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"THE HERD" STAMPEDES OVERSEAS

Introduction

In this month's article, we bring together some observations of the behavior of investors, review fundamentals and revisit our equity market strategy so far this year. More specifically, the strategy focus will be on the non-US equity markets because that is where the largest changes in valuation have occurred since the end of last year.

Not surprisingly, the good performance of non-US equities through the first nine months coincided with sizeable flows of money into international stock mutual funds. Whether the flows were a result or a cause of the gains is less relevant than the observation that they demonstrate the continued existence of the herd mentality. Consistent with past behavior, investors flocked into the asset classes that performed well and avoided those that were not performing.

Our strategy change at the end of September, although based on fundamentals, was reinforced by the increasingly "fashionable" nature of non-US equities.

Market Behavior

The strong gain in the MSCI Emerging Markets Index is shown in the blue line in Figure 1. From the beginning of the year to the peak on October 4, the appreciation was 25%. This excellent performance caused investors to pour record amounts of money into emerging equity mutual funds (see the pink line in Figure 1). Mirroring the flows into emerging market funds were inflows into broader international equity

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CURRENT TOPICS

The Herd Stampedes into Non-US Equity Markets

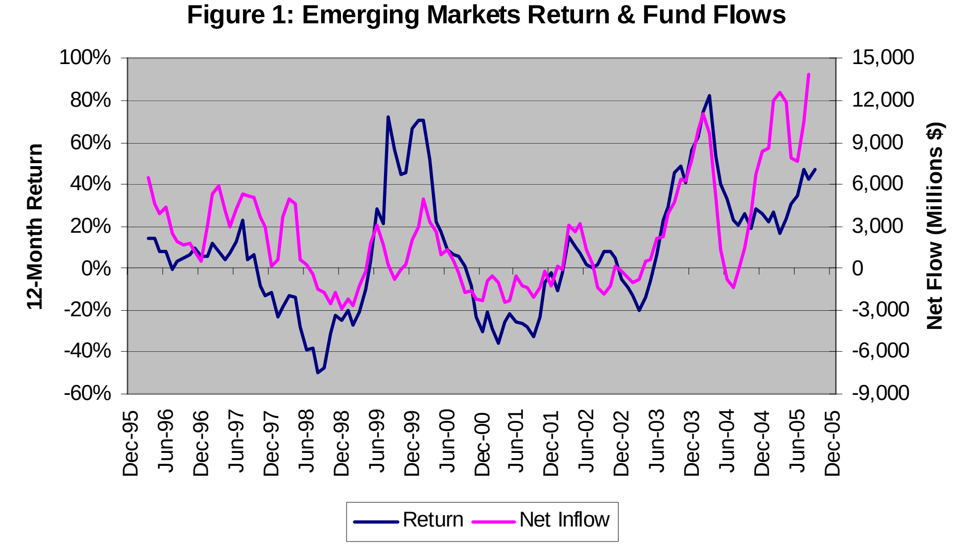
- *Market Behavior*
- *Fundamentals*
- *Strategy*

Expected Returns & Strategies

- *Despite the cheapening of non-US equity markets, we maintain our underweight*
- *High yield and emerging debt markets are unattractively priced given their risk*
- *Municipals and short-term Treasuries are fairly priced*

"Our strategy change at the end of September, although based on fundamentals, was reinforced by the increasingly fashionable nature of non-US equities"

Figure 1: Emerging Markets Return & Fund Flows



Sources: MSCI, Investment Company Institute, Haver Analytics, Stairway Partners
Note: Fund flows measured as annualized 3-month average

"The Herd" Stampedes Overseas - Cont'd

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funds. You may recall that we had referred to this performance-flows phenomenon earlier in our August 2005 *Monthly* piece on currencies and the dollar.

Further evidence that this herd behavior continues unabated appeared in a *Wall Street Journal* article ("U.S. Investors Shift Bets Overseas", October 17) that stated: "Through August, American mutual-fund investors this year have put a net $61.7 billion into stock funds that invest mainly abroad, and $28.1 billion into funds that invest within the U.S. … The last year Americans invested more in foreign-oriented funds than in domestic ones was 1990."

Sentiment can be a valuable component of our analysis when it is at an extreme – either positive or negative – and when it reinforces our fundamental valuation views. It is often the case that investors buy when prices have already neared their peaks (and the asset is expensive on a fundamental basis) and sell when prices have already fallen (and the asset is cheap).

Fundamentals

At the start of this year, we saw non-US equities – Europe in particular – as somewhat more attractive than the US market. Figure 2 shows the expected and hurdle returns for equities and currencies at the end of last year, September 23 (close to the time of our strategy change), and the end of October. Despite seeing developed non-US equity markets as relatively good value at the beginning of the year, our analysis also showed the corresponding currencies to be unattractive (see our December 2004 *Monthly*). Given our inability to hedge currency risk until recently, we were unwilling to move to overweight positions in foreign equity markets. When the market and currency return expectations were combined, the attractiveness of the non-US markets was not compelling enough to justify taking on the added risk of engaging in an overweight strategy.

As it turned out this year, our expectations were in the right direction: the MSCI EAFE Index, when expressed in its component currencies, returned 20.4% through the end of September. However, the dollar's strength caused this return to be cut to only 11.3% when the foreign currency declines are included. Although the currency impact was a large negative, the EAFE Index still outperformed the US market by a wide margin.

These strong advances in non-US developed and emerging equities carried prices too far, too fast, i.e. beyond the growth in fundamentals. But, instead of hearing that foreign stock markets were getting too expensive, comments were more likely to express the notion that they were cheap and attractive investments. Common sense should tell you that when something is 20% more costly than it had been 6 months earlier, it is *more* expensive, not less.

From our perspective, the positive sentiment and strong money flows into non-US stock funds provided evidence that investors were too bullish, both in absolute terms and relative to US equities. While it is true that

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Figure 2: Expected and Hurdle Returns

	December 31, 2004			September 23, 2005			October 31, 2005		
	Expected Return	Hurdle Return	Difference	Expected Return	Hurdle Return	Difference	Expected Return	Hurdle Return	Difference
US Equity	4.8%	7.0%	-2.2%	5.6%	7.7%	-2.1%	5.9%	7.8%	-1.9%
Non-US Equity	6.5%	6.6%	0.0%	2.5%	6.5%	-4.0%	2.1%	6.5%	-4.4%
Emerging Equity	10.4%	12.4%	-2.0%	5.2%	11.6%	-6.4%	6.6%	11.6%	-5.0%
Currency	Euro	Yen	Pound	Euro	Yen	Pound	Euro	Yen	Pound
Expected Change	-4.7%	0.9%	-4.8%	-1.4%	3.3%	-3.1%	-1.1%	4.8%	-2.7%

As prices moved lower in US equities, the expected returns increased because the asset class cheapened relative to its fundamentals. The opposite is true of the non-US developed and emerging equity markets. Prices have moved substantially higher, peaking on October 4, producing expected returns significantly below their hurdle returns.

Expected Return represents the annualized total return Stairway Partners expects over a 3-year time period. *Expected Return* is the result of capital gain or loss from market prices converging to fair value over time plus any cash flows accruing to the investor. *Hurdle Return* represents what an investor should require as compensation for the risk of a given asset class.

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.

WITH SPREADS ON HIGH YIELD BONDS AND EMERGING MARKET DEBT NEAR HISTORICALLY NARROW LEVELS, EXPECTED RETURNS ARE TOO LOW. AS A RESULT, WE HAVE MOVED STRATEGY TO A MAXIMUM UNDERWEIGHT IN CLIENT PORTFOLIOS.

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earnings growth was strong in much of the world this year, there is no reason that this above-normal growth should be extrapolated far into the future. We view the situation not as one of permanently high earnings growth of 15%+, but rather as one of a cyclical peak around the long-run growth rate – resulting in large part from the recovery from recession and the equity bubble bursting.

Strategy

With the less-attractive valuations of non-US equities pointing towards reducing exposure, we made the decision to underweight these asset classes after taking the sentiment factors into account – they clearly reinforced the “faddish” nature of the price gains. The primary risk to this decision was that investors’ behavior would persist and this would continue to put upward pressure on foreign stock markets. In other words, our timing could have been poor.

As it turned out, non-US markets did rise for several days after the strategy change, but October, despite the last 2 trading sessions, has witnessed a turn-around in these markets and our strategy has worked to clients’ advantage (see Figure 3). Increased nervousness about the outlook for inflation and global growth, given persistently high energy prices, seems to be a driving force behind the declines.

Conclusion

Following the herd, although it provides investors with some comfort in the short term, can be costly to your long-term financial results. We continue to stress the importance of a disciplined valuation process as the basis for strategy decisions. Fundamentals, combined with a sense of investors’ exuberance or pessimism, can help us develop strategies that add value to and protect

EFFECT OF STRATEGY CHANGE ON TYPICAL PORTFOLIO

Figure 3

Strategy	Asset Class	Return	Contribution
-2.50%	Emerging Equities - MSCI	-4.24%	0.11%
-2.50%	Non-US Developed Equities - MSCI	-0.99%	0.02%
-5.00%	Total Underweight		0.13%
2.50%	US Equities - Russell 3000	-0.39%	-0.01%
2.50%	Municipal Cash	0.28%	0.01%
5.00%	Total Overweight		0.00%
Contribution to Performance of Client Portfolio			**0.13%**

Sources: MSCI, Russell, Bloomberg, Stairway Partners

This table shows the contribution to performance through October 31 from our strategy change on September 22. The strategy reduced exposure to equities by underweighting non-US equity markets (both developed and emerging) and shifting proceeds into cash and the relatively more attractive US equity market.

Strategy

Asset Class	Expected Return	Hurdle Return	Strategy	Comment
Equities			small under	
US	5.9%	7.8%	small over	Close to fair value; small overweight comes from non-US equity markets
Non-US Developed			small under	Still unattractive relative to US market
Eurozone	4.0%	6.7%		
Japan	-6.0%	4.3%		
UK	7.4%	8.2%		
Emerging	6.6%	11.6%	under	Asset class inadequately pricing risk
Fixed Income				
US Treasury Bonds			under	Shorter maturities offer best relative value
2-Year	4.4%	4.5%		
5-Year	4.3%	4.7%		
10-Year	3.9%	4.9%		
25-Year	3.4%	5.1%		
US Municipal Bonds			neutral	Sector is fairly priced
2-Year	3.1%	3.2%		
5-Year	3.4%	3.5%		
10-Year	4.1%	3.8%		
25-Year	6.4%	4.3%		
US High Yield	4.9%	6.3%	under	Spreads over US Treasuries remain too tight
Non-US Government Bonds			under	Yields generally insufficient compensation for risk
Euro 10-Year	1.4%	4.2%		
Japan 10-Year	0.1%	2.0%		
UK 10-Year	3.0%	4.9%		
Emerging Markets Debt	4.1%	6.5%	under	Spreads over US Treasuries remain too tight
Cash	4.2%	---	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	-1.1%	3.0%	0.3%	
Japanese yen	4.8%	-1.2%	4.8%	
UK pound	-2.7%	4.7%	0.2%	

Notes: **As of: 10/31/2005**

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.