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 6, ISSUE 10 OCTOBER 2009

CURRENCY UPDATE

Introduction

Since the middle of March, the value of the US dollar relative to most major currencies has declined considerably. This has been particularly true for the dollar versus the Euro and the British Pound (Figure 1). Many market commentators believe that this dollar weakness will continue long into the future due to the structural challenges facing the United States. These challenges include budget deficits, excessively loose monetary policy, a persistent trade deficit, and a tacit weak dollar policy within the US Treasury Department. In contrast to most, we believe that the US dollar is not overvalued. In this *Monthly*, we try to bring perspective to the recent dollar weakness by separating out what we believe to be a near-term factor from longer-term fundamentals.

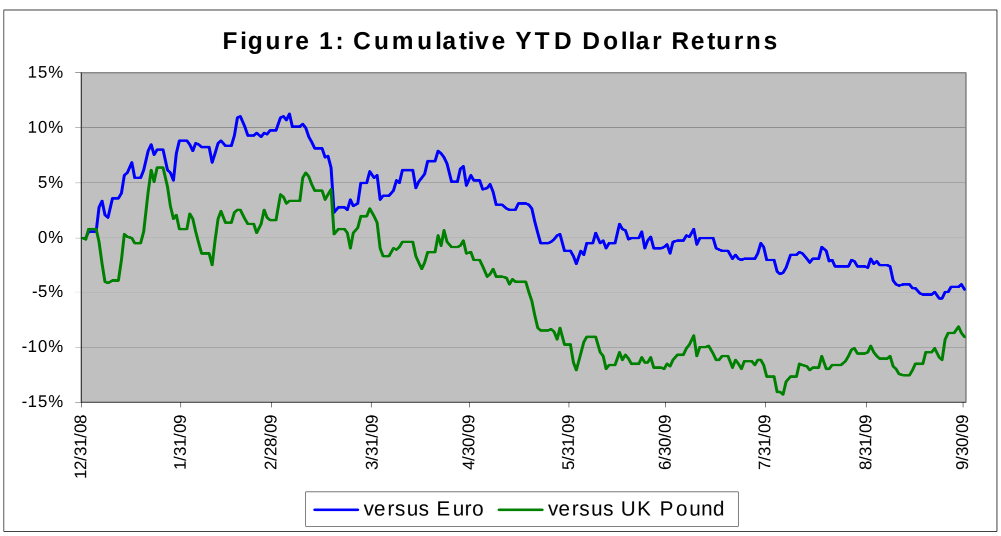
Return Effects

As mentioned before, the dollar has weakened considerably against the Euro and the British Pound since March. This dollar depreciation has been good for US investors with un-hedged holdings in foreign investments. Figure 2 shows the degree to which dollar weakness has increased the returns of overseas developed equity markets since the beginning of the year. As you can see, a US investor who did not hedge out the currency risks of the MSCI EAFE index (the most popular benchmark for developed non-US equities) earned 29%. This is a 8.3% increase over local market returns.

Near-term Factor

Although it is impossible to know for sure, we believe that the majority of this year's dollar movement can be explained by investors appetite for risk. During the first quarter, we experienced the worst effects of the financial crisis with equity markets reaching their

(Continued on page 2)



Sources: Bloomberg, Stairway Partners

CURRENT TOPIC

Currency Update

- *Introduction*
- *Return Effects*
- *Near-term Factor*
- *Valuation Process*
- *Current Valuation*
- *Conclusion*

Strategy

- *As a result of strong performance in the non-US developed equity markets we reduced exposure to this asset class*
- *Portfolio strategy remains overweight developed equity markets and credit*

"SINCE THE MIDDLE OF MARCH, THE VALUE OF THE US DOLLAR RELATIVE TO MOST MAJOR CURRENCIES HAS DECLINED CONSIDERABLY"

CURRENCY UPDATE - CONT'D

cycle low as investors sought out safer alternatives. In this environment, where behavior was driven by the desire for capital preservation and liquidity, the value of the dollar actually increased versus most other currencies. This was most likely the result of flows into US Treasuries by foreign investors seeking a "safe haven" during the crisis.

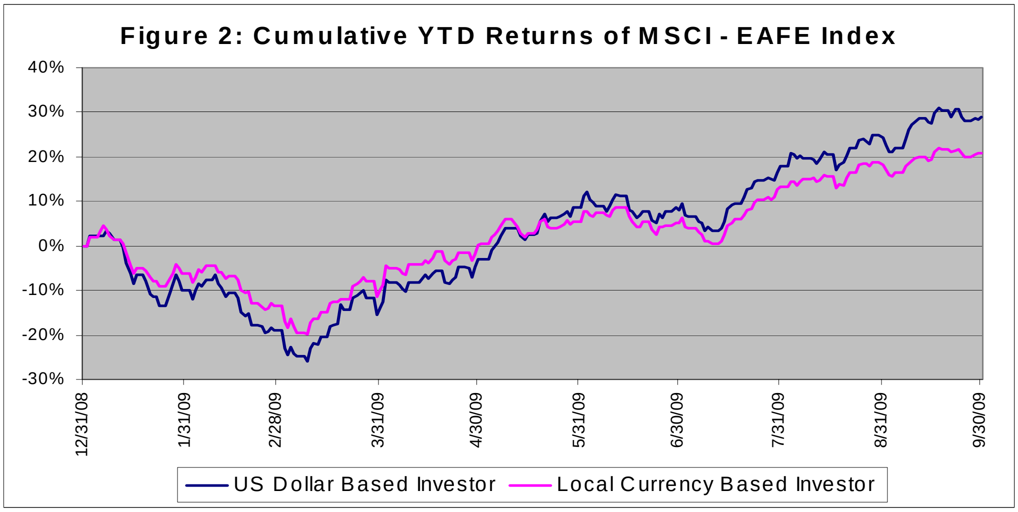
In the second and third quarters, investors' worst fears did not materialize, money flowed back into riskier assets and dollar strength gave way to dollar weakness. By contrasting the S&P 500 index with the Euro, Figure 3 shows that there was a high degree of correlation between equity returns and the value of the dollar (Euro strength equals US dollar weakness).

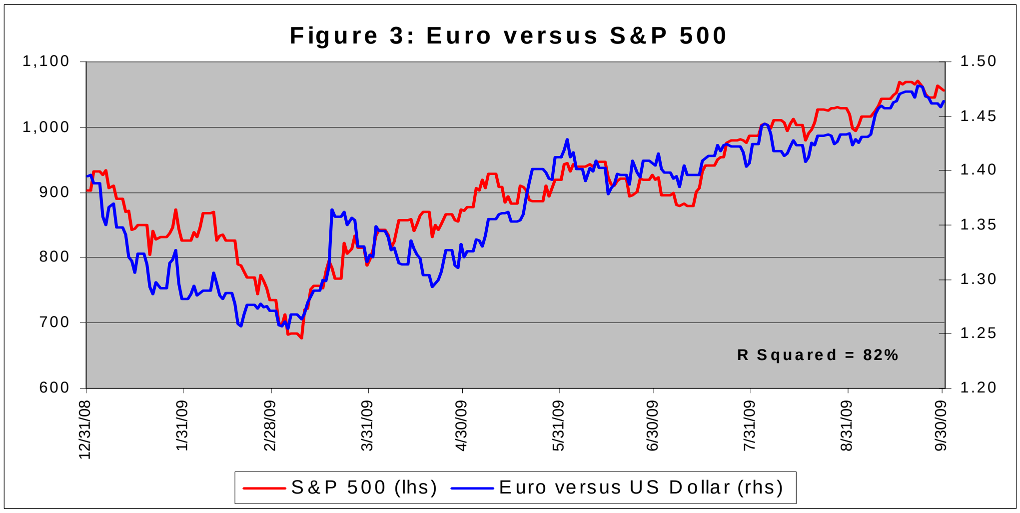
It is interesting to us that many US dollar bears also have a negative views on equity markets. We believe that if risk aversion returns and equity markets decline, it will most likely result in near-term US dollar strength, not weakness.

Valuation Process

Consistent with our firm's overall philosophy, we evaluate currencies from a longer-term perspective and try to avoid focusing on the noise associated with near-term market movements. As we have written about in past *Monthlies,* our currency valuation approach starts with the fundamental notion of purchasing power parity (PPP). This concept is based on tracking the relative amount of goods and services that a unit of currency can purchase in each country. Since many products can be shipped across borders and some service jobs can be outsourced to other countries using modern technology, large discrepancies in currency values should be resolved as businesses take advantage of more attractive prices in countries with weaker currencies.

(Continued on page 3)





Sources: MSCI, S&P, Bloomberg, Stairway Partners

"A US INVESTOR WHO DID NOT HEDGE OUT THE CURRENCY RISKS OF THE MSCI EAFE INDEX EARNED 29% . . . THIS IS A 8.3% INCREASE OVER LOCAL MARKET RETURNS"

*

"WE BELIEVE THAT THE MAJORITY OF THIS YEARS DOLLAR MOVEMENT CAN BE EXPLAINED BY INVESTORS APPETITE FOR RISK"

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.

To illustrate the concept of PPP, *The Economist* magazine publishes a series of indices that track the cost of a McDonalds Big Mac in major cities around the world. The latest release, which was published in July of 2009, indicated that a Big Mac cost a US diner \$3.57 and a European diner the equivalent of \$4.62. This implies that the Euro is overvalued and that the European diner should convert his expensive Euros into cheap Dollars, buy his Big Mac in America and import it for dinner. While crude, simplistic and messy, the Big Mac Index is a good example of how PPP works.

In practice, valuation discrepancies in currencies need to be compelling and exist for a period of time before participants in the real economy will arbitrage goods and service markets. This is why PPP is not a useful tool for traders or short-term speculators. However, as fundamental investors, we believe that PPP is the best measure of a currency's long-term value and is consistent with our investment process.

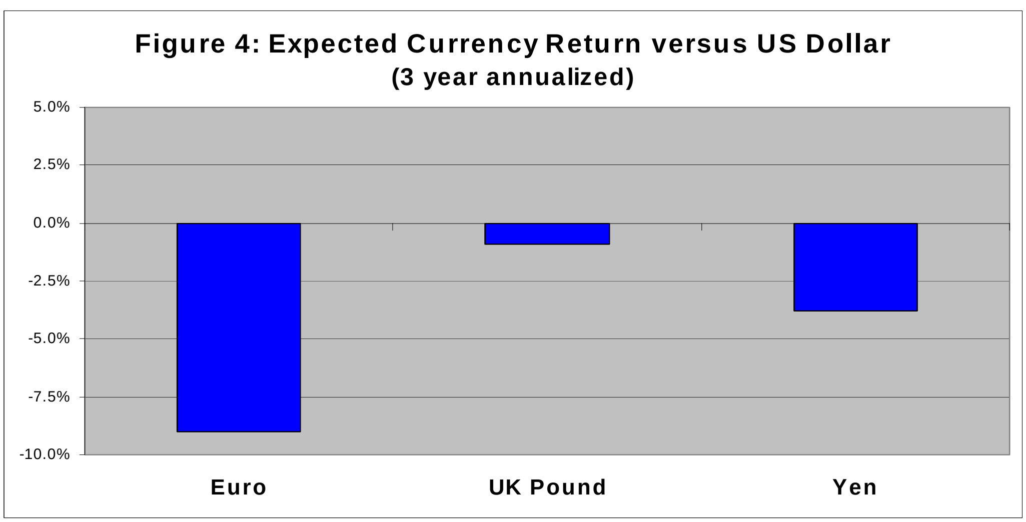
Current Valuation

We acknowledge that there are many demographic, fiscal and monetary policy challenges facing the United States. However, we would note that these issues are not unique to the US. Other developed countries, whose currencies are seen as an alternative to the dollar, face similar and in some cases worse challenges. It is important to remember that exchange rates represent the relative price of one currency versus another, and that fundamental factors should also be analyzed on a relative basis.

Despite the near-term trend of a weaker dollar, we do not agree with the consensus view that the dollar is expensive when compared with other major currencies. Figure 4 shows that over the next three years we expect the major currencies to produce negative returns relative to the US dollar as they move toward towards PPP. This outlook along with recent strong performance across equity markets has led us to reduced exposure to non-US developed equities.

Conclusion

Recent US dollar depreciation has benefited US investors who have exposures to foreign investments. We believe much of this dollar weakness can be attributed to investor risk preferences and the resulting capital flows. Currencies markets, over the near-term, are notoriously volatile and prone to overreaction. For long-term investors we believe that PPP provides a good anchor for currency valuation. As a result of our analysis, we are not bearish on the US dollar.



Source: Stairway Partners

> "DESPITE THE NEAR-TERM TREND, WE DO NOT AGREE WITH THE CONSENSUS THAT THE DOLLAR IS EXPENSIVE WHEN COMPARED WITH OTHER MAJOR CURRENCIES"

Strategy

Asset Class	Expected Return	Hurdle Return	Strategy Exposure	Comment
Equities				
US	17.4%	5.8%	over	Exposure above benchmark weight due to attractive pricing
Non-US Developed			over	Asset class remains attractive despite recent rally
Eurozone	20.2%	5.8%		
Japan	15.2%	4.4%		
UK	16.4%	31.9%		
Emerging	6.0%	10.3%	neutral	Asset class is close to fair value
Fixed Income				
US Treasury Bonds			under	Treasuries expensive, but non-Treasury sectors are more attractive
2-Year	0.7%	2.8%		
5-Year	0.7%	3.6%		
10-Year	1.0%	4.3%		
30-Year	0.3%	4.7%		
US Municipal Bonds			under	In most maturities, municipal bonds are modestly overpriced
2-Year	0.8%	2.1%		
5-Year	1.0%	2.7%		
10-Year	2.1%	3.4%		
30-Year	7.6%	4.4%		
US High Yield	2.6%	4.3%	over	Sector is close to fair value
Non-US Government Bonds			under	Yields remain below fair levels
Euro 10-Year	1.1%	4.1%		
Japan 10-Year	-0.4%	1.9%		
UK 10-Year	1.1%	4.5%		
Emerging Markets Debt	2.7%	4.6%	under	Other asset classes offer better value
Cash	2.6%	---	minimal	

Currencies	Expected FX Change	Equity Return with Currency	10-Year Bond Return with Currency	
Euro	-9.0%	11.2%	-7.9%	Euro is overpriced
Japanese yen	-3.8%	11.3%	-4.3%	Yen is moderately overpriced
UK pound	-0.9%	15.6%	0.3%	Pound is near fair value

Notes: **As of: September 30, 2009**

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.