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MONTHLY

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# BENCHMARKING PERFORMANCE

### Introduction

On June 29th, the Wall Street Journal published an article titled "New Ways to Weigh an Advisor", detailing recent industry progress toward developing more consistent standards by which investors can judge the performance of their current or prospective investment advisors. Since Stairway Partners was founded in 2004, we have provided our clients and prospective clients with detailed and transparent performance reporting, allowing them to make more informed decisions about their financial assets. In the past, we have also written about issues relating to performance reporting, most recently in the February 2010 *Monthly* – "The Value of Objective Reporting".

The Spanish-American philosopher George Santayana said that, "***Those who cannot remember the past are condemned to repeat it.***" One of our founding principles is that a well-informed investor has the best chance for success.

To be well-informed, an investor needs clear and unbiased information in order to evaluate the performance of their investments and those responsible for providing investment advice. In this *Monthly*, we review the need for objective reporting measures, and discuss the industry's best methods for evaluating the performance of an individual's own portfolio and the performance of prospective investment advisors.

### Overall Portfolio Performance

The Securities and Exchange Commission (SEC) require mutual funds and exchange traded funds (ETFs) to show their performance versus relevant market indices. These indices, which are chosen in advance, help to provide investors with a clear indication of the market exposure that a fund can be expected to deliver. Comparing fund returns to the relevant indices also gives investors a clearer picture of how effective a fund has been at delivering results against the broad market.

Although indices like the S&P 500 are widely accepted and used to evaluate individual investments, this concept is seldom used by investors to holistically review the performance of their overall portfolio. This is unfortunate because research has shown that the grand majority of the variation in portfolio returns comes from asset allocation, which cannot be observed by looking at the performance of individual investments.

Most investors own a mix of assets with exposure to

*(Continued on page 2)*

## CURRENT TOPIC

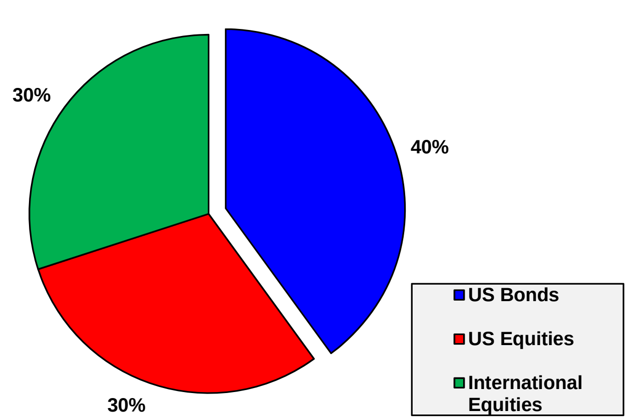
***Benchmarking Performance***

- *Introduction*
- *Overall Portfolio Performance*
- *Benchmark Returns Are Not Free*
- *Investment Advisor Performance*
- *Conclusion*

***Strategy***

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

**Figure 1 - Portfolio-Level Benchmark Exposure**




Source: Stairway Partners

# Benchmarking Performance - Cont'd

different markets, which are expected to provide the long-term returns needed to achieve their financial objectives. At Stairway Partners, the first step in our investment process is to create a portfolio-level benchmark containing the mix of assets which is most appropriate for a specific investor.

Figure 1 shows the market exposure for a portfolio-level benchmark containing 60% global equities and 40% domestic bonds. An explicit benchmark such as this can help investors to evaluate the appropriateness of a given portfolio strategy, before entering the market. Based on our long-term estimates of market returns, we would expect a portfolio using this benchmark to produce annual returns of roughly 7%. Because return does not come without risk, we would also expect this portfolio to produce a negative annual return about once every four years.

A portfolio-level benchmark also provides a useful tool with which to look back at an investor's actual performance versus the returns of the broad market. At Stairway Partners, we provide clients with total portfolio returns and portfolio-level benchmark returns on a monthly basis. Benchmark returns such as these can be compared to an investor's actual returns in order to judge the effectiveness of their portfolio strategies.

Many investors have been frustrated in recent years by increased market volatility and the perception of persistently low returns. Figure 2 illustrates that over the last ten years a diversified portfolio based on the benchmark described above should have produced results far better than the lingering perception of a "lost decade".

Having an objective means for comparison helps investors to put their own experience, either positive or negative, into perspective. Without an explicit benchmark, it is nearly impossible to determine if overall portfolio returns are reasonable and consistent with the investor's objectives.

**Benchmark Returns Are Not Free**

Among investors who have adopted portfolio-level benchmarks, some believe that a collection of index-based funds held passively can be expected to match the return of their benchmark. This may be unrealistic because of several unavoidable factors that detract from the performance of even the most thoughtfully constructed passive portfolio.

Although fees on passive funds have come down significantly in recent years, they still detract from performance, especially in those funds that cover less developed markets. There are also markets comprised of securities that may be difficult to emulate through index funds. This most often occurs in bond markets, where securities are not traded on exchanges and may lack sufficient liquidity. A good example is the municipal bond market, where the broad index contains over 46,000 securities.

The need for rebalancing due to uneven market returns or investor cash requirements can also materially impact overall portfolio performance. Because the component weights within a portfolio-level benchmark remain constant, it is assumed that the portfolio begins each month with the same market exposure. Implementing this in an actual portfolio requires monthly rebalancing transactions, which can be costly over time.

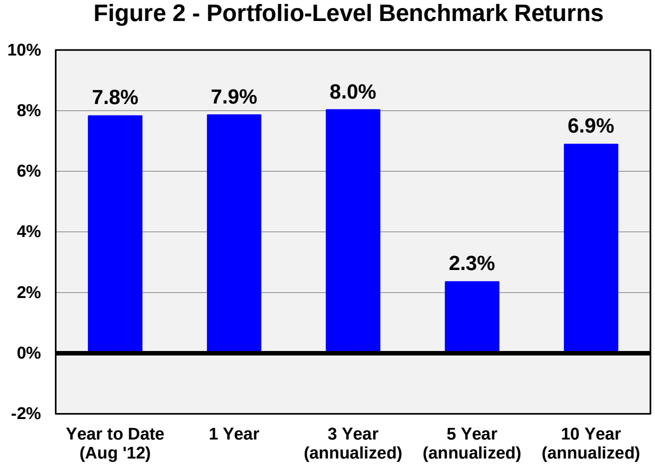
Without rebalancing, a portfolio's exposure to market risk can drift due to the relative appreciation which occurs when one market produces better returns than another. Figure 3 shows how the market exposure of the portfolio described earlier would have drifted over the most recent ten year time-period.

If rebalancing was not done,

(Continued on page 3)

**"OVER THE LAST TEN YEARS, MARKET RETURNS HAVE BEEN SURPRISINGLY POSITIVE, AND MUCH BETTER THAN THE PERCEIVED LOST DECADE"**

Figure 2 - Portfolio-Level Benchmark Returns




Sources: Barclays, Russell, MSCI, 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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the investor's desired equity exposure of 60% at times would have drifted as high as 74% and as low as 55%. Because rebalancing results in purchasing markets that have underperformed and selling markets that have outperformed, it tends to enhance performance. In this case, the rebalancing was worth 0.4% annually.

### Investment Advisor Performance

Although past performance has been shown to be a poor predictor of future results, the ability to observe a manager's returns within known market environments can be very helpful in evaluating the effectiveness of their investment process. Unfortunately this can be difficult, because unlike mutual funds, which must publicly report their performance based on strict rules, investment advisors have much more latitude in how they report their returns. As a result, investors must take great care when thy examine past returns.

Investor advocates, including the CFA Institute, continue to make progress on implementing standards for performance reporting. At Stairway Partners, we report our returns using a strict set of rules known as the Global Investment Performance Standards or GIPS®, which are maintained by the CFA Institute. These standards were created to provide a level playing field for investors to compare the returns of competing investment managers.

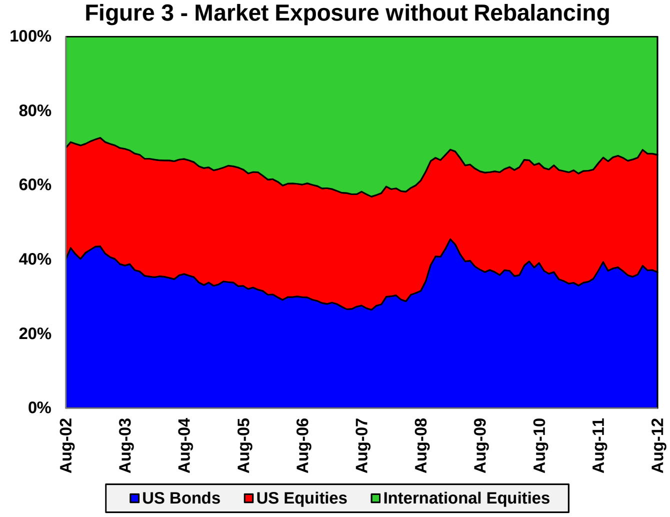
GIPS® requires that all portfolios managed by a firm be reported within relevant composites. This broad inclusion eliminates the potential for a firm to "cherry pick" a portfolio to showcase results that may not be typical for the firm's clients with similar strategies. GIPS® also dictates the methods used to calculate returns and the manner in which those returns must be displayed. Institutional clients generally expect potential investment advisors to use GIPS®, as it is considered the industry's best practice. We believe that individual investors deserve the same level of transparency in the reporting that they receive from investment advisors.

### Conclusion

We believe that having an accurate and objective view of portfolio performance helps investors to make more informed decisions, which will in-turn improve their results over time. Having an explicit portfolio-level benchmark helps investors to understand the likely risks and returns of their portfolio going forward and to look back at the effectiveness of their investment strategies, through time.

Past performance may not predict future performance, but having an accurate view of past results helps investors

Figure 3 - Market Exposure without Rebalancing




"IF REBALANCING WAS NOT DONE, THE INVESTOR'S DESIRED EQUITY EXPOSURE OF 60% AT TIMES WOULD HAVE DRIFTED AS HIGH AS 74% AND AS LOW AS 55%"

Sources: Barclays, Russell, MSCI, Stairway Partners

## 3 Year Annualized Return Estimates for Global Markets

| 9/4/2012 | Total Returns | | | After-Tax Total Returns | | |
|---|---|---|---|---|---|---|
| | Expected | Hurdle | Excess | Expected | Hurdle | Excess |
| **Equities** | | | | | | |
| **United States** | **9.0%** | **4.0%** | **5.0%** | **7.6%** | **3.8%** | **3.8%** |
| **Non-US Developed Markets** | **19.7%** | **4.5%** | **15.2%** | **16.7%** | **4.3%** | **12.4%** |
| EMU | 27.6% | 4.9% | 22.8% | 23.4% | 4.7% | 18.7% |
| UK | 24.6% | 4.8% | 19.8% | 20.9% | 4.6% | 16.2% |
| Japan | 12.1% | 4.9% | 7.2% | 10.3% | 4.8% | 5.5% |
| Canada | -2.0% | 4.3% | -6.2% | -1.7% | 4.1% | -5.8% |
| **Emerging Markets** | **22.0%** | **5.7%** | **16.2%** | **18.0%** | **5.6%** | **12.4%** |
| **Fixed Income** | | | | | | |
| **US Aggregate** | **-1.7%** | **2.1%** | **-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% | -3.9% | -2.6% | 1.1% | -3.7% |
| 10 Year | -6.0% | 1.8% | -7.8% | -5.5% | 1.7% | -7.2% |
| 30 Year | -10.0% | 2.0% | -12.0% | -8.9% | 1.8% | -10.7% |
| **TIPS** | | | | | | |
| 5 Year | -1.9% | 1.4% | -3.2% | -2.0% | 1.2% | -3.2% |
| 10 Year | -6.0% | 1.9% | -7.9% | -5.5% | 1.7% | -7.3% |
| 30 Year | -14.8% | 2.3% | -17.1% | -12.6% | 2.1% | -14.7% |
| **Municipal** | **-0.6%** | **1.4%** | **-1.9%** | **0.0%** | **1.2%** | **-1.3%** |
| 2 Year | 0.1% | 0.7% | -0.6% | 0.3% | 0.5% | -0.3% |
| 5 Year | -1.3% | 1.1% | -2.4% | -0.8% | 0.9% | -1.7% |
| 10 Year | -2.0% | 1.5% | -3.5% | -1.2% | 1.3% | -2.6% |
| 20 Year | 0.2% | 1.7% | -1.5% | 0.8% | 1.6% | -0.8% |
| **High Yield** | **2.3%** | **3.0%** | **-0.6%** | **0.7%** | **2.8%** | **-2.1%** |
| High Quality High Yield | 2.2% | 2.1% | 0.1% | 0.7% | 2.0% | -1.3% |
| **Emerging Market ($ demonimnated)** | **-1.1%** | **3.2%** | **-4.3%** | **-1.9%** | **3.0%** | **-4.9%** |
| **Foreign Aggregate** | **-4.5%** | **3.4%** | **-8.0%** | **-4.2%** | **3.3%** | **-7.5%** |
| Foreign Aggregate (hedged) | -3.5% | 1.7% | -5.2% | -3.5% | 1.6% | -5.1% |
| **Foreign Treasury** | **-4.7%** | **3.0%** | **-7.6%** | **-4.3%** | **2.8%** | **-7.1%** |
| 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 | -2.2% | 2.3% | -4.5% |
| British Pound | -0.7% | 2.2% | -2.9% |
| Japanese Yen | 0.2% | 2.4% | -2.3% |
| Canadian Dollar | -1.6% | 1.4% | -3.0% |

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)