STAIRWAY PARTNERS, LLC

2215 York Road, Suite 515 Oak Brook, IL 60523

www.stairwaypartners.com

630-371-2626 phone 630-371-2617 fax

MONTHLY

VOLUME 4, ISSUE 9 SEPTEMBER 2007

REPRICING RISK

Introduction

We have frequently written about how a number of markets were underpricing risk. As a result, our strategy has been to underweight risk across portfolios. We do not profess to know when investors will reprice risk, but can only observe prices as they relate to fundamentals to gauge if investors are fairly compensated and then set strategy accordingly.

It is interesting to note that when the subprime mortgage market was initially reported as a problem in February, there was only a minor short-lived reaction. It is only more recently that risk has been repriced across most asset classes. Figure 1 shows how two measures of risk, implied equity volatility (VIX Index) and the spread between high yield bonds and US Treasuries, have increased over the last several months.

Background

In the latter part of July, credit and equity markets came under significant pressure. The problem, according to the media, originated in subprime mortgages. A number of factors led up to this situation:

- The housing market had been strong for a long time. In addition, interest rates were unusually low given strong economic growth.
- Investors who were looking for incremental return were eager to explore new markets. Wall Street, along with mortgage originators, provided these investors with higher yielding investment vehicles which came in the form of CDOs (collateralized debt obligations), many of which were backed by subprime mortgages.
- As acceptance grew for these new products, the demand for subprime mortgages to put into these CDO structures grew substantially. This in turn

(Continued on page 2)

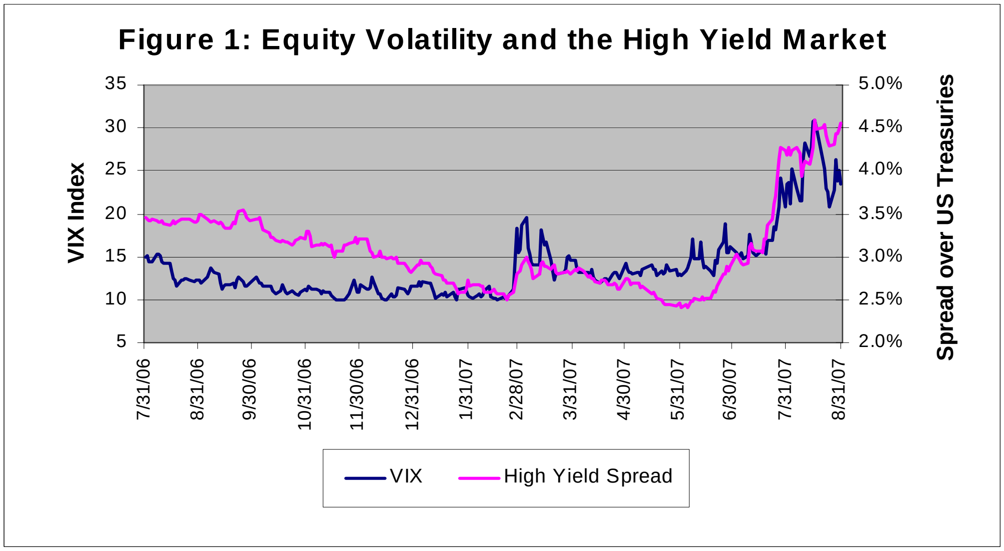
CURRENT TOPIC

Repricing Risk

- *Introduction*
- *Background*
- *Context*
- *Historical Comparison*
- *Conclusion*

STRATEGY

- *We remain underweight equity, high yield and emerging debt across portfolios*
- *In select portfolios, we removed short-term Treasury exposure from cash balances.*



Source: Bloomberg

"IT IS ONLY RECENTLY THAT RISK HAS BEEN REPRICED ACROSS MOST ASSET CLASSES"

Repricing Risk - cont'd

(Continued from page 1)

prompted mortgage originators to become even more aggressive in lending to borrowers who were the weakest financially. Many of these loans did not require down payments, had little or no documentation of income, were adjustable rate, or only required payment of interest (no amortization of principal).

Over time, many homeowners who shouldn't have been granted credit started to run into trouble. With the housing market no longer rapidly appreciating, the credit quality of the subprime sector came into question. As delinquencies and defaults started to increase, investors in CDOs stopped buying as the quest for incremental yield turned into fear of losses. In turn, mortgage originators who were creating these loans to put into CDOs stopped receiving the short-term funding required to run their operations. This forced many of them into bankruptcy. Liquidity started to dry up in other markets as well, most notably in commercial paper which had its own unique association with the subprime mess.

Alarm spread, as investors began questioning the price they were paying for risk. High yield bonds and bank loans, which had just hit their tightest spread over risk-free US Treasuries, started to come under pressure. This removed the easy financing that was supporting the leveraged buyout market (LBOs). Other markets suffered as well, including equities, municipal bonds and investment grade corporate bonds, with the only beneficiary being US Treasuries.

Context

It is possible to separate the recent financial market environment into two elements:

- A shorter-term liquidity "crunch"
- A longer-term repricing of risk

The liquidity crunch occurred when investors in CDOs woke up to the fact that they were taking too much risk and not likely to receive enough compensation. The problems became more serious when good borrowers started to get lumped in with bad borrowers and short-term funding disappeared across the board. Figure 2 shows the enormous gap that opened between the yield on short-term Treasury bills and the rate at which banks were lending to each other overnight (Effective Fed Funds Rate).

The Federal Reserve was able to alleviate this problem by encouraging financial institutions to borrow at the discount window, extending the terms of that borrowing, and also accepting a wide range of collateral, including some commercial paper backed by subprime loans.

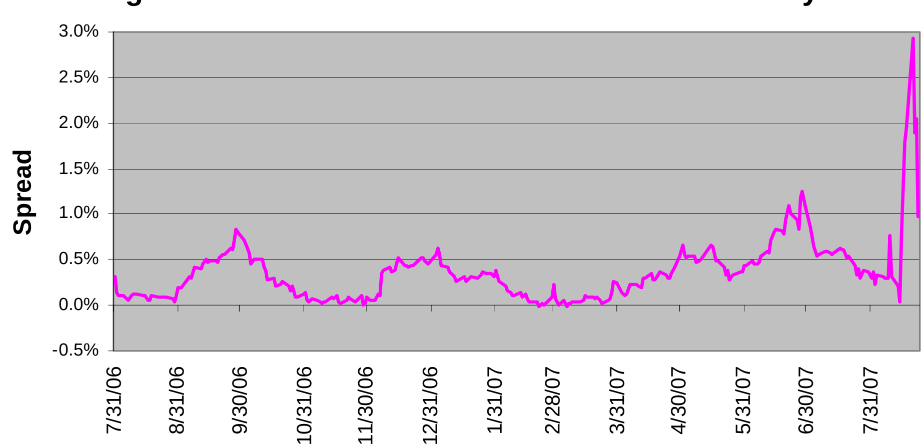
The big question is how investors' perceptions and behavior will change over the longer term. Are these problems now contained? Or will investors who have sustained losses continue to demand more compensation for risk?

Some of the losses are known and obvious, but there may be secondary effects that will take longer to play out. As mentioned earlier, some mortgage originators have already gone bankrupt and credit is harder to get for the purchase or refinancing of a home. Many investors, particularly those that employ leverage to purchase credit-sensitive assets, lost substantial sums of money.

Investors pulled back from the high yield and bank loan markets, which had been supplying cheap credit to fuel leveraged buyouts. This has forced a dramatic increase in borrowing costs for lower-rated highly leveraged companies. Many financial institutions are being forced to fill the gap, via their bridge lending agreements, and take the risk onto their own balance sheets. Earnings of financial institutions that are involved in CDO distribution, mortgage origination, and mergers and acquisitions will suffer.

(Continued on page 3)

Figure 2: Fed Funds less 1- Month US Treasury Bill



Sources: Federal Reserve, Bloomberg, 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.

The increased cost of credit may also affect the broader economy. Higher homeowner defaults and foreclosures should keep housing prices from recovering quickly, which could put a crimp in consumer spending (accounting for 70% of GDP). The cost of capital for businesses has gone up and, along with weakened domestic demand, could lead to softer employment and income. This is what the Federal Reserve is most worried about – the performance of the real economy. We do not believe that the Fed will come to the rescue of the financial markets, unless financial problems threaten to knock the economy into recession.

Historical Comparison

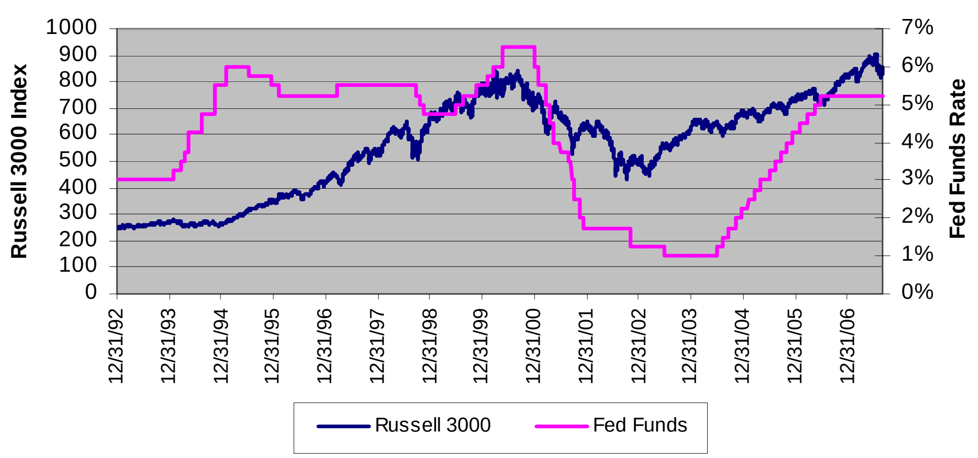
Many investors seem to believe that everything will be fine, if only the Fed were to start cutting interest rates. However, many times in the past, rate cuts were not associated with equity market strength (Figure 3). For example in 2000-01, despite a series of reductions in the Fed funds rate, the stock market entered a period of difficulty – and declined nearly 50% from its peak. Short-term interest rates were cut because the economy was going into recession, not to rescue stock market investors from risk. Reducing interest rates was unambiguously the right policy, given weakness in the economy and dormant inflation.

How does that "typical" episode compare to today's environment? It is not at all clear that the economy is facing a recession. Although GDP growth was relatively weak in the first quarter of this year, it picked up considerably in the second quarter. In addition, unemployment remains low and inflation continues to be a concern to the Fed, although this concern seems to be abating. In light of the data, *aggressive* rate cuts do not seem to be in the cards. If they are, it would signal to us that the Fed has become quite concerned about the economic outlook. If this is the case, we would expect equity markets and risky assets in general to perform poorly, despite the rate cuts.

Conclusion

Over the last six weeks, credit spreads have widened as investors woke up to the risk and illiquidity inherent in credit sensitive markets. In our valuation framework, this cheapening has improved prospective returns . However, our estimates indicate that many asset classes, such as high yield bonds, have only started to approach "normal" levels of risk compensation. Spreads and expected returns, even after widening in high yield bonds, are still well below levels experienced in times of crisis and bad economic environments. Likewise, while stock prices have declined toward fair value, they still need to be lower in order to be priced fully consistent with risk. While we are closer to adding risk back to portfolios, we have not yet changed our strategy.

Figure 3: US Equities and Target Fed Funds Rate



Sources: Federal Reserve, Bloomberg

Strategy

Asset Class	Expected Return	Hurdle Return	Strategy	Comment
Equities			under	
US	3.9%	8.7%	small under	Exposure slightly below normal
Non-US Developed			small under	Moderately unattractive relative to risk
Eurozone	2.2%	7.9%		
Japan	-6.6%	4.7%		
UK	6.9%	9.3%		
Emerging	-5.3%	10.8%	under	Asset class inadequately pricing risk
Fixed Income				
US Treasury Bonds			neutral	Sector is fairly priced except at longest maturities
2-Year	4.1%	4.4%		
5-Year	4.0%	4.6%		
10-Year	3.8%	4.9%		
30-Year	3.5%	5.2%		
US Municipal Bonds			neutral	Yields are attractive relative to risk
2-Year	3.7%	3.4%		
5-Year	3.9%	3.6%		
10-Year	4.5%	3.9%		
30-Year	7.1%	4.3%		
US High Yield	6.3%	7.1%	under	Spreads over US Treasuries have widened considerably
Non-US Government Bonds			under	Yields in some markets too low, especially at longer maturities
Euro 10-Year	3.5%	4.6%		
Japan 10-Year	0.4%	2.0%		
UK 10-Year	4.5%	5.3%		
Emerging Markets Debt	3.6%	7.4%	under	Spreads over US Treasuries remain too tight
Cash	4.9%	---	over	Allocation comes from overpriced asset classes

Currencies	Expected FX Change	Equity Return with Currency	10-Year Bond Return with Currency	
Euro	-5.5%	-3.3%	-2.0%	Euro is somewhat expensive
Japanese yen	5.0%	-1.6%	5.4%	Yen is slightly attractive
UK pound	-6.7%	0.2%	-2.2%	Pound is somewhat expensive

Notes: **As of: August 31, 2007**

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.