	5.1%	6.9%	under	Spreads over US Treasuries remain too tight
Non-US Government Bonds			under	Yields generally insufficient compensation for risk
Euro 10-Year	2.3%	4.4%		
Japan 10-Year	0.4%	2.0%		
UK 10-Year	3.4%	5.0%		
Emerging Markets Debt	3.9%	7.2%	under	Spreads over US Treasuries remain too tight
Cash	4.7%	---	over	Allocation comes from overpriced asset classes

Currencies	Expected FX Change	Equity Return with Currency	10-Year Bond Return with Currency	
Euro	-3.2%	-2.1%	-0.9%	Close to fair value
Japanese yen	5.1%	-4.2%	5.5%	Yen is slightly attractive
UK pound	-5.1%	0.4%	-1.6%	Close to fair value

Notes: **As of: 8/31/2006**

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.