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MONTHLY

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EMERGING MARKET EQUITY UPDATE

Introduction

The continued growth of emerging equity markets and considerable media coverage of their relative economic strength has earned the sector a larger place in many investment portfolios. Over the past two decades, investors have been rewarded for living with the higher volatility of emerging market equities with significant returns. Looking back to the beginning of 1990, emerging equities returned 12.2% per annum, while the US equities returned a lower, but still very respectable 9.5%. Since the end of the financial crisis, the attention given to emerging markets has increased, as developed economies like the United States have been slower to recover from the global recession. As a result, many investors believe that the faster growing emerging markets will produce better returns in the coming years.

In this *Monthly*, we will revisit the topic of emerging market equities to update our readers on developments in the sector and discuss the characteristics of the largest emerging countries.

Market Characteristics

Morgan Stanley Capital International (MSCI) provides the most widely used index data for emerging market equities. The primary factor used by MSCI to categorize countries as emerging is per capita income. This methodology is consistent with the one used by the World Bank, an international institution created in 1944 to reduce world poverty by supplying loans to developing countries. In addition to per capita income, MSCI also takes other equity and currency market factors into account to evaluate if global investors can effectively participate in local markets.

Figure 1 shows the level of output per capita for the ten largest countries which make up 90% of the MSCI Emerging Markets index. The low level of per capita output relative to developed countries like the United States explains why economists believe that emerging economies can grow at a relatively rapid rate for an extended period of time. Under-utilized labor forces in developing countries can be put to work to generate

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CURRENT TOPIC

Emerging Market Equity Update

Strategy Changes

- *We reduced our overweight to US equities as a result of the recent strong performance*
- *We reduced our underweight to municipal bonds in tax sensitive accounts as a result of improved valuations*

Figure 1 - Top Ten Emerging Equity Markets

	Market Capitalization (as of 12/31/2010)			2008 Population and Economic Output		
	Rank	Market Value (US $'s)	% of Emerging Market Equities	Population (Millions)	GDP (Billions)	Per Capita GDP
China	1	676,164	17%	1,336	$4,327	$3,238
Brazil	2	620,437	16%	194	$1,575	$8,110
Korea	3	540,460	14%	48	$929	$19,120
Taiwan	4	448,770	11%	23	$391	$17,050
India	5	312,876	8%	1,186	$1,159	$977
South Africa	6	306,222	8%	49	$276	$5,656
Russia	7	251,058	6%	142	$1,679	$11,841
Mexico	8	176,982	5%	108	$1,088	$10,093
Malaysia	9	111,356	3%	27	$222	$8,222
Indonesia	10	89,732	2%	234	$511	$2,181
Total/Average		3,534,059	90%			$3,630
United States		11,943,896		309	$14,093	$46,350

Sources: MSCI, The Economist, Stairway Partners

Emerging Market Equity Update - Cont'd

output without the need for technological innovations. It is true that demographic and currency differences can impact the effectiveness of per capita output as a measure of potential growth. However, at less than 10% of the level of the United States, the per capita GDP for emerging countries is sufficiently low to justify the higher expectations for future growth that we use in our valuation framework.

When valuing global equity markets, it is important to remember that companies within a given market often have significant exposure to foreign economies. Many companies operate outside of the country in which they are incorporated. As a result, corporate earnings trends within individual countries often reflect global economic trends. This can be seen in figure 2, which shows that the earnings growth of emerging market companies and developed market companies are much closer than would be implied by the economic growth rates of their respective countries over the past fifteen years.

Returns and Market Growth

As mentioned earlier, equities in emerging markets have handily outperformed those in developed markets over the past 20 years. The difference has been particularly note worthy in the last two years. The cumulative return for emerging market equities in 2009 and 2010 was +112.2% versus +50.1% for the United States. Figure 3 illustrates that even after a significant drop in 2008, the growth in market value for emerging equities outpaced the United States and other developed equity markets. In fact, the share of the global equity market taken up by emerging countries has more than doubled in the last six years, as can be seen in Figure 4.

Risk and Prospective Returns

As is often the case, the higher returns achieved by emerging market equities over the past twenty years were accompanied by significantly higher risk. Looking back, the volatility of emerging market and US equities over that time period were 24.5% and 15.5% respectively. These volatilities are consistent with the forward looking risk assumptions that

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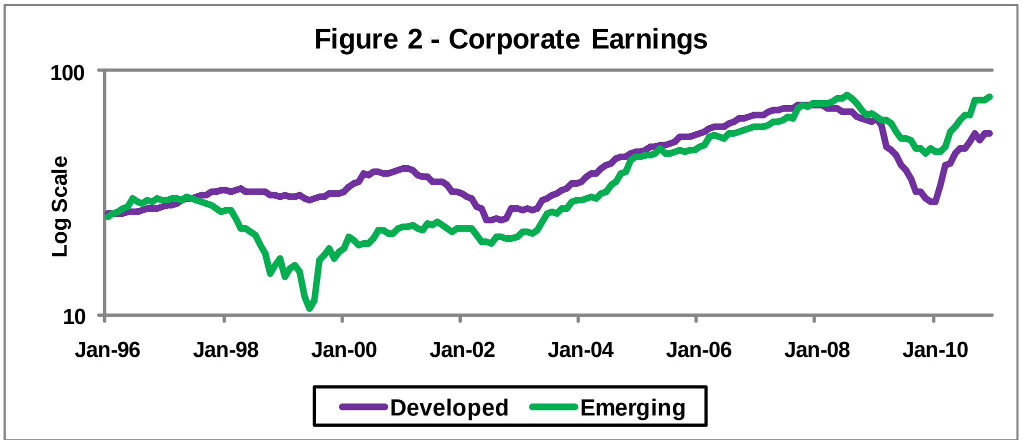

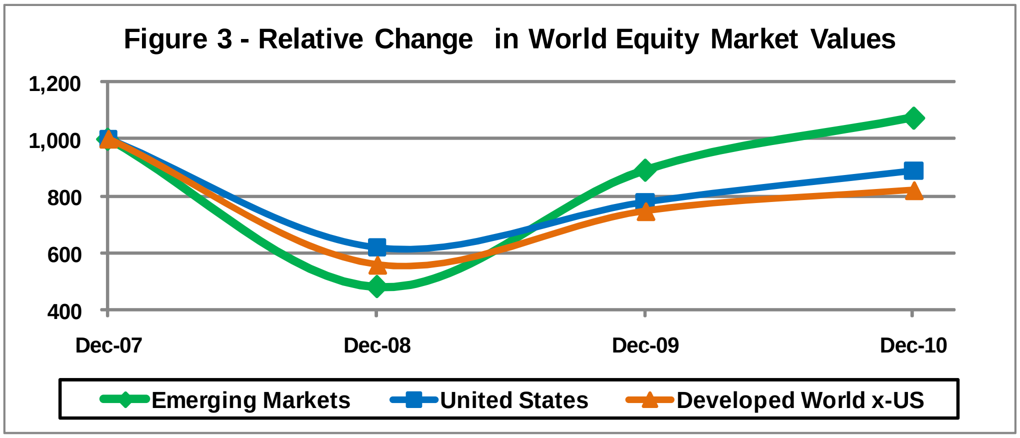

Sources: MSCI , Stairway Partners

"Corporate earnings trends within individual countries often reflect global economic trends"

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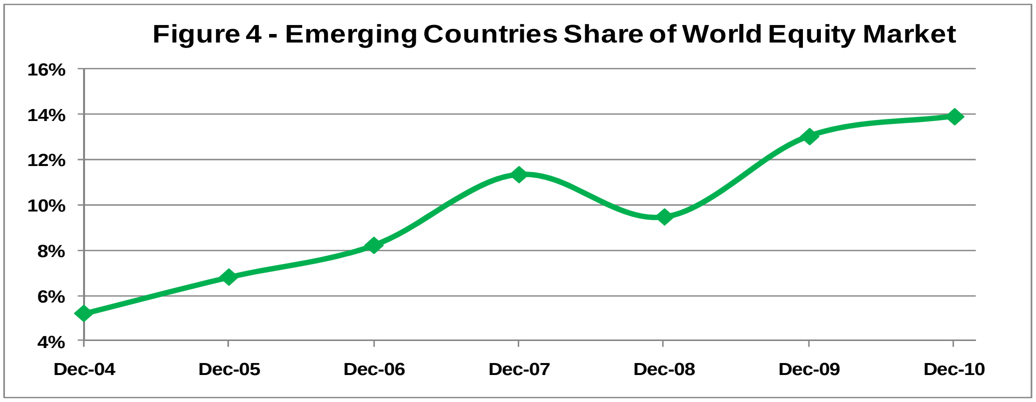
"Even after a significant drop in 2008, the growth in market value for emerging equities outpaced the United States and other developed equity markets"

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.

"THE SHARE OF GLOBAL EQUITY MARKETS TAKEN UP BY EMERGING COUNTRIES HAS MORE THAN DOUBLED IN THE LAST SIX YEARS"



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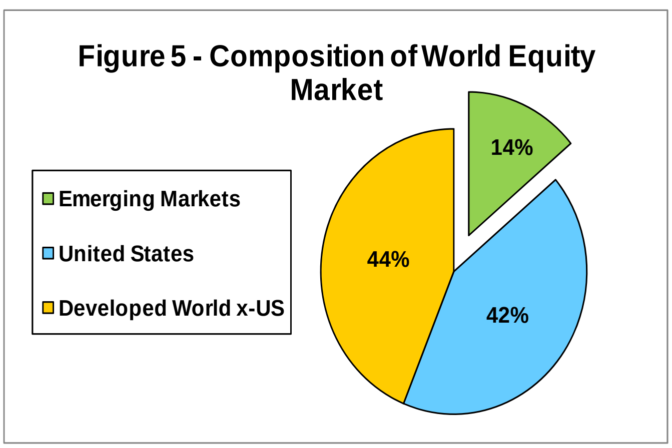
we use to determine the appropriate mix of assets for investment policy benchmarks. The majority of the portfolios that we manage have between 8% and 13% of their benchmark equity weight in emerging markets. This is modestly lower than the current 14% weight of emerging countries in the global equity market, which is shown in Figure 5.

Like non-US developed market equities, the returns that accrue to US investors from emerging market equities include gains and losses associate with the local currencies in which the markets are priced. Although currency exposure does increase risk, we believe that portfolios benefit from leaving exposure unhedged for non-US equities.

Because investors require compensation for higher risk over time, we believe that the long-term returns for emerging market equities are higher than those for developed equities. Our long-term return assumptions for emerging and developed equities are 9.5% and 8.0%, respectively. However, the relative popularity of emerging markets over the past two years has moved current valuations to the point where we believe developed market equities offer better value. As a result, we are overweight developed equities while maintaining a neutral position in emerging markets.



Sources: MSCI, Stairway Partners

Conclusion

Emerging equity markets have grown significantly over the past twenty years and many portfolios now contain more exposure to the sector. We have always included emerging market equities in investment policy benchmarks with the level of exposure determined by client risk preferences, and our own estimates of long-term risk and returns. Although over the long-term we believe that the emerging market equities will produce higher returns than developed market equities, current valuations indicate that pricing in developed market equities is more favorable. As a result, we are maintaining an equity overweight in developed markets including the United States.

Strategy

Asset Class	Expected Return	Hurdle Return	Strategy Exposure	Comment
Equities				
US	10.8%	5.2%	over	Exposure above benchmark weight due to attractive pricing
Non-US Developed			over	Exposure above benchmark weight due to attractive pricing
Eurozone	23.8%	5.8%		
Japan	-1.1%	3.8%		
UK	25.3%	5.9%		
Emerging	3.5%	11.3%	neutral	Asset class is modestly above fair value
Fixed Income				
US Treasury Bonds			under	Most Treasuries expensive, other sectors offer better value
2-Year	0.1%	2.0%		
5-Year	-0.9%	2.7%		
10-Year	-0.6%	3.6%		
30-Year	2.2%	4.3%		
US Municipal Bonds			under	In most maturities, municipal bonds are close to fair value
2-Year	0.8%	1.6%		
5-Year	1.6%	2.3%		
10-Year	3.9%	3.1%		
US High Yield	2.0%	3.7%	over	Sector is close to fair value
Non-US Government Bonds			under	Yields remain below fair levels
Euro 10-Year	-0.7%	3.8%		
Japan 10-Year	-3.3%	1.3%		
UK 10-Year	1.0%	4.3%		
Emerging Markets Debt	2.8%	3.9%	under	Sector is close to fair value
Cash	0.5%	---	minimal	

Currencies	Expected FX Change	Equity Return with Currency	10-Year Bond Return with Currency	
Euro	-5.2%	18.5%	-5.9%	Euro is near fair value
Japanese yen	-2.5%	-3.6%	-5.8%	Yen is near fair value
UK pound	-2.2%	23.1%	-1.2%	Pound is near fair value

Notes: **As of: January 31, 2011**

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.