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Monthly

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Is More Conservative Always Safer?

Introduction

Markets have been very turbulent in recent months. As is often the case, the market volatility has been accompanied by negativity in the media, which has added to investor anxiety. The result is that many investors have fled to the safety of cash or have employed potentially expensive hedging strategies to protect their portfolios from near-term losses.

We believe that even very conservative investors, who are drawn to bond-only portfolios, can more effectively reduce the risk of not achieving their long-term objectives by holding a balanced portfolio with a modest equities weight.

In this *Monthly*, we discuss the nature of portfolio risk and examine several conservative portfolio alternatives to illustrate how lower volatility does not always equate to less risk for investors.

Conservative Portfolio Alternatives

The investment industry broadly defines a conservative portfolio to be one with no more than 50% of its assets invested in equities. Traditionally, investment alternatives such as conservative balanced mutual funds have between 40% and 50% equity allocations. Unfortunately, investors who find these offerings too risky often turn to portfolios that contain only bonds, when a custom-built solution may better meet their needs.

The table in Figure 1 shows the risk and return characteristics of a bond portfolio, a traditional conservative balanced portfolio with a 40% equity weight, and a specially constructed balanced portfolio with a 20% equity weight. As one would expect, as the equity allocation increases, so does the volatility. The probability of experiencing a loss in a given year also increases as

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Current Topic

Is More Conservative Always Safer?

- *Introduction*
- *Conservative Portfolio Alternatives*
- *Impact of Returns and Time on Risk*
- *Return Distributions and Risk*
- *Conclusion*

Strategy

- *We increased exposure to emerging market equities for all portfolios.*
- *Portfolios are overweight global equity exposure and underweight bond exposure.*

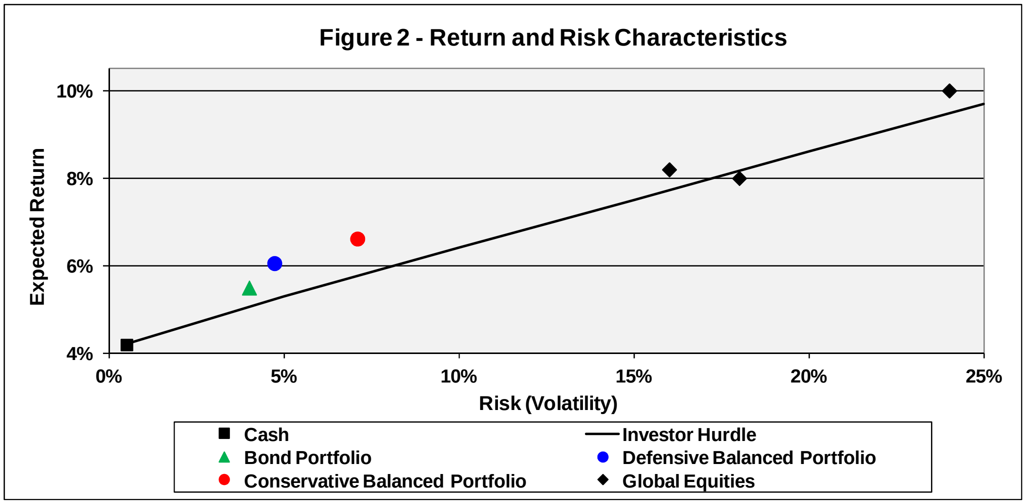
Figure 1- Conservative Portfolio Alternatives

Asset Allocation	Bond Portfolio	Defensive Balanced Portfolio	Conservative Balanced Portfolio
Global Equities	0%	20%	40%
US Bonds	100%	80%	60%
Risk & Return Characteristics			
Expected Returns	5.50%	6.06%	6.62%
Risk (Volatility)	4.00%	4.72%	7.09%
Sharpe Ratio	*0.33*	*0.39*	*0.34*
Probability of Annual Loss	8%	10%	18%

Source: Stairway Partners

"The defensive balanced portfolio's risk is not materially higher than that of the bond portfolio"

IS MORE CONSERVATIVE ALWAYS SAFER? - CONT'D



the equity weight increases, although the difference between the bond portfolio and the more defensive balanced portfolio is quite small.

Over time, riskier assets tend to produce higher returns. This is because investors demand compensation for the risk of incurring a loss. Figure 2 illustrates the relationship between expected returns and risk for domestic bonds, global equities, and the two conservative balanced portfolios. The black line, which originates at cash, represents a reasonable rate of return that an investor may require to invest in riskier assets. One can observe that the balanced portfolios have relatively high expected returns relative to their risk, and that the defensive balanced portfolio's risk is not materially higher than that of the bond portfolio.

Impact of Returns and Time on Risk

Although a portfolio's volatility is an important measure of risk, it does not describe what most investors are seeking to avoid, which is losing money or not achieving sufficient returns to meet their financial objectives. To analyze our conservative investment alternatives beyond the traditional measures, we examined how adverse market conditions may impact portfolio returns over time relative to an estimate of future inflation.

Maintaining a stable principal balance is a common goal for investors, but unfortunately in the long-term, a stable principal balance usually represents a decline in the value of their portfolio due to the effects of inflation. Even though inflation has been modest over the past decade, a dollar saved 10 years ago will only purchase 78 cents worth of goods today.

All three of the portfolio alternatives are expected to maintain their purchasing power because they have expected returns which exceed our 2.5% expected rate of inflation. However, there is a risk that market conditions may result in significantly lower returns which would cause the portfolios to lose purchasing power. To quantify this risk of underperformance, we calculated pessimistic estimates for future returns, which would be in the bottom 5% of expected outcomes.

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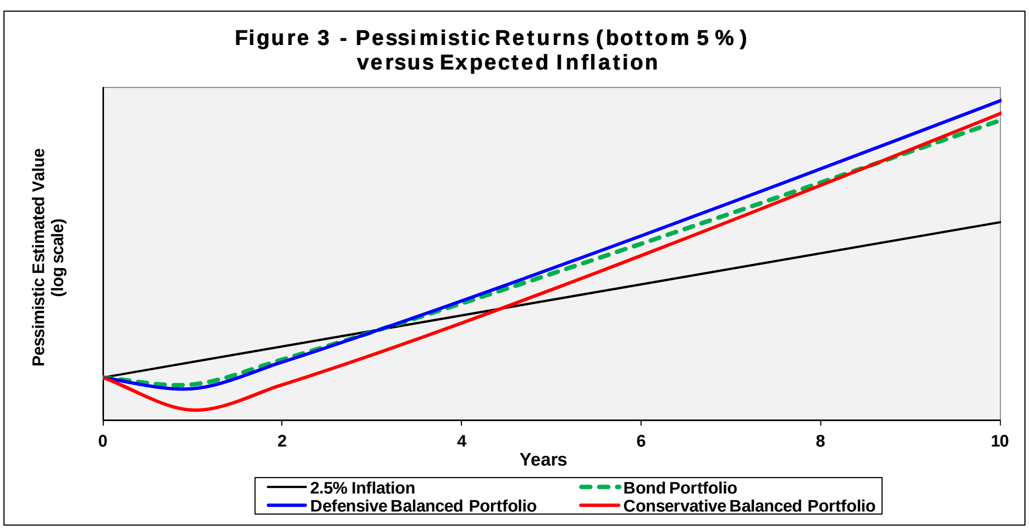

Source: Stairway Partners

"THE CONSERVATIVE BALANCED PORTFOLIO MATERIALLY UNDERPERFORMS THE BOND PORTFOLIO OVER SHORTER TIME HORIZONS, WHERE THE DEFENSIVE PORTFOLIO'S UNDERPERFORMANCE IS NEGLIGIBLE"

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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Figure 3 shows the effects that these pessimistic returns would have on portfolio values relative to inflation. Under adverse market conditions, the conservative balanced portfolio materially underperforms the bond portfolio over shorter time horizons, where the defensive portfolio's underperformance is negligible. As our timeframe increases, the effects of higher average returns eclipse the effects of higher volatility to raise the value of both balanced portfolios above that of the bond portfolio, even under these pessimistic assumptions. Therefore, if risk is defined as the potential for insufficient or negative returns, then a bond-only portfolio may be riskier than both balanced portfolio alternatives over a longer time-horizon.

Return Distributions and Risk

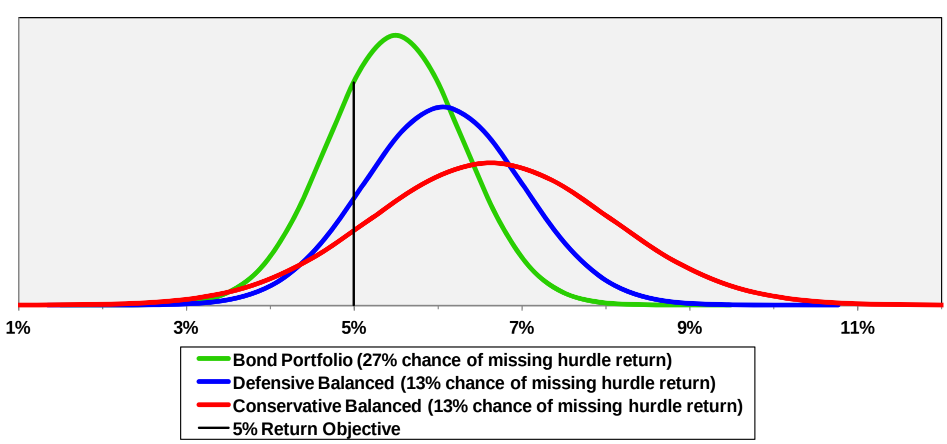
Looking at an expected path of returns over time is useful, but it does not illuminate the full range of potential outcomes. With a given time horizon, analyzing the likely range of returns is a good way to judge the probability of a portfolio achieving the investor's objectives. Figure 4 shows the distribution of returns for our three portfolios over a 10 year time-horizon. The shape of each portfolio's return distribution is determined by its expected returns and volatility. The black vertical line in the figure represents a 5% return objective, required to meet a hypothetical investor's financial needs. The area under each curve to the left of the line represents the probability of a portfolio not meeting the investor's return objective. The figure shows that both balanced portfolios have roughly the same 13% chance of not achieving their objective. Surprisingly, the bond portfolio has a 27% chance of not achieving the 5% return objective. Even though the bond portfolio is usually thought of as the most conservative alternative, it has twice the probability of failure under these assumptions, and may be the most risky of the three alternatives.

Conclusion

Current market conditions have made investors justifiably nervous, but it is important for them to think about how risk affects their portfolio's future returns before running for safety. Too often investors sacrifice their long-term returns by acting to avoid short-term losses. Even under pessimistic market assumptions, our analysis shows that conservative investors with more than a five year time-horizon are likely to be better served by a portfolio that benefits from the higher average returns and diversification of equities.

"Even though the bond portfolio is usually thought of as the most conservative alternative, it has twice the probability of failure"

Figure 4 - Distribution of Ten Year Annualized Returns



Source: Stairway Partners

3 Year Annualized Return Estimates for Global Markets

11/1/2011	Total Returns			After-Tax Total Returns		
	Expected	Hurdle	Excess	Expected	Hurdle	Excess
Equities						
United States	**10.8%**	**4.1%**	**6.7%**	**9.1%**	**3.9%**	**5.2%**
Non-US Developed Markets	**19.0%**	**4.6%**	**14.4%**	**16.2%**	**4.4%**	**11.8%**
EMU	25.8%	5.0%	20.8%	22.0%	4.8%	17.2%
UK	25.0%	4.9%	20.1%	21.2%	4.7%	16.5%
Japan	11.3%	5.0%	6.2%	9.6%	4.8%	4.7%
Canada	-4.3%	4.4%	-8.7%	-3.6%	4.2%	-7.8%
Emerging Markets	**16.8%**	**5.9%**	**11.0%**	**13.7%**	**5.7%**	**8.0%**
Fixed Income						
US Aggregate	**-1.4%**	**2.1%**	**-3.6%**	**-1.8%**	**1.9%**	**-3.7%**
US Treasuries						
2 Year	-0.3%	0.9%	-1.2%	-0.6%	0.7%	-1.3%
5 Year	-3.1%	1.4%	-4.5%	-3.1%	1.2%	-4.3%
10 Year	-5.6%	1.9%	-7.5%	-5.2%	1.7%	-7.0%
30 Year	-9.3%	2.1%	-11.4%	-8.3%	1.9%	-10.2%
TIPS						
5 Year	-2.1%	1.5%	-3.5%	-2.2%	1.3%	-3.5%
10 Year	-4.7%	2.0%	-6.7%	-4.5%	1.8%	-6.3%
30 Year	-13.1%	2.4%	-15.4%	-11.3%	2.2%	-13.4%
Municipal	**0.8%**	**1.5%**	**-0.7%**	**1.2%**	**1.3%**	**-0.1%**
2 Year	0.1%	0.8%	-0.7%	0.4%	0.6%	-0.2%
5 Year	-1.0%	1.2%	-2.2%	-0.5%	1.0%	-1.4%
10 Year	-0.8%	1.6%	-2.4%	-0.2%	1.4%	-1.5%
20 Year	2.7%	1.8%	0.9%	2.9%	1.6%	1.3%
High Yield	**3.4%**	**3.0%**	**0.4%**	**1.4%**	**2.8%**	**-1.4%**
High Quality High Yield	3.0%	2.2%	0.8%	1.3%	2.0%	-0.7%
Emerging Market ($ demonimnated)	**0.2%**	**3.3%**	**-3.1%**	**-1.0%**	**3.1%**	**-4.0%**
Foreign Aggregate	**-5.0%**	**3.5%**	**-8.5%**	**-4.7%**	**3.3%**	**-8.0%**
Foreign Aggregate (hedged)	-3.0%	1.8%	-4.8%	-3.4%	1.6%	-5.0%
Foreign Treasury	**-5.2%**	**3.1%**	**-8.3%**	**-4.8%**	**2.9%**	**-7.7%**
Foreign Treasury (hedged)	-3.3%	1.4%	-4.7%	-3.6%	1.2%	-4.8%
Cash	**0.6%**	**0.6%**	**0.0%**	**0.4%**	**0.4%**	**0.0%**
Currency						
Euro	-3.7%	2.3%	-6.0%			
British Pound	-1.6%	2.2%	-3.8%			
Japanese Yen	-1.1%	2.4%	-3.6%			
Canadian Dollar	-2.0%	1.4%	-3.4%			

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)