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 2, ISSUE 12 DECEMBER 2005

DEALING WITH REALITY

Introduction

Return expectations that are either too high or too low usually result in a poor allocation of investment capital. Investors who expect high returns in a low-return environment may be overly optimistic about their ability to invest or the likely returns that markets will produce.

Being realistic about what financial markets are likely to deliver is critical to any investment process. An objective expected return framework should incorporate fundamentals, discount the appropriate levels of risk and evaluate current market prices. Figure 1 shows our current asset class return expectations. These returns are significantly lower than their corresponding long-term historical averages.

Investor Behavior

Whether due to a rational modification of return expectations or a response to being badly burned by the bursting of the stock market bubble, many investors – both institutional and individual – have been on a mad scramble for yield and return. This has resulted in huge money flows into both alternative investments (hedge funds, private equity, timber, CDOs and other structured products) and higher risk traditional asset classes (non-US and emerging equities, emerging markets debt, high yield bonds).

This behavior was the focus of a recent *Wall Street Journal* article that described "an unprecedented wave of capital flowing around the world, with all of its owners anxiously searching for a better return." ("Huge Flood of Capital to Invest Spurs World-Wide Risk

(Continued on page 2)

CURRENT TOPICS

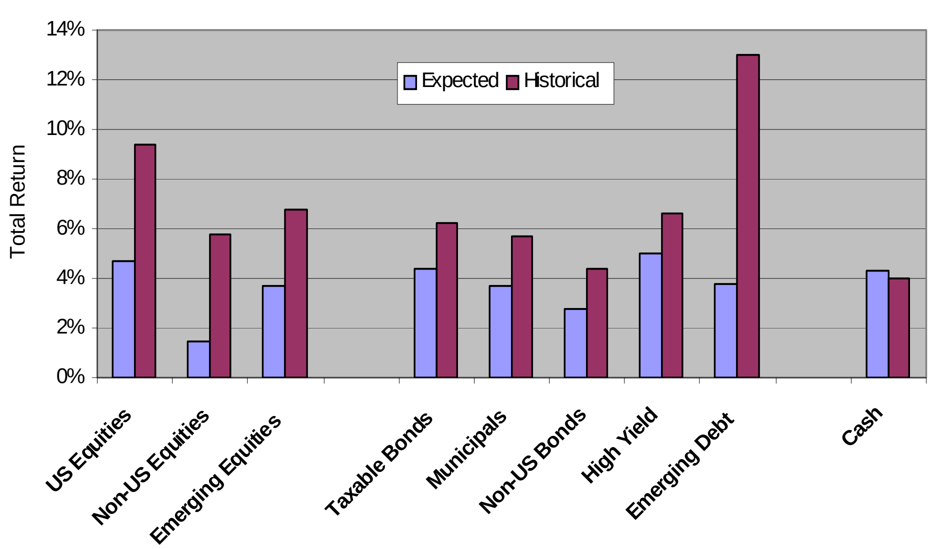
Investors are forced to deal with today's low return environment

- *Introduction*
- *Investor Behavior*
- *Underlying Factors*
- *Implications*

Expected Returns & Strategies

- *Equity markets move significantly higher. We are underweight Non-US Equities both developed and emerging.*
- *Municipals and short-term Treasuries remain the most fairly priced asset classes*

Figure 1: Expected and Historical Total Returns



Expected Returns represent the annualized total returns Stairway Partners expects over a 3-year time period. *Expected Returns* are the result of capital gain or loss from market prices converging to fair value over time plus any cash flows accruing to the investor.

Historical Returns are the average annual total return for each asset class over the last 10 years.

Sources: Russell, MSCI, Lehman, Bloomberg, Stairway Partners, Haver Analytics

DEALING WITH REALITY - CONT'D

(Continued from page 1)

Taking", November 3, 2005) The piece goes on to say that, in addition, many investors are using leverage which "enlarges the already over-flowing pool of investment capital", which drives down risk premiums and expected future returns while raising the risk of a market decline. "Cautious money managers who play it safe and stay on the sidelines run the risk of showing embarrassing low returns, and losing clients."

Underlying Factors

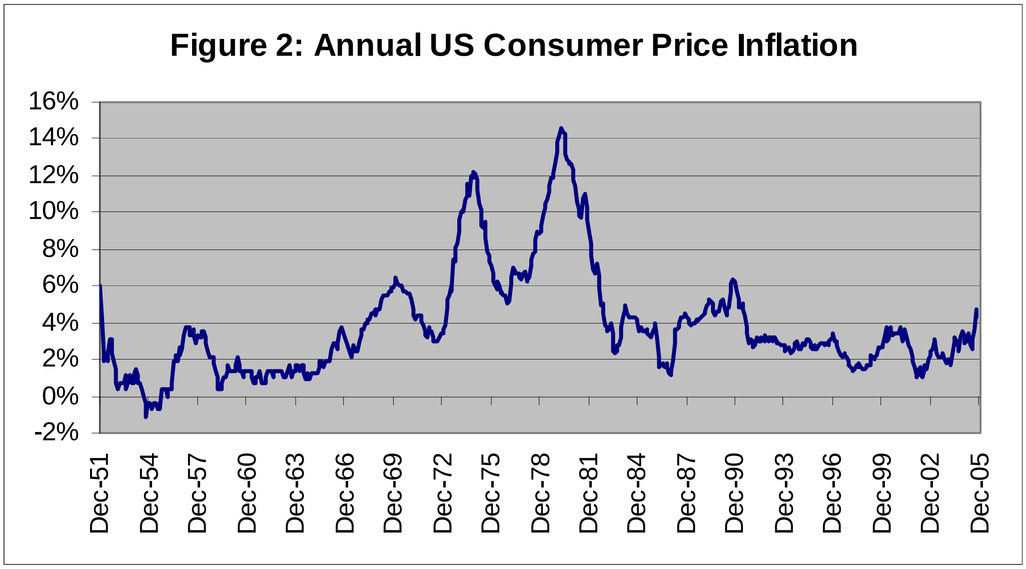
Are there fundamentals that are causing expected returns to be low? For a number of reasons, the answer is most likely "yes".

First, investors need to keep in mind that the return on any investment requires compensation for inflation. Since the start of the 1990s, inflation has been running at a much lower rate than it had been in the 1970s and 1980s (see Figure 2). To the extent that financial markets expect the Fed (and other central banks) to maintain control over inflation, investors will build less compensation for loss of purchasing power into their return requirements. It stands to reason that some of the low return environment is caused by lower inflation expectations.

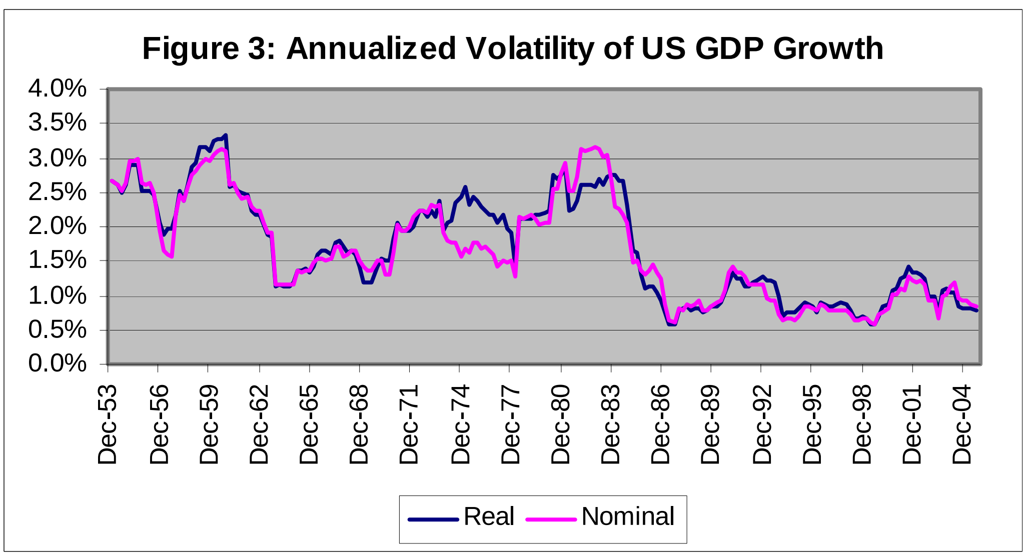
The second reason involves the possibility that the world is in a lower-risk environment. Economic volatility dropped in the mid-1980s for a broad array of measures – GDP, industrial production, unemployment – both in the US and abroad (except Japan). Figure 3 shows the decline in volatility of GDP growth in the US. If this were to persist, it could result in reduced cash flow risk , for example in equity earnings. Lower risk should drive down the return compensation that investors require. However, to date there is little evidence that the reduced economic volatility has produced lower financial market risk.

Demographics are a third possible explanation for lower returns in coming years. As the populations of Japan, many European countries, and China age rapidly,

(Continued on page 3)



"To date there is little evidence that the reduced economic volatility has produced lower financial market risk"



Sources: Bureau of Labor Statistics, Bureau of Economic Analysis , Bloomberg, Stairway Partners

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.

FOR FURTHER READING ON PORTFOLIO STRATEGY IN A LOW-RETURN ENVIRONMENT, PLEASE SEE OUR SEPTEMBER 2005 *MONTHLY* TITLED, *"WAITING FOR THE FAT PITCH"*

(Continued from page 2)

vast amounts of savings need to be built up in order to provide for retirement. This aging populace is beginning to realize that their retirements may need to be funded more from savings than government promises. As a result, growth in savings has driven asset prices up, and consequently returns down. This is one of the central arguments in the "Global Savings Glut" speeches of newly-appointed Fed chairman Ben Bernanke (March 10, 2005 and April 14, 2005).

Finally, the developments in financial markets and investment theory over the last 50 years have undoubtedly contributed to lower forward-looking returns. As investors have been able to achieve significantly better diversification, the riskiness of portfolios has dropped. Because of this, investors are more willing to pay higher prices for assets – which leads to lower prospective returns.

It is important to keep clear the distinction between long-term and short-term return expectations. All the forgoing discussion really pertains to the long run, the reason being that these are primarily structural changes that would generate lower returns in the future. The fact that we currently see many markets as somewhat overpriced only compounds the effect, causing the short-run expected returns to be even lower.

Investment Implications

Aside from the fact that we consider many asset classes to be overpriced currently, we do believe that future long-run returns will be lower than they have been in the past – largely for many of the reasons described above.

One view of how a low-return environment should be handled was proposed several years ago by Peter Bernstein, the investment and economic consultant. His "solution" was to recommend that investors throw away their benchmarks and become very active at seeking out higher return investments and managers. This is very much what appears to be going on in the world today, with people chasing hedge funds, private equity, emerging markets, etc.

We couldn't disagree more with this advice. The idea that investors might forgo the discipline of their benchmark and rely solely on their ability to profitably shift their capital around is frightening. Given most investors' herd behavior and tendency to buy high-sell low, this approach is more likely to disappoint than to succeed. One current example of this is the flood into leverage credit products: the ingoing yields are attractive, but the fact that credit spreads are very tight leaves no margin for "error".

So, how should the low-return environment be handled? We believe that the first step is for investors to accept the fact that they will not earn outsized returns from investing their wealth in either traditional or alternative investments, unless they are willing to take large risks. This is simply being realistic. Investors will only earn what markets end up delivering – less the expenses they incur!

Conclusion

It is likely that we are in an environment with lower returns than were generated in the 1980s and 1990s. In this, we are in agreement with many other investment professionals. However, we disagree strongly with many of the "prescriptions" to this low-return ailment. Instead, we believe that investors need more than ever to maintain discipline, avoid herd behavior and ensure that portfolio exposures are consistent with the risk and return characteristics that are present in markets.

Happy Holidays!

Strategy

Asset Class	Expected Return	Hurdle Return	Strategy	Comment
Equities			small under	
US	4.7%	7.9%	small over	Small overweight from other more expensive equity markets
Non-US Developed			small under	Still unattractive relative to US market
Eurozone	2.7%	6.8%		
Japan	-8.2%	4.3%		
UK	6.6%	8.2%		
Emerging	3.7%	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	3.7%	4.9%		
25-Year	3.2%	5.1%		
US Municipal Bonds			neutral	Sector is fairly priced
2-Year	3.2%	3.2%		
5-Year	3.5%	3.5%		
10-Year	4.0%	3.8%		
25-Year	6.2%	4.3%		
US High Yield	5.0%	6.4%	under	Spreads over US Treasuries remain too tight
Non-US Government Bonds			under	Yields generally insufficient compensation for risk
Euro 10-Year	1.6%	4.2%		
Japan 10-Year	-0.2%	1.9%		
UK 10-Year	2.7%	4.9%		
Emerging Markets Debt	3.8%	6.6%	under	Spreads over US Treasuries remain too tight
Cash	4.3%	---	over	Allocation comes from overpriced asset classes

Currencies	Expected Return	Equity Return with Currency	10-Year Bond Return with Currency	
Euro	-0.5%	2.2%	1.0%	Close to fair value
Japanese yen	5.8%	-2.4%	5.5%	Yen is slightly attractive
UK pound	-2.1%	4.5%	0.7%	Close to fair value

Notes: **As of: 11/30/2005**

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.