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MONTHLY

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PERFORMANCE REPORTING

Background

Measuring and reporting the performance of a portfolio can encompass many different areas – returns, risk and success in meeting objectives, among others. In this *Monthly*, we discuss what we consider to be the important elements of reporting *return* performance.

Investors deserve – and should demand from their managers – an explanation of why their portfolio performed the way it did. Institutional investors expect this information because it provides transparency and the ability to evaluate whether the management of the portfolio is consistent with their expectations going in. There is no reason individuals should be treated differently.

We often see individuals receiving performance reports that are piecemeal or ad hoc, rather than providing a picture of the entire portfolio and a decomposition of the sources of that performance. This ad hoc reporting is not comprehensive, as it typically does not employ a proper comparison benchmark and often the reported time period does not cover the relevant management period.

Importance

The benefits of comprehensive and objective performance measurement should be apparent. It provides the necessary tools for evaluating investment decisions. Good reporting reveals the sources of performance, whether positive or negative. Investors can clearly understand the results of the portfolio management decisions – in other words, *why* they made money or lost it.

One of the most important aspects of reporting is the focus placed on measuring the performance of *both* the portfolio and its benchmark. *Many of our readers know how strongly we emphasize the benchmark as being at the center of the investment process. It captures the risk and return characteristics of your long-term*

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CURRENT TOPICS

"Good performance reporting reveals the sources of performance… investors can see why they made money or lost it."

Performance Reporting - Cont'd

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goals and preferences.

By serving as the anchor for investment strategies, the benchmark acts as the basis for measurement of the investment results. With clear and comprehensive information, there is no place for the manager to "hide". Also, any management fees should be revealed and accounted for during this process.

Apart from providing the client with information, there is another important reason for measuring performance. Good managers want detailed feedback on how they are doing in order to provide answers to some basic questions about the validity and consistency of their investment process. Are they getting the investment results they and their clients expect? Which parts of their investment process are working and which ones are not producing the desired outcome?

The Basic Concept

Just as measuring a return is fairly straightforward, the basic concept of reporting performance is also relatively simple. For each time period, we need a set of weights and returns – these should ideally be broken down along the same lines as the decision-making framework. As an example, our investment process primarily involves asset allocation and security selection, so our performance reporting explicitly shows results along those same lines.

Take a hypothetical decision to overweight emerging equity markets relative to their benchmark weight (which necessarily requires an underweight elsewhere). If emerging equities perform very well – better than other asset classes – that decision should add value to the portfolio's performance. In effect, larger-than-normal exposures to above-average performers are a positive while larger-than-normal exposures to below-average performers are a negative. This is basic to how performance reporting is constructed – comparing weights to their benchmark values, and then looking at whether the returns of those positions were beneficial or harmful to performance.

Reporting Examples

In Figures 1-3, we provide three basic examples of performance reporting. Figure 1, the most general, shows a comparison of a portfolio's performance versus its benchmark. We have kept the example simple by including only two asset classes – stocks and bonds. The outperformance of the portfolio is the result of two different influences – the decision to overweight equities and underweight bonds, and the returns within the two asset classes.

Figure 2 shows a greater level of detail. It demonstrates that, given market returns, the asset allocation (equity overweight and bond underweight) would have generated a return of 2.40% which is 0.20% above the benchmark return of 2.20%. We go one step further by allocating that 0.20% to the stock and bond decisions. The equity overweight contributed 0.08% and the bond underweight added 0.12%, which matches the total of 0.20%.

Figure 3 examines what we have in the past referred to as *Security Selection*, but which actually captures an array of different effects. This includes performance of the investments in each asset class relative to their respective indices (for example, if we invested in the Russell 1000 large cap ETF in place of the broad US equity component). This also captures management fees at the investment vehicle level (for example,

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Figure 1: Overall Performance Summary

	Benchmark Weights	Benchmark Returns	Portfolio Weights	Portfolio Returns	Added Value
Stocks	60%	3.00%	70%	2.90%	
Bonds	40%	1.00%	30%	1.00%	
Total	100%	2.20%	100%	2.33%	0.13%

Difference of 0.13% = Portfolio Return - Benchmark Return

Figure 2: Asset Allocation

	Index Returns		Benchmark Returns		Return Differences		Strategy		Added Value
Stocks	3.00%	-	2.20%	=	0.80%	x	10%	=	0.08%
Bonds	1.00%	-	2.20%	=	1.20%	x	-10%	=	0.12%
	2.20%								0.20%

Figure 3: Implementation (formerly Security Selection)

	Portfolio Returns		Index Returns		Return Differences		Portfolio Weights		Added Value
Stocks	2.90%	-	3.00%	=	-0.10%	x	70%	=	-0.07%
Bonds	1.00%	-	1.00%	=	0.00%	x	30%	=	0.00%
							100%		-0.07%

Note: The sum of added values from Figures 2 & 3 = added value in Figure 1

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.

YEAR TO DATE, NON-US EQUITY MARKETS HAVE PUT IN A STRONG PERFORMANCE RELATIVE TO US MARKETS. WE RECENTLY REDUCED EXPOSURE TO NON-US DEVELOPED AND EMERGING EQUITIES, AND SHIFTED THE PROCEEDS INTO CASH AND US EQUITIES.

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the 0.20% per annum expenses in the iShare Russell 3000 ETF). Another important effect is intra-month allocation changes. For example, consider a month during which the stock market rises in the first half and falls in the second half (Figure 4). If the portfolio is 10% overweight equities during the rising market and 10% underweight during the decline, the strategy clearly would add value. However, because the allocation for the full period averages out to the benchmark weight, this contribution shows up in security selection rather than asset allocation.

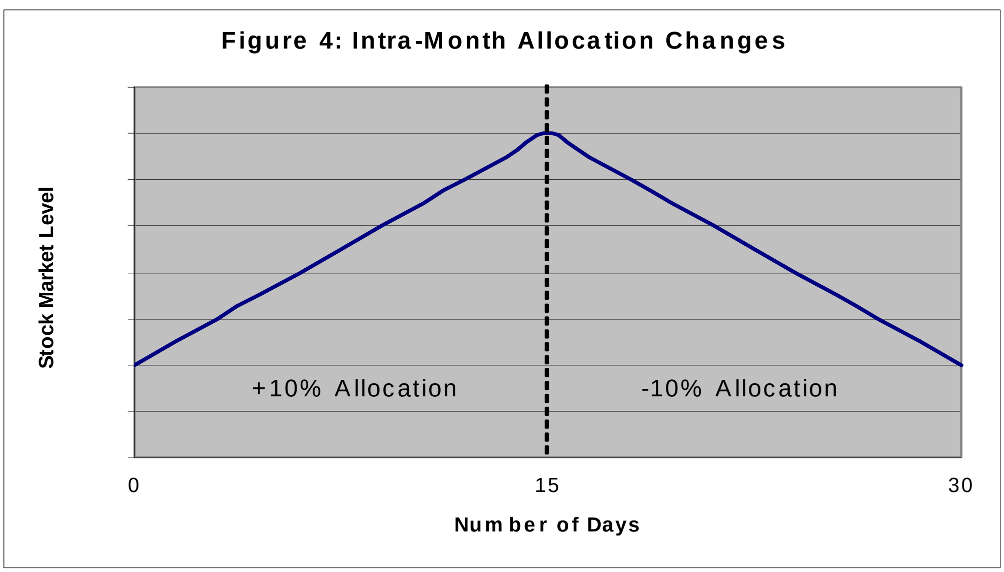
Because the label *Security Selection* is not reflective of the various contributions, we are renaming this category *Implementation*.

Our Reporting

Stairway Partners provides monthly performance reporting on our web site, normally within two business days after month end. Our clients have the ability to look at returns over various time periods – monthly, year-to-date, and since inception. Also, we explicitly identify our management fees as a separate line item in reporting clients' net-of-fee performance.

Conclusion

Measuring performance is one of the most important components of managing portfolios, because of the information it provides not only to clients but to the investment manager as well. We feel strongly that objective and comprehensive performance reporting should be a prerequisite for investment managers serving individual investors. Useful reporting needs to provide returns on the client's portfolio as well as on the comparison benchmark. In addition, detailed information about the contributions to performance – which decisions added value and which did not – is critical to evaluating the manager.



On average, allocation to the stock market was equal to the benchmark weight during the month. However, intra-month the market rose during the overweight period (+10% allocation) and declined during the underweight period (-10% allocation). Added value from this effect would appear in the "Implementation" section of our performance reports.

Strategy

Asset Class	Expected Return	Hurdle Return	Strategy	Comment
Equities				
US	5.3%	7.7%	neutral	Small overpricing; allocation from other more expensive markets
Non-US Developed				Recent gains have made non-US equities more overpriced
Eurozone	2.8%	6.7%	neutral	
Japan	-5.6%	4.3%	neutral	
UK	6.2%	8.2%	neutral	
Emerging	4.1%	11.6%	neutral	Asset class inadequately pricing risk
Fixed Income				
US Treasury Bonds			under	Shorter maturities offer best relative value
2-Year	4.1%	4.4%		
5-Year	3.9%	4.6%		
10-Year	3.3%	4.8%		
25-Year	2.7%	5.0%		
US Municipal Bonds			small under	Sector is fairly priced
2-Year	2.9%	3.1%		
5-Year	3.1%	3.4%		
10-Year	3.6%	3.7%		
25-Year	5.8%	4.2%		
US High Yield	4.5%	6.2%	under	Spreads over US Treasuries remain too tight
Non-US Government Bonds			under	Yields generally insufficient compensation for risk
Euro 10-Year	0.8%	4.0%		
Japan 10-Year	-0.2%	1.9%		
UK 10-Year	2.8%	4.9%		
Emerging Markets Debt	3.4%	6.4%	under	Spreads over US Treasuries remain too tight
Cash	4.1%	---	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	-1.3%	1.6%	-0.5%	
Japanese yen	3.9%	-1.7%	3.7%	
UK pound	-2.7%	3.5%	0.1%	

Notes: **As of: 9/30/2005**

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.