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MONTHLY

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A BALANCED PORTFOLIO - THE DEVIL YOU KNOW

Introduction

To achieve attractive long-term returns, we believe that investors must be willing to accept some level of risk. Unfortunately this risk has been made more visible than before, as investors are now inundated by a near constant stream of equity market data and commentary from monitors in restaurants, elevators, and even bathrooms. This barrage of short-term information can unnerve long-term investors and leave a lasting impression of market returns that don't accurately reflect the cumulative results that can be produced by a well constructed balanced portfolio. To alleviate their anxiety, many investors have shunned traditional investments including balanced portfolios and moved into alternatives that promise attractive returns with substantially lower risk.

As our clients and frequent readers know, we advocate the use of globally diversified balanced portfolios to achieve investors' long-term financial objectives. This is because we believe that a diversified portfolio of public securities is one of the most efficient assets available to investors.

Even though balanced portfolios have performed admirably through some very turbulent times, they have not always been able to alleviate investors' anxiety. This is because many investors focus too much attention on the daily gyrations of the volatile equity components within their portfolios. To use a common metaphor, they focus on a few trees, and may end up missing the proverbial forest.

In this *Monthly*, we review the historical performance and risk characteristics of two balanced portfolios over a twenty year time period which includes the worst equity market returns since the Great Depression. We also compare the returns of a conservative balanced portfolio to a popular fund of hedge funds index.

Constructing Balanced Portfolios

At Stairway Partners, we construct globally diversified

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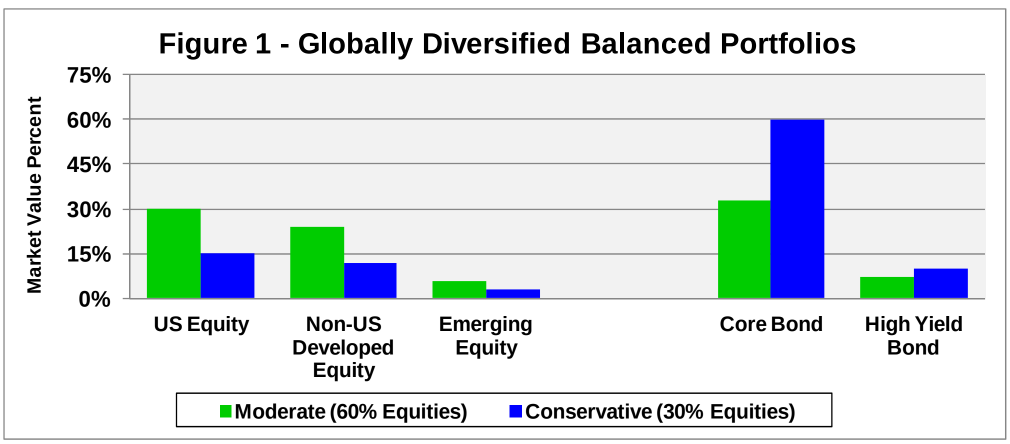

Source: Stairway Partners

CURRENT TOPIC

A Balanced Portfolio - The Devil You Know

Strategy

- *We made no strategy changes during the month of November.*
- *Portfolios remain overweight global equity and high yield bond exposure and underweight investment-grade bond exposure.*

"THE LONG-TERM TARGET WEIGHTS FOR THE INDIVIDUAL ASSET CLASSES ARE SET TO PRODUCE THE BEST POSSIBLE RETURNS FOR THE LEVEL OF RISK THAT IS APPROPRIATE FOR THE CLIENT"

A BALANCED PORTFOLIO - THE DEVIL YOU KNOW - CONT'D

balanced portfolios to meet individual client needs. Within these customized portfolios, the long-term target weights for the individual asset classes are set to produce the best possible returns for the level of risk that is appropriate for the client. These weightings ultimately become the client's policy benchmark. One of the benefits of an explicit benchmark is that it allows us to look back through time and analyze how a portfolio would have behaved in different market environments.

Figure 1 shows the composition of two hypothetical portfolios, which were constructed using the same methodology that we use to construct actual client portfolios. Based on our forward looking assumptions, the conservative portfolio which has 30% of its assets in global equities is expected to produce a 6.5% long-term return with 6.6% volatility. The moderate portfolio which has 60% of its assets in global equities is expected to produce a 7.3% long-term return with 10.6% volatility.

Historical Performance

Using explicit benchmarks comprised of asset classes with reliable historical data allows us to estimate historical portfolio performance with reasonable accuracy. In this case, we used monthly data for the twenty year period which includes 1991 through 2010. As mentioned earlier, this period contains some of the worst equity market returns that have been seen in the last century.

Figure 2 shows a table with overall risk and return statistics for our two balanced portfolios. The observed characteristics of the two portfolios over the twenty year time-period are consistent with our long-term assumptions. As expected, the moderate portfolio experienced a higher level of risk but produced modestly higher average returns over the twenty year period. The Sharpe Ratio, which is a measure of risk adjusted returns, is higher for the more conservative portfolio, which is also consistent with our long-term assumptions.

The relatively recent performance of the global equity market has been disappointing, to say the least. This reality is reflected in the highly negative one year worst-case returns for both the conservative and the moderate portfolios. These numbers should not be surprising to our readers. What may be surprising is the rate at which the worst-case numbers improve over longer time-horizons. Even in the worst 5 year period, the conservative portfolio produced positive total returns, and the moderate portfolio lost less than 1% per annum. There has been much talk about the lost decade of investment returns that we experienced over the timeframe that included the bursting of the tech bubble and the global financial crisis. It is interesting to note that our window of analysis includes this period, and yet there was no ten year period that produced negative returns for either of our balanced portfolios. The conservative portfolio's worst ten year returns actually exceeded inflation, which averaged 2.6% during the "lost decade".

Alternative Investments

Even though the long-term returns for balanced portfolios have been quite reasonable, many investors have been driven toward more exotic investments due to their aversion to short-term losses. These exotic investments often benefit from a relative lack of information, which when combined with

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Figure 2 - Balanced Portfolio Historical Risk & Return

Full Twenty-Year Period	Conservative	Moderate
Annualized Return	8.0%	8.5%
Risk (Annualized Volatility)	6.0%	10.0%
Sharpe Ratio	0.70	0.46

Worst Annualized Returns	Conservative	Moderate
One Year	-17.7%	-32.0%
Three Year	-2.0%	-7.6%
Five Year	1.4%	-0.8%
Ten Year	3.7%	1.9%

Sources: Stairway Partners, Russell, Barclay's, MSCI

"EVEN IN THE WORST FIVE YEAR PERIOD, THE CONSERVATIVE PORTFOLIO PRODUCED POSITIVE TOTAL RETURNS, AND THE MODERATE PORTFOLIO LOST LESS THAN 1% PER ANNUM"

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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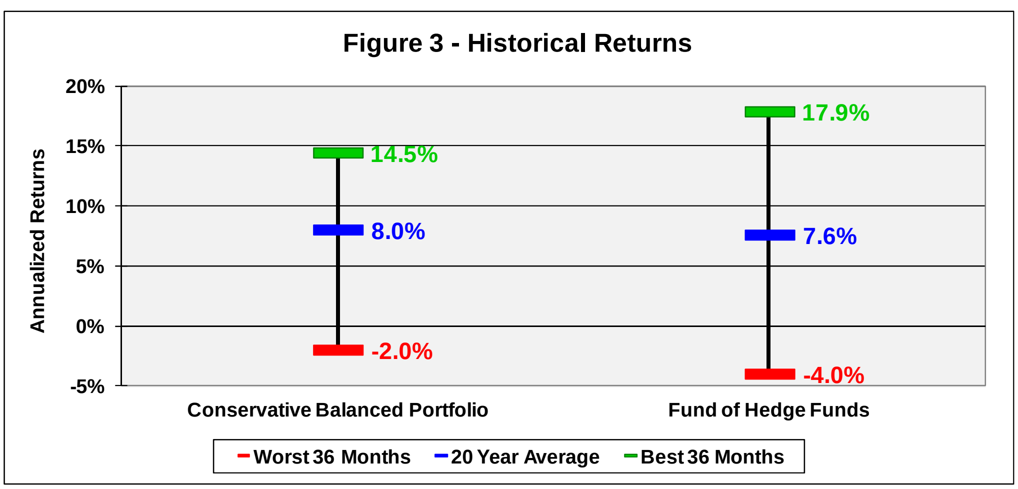
investors' desire for high return low risk may lead to uninformed decisions. This is not to say that we summarily reject all alternative assets. Rather, we believe that there is an asymmetry of analysis, where traditional market securities like equities are held to a higher standard, due to the ready availability of performance data.

To illustrate how a balanced portfolio of stocks and bonds compares to a portfolio of alternative assets with similar overall risk characteristics, we compared the returns from our conservative balanced portfolio to the returns of a collection of hedge funds. The hedge funds are represented by a commonly used fund of hedge funds index published by Hedge Fund Research, Inc (HFR). Over the same twenty year time period that was used in our earlier analysis, the fund of funds experienced the same 6% volatility as the conservative balanced portfolio, making it a relatively fair comparison.

Figure 3 shows the average returns over the twenty-year period and the range of three-year returns for the conservative balanced portfolio and the fund of hedge funds. The average returns are quite similar, which is consistent with the matching overall risk statistics. The range of returns is interesting because it shows that on average hedge funds did not live up to the promise of protecting investors from downside risk, while providing attractive overall returns. In fact, the conservative balanced portfolio had slightly higher average returns and did not decline as much in the worst three year period.

Conclusion

Equities and balanced portfolios containing equities have come under pressure in recent years due to increased market volatility. However, longer-term return analysis shows that the performance of balanced portfolios has been much better than the general perception. Alternative investments like hedge funds or absolute return mutual funds have been able to attract assets in recent years, even though in our opinion many of these offerings lack sufficient data to justify the switch. Our analysis shows that in aggregate, funds of hedge funds have not provided lower risks or higher returns than traditional balanced portfolios. As a result, we believe that abandoning a balanced portfolio for alternative assets may be a mistake. In the end, investors who trade the observable risk of traditional assets for the promise of lower risks in alternative assets may find that they have left the devil they know, only to find themselves with the devil they don't know.



"The conservative balanced portfolio had slightly higher average returns and did not decline as much in the worst five year period"

Sources: Stairway Partners, Russell, Barclay's, MSCI, Hedge Fund Research Inc.

3 Year Annualized Return Estimates for Global Markets

12/1/2011	Total Returns			After-Tax Total Returns		
	Expected	Hurdle	Excess	Expected	Hurdle	Excess
Equities						
United States	**11.0%**	**4.1%**	**6.9%**	**9.3%**	**3.9%**	**5.5%**
Non-US Developed Markets	**20.6%**	**4.6%**	**16.0%**	**17.5%**	**4.4%**	**13.1%**
EMU	27.7%	5.0%	22.8%	23.6%	4.8%	18.8%
UK	26.1%	4.9%	21.2%	22.1%	4.7%	17.4%
Japan	13.1%	5.0%	8.1%	11.2%	4.8%	6.3%
Canada	-3.8%	4.4%	-8.2%	-3.2%	4.2%	-7.4%
Emerging Markets	**20.2%**	**5.8%**	**14.3%**	**16.4%**	**5.6%**	**10.8%**
Fixed Income						
US Aggregate	**-0.7%**	**2.1%**	**-2.8%**	**-1.2%**	**1.9%**	**-3.1%**
US Treasuries						
2 Year	-0.3%	0.9%	-1.2%	-0.6%	0.7%	-1.3%
5 Year	-3.0%	1.4%	-4.4%	-3.0%	1.2%	-4.2%
10 Year	-5.2%	1.9%	-7.1%	-4.9%	1.7%	-6.7%
30 Year	-8.6%	2.1%	-10.7%	-7.7%	1.9%	-9.6%
TIPS						
5 Year	-2.1%	1.4%	-3.5%	-2.2%	1.2%	-3.5%
10 Year	-4.5%	2.0%	-6.5%	-4.3%	1.8%	-6.1%
30 Year	-12.0%	2.3%	-14.4%	-10.5%	2.1%	-12.6%
Municipal	**0.6%**	**1.5%**	**-0.9%**	**1.0%**	**1.3%**	**-0.3%**
2 Year	0.1%	0.8%	-0.7%	0.4%	0.6%	-0.2%
5 Year	-1.2%	1.2%	-2.3%	-0.6%	1.0%	-1.6%
10 Year	-1.2%	1.6%	-2.7%	-0.5%	1.4%	-1.8%
20 Year	2.5%	1.8%	0.7%	2.7%	1.6%	1.1%
High Yield	**5.2%**	**3.0%**	**2.1%**	**2.8%**	**2.8%**	**0.0%**
High Quality High Yield	4.6%	2.2%	2.4%	2.5%	2.0%	0.5%
Emerging Market ($ demonimnated)	**1.6%**	**3.3%**	**-1.7%**	**0.1%**	**3.1%**	**-2.9%**
Foreign Aggregate	**-4.4%**	**3.5%**	**-7.9%**	**-4.2%**	**3.3%**	**-7.5%**
Foreign Aggregate (hedged)	-2.4%	1.8%	-4.2%	-2.9%	1.6%	-4.5%
Foreign Treasury	**-4.8%**	**3.1%**	**-7.8%**	**-4.4%**	**2.9%**	**-7.3%**
Foreign Treasury (hedged)	-2.9%	1.4%	-4.3%	-3.3%	1.2%	-4.4%
Cash	**0.6%**	**0.6%**	**0.0%**	**0.4%**	**0.4%**	**0.0%**
Currency						
Euro	-3.5%	2.3%	-5.8%			
British Pound	-1.3%	2.2%	-3.5%			
Japanese Yen	-1.1%	2.4%	-3.5%			
Canadian Dollar	-1.9%	1.4%	-3.3%			

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)