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MONTHLY

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DISCIPLINE IN A TOUGH MARKET

Introduction

Large and unprecedented events are unfolding that are adversely affecting the financial markets. Here are a few of the more recent ones.

- The government places Fannie Mae and Freddie Mac into conservatorship

- Lehman Brothers files for bankruptcy

- The Federal Reserve institutes and increases a broad array of programs designed to liquefy financial institutions by lending them money against a growing list of acceptable collateral

- Bank of America purchases Merrill Lynch

- The Federal Reserve and Treasury announce a bailout of American International Group – the largest insurer in the world

- The SEC bans short selling of certain stocks and announces actions to combat alleged market manipulation

- The Treasury announces a guaranty program for money market funds

- Washington Mutual and Wachovia are purchased by JP Morgan and Citigroup, respectively

- Congress is struggling to agree on a package that authorizes the Treasury to purchase up to $700 billion of troubled assets from our banking system

In addition to these events, the media are flush with terms such as depression, global meltdown, repeat of Japan's lost decade of the 90s and biggest financial crisis since the 1930s. As seen in Figure 1, the equity markets have already declined a significant amount since the end of last year. This leaves many investors wondering whether they should sell now because things are so bad.

The Economy

Surprisingly, the economy

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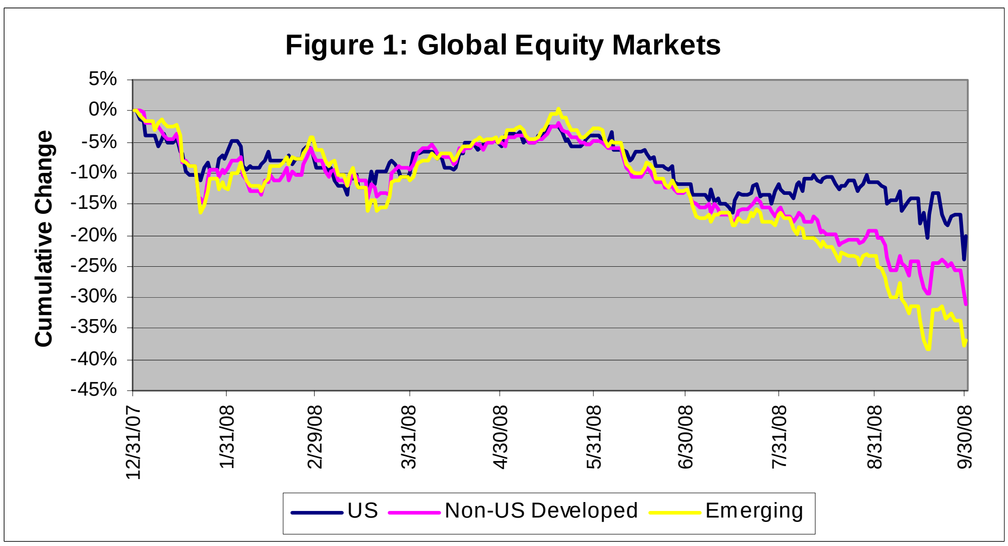

Sources: Russell, MSCI Note: Non-US equity markets are in US dollars

CURRENT TOPIC

Discipline in a Tough Market

- *Introduction*
- *The Economy*
- *Questions*
- *Maintaining Discipline*
- *Conclusion*

Strategy

- *After a dramatic decline in non-US equity markets and the value of the dollar, we added exposure to bring portfolios close to neutral*
- *We are still underweight emerging markets*

"THE EQUITY MARKETS HAVE ALREADY DECLINED A SIGNIFICANT AMOUNT SINCE THE END OF LAST YEAR. THIS LEAVES MANY INVESTORS WONDERING WHETHER THEY SHOULD SELL NOW BECAUSE THINGS ARE SO BAD"

DISCIPLINE IN A TOUGH MARKET - CONT'D

(Continued from page 1)

has held up much better than expected - *so far*. The overwhelming consensus among economists is that it will weaken in the near future. One of the weakest areas has been residential investment. Figure 2 shows the dramatic decline in housing starts. As you can see, starts have reached levels comparable to past troughs despite the growth in the population. We believe that it will be hard for residential investment, from these depressed levels, to be a big detractor from economic growth going forward.

Questions

Significant questions that are of particular concern center on the "knock-on" effects of the financial crisis.

- Will the asset side of the household balance sheet, primarily home values and financial assets, continue to decline, further reducing household net worth? Figure 3, which displays data from the Federal Reserve's *Flow of Funds* report, shows that net worth has declined but is still well above where it was in 2005.

- Will household consumption, which represents 70% of the US economy, decline modestly or will we see, as some economists predict, a significant downturn for a protracted period of time? Figure 4 shows that consumption has been moving steadily higher for a very long period. A protracted period of negative growth in con-

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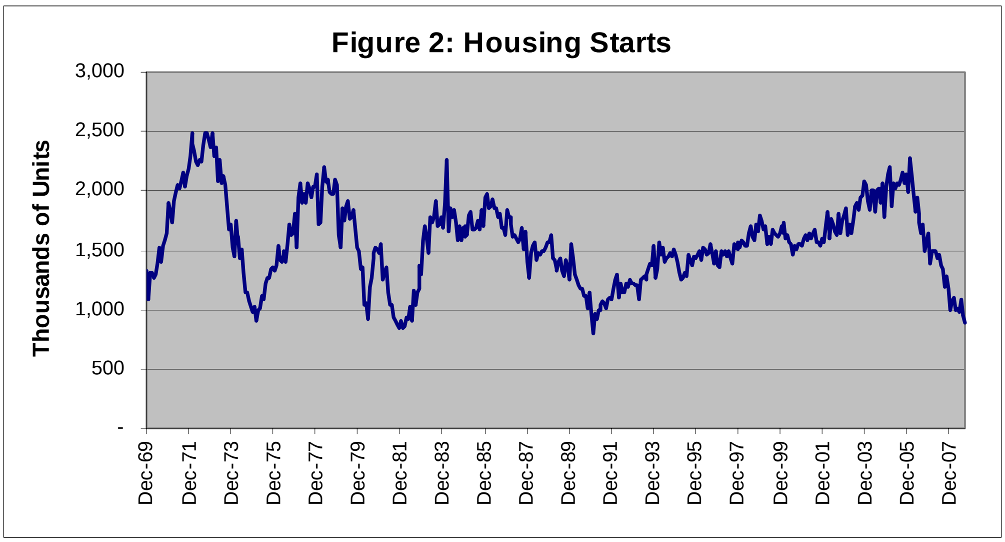
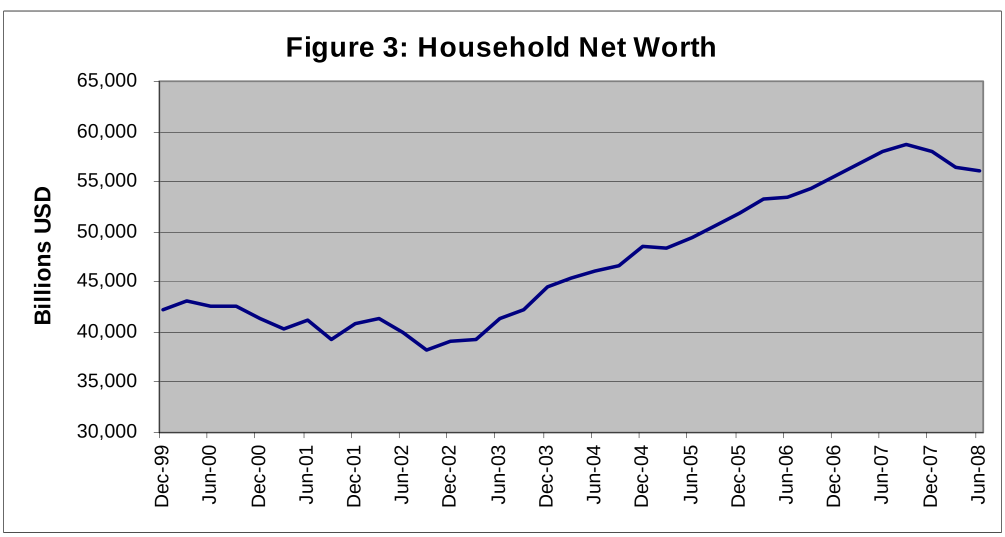


Sources: Bloomberg, Dept. of Commerce Note: Seasonally Adjusted annual Rate



Source: Federal Reserve Quarterly Z.1 Flow of Funds Report

"WE BELIEVE THAT IT WILL BE HARD FOR RESIDENTIAL INVESTMENT, FROM THESE DEPRESSED LEVELS, TO BE A BIG DETRACTOR FROM ECONOMIC GROWTH GOING FORWARD"

*

"NET WORTH HAS DECLINED BUT IS STILL WELL ABOVE WHERE IT WAS IN 2005"

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.

sumption is something we have not experienced in recent history.

- What will happen to employment and income?

- Lastly, from an investment point of view, how much of this is already discounted in the market?

Maintaining Discipline

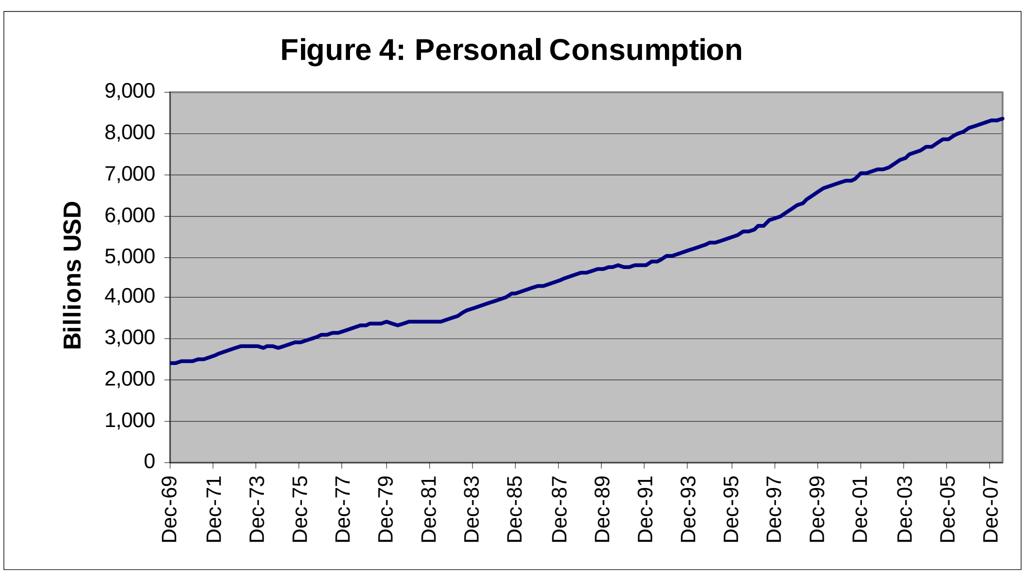
We often use and hear the aphorism "buy low and sell high". Many investors we talk to admit that this is difficult to accomplish in practice. As evidence, they cite past cycles when they bought while things were good and sold after things got bad. Today's environment will test investors' mettle as the decline in asset prices has once again occurred in advance of the bad news, leaving many investors "offside".

Here is where we stand with our investment process. We understand that predicting near-term market moves with any certainty is impossible. From our perspective, the current financial crisis, as bad as it seems, will eventually pass and will not represent a permanent or structural shift in the economies of the world. As a result, earnings will eventually recover. Equities have already moved significantly lower from their 2007 peaks. As our readers know, we view lower prices as indicating *higher* prospective returns.

From a strategy standpoint we have moved closer to a neutral position in equities across the portfolios that we manage. This is purely a result of the better pricing that exists in the equity market today versus a year ago when we had portfolios significantly underweight equities. If stock prices were to move lower, we would continue to add equities across portfolios at these more attractive levels. We believe that our investment process and valuation approach have proved to be a valuable anchor in these difficult times.

Conclusion

Recent events are unprecedented and equity markets have already declined substantially. Equities may move lower but, against a longer-term backdrop, they are starting to look attractive. After being significantly underweighted equity exposure last year, we have recently moved portfolios close to neutral. If stock markets continue to go down, we will again increase equity allocations across the portfolios that we manage.



Sources: Bloomberg, BEA

Note: Real, Seasonally Adjusted Annual Rate

"A PROTRACTED PERIOD OF NEGATIVE GROWTH IN CONSUMPTION IS SOMETHING WE HAVE NOT EXPERIENCED IN RECENT HISTORY"

Strategy

Asset Class	Expected Return	Hurdle Return	Strategy Exposure	Comment
Equities				
US	15.9%	7.8%	over	Exposure slightly above benchmark weight
Non-US Developed			small under	Asset class has become more attractive as markets have fallen
Eurozone	19.6%	8.2%		
Japan	9.2%	4.8%		
UK	20.6%	9.0%		
Emerging	11.3%	12.3%	under	Asset class remains expensive
Fixed Income				
US Treasury Bonds				Non-Treasury sectors attractively priced
2-Year	1.9%	3.3%		
5-Year	1.9%	3.9%		
10-Year	2.1%	4.5%		
30-Year	1.6%	4.9%		
US Municipal Bonds			neutral	Longer-term maturities have become more attractive
2-Year	2.5%	2.9%		
5-Year	3.2%	3.4%		
10-Year	4.8%	4.0%		
30-Year	9.9%	4.7%		
US High Yield	14.4%	6.2%	neutral	Sector is pricing for deteriorating fundamentals
Non-US Government Bonds			under	Yields remain below fair levels
Euro 10-Year	3.1%	4.6%		
Japan 10-Year	0.2%	2.0%		
UK 10-Year	3.3%	5.0%		
Emerging Markets Debt	5.4%	6.5%	under	Spreads over US Treasuries remain too tight
Cash	4.1%	---	over	Allocation comes from overpriced asset classes

Currencies	Expected FX Change	Equity Return with Currency	10-Year Bond Return with Currency	
Euro	-5.6%	13.9%	-2.5%	Euro is expensive
Japanese yen	2.6%	11.8%	2.8%	Yen is close to fair value
UK pound	-2.1%	18.5%	1.2%	Pound is slightly expensive

Notes: **As of: September 30, 2008**

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.

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