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MONTHLY

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INFLATION AND INVESTMENT RETURNS

Introduction

The media attention dedicated to the ongoing actions of the Federal Reserve has many investors concerned about future inflation. This concern is based on the view that keeping rates too low for too long and expanding the Fed's balance sheet will erode the value of the Dollar at home and abroad. Even though current inflation is low by historical standards and the Fed is undertaking these policy actions to avoid deflation and bring the US economy back to full employment, many investors remain skeptical and are looking for ways to protect themselves should the Fed let inflation get out of control.

In this monthly we will review a widely used measure of inflation, analyze the market's pricing of future inflation, and discuss implications for several investments that are commonly thought of as effective inflation hedges.

Measuring Inflation

Although people purchase a large and diverse selection of goods and services, their perception of broad inflation is often dictated by the prices of a relatively small number of frequently purchased items. These items tend to be stable over time and include things like haircuts, gasoline, and groceries. Unfortunately, the bulk of consumer spending goes toward items whose prices are more difficult to observe, because they are not purchased frequently or they change significantly over time. For example, automobile prices have increased over time, but the increase might not be inflationary because there have been significant improvements in safety, reliability, and the features that are included on base models.

Fortunately, the US government measures the quality adjusted prices of thousands of goods and services, and produces many different price indices, which are useful to investors and policy makers. The Consumer Price Index (CPI) is the broadest and most inclusive measure of the prices that affect US consumers.

CPI is important because it is used by the US government to adjust Social Security payments, modify tax brackets, and pay income on Treasury Inflation Protected Securities. The relative weights of the goods and services included in CPI are shown in Figure 1. The

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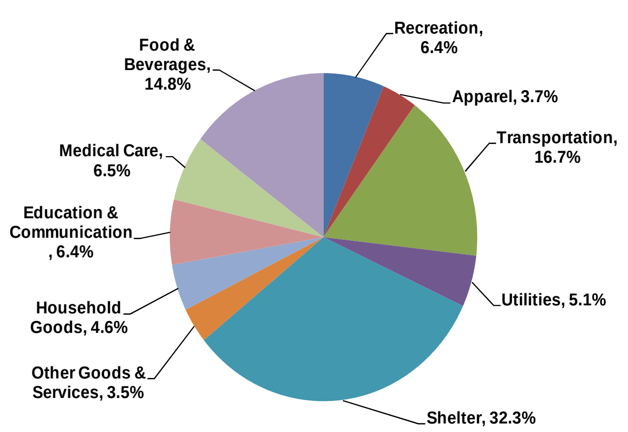
Figure 1 - Consumer Price Index Composition



Sources: Bureau of Labor Statistics, Stairway Partners

CURRENT TOPIC

STRATEGY

- *We made no strategy changes during the month of November.*
- *Portfolio strategies remain overweight developed equity markets and underweight bond exposure.*

"CPI IS IMPORTANT BECAUSE IT IS USED BY THE US GOVERNMENT TO ADJUST SOCIAL SECURITY PAYMENTS, MODIFY TAX BRACKETS, AND PAY INCOME ON TREASURY INFLATION PROTECTED SECURITIES"

INFLATION AND INVESTMENT RETURNS - CONT'D

weights assigned to the components used to construct CPI are based on observed purchases made by urban consumers. Although the basket of goods that makes up CPI does not exactly match what any one individual purchases in a given year, we believe that it is a very good measure of how price changes affect a typical US investor.

Treasury Inflation Protected Securities

Since 1997, the United States has issued Treasury Bonds whose income is indexed to inflation. As mentioned earlier, Treasury Inflation Protected Securities (TIPS) compensate investors based on changes in CPI. This makes TIPS a uniquely effective inflation hedge.

Because traditional US Treasury bonds with the identical maturities and underlying credit terms are available, it is possible to derive market based inflation estimates by comparing yields between the two markets. The difference between the yield on a traditional Treasury bond and the real yield on a TIPS issue with the same maturity is known as the Break-Even Inflation (BEI). The BEI is the average rate of inflation at which an investor will earn the same total return by holding either security until it matures. Because the Treasury market is one of the most liquid markets in the world, we believe that BEI is the best measure of the rate of inflation anticipated by market participants. Figure 2 illustrates that the longer term market expectations expressed in 10 year BEI is less volatile than the inflation that is observed on a year-over-year basis. This is largely because investors recognize that short-term changes in volatile components like food and energy are often reversed in subsequent time periods.

Since there are a variety of maturities for TIPS and traditional Treasury bonds, it is possible to use the available spectrum of BEIs to derive a market implied path of future inflation. Figure 3 illustrates the current market BEI curve, and the implied path of future inflation. The path indicates that the market expects inflation to increase from the low levels that exist today and to stabilize at roughly 2.7% within ten years time. This path is close to our expectations for future inflation and shows that the market has not lost confidence in the Fed's ability to stop inflation from getting out of control.

Other Inflation Hedges

When investing in assets to protect against inflation, it is important to understand what level of inflation is imbedded in the market prices of those assets. The existence of TIPS gives Treasuries the advantage of being the only US securities in which investors can observe how the market pricing of inflation compares to their own expectations. However, the conservative nature of Treasuries does not allow long-term investors to benefit from higher returns that often accompany riskier investments. Unfortunately, when analyzing other assets that are traditionally bought as inflation hedges, it is difficult to know what rate of inflation is assumed by the market and how prices will react to changes in the market's inflation outlook.

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Figure 2 - Observed Inflation versus Market BEI

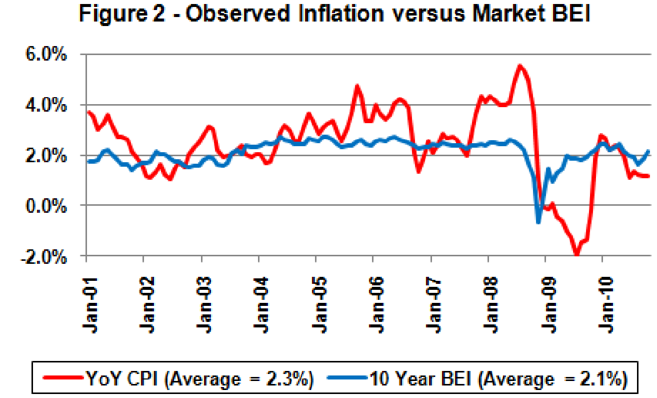
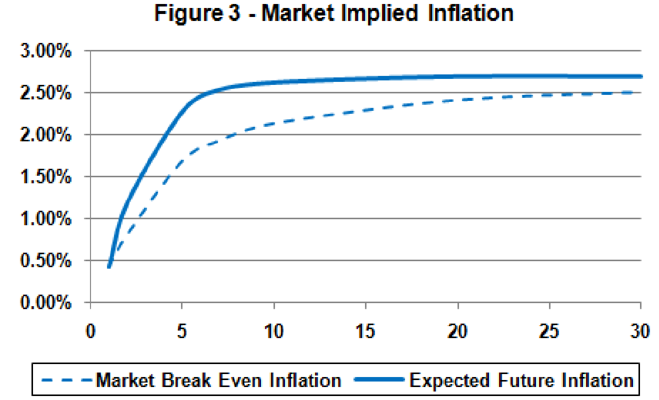


Figure 3 - Market Implied Inflation



Sources: Bloomberg, Stairway Partners

"INVESTORS RECOGNIZE THAT SHORT-TERM CHANGES IN VOLATILE COMPONENTS LIKE FOOD AND ENERGY ARE OFTEN REVERSED IN SUBSEQUENT TIME PERIODS"

"THE MARKET HAS NOT LOST CONFIDENCE IN THE FED'S ABILITY TO STOP INFLATION FROM GETTING OUT OF CONTROL"

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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There are assets whose fundamental cash-flow characteristics respond positively to inflation. For example, equities and commercial real estate can benefit from an environment of rising prices as rents and the prices charged for products and services can increase with the general level of prices. Historically, this has been the case as the returns for these assets have compensated investors for inflation, over time.

Commodities are also commonly used by investors to protect against inflation. It is possible for direct users to protect themselves against escalating prices for commodity inputs. For example, an airline can protect itself against an increase in the price of jet fuel by locking in prices through advance purchases or derivative contracts. Unfortunately, commodities are an imperfect inflation hedge for individuals because it is difficult to know how the price of a specific commodity will respond to an increase in general prices. Since commodities do not generate cash flows, analysts must rely on historical relationships to predict future returns. Figure 4 shows the price of gold compared to CPI over the last decade. The rapid appreciation in excess of changes in CPI may indicate that gold is pricing in significantly more inflation than we have observed in the recent past. If the more benign inflation outcome that is implied by market BEIs comes to pass, then gold prices may reverse a significant portion of their recent gains.

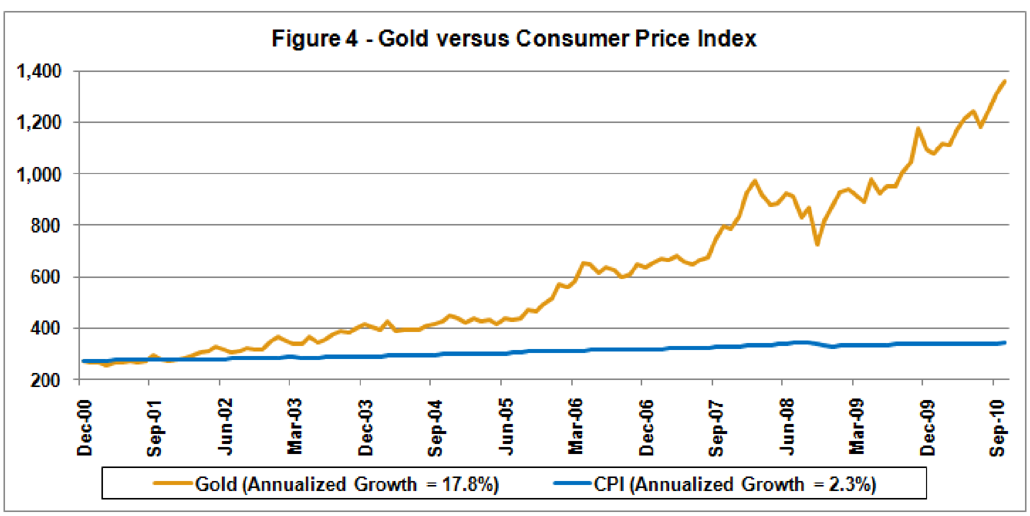
Unfortunately, using different historical time periods as a basis to predict future returns for volatile assets like commodities can produce dramatically different results.

Conclusion

Investors are concerned that policy decisions made in Washington to facilitate a rapid recovery from the latest recession may result in a future inflation problem. As a result, they are looking for ways to protect the purchasing power of their portfolios by increasing their exposure to assets that are thought to be effective inflation hedges.

When investing in assets to protect against inflation, it is important to have a good understanding of how much future inflation is assumed in current market pricing.

US Treasuries allow investors to observe the market's inflation expectations and TIPS provide excellent protection from increasing consumer prices. Unfortunately, other asset classes that may offer higher long-term returns than Treasuries do not have the same level of transparency.



Sources: Bloomberg, Stairway Partners

"The rapid appreciation in excess of CPI may indicate that gold is pricing in significantly more inflation than we have observed in the recent past"

Strategy

Asset Class	Expected Return	Hurdle Return	Strategy Exposure	Comment
Equities				
US	12.8%	5.2%	over	Exposure above benchmark weight due to attractive pricing
Non-US Developed			over	Exposure above benchmark weight due to attractive pricing
Eurozone	27.1%	5.7%		
Japan	0.7%	3.8%		
UK	28.0%	5.9%		
Emerging	3.7%	10.8%	neutral	Asset class is modestly above fair value
Fixed Income				
US Treasury Bonds			under	Most Treasuries expensive, other sectors offer better value
2-Year	0.2%	1.9%		
5-Year	0.3%	2.6%		
10-Year	1.1%	3.3%		
30-Year	3.9%	4.1%		
US Municipal Bonds			under	In most maturities, municipal bonds are modestly expensive
2-Year	0.5%	1.5%		
5-Year	1.0%	2.1%		
10-Year	2.7%	2.9%		
US High Yield	3.2%	3.7%	over	Attractive relative to other fixed income sectors
Non-US Government Bonds			under	Yields remain below fair levels
Euro 10-Year	0.5%	3.6%		
Japan 10-Year	0.8%	1.3%		
UK 10-Year	1.0%	4.1%		
Emerging Markets Debt	2.2%	3.9%	under	Other asset classes offer better value
Cash	0.3%	---	minimal	

Currencies	Expected FX Change	Equity Return with Currency	10-Year Bond Return with Currency	
Euro	-3.7%	23.4%	-3.2%	Euro is near fair value
Japanese yen	-2.6%	-1.9%	-1.8%	Yen is near fair value
UK pound	-1.7%	26.4%	-0.7%	Pound is near fair value

Notes: **As of: November 30, 2010**

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.